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Small Enterprise Employment*

**Small Enterprises, Big Challenges**

**A Literature Review on the Impact of the Policy  
Environment on the Creation and Improvement of  
Jobs within Small Enterprises**

by

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International Labour Office Geneva

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## Foreword

This Working Paper is the first in the series on “Conducive policy environment for small enterprise employment” by the ILO’s InFocus Programme on Boosting Employment through Small Enterprise Development (IFP/SEED).

Policies, institutions and regulations that provide a conducive environment for small enterprises can make a substantial contribution to employment creation. This literature review was initially prepared as a background paper to inform the design of ILO/SEED’s research into policy environment and how it influences business decisions taken by smaller enterprises. It has informed the international comparative research project underway in seven countries: Chile, Guinea, Pakistan, Peru, South Africa, Tanzania and Viet Nam.

The review summarizes current research on the impact of the policy and regulatory environment on employment in small enterprises. Schematic tables provide a quick overview on existing studies.

While many countries have recognized the importance of small enterprises and formulated small enterprise support policies, the overall economic policies are still often favouring large enterprises over smaller ones. Small enterprises often have to incur unnecessarily high costs to comply with laws and regulations. To create a level playing field for enterprises of different size classes, regulations should be clear and the process of implementation transparent and fair.

The evidence on the impact of laws and regulations on employment in small enterprises is still very incomplete. Lowering the costs to establish and operate a small business and increasing the potential benefits of registration may be an effective strategy for integrating smaller enterprises into the formal economy. This enhances their potential for creating more and better jobs.

The research activities are leading to new policy training materials and policy guidelines. Through action programmes at country and regional levels, SEED works with national stakeholders to assess the policy environment and to strengthen national and local capacities to design, implement and evaluate policy reform. SEED also maintains a database on national policies, laws and regulations pertaining to small enterprise development, which can be consulted on-line on SEED’s website (<http://www.ilo.org/seed>).

Gerhard Reinecke is an enterprise development specialist within IFP/SEED. The working paper has benefited from the review and comments from several colleagues within the ILO.

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## **Executive Summary**

A conducive policy environment is increasingly seen as an important factor in enabling small enterprises to create more and better jobs. This paper summarizes available literature on the quantity and quality of employment in small enterprises and the policy and regulatory environment these enterprises face and work in. It also deals with the limited available evidence on the impact of the policy and regulatory environment on employment in small enterprises. The main focus is on developing countries.

The purpose of this literature review is (i) to inform the design of the ILO's on-going international research programme on the impact of the policy environment on small enterprises, (ii) to contribute to the development of appropriate policy advice for ILO constituents and local partners, and (iii) to contribute to the discussion among small enterprise development practitioners and researchers.

Small enterprises make undoubtedly a huge contribution to employment, especially in the developing world. The available data and studies show that in many countries, the share of small enterprises in total employment has been growing over the last decades. However, further research is required as to which type of enterprise creates most employment, as an increasing share of small enterprise employment might just reflect the downsizing of larger enterprises rather than employment creation by smaller ones.

Despite small enterprise support policies in many countries, the overall economic policies are still often biased in favour of larger enterprises. The cost of registering and complying with regulations, relative to the enterprise's turnover or profits, is often higher for small enterprises than for larger ones. Even though small enterprises may often lower their costs by evading tax and labour obligations more easily than larger ones, this may imply constraints on the access to markets, credit and services.

Generally speaking, the literature does not support the view that labour regulations are an important constraint for small enterprises. Additional insights are needed on how labour regulations may contribute to the twin objective of creating employment and raising employment quality.

While there is consensus about the advantages of having clear regulations and a transparent and fair process of implementation, the employment impact of different types of policy and regulatory environment has not been studied sufficiently. This is a field where further research is necessary.





## 1. Introduction

Small enterprise development is increasingly seen as a crucial ingredient of strategies to create employment and to alleviate poverty. In 1998, the International Labour Conference adopted a Recommendation which recognizes the importance of a policy and legal framework in setting an environment for small enterprise development.<sup>1</sup> More recently, in June 2000, the OECD issued a “Bologna Charta on SME policies” (OECD, 2000) in which governments from the OECD member countries and invited non-member states recognize the role of small and medium-sized enterprises and recommend broad policy orientations conducive to their growth.

An appropriate policy environment can be considered a crucial ingredient of strategies to create more and better jobs through small enterprise development.<sup>2</sup> To enhance the knowledge on the characteristics of a conducive policy environment, it is necessary to:

- define criteria to assess desirability of employment patterns in small enterprises in terms of quantity and quality;
- establish in which ways the policy and regulatory environment constrains or enhances small enterprises’ contribution to more and better jobs; and
- identify processes of policy formulation and implementation to improve the policy and regulatory environment.

The InFocus Programme on Boosting Employment through Small Enterprise Development (SEED) within the ILO has therefore initiated a Research and Policy Promotion Programme. Among other activities, this programme develops and co-ordinates an international comparative research programme in seven countries on conducive policy environment for small enterprises (ILO, 2000).<sup>3</sup>

This paper, which was first prepared as a background report for SEED’s policy research programme, reviews the literature on the volume and quality of employment created by small enterprises (section 2), as well as on the impact of different types of policy environment on the growth and employment performance of small enterprises (section 3). Section 4 briefly deals with the policy process of reforming small enterprise policies. Finally, section 5 concludes and mentions some areas which have received only little attention in this paper.

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<sup>1</sup> ILO (1998): Recommendation 189 “Recommendation concerning General Conditions to stimulate Job Creation in Small and Medium-Sized Enterprises”, <http://www.ilo.org/seed>.

<sup>2</sup> There are no universal definitions of what a small enterprise is, but a preliminary approximation for what is meant in this paper would be all non-agricultural enterprises with 1 to 49 workers. The term “small enterprise” is thus used here in a broad sense to include those enterprises which are generally termed “micro enterprises” (e.g., 1 to 9 workers).

<sup>3</sup> The seven countries are: Chile, Guinea, Pakistan, Peru, South Africa, Tanzania and Viet Nam.

## **2. The volume and quality of employment generated by small enterprises**

Small enterprises make undoubtedly a huge contribution to employment in many countries, especially in the developing world. According to most studies, small enterprises are more labour-intensive than larger ones, and some even find that the smaller firms also “produce more output (or value added) per unit of capital and thus generate more output as well as employment for a given investment than do larger firms” (Haggblade/Liedholm/Mead, 1990: 61-62; Steel/Takagi, 1983). However, a seemingly straightforward statement such as “small enterprises account for 80 per cent of new jobs in a given country” needs a number of conceptual clarifications to be understood in an unambiguous manner, and requires sophisticated (and generally unavailable) data to be verified empirically. This section gives a summary of the literature on the employment and employment creation of small enterprises.

### **2.1 Employment by enterprise size class**

A first approach to the measurement of the importance of small enterprises is to consider the employment shares of enterprises of different size classes in total employment. In order to obtain such data, two broad types of data sources can be used:

- Establishment-level sources (establishment surveys, economic censuses or administrative registers).<sup>4</sup> This type of source is used for most analyses of the situation in industrialized countries. Their advantage is that the unit of analysis (plant, establishment or enterprise) can be defined in a precise manner and that the information with regard to size is likely to be reasonably accurate.<sup>5</sup> Moreover, employment data can be combined with other data on the enterprises’ economic performance, such as turnover, value-added or productivity. The downside is that the coverage of this type of information may be incomplete, especially with regard to the smallest and the unregistered enterprises. This becomes particularly acute in developing countries. Moreover, coverage is often restricted to the manufacturing sector. Establishment-level sources are often quite weak with regard to information on the characteristics of individual workers (education, wages, employment quality), but these aspects could be strengthened by improved data gathering procedures.
- Household-level sources (household surveys, labour force surveys, population censuses). The advantage of this kind of information is that it is in principle

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<sup>4</sup> In general, available employment data from this type of sources relate to establishments rather than enterprises. This introduces a distortion because some small establishments belong in fact to large enterprises and should not be counted as “small”. This distortion may be avoided by excluding such small establishments belonging to large enterprises when micro data including a variable on the establishment status (i.e. independent establishment or establishment belonging to a larger enterprise) is available.

<sup>5</sup> Data from administrative registers may however underestimate employment levels as some enterprises tend to give a lower number of employees to avoid social security payments or other legal obligations.

likely to cover the population working as own-account workers or in very small enterprises as well as those working in larger enterprises. It also includes non-manufacturing sectors. Good household-level sources often permit to relate individual worker characteristics with information on income and employment quality. The disadvantage is that the worker (or even worse, other household members answering the survey) will often not have precise knowledge on the number of workers. The information will thus rather be a rough estimate than a precise measurement. Moreover, the surveyed person may not have a clear idea on the difference between plant, establishment and enterprise.

In many OECD countries, the share of small enterprises in total employment (and GDP) has increased since the 1980s. This reverses the previous tendency up to the 1970s, when the small enterprise share in total employment tended to decrease in industrialized countries (OECD, 1998; Hughes, 1999; Loveman/Sengenberger, 1990). In many developing countries for which data are available, the share of employment in small enterprises has increased, too. For example, in Latin America, the employment share of micro and small enterprises with up to 20 workers and self-employment in total urban employment increased from 48 per cent in 1990 to 51 per cent in 1998 (ILO, 1999).

Small enterprises account for a larger share of total non-agricultural employment in poorer countries than in richer ones (Snodgrass/Biggs, 1996). Although most comprehensive data collections for developing countries are badly outdated, they permit to conclude that in most of these countries, more than half of the manufacturing employment is located in small enterprises with less than 50 workers (Haggblade/Liedholm/Mead, 1990: table 1). Hughes (1999) finds that among a sample of EU countries and some non-EU countries, the lower GDP per capita, the higher the share of the smallest (1-9 workers) and the larger enterprises (50 and more workers), but the lower the share of enterprises with 10 to 49 workers.<sup>6</sup> This is consistent with the finding for most developing countries and especially for Africa that the size distribution of employment in these countries is characterized by a “missing middle” (employment being concentrated in micro enterprises and in large enterprises, with little in between). This literature is interesting because it suggests that the “missing middle” by itself may be an aspect of deficient labour market performance and industrial organization as very small enterprises face obstacles that keep them from growing into larger small or medium-sized enterprises.<sup>7</sup>

Having a large share of employment in small enterprises is clearly not an objective in itself. Rather, the positive connotations of small enterprise development are based on the expectation that small enterprise development will lead to a higher overall employment creation than would be the case otherwise, and thus help to decrease unemployment and underemployment. While employment share data by size

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<sup>6</sup> There are several important exceptions to this rule — countries that developed successfully while maintaining a high incidence of small enterprises (notably Italy, Japan and Taiwan).

<sup>7</sup> See section 3 on the policy environment. Apparently, the “mission middle” also exists in terms of capital-labour ratios. Studies on Peru and Uruguay (Mezzer/Christensen, 1997) found that most employment is concentrated in enterprises with either very low or very high capital-labour ratios, with little employment in enterprises with intermediate capital intensity. This finding reinforces the notion of segmentation where very few micro and small enterprises graduate in terms of technology and employment.

class give a measure of the importance of enterprises of different size classes in total employment, they do not inform about the employment creation of small enterprises. Indeed, an increase of the small enterprise share in total employment could stem from the downsizing of larger enterprises (causing them to migrate into the small enterprise size class), rather than from booming small enterprises (Haltiwanger, 1995; Davis/Haltiwanger/Schuh, 1996).

In sum, employment data by enterprise size class are not sufficient to identify patterns of successful small enterprise development. More sophisticated information, describing employment dynamics (2.2) and the quality of employment (2.3), will be needed.

## **2.2 Employment dynamics by enterprise size class**

In order to analyze the employment *creation* (rather than just the employment share) of small enterprises, it is necessary to have longitudinal data sets. This allows capturing enterprise births and deaths and comparing the employment levels of existing enterprises at different points in time. The overall net employment variation over a time period can thus be disaggregated into its components which have to be assigned to the different enterprise size classes:

- The net employment variation in existing enterprises (gross employment creation minus gross employment destruction) and
- The net employment variation from enterprise births and deaths.

When gross flows are considered, the smallest enterprises invariably account for the vast majority of new jobs through enterprise births and for the vast majority of gross job destruction through enterprise deaths. When net employment creation over a time period is attributed to the opening size class of enterprises, the result is that in those OECD countries for which longitudinal data sets are available, the smallest size classes have the highest net job creation rate (Hughes, 1999: 10), thus confirming the opinion according to which small enterprises are the main source of employment creation. However, these results have been criticized as being methodologically flawed. One statistical problem, known as “regression to the mean”, consists in that enterprises often face temporary fluctuations which lead to transitory variations in their employment levels. Thus, some of the enterprises classified as “small” based on the employment level at the start of the time period under analysis may actually be “large” enterprises having suffered a temporary contraction. Conversely, some of the enterprises classified as “large” may actually be “small” enterprises after a temporary increase of employment. These fluctuations will be measured statistically as employment diminution in large enterprises and employment expansion in small ones, and therefore bias the results towards finding that employment growth is negatively correlated to size. The extent to which this may distort the analysis depends on the frequency and importance of such temporary employment fluctuations away from the medium- or long-term “average size” of the enterprise (Davis/Haltiwanger/Schuh, 1996; Hughes, 1999).

There is no readily available solution to deal with this methodological problem. Davis, Haltiwanger and Schuh (1996) as well as Haltiwanger (1995) take the average size of the enterprise over the period of analysis instead of the opening size to classify them by size class. These authors conclude that in the United States, employment creation of enterprises of different size classes is roughly proportional to their share in total employment.<sup>8</sup> Measured this way, net job creation in the US manufacturing sector does not exhibit any strong relationship with enterprise size. Again, both gross job creation and gross job destruction are stronger in small enterprises than in the rest of the economy, implying a higher degree of volatility of small enterprise jobs. Another important conclusion from these authors' work is that, even in the United States, a country with a highly developed statistical system, longitudinal data of the required quality have until recently only been available for the manufacturing sector and not for the whole economy.

Applying a very similar methodology to Taiwanese manufacturing census data, Aw and Batra (2001) find a quite different pattern of employment dynamics. During the period under analysis, 1986 to 1991, small enterprises had a higher rate of net job growth than larger ones in nine out of ten industries. Including productivity data into the analysis, the authors find that at a given firm size, the most productive firms have higher net job creation rates than larger ones. Unlike in the United States, small enterprises appear to be the main source of job creation in Taiwan. In Russia and in several OECD countries other than the United States, net job creation rates also appear to be higher in smaller than in larger enterprises (Brown/Earle, 2001; OECD, 1996).<sup>9</sup>

The longitudinal data sets which are used for the analysis of employment dynamics are often based on administrative records or industrial censuses. However, such a procedure is unsuitable for small enterprises in most developing countries because many small enterprises are characterized precisely by the fact that they are not (or only partly) registered with government offices. Data sets based on these data in most developing countries are thus quite incomplete and do not give a comprehensive picture of the small enterprise sector.

Despite these limitations, longitudinal data sets **based on establishment survey data** have been constructed for several developing countries.

Analyzing employment dynamics in Chile, Levinsohn (1996) uses a longitudinal data set based on establishment survey data for 6,665 manufacturing establishments from 1979 to 1986. When job creation during that period is attributed to enterprise size classes according to their average size over the period, the net employment creation rate is higher in larger than in smaller establishments. As in other countries, gross job creation and destruction rates were found to be higher in

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<sup>8</sup> However, this method of assigning employment variation to size classes may "overcorrect" the regression to the mean bias discussed above, as genuinely growing enterprises (as opposed to enterprises experiencing temporary fluctuations) are assigned to a larger enterprise size class than appropriate.

<sup>9</sup> The study on Russia (Brown/Earle, 2001) only refers to enterprises which already existed in 1985, and most of the enterprises in the smallest size class (1 to 99 workers) are probably rather medium-sized than small. The conclusion on smaller enterprises creating more employment than larger ones (or depending on the period, at least destroying less employment) would probably be much stronger if new enterprise set-ups during the period were taken into account.

smaller than in larger establishments. Levinsohn also analyses the persistence of job creation and job destruction by size class: jobs that are destroyed in smaller firms tend to stay gone the following year at a higher rate than is the case in larger establishments. In the persistence of job creation (share of newly created jobs that is still there the following year), there does not seem to be any systematic difference between small and large enterprises.

Similar longitudinal data sets based on establishment surveys have been constructed for other developing countries such as Colombia, Mexico and Morocco. Although the studies based on these data sets (Roberts/Tybout [eds.], 1996) have so far not focused specifically on the differences in job reallocation and productivity by enterprise size class, it would be feasible to carry out this kind of analysis with these data sets.

As mentioned above, the problem with this kind of data sets is that they exclude the smallest (below ten workers in most countries) and the unregistered enterprises by design, but on top of this, small enterprises which in principle should be covered are often undersampled without any control for the factors which are behind this undersampling.<sup>10</sup>

Several **specific surveys** address this problem of coverage by using a mixed approach, identifying enterprises from large household samples. Mead and Liedholm (Mead, 1994a; Mead/Liedholm, 1998; Liedholm/Mead, 1999) summarize the results of surveys for the early 1990s (mostly undertaken within the USAID Gemini project) in a number of African and Latin American countries.<sup>11</sup> More recent follow-up studies have been carried out in Zimbabwe in 1998 and in Kenya in 1999 (McPherson, 1998; Central Bureau of Statistics et al., 1999). These surveys are designed in a way that permits to capture the employment volume in the surveyed enterprises at different points in time, using at least one of the following research methods:

panel surveys, returning to particular enterprises or locations to follow the evolution of a sample of enterprises over time; “tracer surveys”, that search out and re-interview MSEs covered in earlier studies; surveys of MSEs that had previously been operated by members of a household but are no longer in operation; and modified baseline surveys, using one-shot surveys to provide retrospective information concerning past patterns of growth of currently existing enterprises since their start-up. (Mead/Liedholm, 1998: 61)

The advantage of this type of survey is that it includes even the smallest production units; the main disadvantage is that it does not cover larger enterprises. The data thus permit to compare different types of small enterprises (according to size, age, economic sector and owner characteristics), but not between small and large enterprises.

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<sup>10</sup> For example, the Chilean manufacturing establishment survey is supposed to cover all establishments with at least ten workers, but has been found to severely undersample the establishments with 10 to 49 workers.

<sup>11</sup> The countries covered by nation-wide surveys with comprehensive data on enterprise dynamics were Botswana, Kenya, Malawi, Swaziland, Zimbabwe and the Dominican Republic. Moreover, less comprehensive data sets were used for Guinea, Jamaica, Lesotho, Niger, Nigeria and South Africa.

The main conclusions from these surveys regarding the employment dynamics of small enterprises can be summarized as follows:

- There does not seem to be a scarcity of enterprise start-ups in developing countries. Start-up rates are roughly twice as high as in industrialized countries (Mead/Liedholm, 1998: 64).
- The majority of new jobs in small enterprises in Southern Africa have come from new start-ups. 75 to 80 per cent of all current jobs came into being when the enterprise itself was started, while the remainder resulted from the expansion of existing enterprises some time since start-up (Mead, 1994b: 10-11).
- Younger firms grow faster than older ones, and the very smallest grow faster than the rest. However, only about 1 per cent among those enterprises that started with less than five workers “graduated” and ended up with more than ten workers. The small enterprises that were smaller at start-up tended to grow more rapidly than those that started larger<sup>12</sup> (Mead, 1994a; Mead/Liedholm, 1998: 68, 73).
- Many newly created enterprises have a very short life. The survival likelihood of enterprises is correlated with a number of factors, among which gender is a particularly relevant one: female-headed enterprises are less likely to survive than male-headed ones (Mead/Liedholm, 1998; Central Bureau of Statistics et al., 1999: 63). However, a relatively high share of closings of female-headed enterprises is due to personal and other non-business failure factors. With regard to closings exclusively due to business failure, Mead and Liedholm (1998: 66) did not find any significant gender differential in the countries under study.

Identifying desirable patterns of small enterprise development involves more than just accounting for the number and share of jobs created by small enterprises. In many cases, the start-up of new enterprises is due more to an excess labour supply than to an increased demand for small enterprises’ products:

From the point of view of designing economic policy the central weakness of the job generation literature is that it fails to proceed to an analysis of causation. It does not have anything to say about the characteristics of those few firms which we have seen dominate the job generation process in arithmetic terms. It counts up, however imperfectly, where jobs are located by size class but does not explain why the particular pattern has emerged. This is a particularly important issue in the case of developing economies. The relative importance of transitory macroeconomic shocks, and the powerful ‘supply push’ imperatives to set up survival micro enterprises, may mean that this sector is most likely to contain transitory and marginal enterprises with unstable employment characteristics and low efficiency. (Hughes, 1999: 14)

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<sup>12</sup> However, this finding might be due the fact that enterprises which started with one person cannot contract and still remain in business, thus causing a statistical upward bias in the growth rates of surviving enterprises with small set-up size.

Consistent with this line of argument, the contribution of net enterprise set-ups and net expansion of existing enterprises in developing countries varies depending on the macro-economic conjuncture. In times of rapid economic growth, a significant number of newly created jobs come from the expansion of existing enterprises. In this case, small enterprises grow as entrepreneurs identify and respond to market opportunities, and the incomes obtained through such activity are typically relatively high and possibly rising. In times of recession or crisis, by contrast, existing small enterprises tend to contract while a number of new enterprises are being started as a “labour force supply-driven” survival strategy, often in activities that yield only low returns. Obviously, only the first pattern can be considered a component of successful development (Mead, 1994a: 1882; Mead/Liedholm, 1998: 69).

For Zimbabwe, McPherson (1998) provides some evidence that most small enterprise births are due to excess labour supply rather than to demand factors. Over the 1988 to 1997 period, economic growth was negatively correlated to the small enterprise birth rate: every one per cent increase in the GDP growth rate statistically decreased the small enterprise birth rate by 0.6 per cent. This is consistent with the increase of enterprise set-up rates in low profit sectors with low barriers to entry during economic downturns. However, these low profit sectors are also characterized by high enterprise death rates. Much of the churning that goes on in the small enterprise sector is confined to a small number of economic sectors that are characterized by low profits and low start-up costs (McPherson, 1998: E2-3).

In another approximation to this issue, Mead (1994a) considers employment created in enterprises with at least one paid worker as probably reflecting primarily market-driven demand forces: “The presumption is that enterprises with paid staff would be more influenced by market forces; they would only hire workers if they earned at least a sufficient return to cover the cost of paid employees” (Mead, 1994a: 1888). Using this methodology, the share of the employment creation by enterprises started between 1981 and 1990 probably reflecting primarily demand-pull forces varied between around one fourth in Malawi, Swaziland and Zimbabwe, to around half in Kenya and two thirds in Botswana.

The 1999 follow-up survey for Kenya (Central Bureau of Statistics et al., 1999: 67-68) shows the current activities or employment status of those proprietors whose business closed down between 1995 and 1999. A majority of 57 per cent (65 per cent for women, 47 per cent for men) was reported to be unemployed, while 14 per cent were running a new business and 18 per cent worked as salaried workers. The high share of unemployed among the owners of closed businesses demonstrates the social consequences of the volatility of many small enterprises and the obvious social benefits that would arise from enabling some of these entrepreneurs to consolidate their business.

To sum up, the available data sources on developing countries give rich insight into the processes of employment creation and destruction by small enterprises:

- Virtually all studies find that gross job creation and destruction rates are higher in small enterprises than in larger ones.



- The picture is less clear with regard to net employment flows. According to the available studies, in Taiwan (1986-1991), Russia (1985-1999) and several OECD countries, small enterprises had higher net employment creation rates than larger ones, while the opposite was true in Chile (1979-1986) and no clear association between enterprise size and net employment creation was found in the United States (1973-1988).
- The literature helps to distinguish desirable patterns of small enterprise growth from less desirable ones, where enterprise set-ups are essentially a survival strategy due to a lack of alternatives and the activities tend to generate volatile jobs with low incomes.<sup>13</sup>

The studies under review do not permit to make a reliable statement such as “80 per cent of new employment is created by small enterprises”, at least not if net increases at the establishment level are considered: either they cover only the manufacturing sector, or they do not cover large enterprises.

### **2.3 The quality of employment in small enterprises**

As mentioned in the last subsection, employment growth in small enterprises does not necessarily reflect a successful development strategy. It is also important to consider the quality of employment, which can be broadly defined as the work-related factors that have an impact on the economic, social and psychological well-being as well as on the health of the employed persons (Reinecke/Valenzuela, 2000).

On average, jobs in small enterprises are less productive, less remunerated, less secure and less unionized than jobs in larger enterprises, even after controlling for observable workers characteristics, such as education, sex and age (Hughes, 1999; Oi/Idson, 1999; Söderbom/Teal, 2001; Steel/Takagi, 1983; Schaffner, 1998; Berry/Mazumdar, 1991: table 2).<sup>14</sup> For instance, the study by Söderbom and Teal (2001: 9-10) estimates that in Ghana’s manufacturing sector, a 10 per cent rise in firm size is statistically associated with a 1.6 per cent rise in earnings. For these reasons, many people concerned with employment quality and industrial relations view the growing emphasis on small enterprise employment as a threat rather than an opportunity. Moreover, as mentioned above, some people find work in small enterprises simply because they have no alternative. For these persons, it is a kind of survival strategy that is adopted despite low and possibly declining returns until something better comes along. As such, it is a reflection of economic failure rather than success. These enterprises can be very important in “helping a large number of very poor people become a little less poor” (Mead/Liedholm, 1998: 70), but they can generally not provide employment of high quality.

Most studies considering employment quality in small enterprises largely focus on income levels (or profits for the enterprise owner in the case of very small enterprises). Obviously, income is indeed a crucial dimension of employment quality, especially in countries where many workers’ incomes are insufficient to move the

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<sup>13</sup> For more direct measurements of employment quality, see section 2.3.

<sup>14</sup> Some studies suggest however that the small/large enterprise gap is narrowing in some OECD countries (OECD, 1996: 61-62).

household they live in beyond the poverty line. However, other dimensions of employment quality, such as occupational health issues, job security and the degree of social protection are also crucial for the well-being of the employed persons in small enterprises and their household members. Employment quality is thus a multidimensional concept (Rodgers/Reinecke, 1998).

In many developing countries, an improvement in the labour market performance may not directly be observed via decreasing rates of open unemployment or employment creation. Many persons whose employment situation improves may move from under-employment or bad quality employment to full employment or better quality employment.

Although relatively little systematic research is available on this issue, the following conclusions can be drawn from available studies on developing countries:

- Growth-oriented small enterprises generally create employment of relatively good quality, given that jobs created as a result of the expansion of existing enterprises appear to be substantially more productive than those that result from new business starts (Mead/Liedholm, 1998: 69; Trulsson, 2000: 35).
- The returns per hour of family labour are substantially higher in enterprises with 2-5 workers (and even higher in those with 6-9 persons) than for those with one person working alone (Mead/Liedholm, 1998: 64).
- Studies based on household survey data in several Latin American countries quantified the extent to which a higher share of paid employees in small enterprises works without a written work contract or without being covered by social security systems than is the case in larger enterprises. Workers in small enterprises also have less access to vocational training activities (Tokman/Martínez, 1999; Galindo, 1997). A recent study on Thailand also demonstrated the gap in the coverage of social security and severance pay in case of lay-offs between larger and smaller enterprises (World Bank, 2000).

### **3. Assessing the policy environment for small enterprises ... and its employment impact?**

As many countries have recognized the contribution of small enterprises to employment, the issue of a conducive policy environment for small enterprises has received increased attention. Unfortunately, the knowledge on the impact of the policy environment on small enterprises and on their employment performance is still very limited (Berry, 1995). This section reviews the available literature on the impact of the policy environment on small enterprises, considering the main conclusions with regard to the impact of policy environments on the performance and employment creation of small enterprises.

While some authors insist on the need for policies to privilege small enterprises so as to enable them to compete with larger enterprises and explore their employment creation potential, the dominant opinion is that there are no generally valid reasons for economic policies to favour any specific size class of enterprises.

Rather, well-functioning output and input markets which are biased neither in favour of small nor large enterprises are seen as a key ingredient of an enabling policy environment. However, this does not really resolve the question on the choice of policies given that state interventions of various types may be necessary, precisely to attain such well-functioning markets, for example, in the area of credit for small enterprises (Berry, 1995; Snodgrass/Biggs, 1996). The “underdevelopment of both input and product markets, the too low number of market participants and the resulting high transaction costs” (Goedhuys/Sleuwaegen, 1999: 299) are often mentioned as important obstacles to successful small enterprise development in developing countries.<sup>15</sup>

In many countries, specific small enterprise policies have been designed and implemented in order to help small enterprises improve their performance. However, despite the small enterprise promotion programmes offered, most small enterprises never obtain the information on these programmes. For example, in a survey among small enterprises in Bangladesh, the Philippines and Nepal, more than 70 per cent of the surveyed entrepreneurs did not know about any public agency in their country giving assistance to small enterprises (Meier/Pilgrim, 1994: 37). Moreover, many countries have support programmes for small enterprises while the overall economic policies are biased in favour of large enterprises.

While the specific support programmes may compensate the bias in the overall policies, there is a risk that many enterprises suffer from the anti-small bias without being able to benefit from the specific programmes in favour of small enterprises. This seems to be the case, for example, of the dynamic and growth-oriented small enterprises in Indonesia (Berry/Levy, 1999). Another risk of policies that are specifically oriented towards helping the smallest enterprises is that they may convert themselves into growth-constraining policies for those enterprises which are close in size to the maximum thresholds of these benefits.

In sum, while only a limited number of policies may be designed specifically for small enterprises, virtually all economic policies have an — intended or unintended — impact on small enterprises. For these reasons, it is necessary to adopt a broad perspective when looking at the impact of policies on small enterprises (Meier/Pilgrim, 1994; Snodgrass/Biggs, 1996).<sup>16</sup>

An analysis of the policy environment can be carried out qualitatively in order to assess how conducive these policies are to small enterprise growth (3.1). But there are also some studies which have attempted to quantify policy-induced cost differentials between small and larger enterprises in accessing resources as well as the

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<sup>15</sup> Obviously, not all markets in Developing Countries suffer from a low number of market participants. In general, products for which the domestic demand is high and barriers to entry are low are offered by a high number of enterprises, while other products and services may not be offered at all.

<sup>16</sup> See also ILO (1996: 4): “Most of the developing countries have put into place a set of small industry policies, i.e. policies that are designed specifically to promote and regulate small-scale industries. The success, or more often the failure, of these policies has been much discussed. What has been less discussed is the whole range of economic policies which are not consciously designed to affect small industries as such but have nonetheless far-reaching effects on them. This broader range of policies, which may be somewhat loosely termed as macroeconomic policies, include trade policy, exchange rate policy, credit and monetary policy, taxation policy, investment policy, public enterprise policy, agricultural price policy, and so on.”

cost for enterprises to comply with laws and regulations. Such an analysis would ideally permit to quantify the small enterprise bias of the policy and regulatory environment (3.2). Still another research approach consists in surveys among small entrepreneurs in order to capture their perceptions on the main obstacles for the survival and the growth of their enterprise (3.3). While the access to resources and markets is extremely important, this is not the whole story. Other, “soft” factors such as information and networking with other enterprises are also important ingredients of an enabling policy environment for enterprises. The kind of institutions at the meso-level that foster the exchange of information and networking are especially important for small enterprises which are generally unable to generate the required information on their own. This part of the policy environment, analyzed in studies of industrial districts or clusters, will be dealt with in section 3.4.

### 3.1 Qualitative policy assessments

The rich literature of qualitative assessments of policy environments generally reviews different areas of policies which are relevant to small enterprises, using interviews with key informants and official documents as main sources of information (see table 1 for some examples of country assessments). Often, these studies compare the policy environment in a given country with an explicit or implicit benchmark of “best practice”. In general terms, the three guiding principles for these “best practice” approaches (OECD, 1998: 44-53; OECD, 1999; Hallberg, n.d.) appear to be:

- The policy environment should not unnecessarily restrain enterprise activities in general, and small enterprise activities in particular. While such a principle does not appear to be contentious, there may often be trade-offs between different objectives, e.g. business development and labour standards.
- The policy environment should create a “level playing field” for all enterprises, and not discriminate small enterprises relative to larger ones. Regulations that formally apply in a uniform manner to all enterprises may in fact discriminate the smaller ones for different reasons: uniform registration and reporting requirements involve a much higher cost for small enterprises in relation to their turnover and resources (the same applies for lump sum fees); access to credit and support services is subject to conditions that are not easily fulfilled by small enterprises, etc.
- Where specific support programmes aim at facilitating the development of small enterprises, these programmes should be well-targeted, not require excessive bureaucratic red-tape for participation, and the information on their existence and on how to use them must be readily available for small enterprises.

There has been a lot of discussion on the extent to which **government regulations and registration requirements** constitute an obstacle to new business start-ups or the formalization of existing informal enterprises. One reform approach is to replace demanding license requirements which exist in some countries by a simple registration procedure: “[f]or many economic activities there is the question whether it is desirable to require the enterprises to obtain a license at all, as opposed to just

requiring the enterprise to register. There is a sharp difference between obtaining a license, which requires approval from a government office, and registering, which requires no approval” (Rice, 2000: 20). Moreover, in order to facilitate registration, several countries have set up centralized centres or “one-stop shops”, allowing potential and existing enterprises to obtain all necessary information about existing regulations from one single administrative entity (OECD, 1999: 7).

**Table 1: Examples for qualitative policy assessments at country-level**

Author(s) and year	Country and period	Content	Main results	Main policy recommendations
Keddie et al. (1992)	Uganda (1991)	Comprehensive overview of policies affecting small enterprises	<ul style="list-style-type: none"> <li>• Tax deposit system in practice implies minimum tax, thus discriminating against the smallest enterprises</li> <li>• Tax differentials unduly penalize industrial enterprises relative to traders</li> <li>• Foreign exchange policies make it difficult for small enterprises to purchase imported inputs</li> <li>• Trade policies are biased in favour of large manufacturing enterprises and agricultural producers relative to small manufacturing enterprises</li> </ul>	<ul style="list-style-type: none"> <li>• Reform of the tax system (review tax differentials and deposit system; integrate system of central and local taxes)</li> <li>• Eliminate anti-small bias in trade policies; phase out protection of local producers while maintaining a minimum tariff level to obtain state revenues</li> </ul>
White/Petterson (1995)	Uzbekistan (1995)	Identification of major legal and regulatory constraints for small and medium-sized enterprises in the areas of business registrations, reporting requirements, taxation, finance/banking and international trade	<ul style="list-style-type: none"> <li>• Business registration complex and non-transparent; requires visits to a number of different agencies</li> <li>• Reporting requirements onerous; duplication between different agencies; same requirements and periodicity for small as for large enterprises</li> <li>• Complicated tax system with frequent changes</li> <li>• Underdeveloped finance and banking system hampers access to credit</li> <li>• Difficulties in purchasing foreign currency and exporting out of the CIS</li> </ul>	<ul style="list-style-type: none"> <li>• Standardization and replication of model with centralized and simplified business registration procedures;</li> <li>• Reduction of reporting requirements for small enterprises with yearly turnover of US\$ 20,000 or less; centralization of these requirements</li> <li>• other recommendations for the medium-term</li> </ul>
Mahmood (1997)	Pakistan (early-mid 1990s)	Review of fiscal policies, trade policies, credit policies, labour regulations and provincial policies faced by small enterprises	<ul style="list-style-type: none"> <li>• Small enterprises are often excluded from tax exemptions and formal credit</li> <li>• Despite specific exemptions, costs of formalization have been rising rather than falling</li> <li>• Most labour regulations do not apply to enterprises with less than 10 workers</li> </ul>	<ul style="list-style-type: none"> <li>• Eliminate cheap credit but improve access for small enterprises</li> <li>• Eliminate income tax for enterprises with low incomes, and substitute this with more comprehensive indirect taxes</li> <li>• Extend labour legislation and benefits in a phased manner to enterprises with less than 10 workers</li> </ul>

Source: Elaboration based on the sources mentioned in the first column of the table.

In many countries, the design of the **labour legislation** has not taken the needs of small enterprises into account, and little systematic knowledge exists in this regard:

At this time it is fair to say that too little is known about just how various elements of labour legislation or of labour market functioning more generally affect SME to allow anyone to design the ideal system from that sector's point of view. What is clear is that the needs of SME are seldom fed articulately into the pool of information on the basis of which judgements are made. (Berry, 1995: 15)

Most "best practice" statements (e.g., OECD, 1999) view labour regulations essentially as restrictions that tend to hamper business development and thus employment creation, but there is little consideration of the empirical links between labour regulations and small enterprise development, nor of the potential positive impact of regulations on workers' welfare. An ILO study (ILO, 1997: 32) argues against a separate labour regulations regime for small enterprises, especially where basic minimum standards and worker rights are concerned. With regard to the minimum wage legislation, an analysis of the situation in 14 Latin American countries suggests that a minimum wage of up to two thirds of the average wage in enterprises with up to 5 workers does not have negative consequences in terms of non-compliance and increased informality (ILO, 1997: 42-43).

Labour market policies often generate cost differences favouring small enterprises, but it is not very clear what the net impact of these policies on small enterprises and their workers is. Ideally, an assessment of this impact should take both the volume and the quality of the employment into account, but reliable research methodologies for this are very difficult to develop.

**Trade policies** are another important policy area as they have an impact on the access to imported material inputs as well as the price of the enterprise's final products. Under import-substitution schemes, imported inputs have been licensed or directly allocated by governments. This favours large enterprises which are more likely to gain access to import quota than smaller ones. Moreover, while imports of new capital equipment were often given favourable tariff and quota treatment, small enterprises' imports of capital equipment often do not benefit from these incentives because these enterprises tend to import either cheaper second-hand machinery which is not covered by these benefits, or types of simple machinery classified as final consumer goods (e.g. sewing machines) with less favourable treatment. Finally, large-scale enterprises are often granted industrial investment incentives that enable them to import their capitals goods duty-free for a certain time span (Berry, 1995: 16; Haggblade/Liedholm/Mead, 1990: 72-76).

Import tariffs (as opposed to import quota or other non-tariff barriers) as such do not have a differential impact on small vs. large enterprises as their application is uniform. In principle, therefore, the phasing out of non-tariff import barriers in the context of trade liberalization policies in many developing countries should give small enterprises a more favourable environment. However, even import tariffs can be biased against small enterprises when economic sectors where large enterprises dominate are more protected than is the case for sectors characterized by a strong presence of small enterprises (Osmani, 1996; see section 3.2.). Moreover, new export incentives that have been introduced to facilitate the shift towards more outward-oriented enterprise strategies sometimes repeat the ISI experience of discrimination against small enterprises by establishing minimum export volumes for the incentive schemes. Finally, the trade liberalization process in many developing countries has also led to increased competition which, given the traditionally low import content of small

enterprise production, may in the short term outweigh the advantage of cheaper imported inputs. Many small enterprises do not have the professional management and resources to adapt to the more competitive environment (ILO, 1996).

In many developing countries, **pricing policies** have been unfavourable to agriculture. Since most small enterprises are located in rural areas, policies that restrained agricultural incomes limited the demand base for small non-agricultural enterprises (Steel, 1994: 6).

Another important topic is **taxation policies**. In many cases, small enterprises may pay no or few taxes, either because they are formally exempted or because they successfully evade taxes. On the other hand, tax evasion can make enterprises vulnerable to administrative interference, and the threat of high taxes may keep growth-oriented enterprises from growing as this would increase their visibility. Taxes that are charged as lump sum payments (including license and registration fees) are biased against the smallest enterprises if they are not exempted.

Simplified tax regimes or differentiated tax rates for small enterprises are sometimes used to encourage the inscription of small enterprises into the tax registers. This may be more useful than the direct fight against tax evasion. For example, one study on the Peruvian case showed that each additional Sol of taxes collected from small enterprises through improved enforcement costs 75 Centavos in additional administrative spending (ILO, 1997: 32-33).

Tax exemptions are often given to large enterprises and foreign investors. This can have a direct negative impact on small enterprises when subsidies are channelled towards large-scale producers of goods that compete directly with small-scale production (Steel/Takagi, 1983: 438). In some countries, tax exemptions are granted to small and medium-sized enterprises (for example in Mauritius, SMEs are entitled to a lower corporate tax rate of 15 per cent instead of 35 per cent), but this depends on certification as a registered SME with the government's small enterprise authority (Pochun, 1998: 26).

**Credit policies** in many countries make it very difficult for small enterprises to obtain formal loans. This is partly compensated by specific small enterprise programmes with subsidized credits, but these generally do not have a sufficiently large coverage.<sup>17</sup> Most analyses agree that the lack of *access* to formal credit is a more important obstacle for small enterprises than its *cost*. The policy emphasis should thus be on establishing mechanisms to allow small enterprises to credit at normal market rates, rather than providing cheap credit to a small number of enterprises.

A cross-cutting issue in the quality of the policy environment is its **transparency**. Obviously, transparent and consistently enforced regulations are superior to regulations which are difficult to access, difficult to understand or enforced arbitrarily. Small enterprises are likely to suffer most from a lack of transparency as they have less resources to obtain information or to protect themselves against arbitrary administrative decisions. On the other hand, the very smallest enterprises may be able to avoid unwanted contact with authorities because of their limited visibility or a more indulgent attitude of authorities in their regard. In many cases, the combination of limited enforcement for the smallest enterprises and a lack of transparency of the system may cause a threshold effect where enterprises are given incentives to remain artificially small despite existing growth potential.

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<sup>17</sup> For example, in Pakistan, only 1.5 per cent of small enterprises with less than 10 workers is using formal commercial loans (Mahmood, 1997).



In sum, although some general recommendations on which policies *not* to choose may be derived from the literature, there is no uniform best practice for all policy areas. Rather, a general framework could be conceived as a list of general principles and questions to look into when the issue of conducive policies for small enterprise development is discussed.<sup>18</sup> Most of the studies on the policy environment assume that a favourable policy environment will contribute to more employment creation, but this effect is rarely analyzed more thoroughly. Research on the causal relationship between different policy frameworks and employment outcomes is inherently difficult because of the multitude of factors involved and the methodological problems for measuring them. In the available literature, there are interesting efforts of coping with these measurement problems, but they are restricted to selected policy areas and generally not specific to small enterprises.

### 3.2 Quantitative estimates of policy biases in favour and against small enterprises

The last subsection mentioned the problems of policy bias against small enterprises. The interpretation of such biases is often difficult due to the fact that while some policies may be biased against small enterprises, others may on the contrary favour small enterprises relative to larger ones. A systematic examination of the nature and extent of these policy biases is needed. In this context, it is useful to quantify the bias of different components of the policy environment and ideally, to be able to add the different partial measurements up in order to draw conclusions on the overall policy bias.

Unfortunately the literature aiming at such quantification is relatively limited (for a synthetic view, see table 2). Quantitative data on the differential impact of policies and regulations by size class is also scarce, making it virtually impossible to specify the net impact of such regulations.

Haggblade, Liedholm and Mead (1990) make a main contribution by developing a conceptual framework which operationalizes the **policy bias as policy-induced price differentials** for small vs. large enterprises in factor and other input markets on the one hand, and output markets on the other. Their paper also gives quantitative estimates of such differentials for labour and capital costs in a sample of developing countries. The main conclusions are as follows:

- Measuring policy-induced price differentials involves a lot of methodological difficulties. Not all price differentials are policy-induced; they may be due to quality differences (for labour or for finished products) or to differences in risks or administrative costs (for capital).<sup>19</sup> Price differences may also arise as a consequence of private-sector habits or strategies rather than policies.
- Small enterprises face lower labour costs but higher capital costs than larger ones. The difference in labour costs is generally less important than the one in capital costs, resulting in a negative bias against small enterprises when these two areas are

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<sup>18</sup> This is also the approach of a policy booklet that has been developed by the ILO as a first of a series of tools for stakeholders in the policy-formulation process (White, 2001).

<sup>19</sup> However, the authors also present evidence from several studies that the transaction costs for small-scale loans may be smaller than previously imagined (Haggblade/Liedholm/Mead, 1990: 72).

considered together.<sup>20</sup> Trade policies are also often biased against small enterprises, although less systematic (quantitative) evidence is available.

- Specific programmes that favour small enterprises should not be used to try to compensate for existing macro or sector-specific policy distortions, but instead any laws and regulations causing the distortions should first be removed.
- As there are no estimates of the net employment effects of factor price changes (Haggblade/Liedholm/Mead, 1990: 90), the overall employment impact of these biases is uncertain.

Based on the conclusions of that paper, table 3 gives a schematic summary of the main policy biases of the typical policy environment which the authors found in developing countries during the 1960s and 1970s.

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<sup>20</sup> This point is also made by Steel/Takagi (1983).

**Table 2: Assessments of the policy environment for small enterprises based on quantitative estimates of policy bias**

Author(s)	Countries and period	Coverage and definitions	Methodological observations	Main results	Policy implications
Haggblade/ Liedholm/Mead (1990)	Conceptual framework and quantitative information for various developing countries (1960s-1970s)	Small enterprises are not explicitly defined for the purpose of the quantitative estimates; implicitly, they are assumed to be those enterprises which are outside the scope of formal policy instruments (minimum wages, access to formal credit)	Operationalizes policy bias as price differentials for small and large enterprises in (i) factor and other input markets, and (ii) output markets	Small enterprises face lower labour costs but higher capital costs than larger ones. The latter bias (against small enterprises) is generally more important than the former one. Trade policies are also often biased against small enterprises, although less systematic evidence is available. The overall employment impact of these biases is uncertain	In many cases, it would be better to eliminate biases against small enterprises rather than seeking to offset them by creating specific programmes for small enterprises
Osmani (1995)	Conceptual framework and quantitative information for Malaysia (1978) and the Philippines (1974)	For the quantitative estimate, small enterprises are defined as those with up to 50 workers (Malaysia) and less than 10 workers (Philippines)	Calculates the size distribution of enterprises in different industries according to their effective rate of protection	Smaller enterprises have larger employment shares in sectors with lower effective rates of protection; trade policy is thus biased against small enterprises	Avoid anti-small bias (through differential tariff rates in favour of large enterprise-dominated sectors) when designing trade policy
Tokman/ Martínez [eds.] (1999)	Argentina, Brazil, Chile, Colombia, Peru (late 1980s to late 1990s and changes during that period)	Different enterprise size classes: Argentina up to 5 workers, 6-50, more than 50; Brazil up to 10, 11-30, 31-100, more than 100 (only formal sector); Chile 1-9, 10-49, 50-199, 200 and more; Colombia up to 5, 6-10, more than 10; Peru up to 10 (micro enterprises), three other size classes (small, medium, large) not defined explicitly	Calculates the average labour cost (including non-wage costs) in different enterprise size classes, based on household survey data taking into account different forms of contract and effective rates of compliance with legal obligations	Average labour costs in small enterprises are much lower than in larger ones, due among other things to the widespread use of temporary contracts and workers without written contract	In order to improve workers' economic security while simultaneously increasing competitiveness, the use of temporary contracts should be limited while reducing the costs of permanent contracts and maintaining the possibility of dismissal for economic reasons
Maldonado et al. (1999)	Benin, Burundi, Central African Republic, Ivory Coast, Tanzania, Tunisia, Uganda, Zambia (1989-1995)	Country samples containing both "informal" enterprises and "formal" ones for comparison	Calculates the cost for small enterprises to comply with legal regulations	Costs of legalization would cut the profit rate by roughly one half (variations depending on the country)	Simplify tax regime and regulatory requirements; consider tax relief measures for small enterprises; flexibilize labour legislation; set up appropriate social security systems

Author(s)	Countries and period	Coverage and definitions	Methodological observations	Main results	Policy implications
de Soto (1989)	Peru (1983)	Manufacturing enterprises with 1 to 4 workers	Calculates the cost for small enterprises to comply with legal regulations	The costs for a small manufacturing enterprise to remain formal (taxes, administrative procedure, public utilities) reduce its profits by roughly four fifth. However, remaining informal also has substantial costs in the form of bribes and commissions, as well as from being forced to hide the business	Simplify and ease regulatory requirements for small enterprises substantially so as to integrate them into the "mainstream" of legal businesses

Source: Elaboration based on the sources mentioned in the first column of the table.

**Table 3: Schematic summary of typical factor price differences for small enterprises compared to larger ones in developing countries**

	Policy-induced price differences	Other price differences
Capital	Higher, due to (i) political priorities and pressures in favour of large enterprises; and (ii) minimum thresholds for subsidized financial transactions in many countries	Higher, due to higher risk and incidence of administrative costs
Labour	Lower, due to exemptions and/or lack of enforcement of labour regulations in small enterprises	Lower, due to lower (average) skill-level of labour force
Material inputs	Higher, due to import quotas and other non-tariff barriers which give privileged access to imports to larger enterprises	Higher, due to lack of bargaining power and absence of economies of scale

Source: Elaboration based on information in Haggblade/Liedholm/Mead (1990).

Despite the comprehensiveness of the approach, a certain number of weaknesses and limitations must be taken into account:

- The authors systematically use the word “distortion”, giving an *a priori* negative connotation to policy interventions.
- Most of the data used for the analysis have not been generated specifically for the purpose of comparisons by size class. Rather, “distortions” found in studies on labour policies are assumed to apply to large enterprises, while small enterprises are assumed to operate in an “undistorted” environment.
- Small enterprises are not explicitly defined for the purpose of the quantitative estimates; implicitly, they are assumed to be those enterprises which are outside the scope of formal policy instruments (minimum wages, access to formal credit).
- The authors assume that productive factors are mobile and will be re-assigned according to factor price changes. However, this assumption may not be true, especially in the case of very small enterprises which are closely linked to households. Social variables may play an important role in the choice of economic sector and the combination of capital and labour in these enterprises.
- All the available quantitative information is badly outdated (1960s to 1970s).

In sum, although the methodology presented by Haggblade, Liedholm and Mead is by far the most comprehensive one for the quantitative assessment of the policy bias against or in favour of small enterprises, it cannot cover all aspects of the policy environment.

Assessing the “**anti-small**” bias of trade policy, Osmani (1995) reports calculations of the size distribution of enterprises in different industries according to their effective rate of protection in Malaysia and the Philippines during the 1970s. Smaller enterprises have larger employment shares in sectors with lower effective rates of protection; trade policy is thus biased against small enterprises. Unfortunately, no more updated quantitative information is available. It appears however that the trade liberalization policies carried out in many developing countries during the 1980s and 1990s may have reduced the anti-small bias to some extent. Nonetheless, as mentioned above, sometimes newly established export incentives again favour larger enterprises compared to smaller ones which do not generate sufficient export volumes to benefit from the incentive schemes.

The country studies in Martínez and Tokman (eds., 1999) estimate the average **labour cost in enterprises of different size classes** in several Latin American countries, using detailed survey data to take the effective level of compliance with legal regulations into consideration. However, the average labour cost does not control for differences in the skill level across enterprise size classes. Given that, on average, workers in large enterprises have higher levels of formal education, a part of the difference in labour costs between small and large enterprises simply reflects these skill differentials rather than the impact of policies.

The studies by de Soto (1989), PREALC (1990), Price/Fonseca (1999) and Maldonado et al. (1999) do not directly compare policy-induced costs for small and large enterprises, but rather calculate the additional **costs for micro and small enterprises if they were to comply with all regulatory requirements and tax and labour laws**. When these costs are compared to the enterprise’s turnover or profits, they give an indirect measure of existing policy biases against small enterprises.

The well-known study by de Soto (1989), concluded that it took 289 days to register an informal enterprise in Peru and compliance costs amounted to four fifths of a small enterprise’s profit. The study triggered a discourse according to which deregulation may be the main policy reform that is required in order to increase the dynamism of the small enterprise sector. The studies carried out by PREALC (1990) in different Latin American countries confirm that in several countries it takes one year or more to register an enterprise, while in others it takes only one to three months. The policy conclusions drawn by PREALC are however more differentiated than those drawn by de Soto. First, PREALC recognized that many enterprises chose a pragmatic intermediate position between being “completely formal” and being “completely informal” and that this may enable them to combine some benefits of being formal without all the costs of it. Second, PREALC sees the easing of regulations as only one area for policy reforms among others, and not as the only or the predominating one.

Although the direct comparison between the situation of small and larger enterprises is absent in these studies, there are in fact some similarities with the approach taken by Haggblade, Liedholm and Mead (1990) who implicitly assume in some of their estimates that small enterprises operate outside the legal framework while larger ones comply with legal requirements. Moreover, these studies conclude that in many developing countries the cost of compliance for small enterprises is extremely high compared to their turnover and their profits, suggesting that larger enterprises may be relatively less affected by the costs of becoming and remaining formal.

In a similar way, a study by the South African enterprise promotion agency NTSIKA (1998) quantifies the **potential impact of the introduction of a new Basic Conditions of**

**Employment Act** on small enterprises. This assessment was then used as an input in the discussion on whether or not to exempt small enterprises from some of the regulation in the Act. The study comes up with cost estimations for complying with the new regulations. The methodology included telephone surveys designed to capture the current degree of compliance with legal regulations and binding collective agreements. The report concludes that no general exemptions for small enterprises are necessary, but points to some economic sectors where the additional cost might hamper enterprise development and employment creation, and therefore recommends a more flexible treatment for those sectors. Although this study does not explicitly study the cost differential between large and small enterprises, this issue is nevertheless present in the research on the need for exemptions for small enterprises.

Unfortunately, the research on the consequences of quantifiable policy differentials for small and large enterprises on employment is still in its infancy. While standard theory would suggest that higher labour costs lead to lower employment volumes, there is no conclusive evidence on the link between labour costs and employment. Indeed, “correlations between wages and employment may camouflage a variety of other underlying changes that are more important than wages in affecting employment levels” (Haggblade/Liedholm/Mead, 1990: 89). Even according to conventional economic theory, dropping minimum wages are not likely to result in huge increases in the volume of employment in developing countries with segmented labour markets and a relatively small formal labour market segment (Squire, 1981: 125-130).

In sum, the quantitative analysis of policy biases against or in favour of small enterprises provides a useful framework for systematic analysis. However, this analysis is likely to produce partial estimates on selected policy areas rather than a precise and comprehensive assessment. It must also be conceded that many important characteristics of the policy environment are not readily quantifiable.

### **3.3 Assessments based on entrepreneur surveys on their perception of the policy environment**

Another approach to gather the impact of the policy environment on small enterprises more systematically than through a qualitative assessment is through surveys of small entrepreneurs on the main obstacles to their entrepreneurial activity (for a synthetic view of these studies, see table 4). The responses referring to different government policies allow to identify particularly bothersome regulations and policies in the perception of small enterprises. The same type of survey could of course also be used to assess the extent to which small enterprises have received benefits from government policies, although this is less often done in practice.

The main disadvantage of this method is that the perception of owners and managers may not always capture the underlying mechanisms by which government policies affect the performance of small enterprises, especially in the case of policies which have largely indirect effects (e.g. trade policy). On the other hand, perceptions are clearly relevant because they have an influence on what economic actors do. Moreover, the responses referring to policies can be cross-tabulated with various enterprise characteristics captured in the survey (such as the size and age of the enterprise, the economic sector it is operating in, or the sex of its owner) in order to identify policy-related problems for particular categories of small enterprises.

In most countries where surveys using this methodology have been carried out, only a small share of enterprises reported taxes and government regulations as a serious problem (both at set-up and at the moment of the survey) (Liedholm/Mead, 1999; Morrisson/Solignac Lecomte/Oudin, 1994; Journard/Liedholm/Mead, 1992; Central Bureau of Statistics et al., 1999). In some countries, however, government regulations are perceived as important constraints. In Tanzania, regulatory and tax constraints were important even for the smallest enterprises<sup>21</sup> (Levy, 1993). In South Africa, taxes and regulations were mentioned a little more frequently as a problem for newly starting enterprises, due to the fact that the previous Apartheid governments had an extremely restrictive policy aiming at curbing Blacks' economic activity (Mead, 1994b). In Russia, small entrepreneurs during the 1990s constantly mentioned taxes and harassment by government officials as a key constraint (Polishchuk, 2001).

Overall, these research results do not support de Soto's (1989) conclusions, according to which government regulations are the major obstacle for small enterprises. Several caveats, however, must be made. First, the research methodology introduces a bias as only existing enterprises are included, whereas would-be entrepreneurs who failed to cope with regulations or those who did not even try in the face of the regulatory burden are excluded from the survey. Moreover, many micro enterprises may not perceive government regulations as a serious obstacle simply because they comply not or only partly with them.<sup>22</sup>

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<sup>21</sup> In Tanzania, regulatory and tax constraints even appeared largest for the smallest enterprises because enforcement is comprehensive, making the relative burden of negotiating with government officials greater the smaller the enterprise is (Levy, 1993).

<sup>22</sup> In countries that lack transparency and consistent enforcement of their legal regulations, enterprises often hire specialized professionals who carry out the necessary administrative procedures on behalf of the enterprise, using their specialized knowledge and their contacts to speed up the process (Stone/Levy/Paredes, 1992). This suggests that enterprises often find ways to cope with regulatory constraints, but the "mapping" of administrative procedures (see also PREALC, 1990) is nevertheless very interesting from a policy point of view because it can help to simplify regulations and their bureaucratic implementation.



**Table 4: Assessments of the policy environment for small enterprises based on the perceptions of entrepreneurs**

Author(s)	Countries and period	Coverage and definitions	Methodological observations	Main results	Policy implications
Liedholm/Mead (1999) [Gemini 1 <sup>st</sup> and 2 <sup>nd</sup> round]	Botswana, Kenya, Malawi, Swaziland, Zimbabwe (1991-1993)	Sample size between 1,400 and 9,700; micro and small enterprises with up to 50 workers		Government regulations were not perceived as being the most important problem for the surveyed enterprises, neither at start-up nor at the time of the survey	Put main emphasis on enabling enterprises to grow, of which easing regulations is just one aspect
Central Bureau of Statistics et al. (1999); McPherson (1998) [Follow-up studies to Gemini 1 <sup>st</sup> and 2 <sup>nd</sup> round]	Kenya (1999), Zimbabwe (1998)	Micro and small enterprises with up to 50 workers (7,369 enterprises including agriculture and mining in the case of Zimbabwe)	Survey results are not given disaggregated by enterprise size, but access to micro data may be possible	Kenya: "Interference from authorities" (including harassment by local officials and troubles in obtaining business licenses) was mentioned as most severe constraint by 6.0 % of the entrepreneurs. It was given as a reason for business closure in 4.0 % of the business closures from 1995 to 1999; Zimbabwe: Government and regulatory constraints account for 1.3 % of mentions of most common business problems	Implementing regulations in a fair and transparent way may be more crucial than reforming regulations as such
Maldonado et al. (1999)	Benin, Burundi, Central African Republic, Ivory Coast, Tanzania, Tunisia, Uganda, Zambia (1989-1995)	Samples between 60 and 325 enterprises per country; 95 % of sample enterprises have less than 10 employees		In none of the studied countries were administrative constraints mentioned by entrepreneurs in the first or second place of the obstacles faced	Put main emphasis on enabling enterprises to grow, of which easing regulations is just one aspect
Morrisson/ Solignac Lecomte / Oudin (1994); Journard/Liedholm/Mead (1992) [Niger and Swaziland]; Bunjongjit/Oudin (1992) [Thailand]	Algeria, Tunisia, Niger, Swaziland, Thailand, Ecuador, Jamaica (1991)	Sample size around 300 enterprises per country (Thailand 500). Mostly micro enterprises with up to 10 workers, some with 11 to 20 workers		In none of the studied countries are administrative constraints cited in first or second place among the major obstacles; the average waiting time between the entrepreneur's application and the issuance of a licence was usually relatively short	Easing regulations is only one part of reforms to make the environment more conducive to small enterprise growth
Trulsson (2000)	Tanzania, Uganda, Zimbabwe (1999)	43 enterprises with 10 to 50 employees whose number of employees has increased by at least 50% over a 5-year period	Explicit focus on growth-oriented enterprises	Most enterprises did perceive negative aspects in the policy environment, among which taxation was most frequently mentioned in two of the three countries (Tanzania and Uganda)	Reforms of the policy environment may be more urgent for growth-oriented small enterprises than for other small enterprises

Author(s)	Countries and period	Coverage and definitions	Methodological observations	Main results	Policy implications
Goedhuys/Sleuwaegen (1999)	Burundi (1993)	120 enterprises of different size classes, including informal and micro enterprises		The perception of government regulations as an obstacle to enterprise growth is positively correlated with enterprise size	The impact of easing regulations may be bigger for larger small enterprises than for the smallest ones
Levy (1993)	Sri Lanka, Tanzania (1989-1990)	Sample size 38 in Sri Lanka, 24 in Tanzania; restricted to one manufacturing subsector per country		In Sri Lanka, government regulations are perceived as a relatively small burden for enterprises up to 15 workers, but it was higher for those with 6 to 15 workers than for those with 1 to 5 workers. In Tanzania, small and medium enterprises of all sizes perceive a high burden, although it appears largest for the smallest enterprises	Regulatory and tax reforms: (i) eliminate regulations that serve no social purpose; (ii) reduce formal tax obligations where they are too high; (iii) increase transparency of bureaucracy; (iv) decide on appropriate coverage of tax and regulatory obligations
Meier/Pilgrim (1994)	Nepal, Philippines, Bangladesh (no period given)	80 small enterprises in the three countries		The majority of the enterprises reported delays, hidden costs and bureaucratic procedures when dealing with public administration More than 70 per cent did not know of any public agency in their country giving assistance to small enterprises	Improving public sector efficiency would make a difference for small enterprises Existing support schemes should be well-publicized
Wasuntiwongse (1999)	Thailand (1999)	Sample size 100; small and medium enterprises with up to 50 workers		90 per cent of the surveyed enterprises did not perceive any legal constraint on their business	The improvement of the policy environment should concentrate on the provision business development services
Polishchuk (2001)	Russia (1990s)	Summarizes various surveys of small and medium-sized enterprises		Taxes and government harassment stand out as major constraints for enterprises	Despite reforms aiming at simplifying the tax regime, further reforms are necessary to tap the potential of small enterprises

Source: Elaboration based on the sources mentioned in the first column of the table.

The picture may change for enterprises which are a little bit larger or are growth-oriented. Growing enterprises become more visible and it becomes therefore more difficult to evade taxes and other legal regulations. For example, in Sri Lanka, the perceived regulatory burden rises with firm size because legal enforcement is more stringent for the larger and more visible enterprises (Levy, 1993). A study among a sample of growth-oriented small enterprises in Tanzania, Uganda and Zimbabwe (Trulsson, 2000) showed that most enterprises did perceive negative aspects in the policy environment, among which taxation was most frequently mentioned in two of the three countries (Tanzania and Uganda).

While regulations as such are not seen as an important obstacle by most enterprises, the main perceived obstacles to small enterprise development — access to credits and markets — are in fact also related to the policy environment. It is thus necessary to take a more comprehensive perspective on the policy environment that goes beyond removing regulatory constraints.

One key problem of almost all the literature on the policy environment for small enterprises that has been reviewed in this section is that it does not permit conclusions on the differential impact of different policy environments on employment creation and employment quality. The studies based on the perceptions of entrepreneurs can only give very partial answers to this question because the primary objective of entrepreneurs is not to create employment, but rather to earn money.

Some studies (e.g. Goedhuys/Sleuwaegen, 1999 on Burundi) find that despite perceiving regulatory constraints more strongly than informal enterprises, formal enterprises grow stronger than informal ones. A tentative explanation of this phenomenon is that “[f]ormal firms tend to grow faster as scarce resources are allocated to established firms which have legitimated themselves in markets characterized by high transaction costs” (Goedhuys/Sleuwaegen, 1999: 306). However, the studies on Chile, Ecuador and Jamaica in Tokman/Klein (eds., 1996) do not find any significant association between formalization and enterprise employment growth.

In sum, much of the recent discussions on regulatory and policy reforms for small enterprises has focused on the degree to which the policy environment is appropriate for persons who are willing to set up a new business. However, the results of the studies reviewed above suggest that it may be as important or more important to make sure that the policy environment is conducive to the growth of existing small enterprises. The issue then becomes much broader than the regulatory requirements as such. The access to capital, markets, inputs and information is also dependent on the policy environment: discrimination against small enterprises increases their costs relative to larger enterprises (section 3.2) or simply does not permit access for small enterprises at all.

### **3.4 Analysis of clusters and industrial districts**

The previous sections 3.1 to 3.3 discuss assessments of a number of aspects of the policy environment for small enterprises. However, these approaches tend to neglect the issue of the “industrial climate” and the co-operation between small enterprises in clusters or industrial districts. Although such cooperative structures owe much to historical or cultural factors that may not be easily affected by policy decisions, the issue does have a policy dimension, too.

Italy — and especially Northern Italy — is peculiar among industrialized economies because of the continued dominance of small enterprises and traditional sectors in its manufacturing sector. One part of the explanation of the Italian example is the industrial districts — agglomerations of small and medium enterprises of some industrial sectors (including upstream and downstream activities as well as annex productive services) among which a certain degree of networking takes place. In this way, the lack of economies of scale due to the small average enterprise size is compensated by external economies of scale created by the special “industrial climate” which predominates in some of these agglomerations (Pyke/Sengenberger, 1992; Fabiani et al., 2000).

Most of the studies describing how the fact of being located in an industrial district brings competitive advantages through external economies of scale and improved access to market information, skilled labour and technology are qualitative in nature. Very few studies have attempted to quantify the supposed competitive advantages of industrial districts compared to other forms of industrial organization. Although such a quantification is an inherently difficult task (among other problems, there is no unique way to assess whether an agglomeration of firms is an industrial district or not, and which are its precise boundaries), one recent study finds that the efficiency of enterprises is significantly higher in (statistically defined) industrial districts than outside them in most manufacturing subsectors in Italy. The few subsectors where this does not occur in a sense reinforce this result, as they are related to industries in which industrial districts are known to be largely irrelevant. On average, the profitability of district enterprises is 2 to 4 per cent points higher than is the case of non-district enterprises (Fabiani et al., 2000).

An interesting topic is the extent to which government policies can contribute to the creation or strengthening of industrial districts in developing and transition countries. Most researchers agree that in Italy, the spontaneous clustering of enterprises preceded the creation of institutions to foster the exchange of information and technology. There is scepticism about the possibilities of creating a local productive system of small enterprises based on collective efficiency from scratch (UNCTAD, 1998).

However, while private enterprises are the main actors who need to restructure their internal operations and their external links with suppliers and customers, the public sector can contribute as a catalyst by creating favourable framework conditions. Local and regional governments “can assist in sustaining the establishment of support service agencies and implementing programmes for networking” (UNCTAD, 1998: 1).

A number of governments of developing countries have undertaken activities to strengthen the networking between enterprises, often with the help of technical cooperation projects. The subsidy element for enterprises' activities are justified by externalities and the expectation of spill-over effects to non-participating enterprises. Comprehensive government programmes are documented for example in Mexico (Ministry of Trade and Industrial Development, 2000) and Chile (Benavente et al., 1997).<sup>23</sup> UNIDO implemented cluster and network development projects in countries such as Honduras, Nicaragua, Mexico and Jamaica (Ceglie/Dini, 1999). UNCTAD has used a similar approach in its entrepreneurship development projects. These projects are believed to be successful, but the project impact is very difficult to quantify and quantitative assessments are therefore generally not available.

Among the few quantitative assessments, Benavente et al. (1997) assess the impact of a support programme for small and medium-sized enterprises in Chile. The support programme consists in financial incentives for enterprises to form strategic alliances in order to jointly establish business plans, access services, develop marketing strategies or participate in business missions abroad. The study uses a sample of enterprises that have participated in the programme and a control group of enterprises outside the programme. The results show several beneficial impacts of the programme in terms of business activities, as well as an increase in turnover and employment compared to non-participants. However, no significant impact on labour productivity has been identified.

#### **4. The policy reform process**

Section 3 of this paper has dealt with existing research on conducive policy environments for small enterprise development. However, having the right answers to the questions regarding the best design of the policy environment does not guarantee that policies will actually be designed in that way and implemented effectively. In many countries the most urgent problem may not lie in the *design* of policies, but rather in their *implementation*. Factors of success and failure in policy implementation therefore deserve special attention.

One reason for the large enterprise bias of the policy environment in many countries is that small enterprises are “seldom organized in such a way as to have much involvement or influence on public policy-making” (Berry, 1995: 1). Although there are now many examples of small enterprise associations working with government, it is still very difficult for small enterprises to voice their interests, especially when they operate in the same sectors as larger enterprises.

Relatively few studies are available on the process of small enterprise policy formulation and implementation. The main conclusions from the contributions in English and Hénault (Eds., 1995) and Franz and Oesterdiekhoff (Eds., 1998) on various African countries can be summarized as follows:

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<sup>23</sup> For an overview of different types of cluster development initiatives around the world, see Enright/Ffowes-Williams, 2000.

- Almost all of the countries had used some kind of participatory approach. However, the extent to which participatory mechanisms actually shaped the policy-making process strongly varied across countries.<sup>24</sup> Another important issue is the acceptance of the representatives of different categories of stakeholder by the stakeholders themselves (for example, private sector representation is sometimes problematic because various associations each aim at securing their interests).
- When proposals for reforms are prepared exclusively by external experts, there is a strong risk that local ownership is insufficient and follow-up on recommendations does not occur. On the other hand, task forces consisting of representatives of local institutions only may suffer from a lack of technical skills and budget to sustain operations. The most promising approach appears to lie in the interaction of predominantly local experts with selected external experts to generate recommendations on which there is a wide local consensus (Onyang/Tomecko, 1995).
- Many policies do not quantify the objectives they proclaim, nor do they specify a time frame for implementing the policy. This often makes it difficult to carry forward and monitor the implementation of new policies.

Gross (2000) studies the functioning of the Coordinating Committee which was convoked by the Namibian Ministry of Trade and Industry in 1997 to oversee the implementation of the country's small enterprise policy. The study finds that all institutions invited to join the Committee accepted this invitation, and attendance was generally high. Several sub-committees successfully tackled addressed specific problems and designed action plans. However, the work of the Coordinating Committee also had serious shortcomings. The Committee tended to spend too much time discussing on proceedings and administrative matters. Moreover, the Ministry of Trade and Industry did not take a strong role as secretariat but rather relied on external advisers for technical inputs.

Other problems in the implementation stage may arise if policies at the different levels of public authorities (local/regional/national) are not or not sufficiently coordinated. For example, one study on Kenya shows that national policy reforms aiming at removing regulatory constraints for micro enterprises may not have much impact if the local governments do not act accordingly (DeGroot, 1990).

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<sup>24</sup> Regardless of the formal set-up of the policy reform process, there can also be important differences due to a "stakeholder-driven approach" in some cases and a "consultant-driven approach" in others. The latter may lead to technically good policy recommendations, but the decision-making and the implementation are often hampered by a lack of sense of ownership among the stakeholders.

## 5. Conclusions

This paper has attempted to summarize the literature on employment in small enterprises and the policy environment.

While small enterprises create most new jobs, small enterprises also contribute disproportionately to job destruction. Depending on country, period and methodology, different studies come to different conclusions regarding the net employment creation rate of small enterprises compared to larger ones.

Despite small enterprise support policies in many countries, the overall economic policies are still often biased in favour of larger enterprises. The cost for small enterprises to comply with existing regulations is often unnecessarily high. To create a level playing field for enterprises of different size classes, regulations should be clear and the process of implementation transparent and fair.

The impact of different types of policy and regulatory environment has not been studied sufficiently. In most developing countries, enterprise owners and managers of small enterprises do not mention government regulations, but rather low demand and lack of credit as the key constraints for running and expanding their business. However, market demand and access to credit also depend on the policy environment. On this *indirect* impact of the policy environment, as well as on the specific *employment* impact, further research is necessary.

Finally, it should be noted that there are other aspects to the link between the policy environment and employment, on which little research is available and which have not been dealt with in the present literature review:

- At least some aspects of the impact of policies on employment depend on the country's socio-economic development, its institutional history and are thus country- or region-specific.
- The different levels of government — national, regional and local — have only occasionally been mentioned in this paper, but addressing the issues of any of these levels specifically can make the analysis more concrete and useful for policy formulation purposes.

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