



Small and Growing Businesses:

Investing in the Missing Middle for Poverty Alleviation

Literature Review

March 2012

The ANDE Research Initiative

Small and Growing Businesses: Investing in the Missing Middle for Poverty Alleviation

Executive Summary—March 2012

The Aspen Network of Development Entrepreneurs (ANDE) is an international network of over 150 organizations that support an important subset of firms in developing countries - Small and Growing Businesses (SGBs), defined as growth-oriented firms employing between 5 and 250 people, and seeking between \$20,000 and \$2 million in investment capital. These are small firms with the potential to grow and generate economic development and job creation, but face constraints to human capital, access to finance, access to markets, and other barriers. ANDE members support SGBs based on the hypothesis that these businesses can help raise people out of poverty, through the jobs they create, and the products and services they provide to low income populations. This working paper summarizes the existing literature on the following questions and charts an agenda for ANDE to facilitate and fund future research on this topic:

- What kinds of firms employ or engage poor and low income people?
- Will these firms help people out of poverty? Specifically:
 - What are the financial and non-financial impacts (health, family welfare, spillover effects on the community) of these jobs, compared to the alternative sources of employment available to the poor?
 - What are the impacts of the products and services provided by these firms, compared to alternative sources available to the poor?

Household Poverty and the Role of Small and Growing Businesses

Around the world, it is clear that one of the most effective ways to raise incomes is the creation of more, and more stable, jobs. While over a billion people earn less than \$1 a day, and over 2.5 billion earn less than \$2 a day, it is not only the level of income, but the *variability* of income that characterizes the lives of the poor¹. Poor households earn their livelihoods from multiple sources that are often unreliable – smallholder agriculture, casual labor or self-employment. These low and uncertain incomes have a tremendous impact on their wellbeing, in terms of health, education, early childhood development and access to essential services like clean water and electricity.

While small and medium enterprises (SMEs) are the largest contributors to formal jobs in low-income countries (78%), most of these firms suffer from low productivity, and their contribution to economic

¹ Banerjee, A. V. and E. Duflo (2007). The Economic Lives of the Poor. The Journal of Economic Perspectives 21 (27), 141–167

growth is less evident². Only a small fraction of these firms will achieve rapid growth, and create jobs and economic prosperity on a significant scale. These firms face significant barriers to growth, and have been the focus of a number of impact investors, capacity development providers, development finance institutions and government agencies in recent years. These intermediaries support firms through matching grants, business training, credit guarantees and direct investment.

A number of studies have looked at the impact of these supportive interventions SMEs in developing countries. Across a sample of 30 impact evaluations reviewed, the overall findings are decidedly mixed. Some of the more recent studies (Table 1) confirm this variability in findings with several short to medium term positive impacts on research and development, worker training, and quality control practices. However, the longer term impacts on outcomes such as sales growth, wages and labor productivity were not as clear.

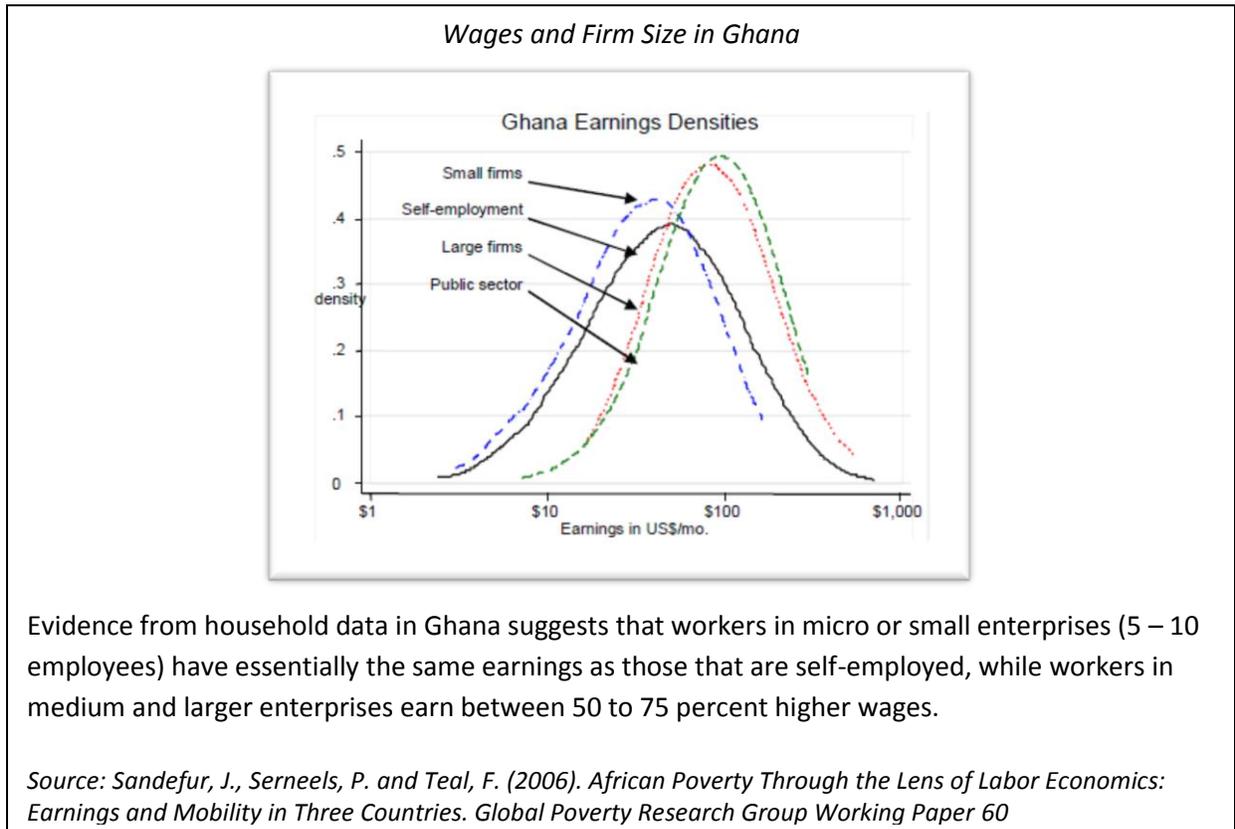
Table 1: A Summary of SME Impact Evaluations

Country	Program(s)	Study	Findings
Bangladesh	'SME Support Services' (1993) – financial, technical and marketing assistance to SMEs (< 50 employees)	Sarder, et al. (1997), "The Importance of Support Services to Small Enterprises in Bangladesh"	5-16% increase in employment, productivity and sales
Mexico	Range of SME programs (1995 – 2001) providing subsidized training, technology upgrades, market development and export promotion	Tan & Lopez-Acevedo (2005), "How Well Do Small and Medium Enterprise Programs Work? Evaluating Mexico's SME Programs Using Panel Firm Data"	9-14% improvement in training, 9% improvement in technology adoption, no significant impacts on employment and productivity growth
Argentina	Matching grants for R&D and technology development t – FONTAR	Chudnovski et al., (2005), "Evaluating a Program of Public Funding of Private Innovation Activities: An Econometric Study of FONTAR in Argentina"	57-79% increases in innovation investment, no significant impact on labor productivity or sales.
Colombia	FOMIPYME – Technology development and adoption by SMEs (1995-2005)	Tan & Lopez-Acevedo (2010), "Impact Evaluation of SME Programs in Latin America and Caribbean"	Positive effect on wages in first 2 years, negative afterwards.

When successful, we know that firms largely improve the lives of the poor through the number and quality of jobs they create, but most studies do not shed much light on the ultimate impact of these programs on poverty. To better understand whether supporting SGBs can help people out of poverty, we need to look beyond firm level measures, and look at the impact of different kinds of jobs on households and individuals. Studies that track both firms and workers can help us understand who is

² Ayyagari, M., Demircuc-Kunt, A. & Maksimovic, V. (2011). Small vs. Young Firms Across the World: Contributions to Employment, Job Creation, and Growth. World Bank Working Paper 5631

being employed by particular types of firms, whether their incomes are rising, and how people transition between types of employment.



SGBs and Poverty: The Evidence So Far

Returning to our original research questions, what kinds of firms employ or engage the poor, and will these firms help people out of poverty, we can suggest some general conclusions based on this review.

- We know that the poor have multiple sources of income in most developing countries, and are largely employed in agriculture, self-employment or small firms. It is not only the level of income, but also the variability of income that characterizes the lives of the poor. Steady employment at a relatively higher wage rate can help alleviate poverty, as it has done in several countries over the past few decades.
- However, most micro and small firms that employ the poor may not actually be helping them out of poverty. These micro-enterprises are typically established out of necessity, rather than entrepreneurial ambition, and are generally unlikely to grow beyond a certain limit. They create few jobs, and offer low wages, relative to self-employment or other sources of income.
- Relatively larger, more formal firms (with 50 – 200 workers) offer higher wages, more stable income and in many cases, better working conditions. However, jobs in these types of firms are

limited in many developing countries, and not easily available to the poor. Many high-growth firms will create large numbers of jobs, but these may not necessarily be for the poor. Nor are the impacts of formal jobs wholly positive – the availability of low-skilled manufacturing jobs may lead to higher school dropout rates. Factory jobs may have negative impacts on health, family and community ties, environmental conditions and general welfare.

We see that the evidence for supporting SGBs as a mechanism for poverty alleviation is compelling, though not conclusive. Our review of the literature highlights the importance of SGBs in alleviating poverty – while it is mainly *small* firms that currently employ or engage the poor it is the *growing* firms that can help them out of poverty by providing them with higher, more stable wages.

ANDE’s Research Initiative: Building the Evidence Base

We recognize the need to develop a more rigorous research agenda that builds on this evidence base, and measures the impacts of SGBs on poverty. We also understand that the magnitude of these questions is considerably larger than what we can achieve on our own. However, ANDE is uniquely positioned to drive this research agenda, as the only global intermediary organization focused on SGB development. We expect to support and catalyze ongoing research efforts that will answer these key research questions, through a two-pronged research strategy:

- *SGB Sector Impact Assessment*: With the new ANDE Research Development Fund, we will support rigorous impact evaluations of jobs or services provided by SGBs, compared to alternative sources of employment or service delivery. Beyond the impact on income levels and variability, we also hope to understand the effect on overall household wellbeing, as reflected by health, community ties and spillover effects.
- *Filling the Data Gap*: Recognizing that we cannot rely on firm-level data alone to measure impact on poverty, we will support the development of more matched firm-employee datasets, to better understand how firm and individual factors affect job mobility and poverty alleviation. As part of this process, we will aim to address some of the challenges of household and firm level data collection by testing innovative approaches such as the use of mobile phone surveys and poverty measurement toolkits. Datasets collected through this initiative will be made available to researchers.

Through this initiative, we expect to spur increased academic research on the impact of SGBs by overcoming some of the key constraint noted by researchers. Ultimately, we expect the research produced through this initiative to inform and influence impact investors, policy-makers, development finance institutions and foundations on how to maximize the social benefits of their investments and grants. As support for SGBs continues to grow, there is an imminent need to test some of the core hypotheses on their impacts. The research funded by ANDE through this initiative will fill this critical gap.

For the full research literature review, please see www.aspeninstitute.org/ande

Small and Growing Businesses: Investing in the Missing Middle for Poverty Alleviation Literature Review

Introduction

“What the whole world wants is a good job”. This is the main finding of a Gallup poll, conducted over 129 countries in 2009-2010. In terms of life satisfaction, while the self-employed considered themselves to be doing better than the unemployed, they still lagged behind those who were employed by a firm (Clifton & Marlar, 2011). In most countries, the stability of formal, salaried, employment is what distinguishes the middle class from the poor. Around the world, the poor hope for jobs, if not for their generation, then for their children (Banerjee & Duflo, 2011). Recent evidence from South Asia suggests that it has been job creation, on a massive scale, that has led to a dramatic decline in poverty levels in the region (World Bank, 2011).

But who can provide these jobs?

We know that Small and Medium Enterprises (SMEs) account for the majority of total formal employment and job creation in developing countries, but the evidence on their impact on poverty is limited (Ayyagari, Demirguc-Kunt & Maksimovic, 2011; Beck, et al, 2005). Beyond the simple measures of job creation, other questions arise. Are all SMEs the same? How do different types of firms affect broader socio-economic development? Finally, how can mission-oriented investors, governments and other intermediaries support economic development through the private sector?

The Aspen Network of Development Entrepreneurs (ANDE) is an international network of over 150 organizations that support an important subset of firms in developing countries - Small and Growing Businesses (SGBs), defined as growth-oriented SMES employing between 5 and 250 people, and seeking between \$20,000 and \$2 million in investment capital. These are small firms with the potential to grow and generate economic development and job creation, but face constraints to human capital, access to finance, access to markets, and other barriers. ANDE members support SGBs based on the hypothesis that these businesses can help raise people out of poverty, through the jobs they create, and the products and services they provide to underserved populations. This working paper reviews the existing literature on this hypothesis, and charts an agenda for the Aspen Network of Development Entrepreneurs to facilitate and fund future research on this topic.

Looking for the Missing Middle: The Role of the Private Sector in Socio-Economic Development

The debate on reducing poverty through private sector development has been mixed. The majority of the poor in developing countries earn their livelihoods in the small scale and informal sector, through small-holder agriculture and self-employment, giving rise to the view that pro-poor economic development involves raising incomes in these sectors (World Bank, 2005). Over the past few decades, much of the policy emphasis in poverty alleviation has focused on smallholder agriculture, micro-enterprise development and the informal sector (Sandefur, Serneels & Teal, 2006). However, recent evidence suggests that microenterprises typically do not create jobs for others outside the family and actually represent entrepreneurship out of necessity, rather than entrepreneurial ambition. These

‘necessity’ or ‘subsistence’ entrepreneurs lack skills and opportunities to find employment, and start businesses to earn additional income. Rarely, if ever, do they graduate to larger businesses or create jobs for the local community (Banerjee & Duflo, 2007; Schoar, 2009; Collins, et al., 2009; Banerjee, et al., 2009; Banerjee & Duflo, 2011).

In contrast, the traditional view of economic development is that of sustained growth through large scale industrialization and rapid advances in productivity, involving a fundamental shift in economic activity (Murphy, et al., 1989; Bigsten et al., 2004). As Teal (2011) notes, “the stylized view of the development process has been the transformation of the economy from one dominated by farms and informal household labor, to one dominated by firms and labor contracts”.

The reality of the role of firms in poverty alleviation appears to be more nuanced, and the underlying theories of change are far more complex. The fact that formal workers earn more than informal workers doesn’t mean that informal workers can simply switch jobs to earn more (Teal, 2011; Blattman & Dercon, 2011). Nor are the impacts of formal jobs wholly positive – the availability of more low-skilled manufacturing jobs may lead to higher drop-out rates in local schools; poor working conditions may lead to negative impacts on health, family and community ties, environmental conditions and general welfare (Atkins, 2009; Seligsohn, 2008; Heymann, Ed., 2003).

In terms of employment, the largest contributors around the world are Small and Medium Enterprises (SMEs). Recent research suggests that SMEs contribute to approximately 66% of total, full-time employment and generate 86% of new jobs in the formal sector. In low income countries, the SME contribution to employment is even higher, at 78.25%, underscoring their importance in the economy (Ayyagari, Demirguc-Kunt & Maksimovic, 2011).

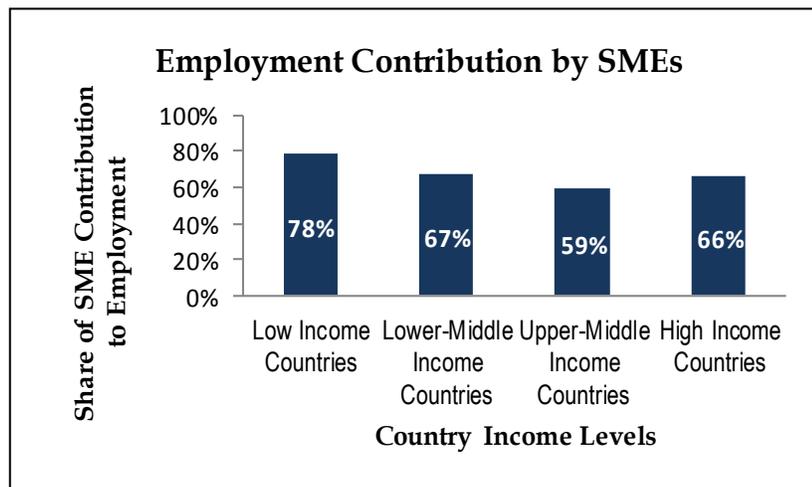


Figure 1: Employment Contribution by SMEs (Source: Ayyagari, Demirguc-Kunt & Maksimovic, 2011)

While SMEs are tremendous contributors to employment in developing countries, they are less productive than their larger counterparts, making their contribution to economic growth less evident (Ayyagari, Demirguc-Kunt & Maksimovic, 2011). Nor are all SMEs the same, and there is a difference

between the ‘lifestyle’ SMEs that will remain small and growth-oriented firms that have the desire and potential to expand. Most approaches to private-sector led development do not adequately recognize this distinction, and many governments (including those in developed countries) provide incentives to small firms to remain small, restricting growth and productivity (Garciano, LeLarge & Van Reenen, 2012; Banerjee & Duflo, 2004). Only a small fraction of firms will achieve rapid growth and create jobs and economic development (Schoar, 2009; ANDE, 2009).

The firms that seek to grow (SGBs) face significant challenges to scale, particularly in their ability to access finance and human capital. These firms often fall into what is often termed the ‘missing middle’ of finance, being too large for microfinance but too small for corporate banking and private equity in most countries (Stein, Goland & Schiff, 2010; ANDE, 2011; Barreiro, et al., 2009; Kauffman, 2005).

Can SGBs contribute to poverty alleviation by providing quality jobs and access to essential products and services to poor and low-income households? In order to develop a holistic understanding of the dynamics of firms and poverty alleviation, we focus on two broad questions:

- *What kinds of firms employ or engage poor and low income people?*
- *Will these firms help people out of poverty? Specifically:*
 - *What are the financial and non-financial impacts (health, family welfare, spillover effects on the community) of these jobs, compared to the alternative sources of employment available to the poor?*
 - *What are the impacts of the products and services provided by these firms, compared to alternative sources available to the poor?*

Our questions are based on the theory that people will move out of poverty if SGBs can create jobs that match the skills and education levels of the poor, and therefore raise and stabilize income streams. Additionally, some SGBs also provide the poor with access to essential services such as electricity, water and affordable housing. In many countries, public distribution of these services is missing or inadequate, and SGBs are filling this gap, particularly in rural underserved areas (Bairiganjan, et al., 2010; Hammond, et al., 2007).

To answer these questions, we examined a range of literature on poverty, firms and the impact of various firm interventions. In Section I, we briefly describe the instability of incomes, and how SGBs can play a role in helping people out of poverty. In Section II, we develop a more nuanced understanding of the term SGB, and the kinds of firms that are most likely to have an impact on the poor. Recognizing that the term ‘SGB’ was coined in the last five years, and as such, no academic research exists on this specific subset of firms in developing countries, we examine related literature on SMEs, social entrepreneurship and high-growth firms to develop a working definition of SGBs. In Section III, we examine the impact of various interventions on SMEs and other firms, looking at the evidence of their impact. In Section IV, we return to our original research questions, and highlight gaps in the existing evidence base, concluding with a plan for ANDE’s research agenda.

Section I: Household Poverty: Low and Uncertain Incomes

Poverty is classically framed as the lack of income³, and international poverty rates count 2.5 billion people earning less than \$2 a day, and over 1 billion earning less than \$1 a day (World Bank, 2010). But as many researchers have pointed out, it is not only the average level of daily income, but rather, the *variability* and *uncertainty* of income that characterizes the lives of the poor. In the classic book, ‘Portfolios of the Poor’, a team of researchers followed the daily economic lives of 250 families in India, Bangladesh, and South Africa. They captured detailed “financial diaries” of their day-to-day economic transactions, and found the delicate and unreliable balance of income flow that these families faced (Collins, et al., 2009). The poor also earn their incomes from multiple sources, as researchers Abhijit Banerjee and Esther Duflo found using data from eighteen countries. In urban areas, over 50 percent of the poor operated their own microenterprise, while 25 to 98 percent of the rural poor were self-employed in agriculture. In urban areas, casual daily labor accounts for about 40 percent of employment, while in rural areas a substantial percentage of the poor also operate micro-enterprises to supplement their agricultural income. Uncertainty of regular income is a familiar characteristic of all these sources of employment – farm earnings are highly dependent on weather and commodity prices, casual labor jobs are the first to be cut during difficult times, and the overall profits of micro-enterprises are extremely low in the long run (Banerjee & Duflo, 2011).

Beyond the immediate contribution to income, employment affects other important dimensions of well-being, such as life satisfaction, health and family relationships. For example, research suggests the impact of poverty is felt most strongly by young children in the household, with over 700 million children worldwide suffering from at least two or more forms of severe deprivation (shelter, safe drinking water, sanitation facilities, education, information, health and adequate nutrition). The Global Working Families Project identified the quality of parents’ jobs as a key determinant of childhood poverty and early childhood development. Heymann & Barrera (2008) found that 58 percent of low income households in Mexico (earning less than \$10 a day) lost income or had difficulty retaining a job because of childcare responsibilities, compared to 25 percent of families earning over \$10 a day. The lack of appropriate childcare has severe consequences for the health, education and other developmental outcomes of young children, and 35 percent of parents who had to leave their children home alone reported developmental or behavioral problems. The research suggests that when parents lack childcare options, school age children are often kept home from school to care for younger siblings, further strengthening the poverty trap.

Thus, it is not only the higher income, but the stability of jobs that is essential in helping families move out of poverty. A regularly cited statistic is that regular salaried workers have the highest wages and the lowest poverty rates, and the self-employed and casual laborers have the lowest wages and highest poverty rates (World Bank, 2011; Sandefur, Serneels & Teal, 2006). The availability of better jobs (defined as jobs that provide higher wages and reduce the risk of uncertain income) for the poor has led

³ It is interesting to note that the *determinants* of poverty are based on *income*, but the *measures* of poverty are typically based on household *expenditure* surveys, due to the difficulties of measuring income from informal sources (Sandefur, Serneels & Teal, 2006).

to a large decline in poverty levels in South Asia. The increased level and regularity of income has led to improved developmental outcomes for workers and their families (World Bank, 2011; Heymann & Barrera, 2008).

It is important to remember that global poverty is a multi-faceted phenomenon, and income represents just one facet of the economic pyramid. Gender, ethnicity, education and other social barriers make up other facets of the poverty problem, and SGBs may not be the solution to all of these challenges. However, we believe that SGBs can contribute to poverty alleviation in two critical ways – providing quality jobs (directly or indirectly), and providing access to essential products and services to underserved parts of the population. In Section II, we discuss the nature of SGBs that can contribute to poverty alleviation.

Box 1: Beyond Jobs: Markets at the Base of the Pyramid

The poor not only suffer from low and unreliable incomes, but also lack of access to essential services. For example, over one billion people around the world have no or limited access to electricity and improved energy sources (UN, 2012). Others lack access to clean water, healthcare and other basic services.

In some cases, SGBs are filling these gaps by providing the poor with access to these products and services. The Global Impact Investing Network (GIIN) and J.P. Morgan identified water, healthcare, housing, education, energy and financial services as the main target sectors for ‘Base of the Pyramid’ focused firms.

Our definition and understanding of markets at the base of the pyramid has evolved considerably since C.K. Prahalad’s book ‘The Fortune at the Bottom of the Pyramid’. There is a greater recognition of the nuances of consumer behavior in low income groups. Additionally, it is evident that these approaches may be more successful in some sectors than others, and understanding the actual demand for products, rather than perceived needs, is important in developing these markets. For example, Dupas (2009) in collaboration with Acumen Fund, found that people were unwilling to pay even small amounts for insecticide treated malaria bed nets, despite the obvious benefits. On the other hand, researchers from the World Resources Institute found considerable willingness to pay for electricity in India, and there are a growing number of SGBs providing electricity generated from renewable resources such as solar, waste biomass and micro-hydro in rural India and Sub Saharan Africa (Bairiganjan et al, 2010).

The challenge of understanding markets at the base of the pyramid remains an exciting area of research on SGBs. We expect the sector to start moving beyond measuring success by *outputs* or the number of products sold, to measuring *outcomes*, or measurable changes in the lives of customers as a result of these products, and the determinants of consumer interest. Ongoing work by the William Davidson Institute and others is expected to contribute to the evidence base for supporting markets at the base of the pyramid (T. London & H. Esper, personal communication, February 10, 2012).

Section II: Identifying Small and Growing Businesses

To understand whether SGBs can play a role in poverty alleviation, we aim to develop a more nuanced understanding of the kinds of firms that will 1. Employ or engage the poor; and 2. Help them out of poverty. We start by looking at the broad set of SMEs in developing countries, and then focus on the literature on high growth enterprises or ‘Gazelles’, as well as enterprises with inclusive business models or a social mission. Drawing from the literature on different kinds of firms, we aim to identify what kinds of firms deserve support from intermediaries seeking a positive impact on growth and poverty.

The Universe of SMEs

In a recent study, Ayyagari, Demirguc-Kunt and Maksimovic (2011) examined the contribution of formal SMEs to employment and job creation in 99 developing countries, using a new dataset from the World Bank’s Enterprise Survey database. Based on this new dataset, they found, that SMEs were more prevalent and larger contributors to employment and job creation in low income countries than high income countries. Specifically, the Enterprise Surveys provided data from a sample of over 47,000 firms from 99 developing countries, surveyed in the period 2006-2010. As referenced previously, they found that in the median country, SMEs contribute to 66% of total, full-time formal sector employment and generate 86% of new jobs. In low income countries, the SME contribution to employment is even higher, at 78.25%. In particular, they find that small and mature firms (over 10 years old, with 5-99 employees) have the largest proportional share of total employment, compared to other size-age groups. Interestingly, while small and *young* firms are traditionally considered to be greater contributors to employment in developed countries, it appears that small and *mature* firms provide greater job opportunities in lower-income countries (Ayyagari, Demirguc-Kunt & Maksimovic, 2011).

Notably, the authors also find that while there are significant numbers of SMEs in developing countries that provide employment, they are less productive than their larger counterparts, making their contribution to economic growth less evident. Related research suggests that low income countries suffer from a lack of ‘dynamism’, or a high rate of firm entry and exit in the economy (often referred to as Schumpeterian ‘creative destruction’), which is an essential part of economic growth. Dynamic business creation occurs in countries with the right policy environment to stimulate entrepreneurship. Factors like the legal and regulatory regime, the speed and expense of the business registration process, flexibility of employment regulations and low corporate taxes (characteristics of developed country economies) typically lead to a greater level of firm entry and exit (Klapper & Love, 2010).

High Growth Enterprises – The Search for ‘Gazelles’

While the broader SME sector has been extensively discussed in policy research, other scholars have asked the question, “Are all small businesses equal?” Schoar (2009) distinguishes between ‘subsistence’ and ‘transformational’ entrepreneurs, arguing that only a small percentage of entrepreneurs are likely to successfully scale their businesses to increase profits and create jobs. Small business research pioneer David Birch suggested that a small percentage of SMEs in the United States were disproportionately responsible for growth and job creation (Birch, 1979). He called these businesses ‘Gazelles’, defining the

concept as “A business establishment which has achieved a minimum of 20% sales growth each year over the interval, starting from a base-year revenue of at least \$100,000” (Birch, 1995).

The literature does not reveal a consistent definition of Gazelles, though there is a consensus that they represent the top performing 5-10% of enterprises in an economy, and are responsible for 50-80% of employment generation in high-income countries (Holzl, WIFO, 2008). Thus, they represent a highly significant subset of the SME sector, and an important topic for new academic research and policy focus, particularly in developing countries (Stone & Badawy, 2011; Henrekson & Johansson, 2008). Henrekson & Johansson (2008) conduct a comprehensive review of the literature on Gazelles published after 1990, and conclude that the relatively limited number of studies on the topic stem from a lack of reliable data sources, particularly in less developed countries. However, it is important to note that research on Gazelles in developed countries is remarkably consistent. David Birch and one of his critics, James Medoff, concluded that 4% of firms generated 70% of all new jobs among ongoing firms in the United States between 1988 and 1992. Storey (1994) reviewed thirteen studies in the United Kingdom, with similar findings – 4% of firms created approximately half the new jobs over a decade. Gazelles have also been found in other developed countries such as Canada, Finland, Germany, Sweden and Spain (Picot & Dupuy, 1998; Autio, et al., 2000; Bruderl & Preisendorfer, 2000; Schreyer, 2000).

Overall, Henrekson & Johansson’s research synthesis arrives at the following important conclusions, based on the existing literature on gazelles in developed countries:

- A few rapidly growing firms generate a disproportionate share of all new net jobs, compared to other firms.
- Gazelles tend to be younger on average, but may be of various sizes. Small firms are over-represented, but large firms are also important contributors for job creation in absolute terms.
- Interestingly, there is no evidence that Gazelles are over-represented in high technology sectors, but appear in all industries.

Critics of Gazelle literature have pointed to the quality of data, the narrow emphasis on net job contribution, and the disregard of gross job flows and regression-to-the-mean effects (Haltiwanger & Krizan, 1999). Others caution that the idea that policy interventions focused on gazelles amounts to ‘picking winners’, which should not be the goal of governments. In developing countries, however, research on Gazelles remains extremely limited. Andrew Stone and Lina Tarek Badawy from the World Bank identified characteristics associated with high growth among SMEs in the Middle East and North Africa region in their note, ‘SME Innovators and Gazelles in MENA’ (Stone & Tarek-Badawy, 2011). Using data from the Enterprise Survey series, they find that being innovative, offering formal training programs to employees, and possessing international quality certifications (such as ISO 9000) were associated with high growth SMEs in six countries in the region⁴.

A new strand of the Gazelle literature focuses not on the successful firms, but the second tier firms that are considered constrained or potential gazelles. A recent study in West Africa suggests that Gazelles exist even in the informal sector in several countries, but are often constrained. Grimm, Knorringer & Lay

⁴ Lebanon, Egypt, Libya, Morocco, Syria and Yemen

(2011) use a representative sample of informal enterprises from seven West African urban centers⁵ to identify three distinct tiers of entrepreneurs: An upper tier of high-growth oriented companies, a lower tier of ‘survival’ enterprises that struggle to stay afloat, and a middle tier of ‘constrained Gazelles’. These constrained Gazelles share many characteristics with the top-performers, demonstrating high returns to capital, but are limited due to institutional factors such as a lack of access to credit and business development services, as well as restrictive policy environments. The authors argue their empirical strategy enables the identification of these constrained but potentially high growth enterprises, which could significantly improve the targeting of policy and investment interventions for this sector. These firms, the authors argue, have the potential to be high-growth firms, but would not succeed without support from intermediaries.

Social Enterprises – Inclusiveness and Impact

Firms that have a positive social impact, particularly on low income or poor people, are more difficult to classify than growth-oriented firms, since they reflect a particular mission or business model that may have a non-financial impact in addition to profits. The term ‘Social Entrepreneurship’ is not new, and incorporates a number of different types of organizations and themes. The study of social entrepreneurship crosses academic disciplines and challenges the core assumptions of business and economic development. Social entrepreneurship can incorporate many aspects that would be traditionally considered positive externalities as a core component of business practice, giving rise to a new form of organization that can be considered a hybrid of a traditional profit-driven business and a mission-driven non-profit (Dart, 2004; Leadbeater, 1997; Mair & Marti, 2006; Peredo & MacLean, 2006).

While the definitions of social entrepreneurship vary extensively, they typically share a common thread – social entrepreneurs have an ability to leverage resources that address social problems. Similar definitions of ‘Inclusive Business’ refer to firms that employ or engage the poor in a socially beneficial way, as a core part of their business operations (UNDP, 2011; IFC, 2005; UNDP, 2003). Inclusive businesses provide employment or services to low income, or underserved populations as a core part of their business strategy, even though they may not always claim an explicit social mission (UNDP, 2011). We recognize that some definitions of social enterprise include non-profits that employ business-like practices, but in this paper, we specifically refer to the narrow definition of “economically sustainable ventures that generate social value” (Emerson & Twersky, 1996; Robinson, 2006). Based on the definition of an ‘Impact Investor’ - a capital provider that seeks to create positive impact beyond financial returns, it is primarily this subset of for-profit social entrepreneurship or inclusive business that is relevant to our study. While many impact investors may be content to receive lower financial returns to drive greater social impact, it is understood that they are not philanthropic organizations and will only invest in economically viable enterprises that will at least return their capital as well as create social impact.

⁵ Abidjan (Cote d’Ivoire), Bamako (Mali), Cotonou (Benin), Dakar (Senegal), Niamey (Niger), Lome (Togo) and Ouagadougou (Burkina Faso)

Identifying SGB Characteristics

ANDE members aim to support SGBs with high growth potential, which can be likened to ‘Constrained Gazelles’ in the literature. A large number of members also focus on inclusive businesses or social enterprises with growth potential, which would be considered the most impactful in terms of poverty (Figure 2). These firms lie at the intersection of these two subsets of SMEs, ‘Constrained Gazelles’ and ‘Social Enterprises/Inclusive Businesses’, and typically share the following characteristics

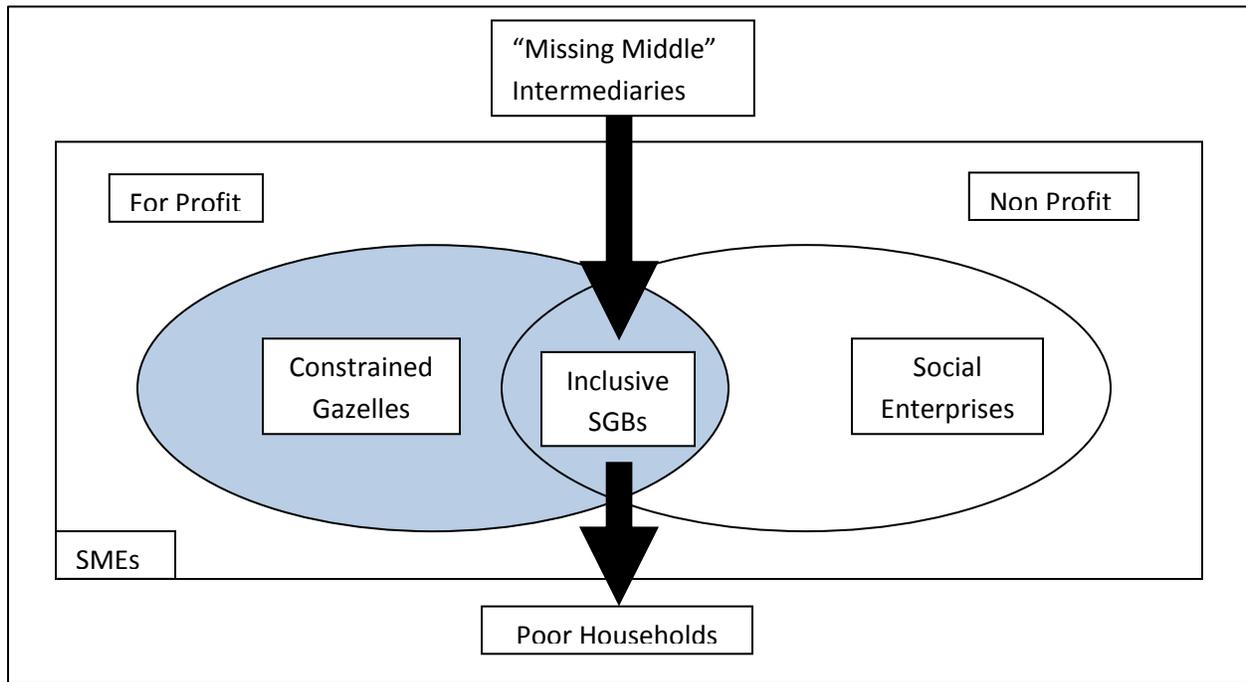


Figure 2: Identifying SGBs, Constrained Gazelles and Social Enterprises

- **Formal Small and Medium sized Enterprises:** While the informal sector can be significant and large in many countries, Small and Growing Businesses are typically formal firms (usually employing between 5 and 250 employees) in a variety of sectors (Barreiro, et al., 2009; ANDE, 2010).
- **Desire and Potential to Grow:** The management desire and ability to grow the business. While these characteristics are difficult to quantify, the amount of investment capital sought can be a useful proxy for this potential (ANDE, 2011). These firms typically require between \$20,000 and \$2 million in investment, placing them in the ‘missing middle’ of private finance. Similar to the ‘constrained’ or latent Gazelles identified in Grimm, Knorringa & Lay (2011), these firms clearly have the potential to grow, but face specific barriers that invite an intervention in the form of capital or technical assistance.
- **Specific Social or Environmental Benefits:** Drawing from the literature on social entrepreneurship, some firms also aim for social impact or an ‘inclusive’ business model. These enterprises engage the poor either by providing employment (direct or indirect) or by

providing essential products and services (such as electricity, water, health care) (GIIN, 2011; UNDP, 2011; ANDE, 2010; Barreiro, et al., 2009).

Thus, we can define SGBs as small firms which share many characteristics of high-growth firms, but are constrained by various factors. A further distinction can be made for socially beneficial SGBs that will have the most direct impact on the lives of the poor. These firms provide the best combination of financial, social and environmental returns on capital, and are constrained by institutional and other factors. The small group of enterprises that share these key characteristics provides a unique opportunity for impact investors, capacity development providers and other intermediaries to drive social and environmental change through strategic interventions.

Section III: Will Supporting SGBs contribute to Poverty Alleviation?

How can intermediaries most effectively support SGBs, with the ultimate goal of contributing to poverty alleviation? Over the past two decades, an industry has coalesced around this theory of change. Impact investors aim to fill the financing gap, while capacity development providers provide business training and mentoring. Governments, development finance institutions and other public agencies provide incentives and training programs to stimulate the development of SMEs in several countries (ANDE, 2011).

Private sector development interventions typically follow two approaches. In the first approach, governments aim to improve the enabling environment for all firms (or all firms within a certain category), by reducing administrative and regulatory barriers, investing in infrastructure (such as roads, electricity) and incentivizing access to finance (such as India's Priority Lending Sector program)⁶. The second is a more direct approach, by developing programs that provide firms with matching grants, business training, partial credit guarantees, direct investment or wage subsidies to enhance their growth and create employment (McKenzie, 2011; GIIN, 2011; ANDE 2011).

The financing gap is generally considered a severe problem, and the IFC estimates the total unmet need for credit by all formal and informal micro, small and medium enterprises in developing countries to be in the range of \$2.1 to \$2.5 trillion. Of the approximately 365 – 445 million enterprises, approximately 70% do not use external bank financing, though they are in need of it. The IFC estimates formal SMEs account for about 35% of the total gap, and interestingly, about 80-88% of the value of the credit gap for these formal SMEs is for companies with a bank account. Local bank funding is limited due to high interest rates and collateral requirements. Other barriers include infrastructure (lack of electricity, roads), regulatory, tax-related and corruption-related obstacles (ANDE, 2011; Stein, Goland & Schiff, 2010; Ayyagari & Maksimovic, 2008; Beck, et al., 2008; Klapper, et al., 2007).

While these macro-level studies explain the global credit gap, the nuances of credit constraints faced by SMEs are more complex. Banerjee & Duflo (2006) draw a further distinction between enterprises that

⁶ India's Priority Sector Lending program intervenes in the way banks allocate credit. The program requires all banks to allocate a certain amount of their credit each year to sectors that are deemed socially beneficial and credit constrained, such as agriculture, small scale industry and education loans.

are *credit rationed* and *credit constrained*. They argue that firms may have two main sources of credit available to them – lower cost credit from banks, and more expensive credit from other sources (such as informal lenders). Firms can be considered *credit rationed* if they are unable to borrow from a particular lender, but can borrow from other actors in the market by paying a premium interest rate. They suggest that firms are *credit constrained* if they are unable to borrow from any source. Using variation in a targeted lending program in India as a natural experiment, they find that most firms were in fact, credit constrained, and had not been able to access market credit prior to being eligible for directed lending under policy directives. They also found that public sector bank officials, being particularly risk averse, prefer to lend greater amounts to existing SME clients, rather than take risks by lending to new clients.

The Challenges of Doing Research in the Missing Middle

David McKenzie identifies several challenges associated with evaluating firm-level interventions in some countries. He argues that the number of firms above a certain size is relatively small in most countries in Sub-Saharan Africa, and the number of firms participating in an intervention is even smaller. He points out that there are several thousand micro-enterprises in these countries, but very few firms with over 100 workers (80 in Tanzania, 114 in Uganda, and 250 in Ghana, according to the data). Moreover, these firms are considerably heterogeneous in terms of industry, size, employment and sales, making it difficult to generalize findings across firms. He suggests that doing more frequent and intensive data collection to generate panel datasets (tracking the same firms over time, with multiple rounds of data collection before and after an intervention) is a promising approach to accurately measure the impacts of different interventions. Given the dynamic nature of firms, where outcomes can vary dramatically due to a variety of reasons, this approach will be more effective in unlocking the causal effect of program interventions, as well as providing a descriptive picture of how firms survive and grow (McKenzie, 2011; Teal, 2008).

Panel data has been used to some extent in the evaluation of SME programs in Latin America. In a comprehensive review, Lopez-Acevedo and Tan (2010) used longitudinal firm level datasets in four Latin American countries (Chile, Colombia, Mexico and Peru) to evaluate the impact of public programs supporting SMEs. Their findings were decidedly mixed, with several positive short to medium term impacts on research and development (R&D), worker training, and quality control practices. However, the longer term impact on outcomes like sales growth, wages and labor productivity was not as clear. For example, in Colombia, the Modernization and Technological Development Fund for Micro, Small, and Medium Enterprises (FOMIPYME) was evaluated. The program was found to have a positive effect on wages for the first two years, but negative from the third year onwards. Similar program evaluations of an R&D program in Argentina found large increases in innovation investment, but no significant impacts on labor productivity or new product sales (Chudnovski, 2005). More recently, the Inter-American Development Bank evaluated the impact of public credit programs managed by Brazil's largest state-owned development bank, the Banco Nacional do Desenvolvimento (BNDES), and found that

access to public credit increased employment by 23 percent and exports by 39 percent (DeNegri, et al., 2011). Table I summarizes the main findings of the sample of the 30 impact evaluations reviewed⁷.

Country	Program(s)	Study	Findings
Brazil	Public Credit Programs managed by BNDES and FINEP	DeNegri, et al. (2011), “The Impact of Public Credit Programs on Brazilian Firms”	24% increase in employment, 39% increase in exports, no effect on wages
Bangladesh	‘SME Support Services’ (1993) – financial, technical and marketing assistance to SMEs (< 50 employees)	Sarder, et al. (1997), “The Importance of Support Services to Small Enterprises in Bangladesh”	5-16% increase in employment, productivity and sales
Mexico	Range of SME programs (1995 – 2001) providing subsidized training, technology upgrades, market development and export promotion	Tan & Lopez-Acevedo (2005), “How Well Do Small and Medium Enterprise Programs Work? Evaluating Mexico’s SME Programs Using Panel Firm Data”	9-14% improvement in training, 9% improvement in technology adoption, no significant impacts on employment and productivity growth
Colombia	FOMIPYME – Technology development and adoption by SMEs (1995-2005)	Tan & Lopez-Acevedo (2010), “Impact Evaluation of SME Programs in Latin America and Caribbean”	Positive effect on wages in first 2 years, negative afterwards.
Chile	Various SME programs – Business Advisory Services, Technology Development, Credit, Supplier Development (1992 – 2000)	Lopez-Acevedo & Tan (2010), “Impact Evaluation of SME Programs in Latin America and Caribbean”	8% increase in wages, 9% increase in labor productivity.
Argentina	Matching grants for R&D and technology development t – FONTAR	Chudnovski et al., (2005), “Evaluating a Program of Public Funding of Private Innovation Activities: An Econometric Study of FONTAR in Argentina”	57-79% increases in innovation investment, no significant impact on labor productivity or sales.

Looking at Firms and Households

While there is clearly a growing body of research on the impact of SME support programs, these studies do not shed much light on the ultimate impact of these programs on poverty, and whether they are actually helping people out of poverty, though that is the stated goal of many interventions (Benavente & Crespi, 2003). As a recent report on private sector development by the World Bank Group’s Independent Evaluation Group notes, “the link from growth to poverty reduction is not automatic,

⁷ The majority of rigorous impact evaluations of SME programs use a combination of propensity score matching and difference-in-difference econometric methods to estimate the impact of various interventions to support SMEs.

particularly in situations where market failures and other inefficiencies limit participation of the poor in growth” (World Bank Independent Evaluation Group, 2011). While some of these studies track the growth of jobs and wages, they do not capture who these jobs were for, and whether the people are earning more than they would have, compared to other sources of employment. Thus, panel data on firms alone, is insufficient to answer our research questions.

In her conceptual article on the evaluation of enterprise policy, Helena Lenihan (2011) argues that the metrics for measuring the impact of enterprise policy are too narrow and focus exclusively on the benefits to the firms themselves, rather than aiming to understand the broader effects on society. She argues that policy-makers need to ensure enterprise-focused interventions are effective in generating positive outcomes, beyond the limited focus of the firms themselves. Firms affect poverty primarily through the number and quality of jobs they create, and the incomes generated as a result of wages (Teal, 2008).

As a first step, it is essential to better understand what kinds of firms actually employ poor people, and the dynamics of labor markets at the base of the economic pyramid. In many developing countries, there is a difference between the kinds of firms that employ poor people, and the kinds of firms that can actually help them out of poverty. As we shall see in the literature, the firms that employ the poor are most likely to be small, informal, and low in productivity. The vast majority of the poor earn their living in the small scale sector, usually in smallholder agriculture (in rural areas) or in self-employment and micro-enterprise (in urban areas). Firm size is also a key determinant of wages, with evidence from Ghana and Tanzania suggesting that workers in micro or small enterprises (5 – 10 employees) have essentially the same earnings as those that are self-employed, while workers in medium and larger enterprises earn between 50 to 75 percent higher wages. A worker who moves from a firm of 5 employees to one with 100 can expect to earn over 50 percent higher wages in Ghana, and 76 percent higher wages in Tanzania. The panel dimension of the data can help uncover some of the mobility that workers have between types of firms. While the existing dataset cannot record transitions between different types of firms, they can help track mobility across individuals who report having no income, being self-employed and being a wage-employee.

However, it is unclear how much of the firm size-wage differential can be explained due to the inherent skills and abilities of the workers (Sandefur, Serneels & Teal, 2006). To effectively understand the linkages of firm growth and poverty alleviation, we need to better understand the mobility of workers, between different types of firms and occupations, which is not possible using cross-sectional data or firm-level panel data.

Matched panel datasets, which track both firms and workers over time, can help describe some of these dynamics. These panels will allow us to better understand how incomes rise for the poor, and how much can be attributed to switches between types of jobs versus increases in education and experience. Research in Brazil, Mexico, Ghana, Tanzania, Kenya and Nigeria using matched panel datasets also suggests that years of education have a positive and significant effect on wages. An extra year of education raises the average salary by 6 percent in Tanzania and by 9 percent in Kenya (Van Biesebroek, 2003). As expected, returns for academic education are higher than those for vocational education.

Panel data also reveals interesting dynamics between earnings and workers' ages. Earnings rise by nearly 80 percent between the ages of 15 to 35 in Ethiopia and Ghana, and then start to fall, while they increase at a slower pace in Tanzania, and continue to rise beyond 35 (Teal, 2008).

In Ghana and Tanzania, most of those who exit wage employment or self-employment enter the no-income category, illustrating the precarious nature of employment in these countries. There is little movement between wage and self-employment over the one year period that the data were collected (2004 to 2005). This is consistent with the finding that there is little income difference between those who are self-employed and those working for small enterprises, which is where the majority of the poor are found. Household panel data from Ethiopia covered six years, during which 23 percent of wage employees changed jobs, while 44 percent of the self-employed did so. (Sandefur, Serneels & Teal, 2006).

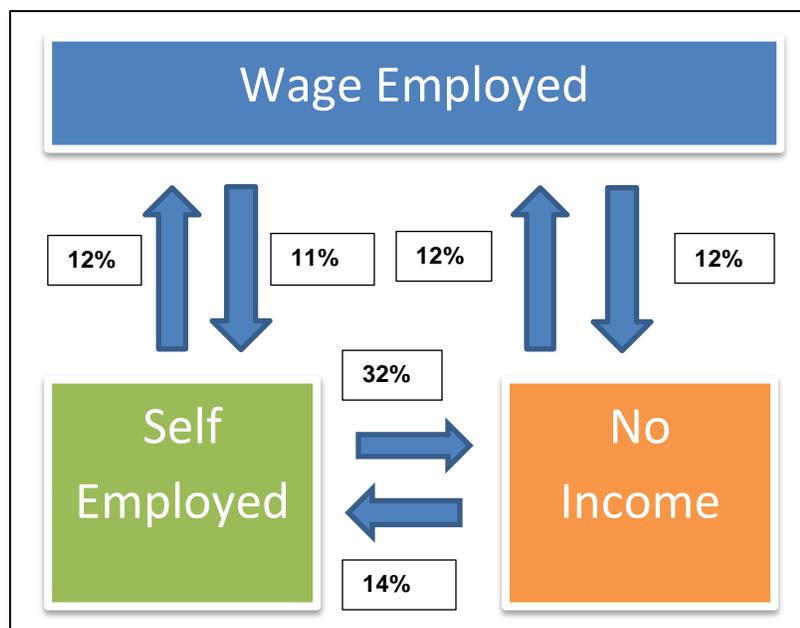


Figure 3: Job Mobility in Ethiopia Over 6 Years (n = 2499). Source: Sandefur, Serneels and Teal, 2006

Researchers from the Centre for the Study of African Economies at Oxford found that the decline in poverty in Ghana over the period 1991 to 2005 coincided with an increase in employment in small firms, and a shift from public sector jobs and self-employment (Nsawah-Nuamah, Teal & Awonoor-Williams, 2010). However, poverty declined at a relatively slow rate – about 10 percent per decade over the 1990s, supporting the hypothesis that the income gain in shifting from self-employment to small firms is modest. The analysis illustrates a lack of opportunities for the poor in medium and large sized firms, where they might earn higher incomes (Soderbom, Teal and Wambugu, 2005).

Panel datasets, on their own, are insufficient in answering the question as to whether these firms can actually help people out of poverty. They cannot fully account for selection bias, in terms of who is and is not employed by firms. As we see from the panel data in Africa, the poorest people have fewer opportunities to move to the formal sector since firms are more likely to select workers of the highest

ability. Therefore, we cannot be sure if these firms would help alleviate poverty for people, regardless of inherent ability. While the panel data will help us answer the first question, and unlock some of the dynamics of job mobility at a broader level, the question of whether SGBs will actually have a positive impact on the poor requires a more experimental approach.

An ongoing study by Chris Blattman and Stefan Dercon addresses the issue of selection bias by randomizing assignment of workers to jobs, through an innovative research design. Working with the researchers, a number of firms in Ethiopia hired a random selection of low-skilled workers from a pool of pre-screened applicants. A second randomly selected group within the pre-screened applicants received support from a local microfinance institution, while the third group did not receive any intervention. Blattman and Dercon will compare the poverty levels, health, household impacts, as well as social behavior over a period of two years to understand the broader welfare effects of these different sources of employment. While their results are forthcoming, early evidence suggests the research design has been successful in addressing the question of selection bias, and is a promising approach for replication in other settings.

We believe that both observational and experimental approaches are equally important in improving our understanding of the kinds of firms that can help move people out of poverty, and how best to support them. ANDE's Research Initiative will build on these approaches, and draw from the experience of these researchers through its advisory panel. As discussed in the research overview, we will support similar studies that will not only illuminate the development impacts of various kinds of firms, but can eventually help impact investors, development banks and other organizations better target firms with the greatest impact on poverty.

Section IV: Filling the Gaps

Returning to our original research questions, what kinds of firms employ or engage the poor, and will these firms help people out of poverty, we can suggest some general conclusions based on this review.

- We know that the poor have multiple sources of income in most developing countries, but are largely employed in agriculture, self-employment or small firms. It is not only the level of income, but also the variability of income that characterizes the lives of the poor. Steady employment at a relatively higher wage rate can help alleviate poverty, as it has done in several countries over the past few decades (World Bank, 2011).
- However, most micro and small firms that employ the poor may not actually be helping them out of poverty. These micro-enterprises are typically established out of necessity, rather than entrepreneurial ambition, and are generally unlikely to grow beyond a certain limit. They create few jobs, and offer low wages, relative to self-employment or other sources of income.
- Relatively larger, more formal firms (with 50 – 200 workers) offer higher wages, more stable income and in many cases, better working conditions. However, jobs in these types of firms are limited in many developing countries, and not easily available to the poor. Many high-growth firms will create large numbers of jobs, but these may not necessarily be for the poor.

We see that the evidence for supporting SGBs as a mechanism for poverty alleviation is compelling, though not conclusive. Our review of the literature highlights the importance of SGBs in alleviating poverty – while it is mainly *small* firms that currently employ or engage the poor it is the *growing* firms that can help them out of poverty by providing them with higher, more stable wages.

However, we believe it is essential to develop a more rigorous research agenda that builds on this evidence base, and identifies both positive and negative impacts of SGBs on poverty. We aim to do this through a two-pronged research strategy

- *SGB Sector Impact Assessment*: We aim to support rigorous impact evaluations of jobs or services provided by SGBs, in comparison to alternative sources of employment or service delivery. Beyond the impact on income levels and variability, we also hope to understand the effect on overall household wellbeing, as reflected by health, community ties and spillover effects.
- *Filling the Data Gap*: Recognizing that we cannot rely on firm-level data alone to measure impact on poverty, we will support the development of more matched firm-employee datasets, to better understand how firm and individual factors affect job mobility and poverty alleviation. As part of this process, we will aim to address some of the challenges of household and firm level data collection by testing innovative approaches such as the use of mobile phone surveys and poverty measurement toolkits. Datasets collected through this initiative will be made available to researchers.

Ultimately, we expect the research produced through this initiative to inform and influence impact investors, policy-makers, development finance institutions and foundations on how to maximize the social benefits of their investments and grants. As the SGB support and Impact Investing sectors continue to grow, there is an imminent need to test some of the core hypotheses on which they are based, and the research funded by ANDE through this initiative will fill this critical gap.

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