THOUGHT LEADER

Small size, big impact: MSMEs further sustainable development

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Micro, small and medium-sized enterprises (MSMEs) are a major source of growth, innovation and jobs across the globe. They create most of the employment and represent more than 90% of the business population. They are key to creating the 600 million new jobs that will be needed by 2030 to keep pace with the growth of the world's working age population. Their potential impact on achieving many of the Sustainable Development Goals (SDGs) is much greater than their size might indicate.

However, the contribution of MSMEs to sustainable development is constrained by at least three factors: unfavourable business environments, inadequate access to finance and high levels of informality. Governments need to address these barriers to unlock the development potential of MSMEs. The 2019 Finance for Sustainable Development Report, produced by 60 United Nations agencies and international institutions, provides a range of policy options to this end.

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Building an enabling environment

Policymakers set the environment that enables entrepreneurship and a vibrant business sector. Many developing countries have embarked on reforms to facilitate business development. In 2017–2018, 128 economies undertook 314 reforms – a record number – to help improve the business environment. Since 2015, least developed countries (LDCs) have cut the time and cost of starting a business by factors of two and four, respectively.

Governments can also take measures to support innovation by MSMEs and foster their participation in the economy. One good example of such a policy change is in India, where the government recently amended its public procurement policy to increase the minimum percentage of goods and services public entities must procure from small enterprises. It also included a provision mandating that a minimum proportion of public procurement be sourced from micro and small enterprises owned by women.

Well-functioning sustainable and resilient infrastructure is also key to business development. In the growing world of digitalization, e-commerce opens new trade opportunities for MSMEs. However, many developing countries, particularly in Africa, remain relatively under-connected to the internet and thus to e-commerce platforms.

It is estimated that more than 36% of the African population is out of reach of an operational fibre optic transmission network, while only 17.5% of people living in LDCs used the internet in 2017. This underlines the importance of increasing investment in information and communication technology, especially infrastructure.

Bridging the financing gap

Despite some improvements, MSMEs continue to identify a lack of adequate financing as the biggest obstacle to growing their business. The MSME financing gap is estimated to be more than $5.2 trillion. Female-owned businesses (typically smaller than male-owned) account for an outsized share of the financing gap, representing 28% of business establishments and 32% of the MSME financing gap.

Financial constraints also prevent MSMEs from fully taking part in international trade, as trade finance gaps affect them disproportionately. Financing challenges are on both the demand and supply side, including issues such as cumbersome collateral requirements and high interest rates. Lack of credit history, high transaction costs and high levels of informality also impede lending to MSMEs. To bridge the MSME financing gap, countries should consider:

- **Harnessing technology:** Technology offers great potential to address this gap. The fast-growing digital footprint of MSMEs can help overcome information asymmetries and ease the assessment of creditworthiness by lenders. In some cases, digital lending tools have brought down 'time to cash' for small business lending from an average of three months to less than 24 hours. Lending through technology-enabled platforms is growing rapidly. In Latin America such lending reached $663 million in 2017, six times higher than in 2015; technology can also support access to credit information in countries where credit bureau coverage is limited.
- **Building an institutionally diversified banking sector:** Different types of financial institutions bring different benefits. For example, small firms have a better chance of building trust and a long-term relationship with a local banking partner. Some local institutions, such as savings, cooperatives and development banks, also include a development mandate. These financial institutions can be helpful complements to commercial banks while contributing to addressing the needs of MSMEs.
- **Designing supportive tools:** Governments can, for instance, support access to finance for MSMEs through partial credit guarantees or investments in small companies (directly or indirectly via investment funds). These types of interventions are often most effective when done through a specialized institution, such as a national development bank. They are not fiscally neutral and need to be properly designed to achieve their goals.

Efforts to support access to finance for MSMEs need, however, to be balanced with preserving financial sector stability and protecting consumers. For example, financial technology – or fintech – creates its own risks. Given that new actors involved in fintech are blurring the lines between software, settlement and financial intermediation, financial regulators may need to shift from looking at the type of financial institution providing financial services to the risks associated with the underlying financial activity.

Integrating small businesses into the formal economy

More than 780 million working women and men are not earning enough to lift themselves and their families out of $2-a-day poverty. Informal firms account for a large portion of MSMEs, but informality of businesses can undermine labour rights and safe working conditions.

Countries with large informal sectors can pursue efforts to formalize businesses in ways that do not harm the poor. For example, policymakers can use fiscal systems to provide an incentive for formalization and growth of MSMEs by setting relatively high tax-exempt thresholds. This can spur businesses to become formal and encourage greater levels of compliance, without the tax system burdening the poor.

MSMEs are central to sustainable development. Governments and the international community need to create the conditions for them to thrive and become more productive and sustainable. Reinforcing cooperation between governments, the United Nations, civil society and business should go a long way in this respect. These efforts include facilitating exchanges of practical experiences, providing the necessary capacity support and identifying forward-looking policy guidance, such as through the Financing for Development Forum.

The United Nations system is fully committed to making this cooperation a reality, including through a new generation of UN country teams to accompany and support national development efforts on the ground. The International Trade Centre's contribution to these efforts is highly appreciated and this report will play a welcome role in making MSMEs in developing countries a more attractive investment option for private finance.