



## Localizing the Architecture of Business Engagement through Small and Medium-sized Enterprises Implementing the Post-2015 Development Agenda

***Executive brief: Key to job creation, SMEs can be a major driver of inclusive growth and sustainable development. But they can be prone to low productivity and high exposure to workplace disasters and other sustainability risks. Better access to credit, bringing down structural barriers and support from conglomerates and multinationals are needed to realize SME's sustainable development potential.***

### Size ("small and medium") matters

Companies with less than 250 employees are reliably estimated to account for 95 per cent of all registered businesses worldwide, and nearly half of global world output (about \$33 trillion in 2010). This also makes them the main source of jobs – significantly, of about 80 per cent of employment in high-income countries and 60 per cent among the mid-range, but only 40 per cent in poor nations.<sup>1</sup>

The very nature of SMEs makes them key drivers for global sustainability at many levels. Although very modest in capitalization and scale of operations in comparison with multi-nationals and major state-owned enterprises, SMEs have the most to offer in terms of job creation. Their existence also broadens and stabilizes national tax bases, offsetting reliance in smaller countries on receipts from a handful of large-scale firms. The upside to this potential is highest where it arguably counts the most – among the least developed countries.

An upgraded capacity among companies of this scale is likely to improve the quality of the jobs on offer, including for women and for marginalized groups, and building national skill levels. It would improve national competitiveness and, ultimately, contribute to sustainable development.

But due to lack of economies of scale, productivity is far lower among these firms than in large-scale companies. SMEs are constrained in their ability to invest in technology, capital goods, distribution and marketing, and are often isolated from global supply chains. Even the exigencies of sustainability reporting or taking part in local councils of sustainable businesses can pose major management challenges. Lack of SME capacity undermines sustainable development due to unsafe or unhealthy workplaces and production practices. A precarious business situation increases vulnerability to corruption and to violations of human rights, labour standards, and environmental protection.

Entrepreneurs in the SME sector identify access to finance as a major barrier to improvement. The perception of SMEs as risky investments reduces their ability to qualify for loans, and raises the cost of financial and human capital when they do.

There are high costs associated with searching for, hiring and maintaining well qualified employees. Talented individuals may seek out larger-scale businesses, on the one hand, and on the other the loss of even a single employee impacts an SME more severely than a larger company.

To enhance their own long-term stability and value-creation capacities, many SMEs also need to address sustainability aspects of their operations and use of resources.

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<sup>1</sup> International Finance Corporation, of the World Bank Group

## A strategy for scaling up SME capacities

Multi-nationals and large-scale companies have a vested interest in the success of SMEs, who constitute major suppliers and purchasers. In the process of doing business together, larger firms impart knowledge and technology that builds capacity and translates to more capable workforces and better jobs.

Conversely, an uninvolved approach can lead to disruptions in quality and reliability of supply or worse, workplace disasters or gross violation of workers' rights in which the larger companies share the blame. Healthy supply chains are fundamental to sustainable business practice. A strong incentive thus exists to help SMEs to upgrade the sustainability profile. Given the high degree of SME interdependence with larger firms, support from these large-scale companies is essential.

Creation or expansion of export markets may offer additional pathways to SME sustainability, and is an area where government export-promotion boards, multinational partners, investment firms and SMEs themselves can play active roles.

Particularly promising for SME scale up is the rural sector, which in poor nations is dominated economically by smallholder farmers. Through cooperatives, partnerships and other formats, niche markets are being established and supplied across borders. At home, the rise of local businesses is encouraging the economic diversification, job creation and skill building that is required to attack poverty where it is most entrenched – in the countryside of both developed and developing countries.

Seeking markets in neighbouring or even distant nations can also help to bring a competitive edge to SME performance as well as expand scope and capacities. It also may provide a clearer outlook on sustainable development, as they look to find products that support the well-being of these new markets. This is similar to how multinationals have developed product lines that respond to important development needs – infant care and medicines that are accessible to populations living in poverty, LED lighting systems that save money and energy consumption at the same time. Advanced SMEs can align themselves as development partners in overseas countries where they are engaged. This is especially apparent in the case of innovative firms known as “social enterprises” (*see below*).

In fact, SME's often are more flexible and have faster decision-making processes than large-scale companies. Quickness and adaptability are strengths in terms of innovation. And in the case of sustainability, new solutions are indispensable. Special attention should be paid to start-ups especially those that are related to universities where more new and “disruptive” solutions can emerge.

## An enabling environment

Promotion of SMEs is sometimes thought of in terms of protection from foreign competition, or of granting tax breaks. Circumstances may sometimes warrant such steps – but often they exacerbate rather than solve the underlying problem relating to productivity and competitiveness. Targeted support and cutting unfair restrictions may prove more beneficial for companies, government and society:

- Bolstering credit information: Provision of detailed information in loan applications may be difficult for many SMEs. Government bureaus often are able to provide supportive information or to verify or supplement information provided by the SMEs themselves.
- Building in stability: Unanticipated high rates of inflation have a disproportionately negative impact on SMEs, who rarely have access to instruments to hedge risks. Saving up for such

macro-economic contingencies takes an estimated US \$150 billion out of SME cash balances worldwide – resources that otherwise could be deployed for productive investments or would add to the capital reserves of banks. Similarly, frequent changes in government regulations challenge the capacities of SMEs more so than those of big corporations.

- Strengthening legal rights: Uncertainties regarding legal recourse and the enforcement of the lending contract in the case of a non-performing loan discourage lending. So do difficulties in acquiring formal registrations of SME assets, which could potentially serve as collateral.
- Bringing down barriers to formalization: These include long wait times and high costs -- often compounded by corruption -- to register a business.
- Creating spaces for innovation and collaboration: Governments can facilitate a university-business nexus that connects SMEs to technology and supports productivity. Conversely, SME input can be brought into university curricula, contributing to a workforce development and mitigating SME challenges in sourcing talent.
- Incorporating sustainability into business models: Subsuming sustainability practices within strategies and operations can be hard for firms with limited resources. Support from governments, larger companies, the international community and the non-governmental sectors is crucial to upgrading SME sustainability.

#### Social enterprises - producing social, economic, and environmental value by design

Another example of SME contribution to sustainability is the case of social enterprises (SEs). A subset of SMEs, they strive for positive social and/or environmental outcomes while generating a financial return. They are pioneering business models that have the potential for transformative approaches in several sectors.

For example, social enterprises are expanding access to health in remote regions, creating innovations to improve maternal and child health, HIV/AIDS and non-communicable diseases. It is estimated that SEs contribute US \$41 billion annually to health sector revenue.

Social enterprise solutions are also prevalent in the areas of climate change mitigation. In addition to addressing the long-term impacts of CO<sub>2</sub> emissions, these SE business models are expanding to include the reduction of emissions of short-lived climate pollutants such as, black carbon, methane and hydro-fluorocarbons, and to support marginalized communities.