

Executive Summary of Evaluation

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Background

Small and medium enterprises (SMEs) are a key priority of the International Finance Corporation (IFC) given their importance in growing economies. To effectively support the growth of SMEs requires an understanding of which interventions can produce results and under what conditions. The Development Impact Department has been undertaking a series of meta-evaluations in strategic areas of IFC's work to address these issues. The first meta-evaluation analyzed job creation effects of private sector interventions. A second meta-evaluation was undertaken on private sector interventions in agribusiness and food security focusing on access to finance and farmer/business training.

This systematic review adds to this knowledge base and focuses on two other key areas of IFC's work—SME Banking and Business Regulation. Unlike literature reviews, systematic reviews are undertaken using strict methodological guidelines to ensure that the evidence presented is of high quality. This systematic review followed a structured process to assess the evidence of the effects of SME Banking and Business Regulation and which approaches, tools or combination of instruments produce results. The review was structured around IFC's products in order to be relevant to IFC management but it was not an evaluation of IFC's interventions or performance. The review was based on secondary sources only. A rigorous process was used to select the best research and evaluations to synthesize the experience globally in these two areas.

IFC's Advisory Services (AS) and Investment Services (IS) have SME Banking as a priority for FY 2014-16. Working through financial institutions (FIs), IFC provides assistance to expand the FIs' SME banking products and reach. Business simplification is also a priority area for AS. Working with government organizations, AS has products aimed at streamlining the burden on firms for starting and operating a business. This is done through providing assistance to governments at the national and sub-national levels in a range of areas to streamline processes. These reforms are aimed at benefiting all enterprises within the economy.

Since IFC works through intermediaries for both areas, the analysis of the evidence focused on understanding the results that were emerging on two levels. One captures the changes at the FI or

government level; the second focuses on the longer term changes at the enterprise level. This allows questions to be asked such as: Are FIs reaching SMEs? If so, what effect does this have on the firms' performance?

Objectives

The objective of the systematic review was to assess the evidence of the effects of SME Banking and Business Regulation and which approaches, tools or combination of instruments produce results. The review was structured around IFC's products in order to be relevant to IFC management but it was not an evaluation of IFC's performance. The review was based on secondary sources only and a rigorous process was used to select the best research and evaluations to synthesize the experience globally in these two areas.

The key questions for the systematic review were:

1. What types of IFC-related work with financial institutions, to increase provision of financial services to SMEs (SME Banking), are most likely to have the largest effects?
2. What types of IFC-related public sector interventions, aimed at reforms in Business Regulation, are most likely to have the largest effects?
3. What methodologies/approaches have been used to conduct the research and evaluations? Were they appropriately applied and relevant to the subject?
4. What lessons, conclusions and recommendations can be extracted from the research and evaluations that can inform management decision making?

Analysis

SME Banking

Access to finance is one of the primary constraints stifling SME development. One snapshot of the extent of the constraint shows that 13.8 to 20.4 million formal SMEs in developing economies may be unserved or underserved by the formal financial sector. This credit gap represents an opportunity for FIs but one that requires FIs to strengthen their current business models and expand their reach. IFC's AS and IS provide assistance to achieve this.

It was important for this review to clearly define what is meant by SME Banking in order to distinguish it from microfinance. This was done using three filters. First, the focus was on the core SME banking products—namely with commercial banks. Second, care was taken to ensure that the firms covered by the review reflected the experience of SMEs not microenterprises. While definitions varied across studies, a focus was placed in the review process on ensuring the results for small enterprises were clearly separated from microenterprises. Third, where a loan size was mentioned in an evaluation or research document, the review used IFC's loan proxy measure as the method to distinguish between SME Banking and microfinance. IFC has developed a proxy based on the loan size given by the FI at origination to the enterprise and covers loans above \$10,000 and below \$1 million or \$2 million. Using

these three factors, the review ensured that the evidence gathered and analyzed was applicable to IFC's SME Banking AS and IS work.

Two problems were encountered in undertaking the review. First, it proved difficult to find good quality evaluations and research that provided insights into the effect of lending to SMEs through financial intermediaries. Beyond stocktaking exercises and gathering of lessons, limited work has been done on systematically assessing the interventions with FIs and the conditions under which the interventions can have the largest effects. This severely limited the ability to identify the effects taking place at the FI level and required focusing on broader research on commercial banks and their relationships with SMEs.

Second, by focusing on loans that fit within the SME Banking definition, most of the research that has been done to date on the effects of lending on firms was not appropriate. This was true for the growing number of randomized control trials (RCT) and all impact assessments that were covering lending to micro and small enterprises. In addition, most international research confuses finance for micro and small enterprises and combines the two under an "SME Finance" heading. This lack of distinction made it difficult to find clear evidence on the effects of the financial intermediation on SMEs versus microenterprises. Most evidence fell into the latter category. As a consequence, the firm level effects from SME Banking could only be identified from research on financing constraints not from research or evaluations that tracked SMEs accessing finance through FIs.

Given these constraints, a number of findings did emerge that can provide insights on SME Banking interventions.

- In general, the types of interventions that international financial institutions (IFIs), including IFC, are using with FIs in terms of advisory and investment services appear to be in line with how FIs are building their SME financial portfolios. A wide range of business methods are now being used by FIs including dedicated SME units, credit scoring and innovative banking methods. This includes greater use of existing inter-firm linkages such as value chains and factoring. Many of these models were developed and tested by IFIs with financial institutions.
- The lack of well-done evaluations or research on the intermediation model and its effects on FIs means that it is impossible to pinpoint which interventions with FIs had an effect and under what conditions. Evaluations of intermediation are needed in order to gather more information on the conditions for sustainability of SME lending and leverage that comes from IFI's advisory and investment participation. This would allow a better targeting of interventions, including by SME target group, and methods to track performance.
- A wide range of banks are now interested in SME Banking based on the profitability of cross-selling products. This profitability is generated from a portfolio of services, however, not just loans. The research reviewed showed the wide variation in the extent to which the revenues were generated from credit services—ranging from a low of 22 percent to a high of 73 percent. This cross-selling of products drives the interest but also means the extent to which SMEs actually have access to credit as part of the relationship with the FIs varies widely across countries. This explains why 80 to 88 percent of the credit gap of SMEs is actually for firms with existing accounts with FIs.
- Having an existing relationship with an FI should enhance the chances of an SME accessing loans but a wide range of factors make this difficult to realize. The G-20 stocktaking report indicated that

closing the credit gap for formal SMEs will be more manageable than for informal firms since a vast majority of the formal SMEs have an existing relationship with a financial institution even if they do not have credit. Leveraging this relationship may be more difficult than anticipated given the wide range of factors influencing the lending patterns. These include factors such as: the extent and character of SMEs in the economy; competition from other borrowers such as consumers, corporations and government; levels of informality within a sector; the innovation of the banks in terms of the development of methodologies such as credit scoring; presence of different types of banks within the country (e.g., foreign banks); competition in the banking sector; and the state of the financial sector infrastructure such as credit information systems and collateral registries. These conditions vary on a country by country basis and influence the extent to which an existing relationship between a FI and SME can be extended to include credit.

- Reforms to the financial infrastructure are becoming increasingly important since this influences the type of techniques FIs adopt for their SME portfolios. A number of recent studies have reviewed the effects of reforms in these areas. Collateral registries allow FIs to use different types of collateral such as movable assets in dealing with SMEs. Reforms have facilitated an increase in access to finance for SMEs for a range of credit products and decreased lending rates. Similar patterns are seen with the introduction of credit information systems such as credit bureaus. Here the research shows that not only do SMEs have greater access to finance but banks also increase their profitability and decrease their risk. For both collateral registries and credit information systems, however, the quality of the implementation of reforms at the country level dictates whether these results will emerge. This is an important consideration for AS.
- The available research focused on credit constraints of SMEs and confirmed that the lack of access to finance is constraining growth, investment and employment. SMEs are more likely to see finance as a key constraint to their development and more likely to be disadvantaged in economies with underdeveloped financial systems. This hinders firms growing from small to medium and affects the prospects for high growth firms.
- Despite this research on the credit constraints facing SMEs, little is actually known about the effects of having access to finance through FIs on SMEs. The research available did not verify the effects at the SME level in sales, productivity or investment with having access to finance nor did it explain the channels that lead to these outcomes. While the research showed a link between finance and these effects, the causality is not clear. The studies also did not adequately separate out different types of firms and differing impacts, such as on women-owned enterprises or high growth firms. The special challenges in terms of access faced by different firms need to be investigated further. Without this work, interventions cannot be better targeted.

The gaps in the evidence for SME Banking are substantial and need to be addressed. Primary research and evaluations should be undertaken that directly look at SME banking and financial intermediation. This is particularly true around the issue of the extent that SMEs improve their performance with the availability of finance and under what circumstances. This includes separating the analysis by types of firms such as women-owned and fast growing.

Business Regulation

Three areas of focus for IFC in business regulations are covered here—business entry, operations and corporate taxation. The evidence for each group of reforms is presented separately to capture different effects for each area. However, it is recognized that they are closely linked and this is dealt with in the overview section.

Business Entry

Streamlining business registration processes is one of the most common reforms undertaken by countries to improve the investment climate. The establishment of one stop shops and revisions to regulations has resulted in substantial drops in the average time to start a business globally. One stop shops are now operational in 96 countries.

This streamlining has produced some evidence on the effects of the reforms.

- In most cases, the number of businesses registered increases initially after the reforms are implemented. These increases have ranged from 5 percent to over 100 percent depending on the country context.
- However, these increased levels of registration drop off after a period of time as the backlog of firms entering dries up. The level of registrations often settles slightly above that seen before the reforms. The temporary nature of the increases reflects other factors that influence the start-up and formalization of firms beyond the specific entry reforms. Simplifying the regulations is necessary but not sufficient for new firm entry.
- Country specific factors come into play in the level of response by entrepreneurs. These factors include variables such as: the overall levels of entrepreneurship within the country; pent up demand in situations such as post conflict periods; and state of the economy.
- The approach to entry reforms has an influence on how firms will respond. Entry reforms need to have a critical mass to have an effect on registration. Countries with weaker environments require larger reforms. The approach taken to the reforms has an influence on the extent to which gains are seen in registrations. In some cases, there may be a temporary decline in registrations due to the way reforms are implemented.
- Distinctions need to be made among the types of firms registering since this reveals the prospects for growth or exit of the new firms. Difficult entry environments affect firms in sectors with low entry barriers such as retail, blocking their entrance and sometimes forcing them to operate informally. Firms in sector that have higher entry costs such as pharmaceuticals are less affected by difficult entry environments. Easing entry requirements may draw in more marginal firms, resulting in higher exit and increased competition to the existing firms. High growth firms are encouraged with a reduction in entry restrictions but to maximize their growth potential means that the overall regulatory environment, including rule of law, needs to be conducive.
- Entry reforms have limited effect on bringing informal subsistence firms into formality. Firms operating informally that are more business oriented may be more drawn in by the reforms but a vast majority of the subsistence firms are not.

- Some evidence on job creation and investments was seen from the entry of the firms. It was not clear, however, whether the jobs figures were overinflated since some firms may have already existed and were simply formalizing. It is also not clear the extent to which the investment levels were above the minimum capital requirements seen in many countries.

Business Operations

A wide range of tools has been developed for improving licenses and inspections. Countries are beginning to adopt these reforms, although they are proving complex in many cases. The evidence around licensing and inspections reform is far more limited than entry reforms, however. Few good quality evaluations or research were found in this area. The evidence that was available shows the following trends.

- Licensing reforms can substantially decrease the time required, costs and steps in the process. This can have a positive effect on the number of firms obtaining licenses. However, the implementation processes for reforms can be lengthy and require substantial time before registrations increase.
- In countries moving quickly from a highly regulated licensing environment, reforms can have more immediate and obvious effects. The classic case is India where for certain sectors setting up factories and subsequent production activities were all subject to extensive licensing requirements. The removal of the restrictions increased the number of factories and the productivity of firms. This was true for both existing and new entrants.
- A reduction in compliance costs has been seen with a number of licensing reforms but these are relatively small in scale. Evidence of decreases in the time required and fees paid has resulted in some cost savings for firms. However, the evidence to date shows the savings are not as dramatic as other reforms such as entry reforms and may depend on whether or not the requirements are one-off or annual.
- The overall effects of reforms on firms' performance are not clear at this point and need further research. The Peru licensing evaluation showed no improvements in performance after obtaining a license but the study only focused on informal firms that obtained a license not new entrants. Some of the informal firms that did enter were not interested in growing. A comparative evaluation of four African countries concluded that business licensing did not result in increases in investments. They suggested that the outcomes may militate against placing a strong emphasis on business licensing reform in future operations.
- Further research is needed to better understand the spectrum of firms that respond to these reforms and the conditions under which this takes place.

Corporate Taxation

The review focused on a small portion of overall tax reforms, namely corporate taxes. This is an area where significant progress has been made globally in number of tax payments required, time required to comply and total tax rates.

- The simplification of taxes has a positive effect on firm creation and formalization but the results vary widely by type of firm. Some unofficial small firms may respond to tax reforms since it provides them an opportunity to expand their customer base by doing more advertising and issuing tax receipts. The more subsistence informal firms do not respond to incentives to register and see few benefits regardless of the extent of reforms. Some larger firms that appear to operate formally but in fact are under-representing sales are not enticed into full compliance even with a streamlining of the tax processes. They have found methods to circumvent the system and full tax compliance has limited influence on their ability to access credit. The results also vary by sector with sectors with low entry costs (e.g., retail) having greater compliance after reforms. Little effect was seen with high entry cost sectors.
- Registration for taxes can improve a firm's profitability under certain circumstances. This is particularly the case when formalization of firms allows them to expand their sales base, have more options for purchasing inputs and reorganize their workforce.
- A number of cross-country studies have concluded that higher tax rates result in lower investment, productivity and overall growth of firms. This research indicates that the level of tax rates has an influence on a firm's performance. Firms of all sizes are affected, although small firms have lower profitability and therefore taxes. High tax rates also stifle investments in new technology and impact manufacturing firms more than services.
- Recent evidence shows that tax rates may not be the biggest drag on growth but the complexity of the tax administration has a larger impact. The hardest hit region is Africa in terms of overall drag on the economies. Administrative burdens are more important for domestic firms than international investors. Tax rates are more important for the latter group.
- In some situations, increased tax enforcement is more effective than tax reforms in terms of increasing tax revenues. If enterprises do not think they will be found, they will avoid registration. In situations where tax inspectors have visited firms, the rates of registration have increased regardless of the reforms undertaken.

Common Patterns and Gaps

A number of common patterns are seen across the three reform areas. A few are highlighted here.

- Different types of firms respond to reforms in differing ways. The evidence of responses to reforms varies by type of firm and sector. This is true both in terms of performance and likelihood of new firms surviving. This is an important consideration when designing reform programs with governments. While some research is starting to make these differentiations, more work is needed to distinguish what reforms trigger both registrations and firm level effects, by which type of firms and under what conditions.
- The expectation that large numbers of informal microenterprises will formalize in response to reforms has not proven to be the case. Reforms may result in a small number formalizing that are more business oriented and see opportunities to grow. Few of the subsistence microenterprises will formalize. The benefits for this group from formalizing are few and therefore they will not be influenced

by reforms. Focusing efforts at this level to bring firms into the formal sector will likely not increase registrations and bring the benefits from formalization that are anticipated by governments.

- Potential exists for encouraging formality with firms that are not subsistence level but more successful and larger scale. These informal firms are more likely to be competing with formal firms with similar characteristics and have an advantage given their lower costs. There is some evidence that reforms that lower costs and complexity of being formal will entice these firms into registering and expanding their operations.
- The differential effects of reforms on women-owned enterprises need to be further investigated. While projects may integrate gender into their implementation, the research reviewed here provides few insights into the effects on women.

Overall the quality of the research available was good but some challenges were seen that should be addressed in future research agendas.

- Much of the research was on the same reforms and countries, with an over-representation on the Americas. The varying conditions in each country and region bring into question the extent to which some of these findings can be more broadly applied. A study may have validity for one context but not be relevant for another.
- While a wide range of projects have been undertaken to support reforms, few evaluations have been of a quality where they can inform decision makers. IFC is at the forefront here with impact evaluations that are providing more solid evidence. Other donors should be encouraged to improve the quality of evaluations and monitoring systems.
- The causal links underlying much of the research need to be reassessed based on the emerging experience. Reforms will have differing effects on firms, with business entry being different from licensing or inspections. In some cases, it appears that results can be seen more quickly at a firm level, for example with business entry reforms. In other cases, the chain is more complex and the reforms may not be that important for encouraging growth and jobs. As more evidence emerges, these issues need to be better integrated into the approaches to designing and implementing interventions.
- The research needs to be better disaggregated by type of firm including ownership. This includes distinguishing between new entrants, formalizing firms and firms that exit.

Conclusions and Recommendations

Specific Implications for IFC

This review did not evaluate interventions implemented by IFC. Instead the focus was on gathering credible evidence on the experience to date in SME Banking and Business Regulation that could inform IFC's decisions. The following are some implications of the findings for IFC's work in these two areas.

SME Banking

- The lack of evaluations and research on the intermediation model with FIs makes it more important for IFC to further develop methods for results tracking of interventions with FIs. Currently IFC is tracking indicators such as the overall loan portfolios. Further analysis of the current indicators is required to provide insights into trends across countries and FIs. This will allow the development of data that can be used to gain a better understanding of the effects at the financial institutions of the AS and IS interventions and conditions under which these take place.
- The movement by IFC to undertake impact assessments on the SME banking portfolio is important given the lack of information currently on the effects at the SME level. These assessments should look at SME banking under different conditions and by different types of firms in order to help fill in the current knowledge gaps. They should clearly define effects such as jobs to allow consistent analysis. For example, are the jobs new or sustained? Short term?
- IFC could leverage its leadership position on the global stage through groups such as the SME Finance Forum to encourage more evaluations and research on SMEs receiving financing from banks. An increase in the volume of evaluation and research on different types of SMEs will provide insights into how to better target groups such as women owned enterprises and gazelles.
- Building on the existing relationships between FIs and SMEs can continue to be an effective technique for expanding access to credit but the conditions within a country will dictate the feasibility of the approach. Evidence is showing the complexity of factors that influence and deter an FI, with an existing relationship with an SME, from including credit as part of its package of services. New approaches may be needed under some circumstances by AS and IS to better address these differences.
- IFC can continue to play an important role in supporting the development of financial infrastructure—collateral registries and credit information systems. The awareness of the importance of these reforms for allowing increased access to credit is at a high level currently. The effects from these types of interventions to date show the importance of these reforms on increasing SMEs' access to finance. But the interventions need to be carefully planned since the method of implementation across countries has an effect on whether access to finance for SMEs improves. These effects are not seen across the board.

Business Regulation

- The business regulation reforms that are supported by IFC need to be decided based on the extent to which the outcomes of growth, jobs and investments can be achieved. As more evidence emerges, some products may be less important for achieving these results. This will require a careful tracking of what has worked, what has not and why.
- IFC should make clear to government partners what expectations are realistic from reforms particularly in areas such as formalization. For some groups of enterprises, other support programs may be more important for promoting formalization than business regulation reforms.
- Being able to reach a critical mass of reforms is important and should be integrated into the decisions on a country basis. If the potential for a critical mass of reforms is not evident, the likelihood of a response from enterprises is more limited. This will require a more tailored approach by country and a choice of tools to match the opportunities.

- The causal links between certain reforms and outcomes need to be better understood. The paths from the reform areas of entry, permits and taxation to changes at the enterprise level vary. Some are more straightforward such as reforms around one stop shops. Areas such as inspection are more complex. The types of firms also influence the potential effects from a reform. Understanding the differences will allow better targeting of interventions and tracking of effects.
- IFC should continue to do more impact assessments that provide evidence from a broader range of reforms and geographic locations. This will begin to fill in the gaps of knowledge around the conditions under which enterprise effects may take place.

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