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ENTREPRENEURSHIP AND SMES: A CONCEPTUAL POLICY FRAMEWORK TO FINANCING

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I – INTRODUCTION

Over the long history of the development of economic doctrine, many great minds have turned to the concept of the entrepreneur. This term has long been used by economists with varying emphases at different times because of the evolution of global markets and the boost it generated to small-business. The concept remains relevant to economic development as one enters the new millennium, for how the market treats entrepreneurs has immediate and profound effects on overall internal and external economic performance and the direction of economic activity.

The purpose of this paper is to clarify and identify the importance of entrepreneurship, through its role in the development of small and medium-sized enterprises and, consequently, to economic growth. It also highlights the access to finance challenges faced by these enterprises to survive in increasingly competitive markets.

The paper is structured in seven chapters as follows: Chapter one provides some theoretical background on the link between entrepreneurship and economic growth inspired by ideas of Schumpeter, Cattillon, Say and Drucker. Chapter two describes the important relationship between entrepreneurship and small and medium-sized enterprises. The third chapter addresses the importance of access to finance to small and medium-sized enterprises, whereas chapter four provides a theoretical view for the lack of access to financing. Chapter five then provides a broader framework to explain factors behind the difficult access to financing for small and medium-sized enterprises. Based on the discussion presented throughout the paper, chapter six illustrates potential policies to increase access to financing and chapter seven concludes by providing policy recommendations.

CHAPTER 1. ENTREPRENEURSHIP AND ECONOMIC GROWTH – AN ECONOMIC POINT OF VIEW

The term entrepreneur originated in French economics as early as in the 17th and 18th centuries. Two authors are usually identified as the pioneers of the field. The first is Richard Cattilon (1755) an Irish economist of French descent. In his writings, he formally defines the term: "Entrepreneurship by at certain prices in the present and sell at uncertain prices in the future".

Jean Baptiste Say (1816), the second author, claims that an entrepreneur is the agent "who unites all means of production and who finds in the value of the products...the reestablishment of the entire capital he employs, and the value of the wages, the interest, and rent which he pays, as well as profits belonging to himself."

In the 20 century, the economist most closely associated with the term, was Joseph Schumpeter (1928-1954). The idea that entrepreneurship and economic growth are very closely and possily linked together has undoubtedly made its way since the early works of Schumpeter. He described the entrepreneur as a person who is willing and able to convert a new idea or invention into a successful innovation. Entrepreneurship forces "creative-destruction" across markets and industries, simultaneously creating new products and others business models. Creative destruction is largely responsible for the dynamism of industries and long-run economic growth. In his words: "…the entrepreneur is the innovator who implements change within markets though the carrying out of new combinations. The carrying out of new combinations can take several forms:

- The introduction of a new good or quality thereof;
- The introduction of a new method of production;
- The opening of a new market;
- The conquest of a new source of supply of new materials or parts;
- The carrying out of the new organization of any industry…"

For him, the entrepreneur moves the market away from equilibrium. His definition also emphasized the combination of resources. Yet, the managers of already-established business are not entrepreneurs to Schumpeter.

> "The essence of entrepreneurship lies in the perception and exploitation of new opportunities in the realm of business…it always has to do with bringing about a different use of national resources in that they are withdrawn from their traditional employ and subjected to new combinations."
>
> (Schumpeter J, 1928-1954)

Schumpeter's entrepreneurs are the change agents in the economy. By serving new markets or creating new ways of doing things, they move the economy forward. Not only did Schumpeter associate entrepreneur with innovation, but also his imposing work shows the importance of entrepreneurs in explaining economic development.

Contemporary writers have presented a wide range of the theories of entrepreneurship. Many of the leading thinkers remain true to the Say-Schumpeter tradition while offering variations on the theme. Hisrich, Peters and Shepherd (2005,p.8-17), review various definitions of entrepreneurship and come up with a short definition of entrepreneurship as something that involves the process of creating something new and assuming risks and rewards.

For instance, in his attempt to get at what is special about entrepreneurs, Peter Drucker (2006) starts with Say's definition, but amplifies it to focus on opportunity. Drucker does not require entrepreneurs to cause change, but sees them as exploiting the opportunities that change (in technology, consumer preferences, social norms, etc.) creates. He says "this defines entrepreneur and entrepreneurship - the entrepreneur always searches for change, responds to it, and exploits it as an opportunity." The notion of "opportunity" has come to be central to many current definitions of entrepreneurship. An opportunity, presumably, means an opportunity to create value. Entrepreneurs have a mind-set that sees the possibilities rather than the problems created by change.

There are many aspects that have to be considered about the caractherists of entrepreneurship, as described in Table 1, below.

TABLE 1: PERSONALITY CHARACTERISTICS OF ENTREPRENEUR: ECONOMIC POINT OF VIEW

Characteristics	Definition
A desire to achieve	The push to conquer problems, and give birth to a successful venture
Future Vision	The entrepreneur has an enthusiastic vision, the driving force of an enterprise, is usually supported by an interlocked collection of specific ideas not available to the marketplace. The overall blueprint to realize the vision is clear; however details may be incomplete, flexible, and evolving. The entrepreneur promotes the vision with enthusiastic passion with persistence and determination, develops strategies to change the vision into reality and takes the initial responsibility to cause a vision to become a success. They assess costs, market/customer needs and persuade others to join and help.
Hard work	It is often suggested that many entrepreneurs are workaholics
Desire to work for themselves	Entrepreneurs like to work for themselves rather than working for an organization or any other individual. They may work for someone to gain the knowledge of product or service that they may want to produce.
Nurturing quality	Willing to take charge of, and watch over a venture until it can stand alone.
Acceptance of responsibility	Are morally, legally and mentally accountable for their ventures. Some entrepreneurs may be driven more by altruism than by self-interest.
Reward orientation	Desire to achieve, work hard, and take responsibility, but also with a commensurate desire to be rewarded handsomely for their efforts; rewards can be in forms other than money, such as recognition and respect.
Optimism	Live by the philosophy that this is the best of times, and that anything is possible.
Orientation to excellence	Often desire to achieve something outstanding that they can be proud of.
Organization	Are good at bringing together the components (including people) of a venture.
Profit orientation	Want to make a profit; but the profit serves primarily as a meter to gauge their success and achievement.

Source: John G. Burch, Business Horizons - September, 1986 & Wikipedia, Encyclopedia, 2007.

> "Vision without action is a dream. Action without vision is simply passing the time. Action with Vision is making a positive difference."
>
> (Baker, J. 1992)

Research on entrepreneurship and its link to economic growth is vast. Although further investigation is warranted, a growing set of evidence points out the importance of the entrepreneur in bridging the gap between science and the market and in helping to increase GDP and GDP *per capita*.

In addition, The Global Entrepreneurship Monitor - GEM (2006, p. 11-16)[1] says that a systematic relationship exists between a country's level of economic development and its level and type of entrepreneurial activity. The rate of aggregate entrepreneurial activity depends on the demographic, cultural and institutional characteristics of each country.

1 See also GEM-Global Entrepreneurship Monitor, 2006 results.

> "Countries with similar *per capita* GDP tend to exhibit similar levels of entrepreneurial activity, while significant differences exist across countries with different *per capita* GDP levels…"
>
> (GEM, 2006)

TABLE 2 – COUNTRIES WITH SIMILAR *PER CAPITA* GDP LEVELS

Middle Income Countries[1]	Argentina, Brazil, Chile, China, Colombia, Croatia, Czech Republic, Hungary, India, Indonesia, Jamaica, Latvia, Malaysia, Mexico, Philippines, Russia, South Africa, Thailand, Turkey and Uruguay.
High Income Countries[2]	Australia, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Netherlands, Norway, Singapore, Slovenia, Spain, Sweden, United Arab Emirates, United Kingdom and United States.

Source: GEM 2006 results, London Business School and Babson College.[2]

Supporting what has been mentioned previously - recent literature shows that the link between entrepreneurship and growth occurs through the intermediation of new knowledge -. Hart and Oulton (1996) conduct cross-sectional analysis and reveal that newer enterprises tend to have a systematically higher growth rate than average.

Also, Audretsch and Thurik (2001) regress economic growth rates for a range of OECD counties on several measures of entrepreneurship, including the self-employment rate and the economic share of small firms, and confirm a positive relationship between entrepreneurship and growth rates.

CHAPTER 2 - ENTREPRENEURSHIP AND SMALL AND MEDIUM-SIZED ENTERPRISES

> "Entrepreneurship is the mind-set and process to create and develop economic activity by building risk-taking, creativity and/or innovation with sound management, within a new or an existing organization…it is commonly agreed that entrepreneurship is a driving force behind SMEs".
>
> (OECD, 2004)

2 IMF's World Economic Outlook Database (October 2006). Obs: (1) These countries have per capita (PPP) GDP lower than USD $ 20,000. In 2006, their average real GDP growth (2005) equals 5,4%. (2) These countries have per capita (PPP) GDP higher than USD$ 20,000. In 2006, their average per capita (PPP) GDP is USD$ 34,139 and their average real GDP growth (2005). Equals 3, 5%.

2.1 Relationship between Entrepreneurship and Small and Medium-sized Enterprises

Regardless of the level of development, and firm size, entrepreneurial behavior remains a crucial engine of innovation and growth for the economy and for individual companies since, by definition, it implies attention and willingness to take advantage of unexploited opportunities. In this respect, entrepreneurship borders with the concept of economic activity and it does not exclude large companies that could undertake innovative and groundbreaking initiatives. The role of entrepreneurship has changed dramatically and fundamentally, so that it is now seen as a requisite ingredient for economic growth, international competitiveness in the global economy and generating employment.

2.2 Measure of Small and Medium-sized Enterprises - SMEs

The activity of Small and Medium Enterprises embodies all the characteristics of the human entrepreneurial spirit. It is the quintessential of the private initiative: the entrepreneur sees an opportunity, a market, domestic or foreign, and grabs that prospect by organizing the factors of production and delivering the product - and this implies risk, innovation, and creativity. In doing that, SMEs further competition and play an essential role in developed and emerging economies alike.

SMEs possess certain advantages to operate effectively in the actual business context, given their activities and dynamism, modest flexibility and adaptability to react and adapt to changes (Peres et al, 2002). SMEs' capacity to assimilate knowledge, know-how and technology to produce and cooperate in the market place, are crucial elements that facilitate the efficient use of resources, increasing their innovative capabilities, productivity and competitiveness[3].

Finally, yet importantly, geographic proximity is an ingredient in building an environment conducive to SMEs development. This geographic concentration of SMEs and close connection between the financial aspects and non-financial aspects of SMEs reinforces that the most important precondition for a successful system of SME finance is the broader social, technological and business environment in which the SME operates.

The SMEs normally cultivate greater social and economic inclusion within the community and so stand as cornerstone of civil societies. This is what constitutes "social capital"[4], something that has to do with the trustworthiness of the social environment, the information flow capability of the social structure and the existence of behavioral norms accompanied by social and not necessarily legal sanctions.

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3 This is to say: when access to technology is not blocked due to market failures and/or lack of appropriate policies of access.

4 Defined by the OECD as "…networks, together with shared norms, values and understandings which facilitate cooperation within or among groups". Social Capital is the attitude, spirit and willingness of people to engage in collective, civic activities. Over time, social capital builds what may be termed as social infrastructure, a key item discussed in the Strategic Social Plan.

SMEs are an important pillar of job-creation, are one of the main vehicles of entrepreneurship and competition, increase the flexibility of the productive sector – a key element in the often instable process of development – and are central development of the “social capital” of any economy. In Latin America, one may say, all these characteristics seem to be even more prominent than in developed economies.

Not surprisingly, very different practices are used across countries and over time. SME reference is usually made to quantitative and qualitative elements. The most commonly used quantitative measure of an SME is the number of people employed by the business and secondly either the turnover income or the assets of the business.

2.3 START-UP AND ECONOMIC GROWTH

Why are new enterprises started? The theorethical framework linking entrepreneurship and economic growth is provided by new theories of industry evolution. In accordance with The Observatory of European SMEs (2003)[5] while traditional theories suggest that entrepreneurship will retard economic growth, these new theories suggest exactly the opposite - that entrepreneurship will stimulate and generate growth. People have an incentive to leave an enterprise and start a new enterprise in an attempt to commercialize the perceived value of their knowledge. A distinguishing feature of these evolutionary theories is the focus on change as a central phenomenon. Innovative activity, one of the central manifestations of change, is at the heart of much of this work. Entry, growth, survival, and the way enterprises and entire industries change over time are linked to innovation. The dynamic performance of regions and even entire economies is linked to how well the potential from innovation is tapped.

The traditional, equilibrium-based view is that new enterprises to an industry, whether they are start-up or enterprises diversifying from industries, enter when existing enterprises in the industry earn supra-normal profits. By expanding industry supply, entry depresses price and restores profits to their long-run equilibrium level. Thus, in equilibrium-based theories entry serves as a mechanism to discipline existing enterprises. The new theories of industry evolution develop and evaluate alternative characterizations of entry based on innovation and costs of enterprise growth.

> “Gaining access to global markets can help prospective high-growth firms realize their potential and are often an essential strategic move for SMEs with large investments in intellectual property technological capability ways of spreading”.
>
> (OCDE, 2006)

[5] Part of this chapter have been derived from: David b. Audretsch, Entrepreneurship: a Survey of the Literature, Prepared for the European Commission, Enterprises Directorate General, Institute for Development Strategies, Indiana University & Centre for Economic Policy Research (CEPR), London, July 2002. See also ESNR-European Network for SME Research. www.ensr-net.com.

OECD researches also highlight that the globalization of business has increasingly drawn SMEs into global value chains through different types of cross-border activities. Many entrepreneurs are recognizing the opportunities that this process offers and gaining access to global markets has become a strategic instrument for their further development. Access to global markets for small business can offer a host of business opportunities, such as larger and new niche markets; possibilities to exploit scale and technological advantages; upgrading of technological capability; ways of spreading risk; lowering and sharing costs and in many cases, improving access to finance.

The EU has started to standardize the concept of SME. In 2003, the Commission adopted a new Recommendation on the definition of SMEs. The new definition came into force on 1st January 2005 applying to all Community acts and funding programs as well as in the field of State aid where SMEs can be granted higher intensity of national and regional aid than large companies. The new definition provides for an increase in the financial ceilings, see Table 3.

TABLE 3 – NEWLY ADOPTED EU DEFINITION OF SMEs

Category	Number of employees	Turnover*
A medium-sized enterprise	from 50 to 249 employees	Should not exceed EUR 50 million
A small enterprise	from 10 to 50 employees	Should not exceed EUR 10 million
A micro-enterprise	Less than 10 employees	Should not exceed EUR 2 million

Source: Commission Recommendation 2003/361/EC of 6 May 2003 Concerning the definition of micro, small and medium-size enterprises, Oj L 124,20.5.2003, p.36. Obs: * Alternatively, balance sheets for medium, small and micro enterprises should not exceed EUR 43 million, EUR 10 million and EUR 2 million, respectively.

In addition to satisfying the criteria for the number of staff and one of the two financial thresholds, an SME must be independent. To this end the new definition distinguishes between autonomous enterprises, partner enterprises and linked enterprises. Finally, the new definition, introducing precise financial thresholds for micro enterprises, thus recognizes the essential role of the latter in the economy.

In the United States, when small business is defined by the numbers of employees, it often refers to those with less than 100 employees, while medium-sized business often refers to those with less than 500 employees. However, the most widely used American definition of micro-business by the number of employees is the same of that of European Union, less than 10 employees.

The OECD defines establishments with up to 19 employees as "very small"; with up to 99 as "small"; from 100 to 499 as "medium"; and with over 500 as "large". However, many establishments in some developing countries with 100 to 499 employees, the OECD definition for "medium", are regarded as relatively large firms.

In developing countries, the economic and social significance of small – scale enterprises is well recognized. They provide employment to very large numbers of men and women and, in many places, offer the only opportunity for the poor to secure some form of livelihood. By one estimate, between 17% and 27% of the labor force is employed in micro and small-scale enterprises (Mead and Liedholm 1998).

In Africa and Asia the majority of the population lives in rural areas where small-scale provide 20% to 45% of full time employment and 30% to 50% of rural household income (Haggblade and Liedholm 1991). Latin American, which is more urbanized, has an estimate 50 million micro and small – scale enterprises, employing 120 million people (Berger and Guillamon 1996).
Enterprises employments up to 50 workers are usually categorized in developing countries as small and medium-sized enterprises (SMEs). The vast majorities of these are at the lower (micro) end of the size spectrum, and employ fewer than five workers. They are characterized by low returns and generally use simple, low-cost technologies. They serve local, low-income markets, and are often part-time or seasonal concerns. Many are in the informal sector (they operate outside any regulations).

The small – scale enterprises in developing countries tend to be concentrated in a small number of industrial sectors. The majority are engaged in trading activities of one kind or another, but they also account for a large proportion of these employed in the manufacturing sector. In case of Brazil, for example, the dimensions of the companies are related to the number of employee as indicated in the Table 4.

TABLE 4: BRAZIL: DEFINITION OF SMES [6]

Enterprise	Industrial sector number of employees	Commerce and Services Sector number of employees
Micro	from 1 to 19 employees	from 1 to 9 employees
Small	from 20 to 99 employees	from 10 to 49 employees
Medium	from 100 to 499 employees	from 50 to 99 employees

Source: Micro and Small Enterprise Statute, Law n. 9.317/96 and n.9.841/99

Small and medium-sized enterprises are the backbone off all economies and are a key source of economic growth, dynamism and flexibility in advanced industrialized countries, as well as in emerging and developing economies, by playing a key role in creating new jobs.

CHAPTER 3 - ACCESS TO FINANCE

3.1 ENTREPRENEURSHIP AND FINANCING

[6] The SME sector is the base of the economy, representing an extremely respectable force in Brazil and having impressive numbers such as: totals 4.410.000 of small formal businesses; accounts for 98% of industrial, commercial and service undertakings; represents more than 60% of urban jobs and provides 21% of the GDP. In totals, Brazil has today more than 14.000.000 entrepreneurs. Despite they are a respectful workforce, they face several and crescent challenges to maintain the business running. In the period between 1991 and 2000, about 5.4 million of enterprises were constituted in Brazil; more than 3 million of them were SME. On a yearly basis, 470,000 enterprises are constituted in Brazil, however near 50% of them finishing their operations in less than 2 years. This represents a huge loss for the country's economy and the families' savings, costing near US$ 2, 5 billion per year.

"In the very competitive, global marketplace nations, that forget how their entrepreneurs contribute to technological change, productivity, resource efficiencies, and economic growth do so at a potentially high cost…"

(Drozdiak, W. 2001)

What causes economic growth? Over the long history of the development of economic doctrine, many great minds have wrestled with these questions and many have turned to the concept of the entrepreneur. According to modern economic theory, an entrepreneur is an individual who takes on certain tasks based solely on a perception of market opportunities and how to exploit them. This person is, to varying degrees, a risk taker, resource manager, innovator, arbitrager, and both creator and destroyer. Entrepreneurship is not planning by groups or management decisions by corporate bodies, but the exploitation of perceived opportunity by individuals based solely on personal judgments and visions that others either don't see or can't bear the risks of acting on. It was entrepreneurs who created the New Economy[7].

Joseph Schumpeter (1950)[8], with his evocative phrase "creative destruction," gave the most sophisticated explanation of the concept. Schumpeter was specific in arguing that the entrepreneur doesn't invent things, but exploits in novel ways what has already been invented. In combining existing inventions, the entrepreneur triggers creative destruction and brings into being new industries even as old ones are sometimes destroyed. Nor is Schumpeter's entrepreneur a risk bearer, for that role is played, in his view, by the financial intermediary who lends the funds for the new combination. Entrepreneurs then, are managers, deciding how resources will be used in a capitalist economy. They also are destabilizing agents because they change the existing relations and techniques of production. They lead the economy toward a better use of capital and knowledge, which is vital for macroeconomic growth and rising productivity. Finally, Schumpeter's entrepreneurs are the causes of business cycles because their actions create dislocations that can come in waves[9].

3.2 Finance and Medium-sized Enterprises - SMEs

Financing is necessary to help the entrepreneurs to set up and expand their operations, develop new products, and invest in new staff or production facilities. Many small business start out as an idea from one or two people, who invest their own money and probably turn to family and friends for financial help in return for a share in the business. But if they are successful, there

7 Wolfe's (2000, 17-65) essay "Two Young Men Who Went West" captures, in a way that theory could never duplicate the combination of chance, motive, attitude, and ability that created Silicon Valley and is a consistently fascinating examination of America's remarkable predilection for creating and nurturing entrepreneurs.

8 Schumpeter's definition of entrepreneurs and their activities is mostly found in his Theory of Economic Development (1961), although it is restated in his Capitalism, Socialism, and Democracy (1950, 132-33).

9 Schumpeter emerged from the Austrian tradition, and his business cycle theories as well as his ideas about entrepreneurs were influenced by previous work in that tradition. For example, it was Austrian school founder Menger who first elaborated that paradigm's view of entrepreneurs. According to Menger, entrepreneurs acquire information, make economic calculations, supervise production, and bear risks due to the uncertainty inherent in all human undertakings. But surprisingly, he held that the risk bearing aspect of entrepreneurship is trivial because of the possibility of profits. Like Menger, Schumpeter denied that entrepreneurship was primarily about risk taking (Hebert and Link 1988).

comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger business to obtain financing from banks, capital markets or other suppliers of credit.

SME identify lack of access to credit as the most important obstacle to the development of their business. This fact, in the point of view Ayyagary, B. & Demirgüç-Kunt (2003), combined with the sheer size of the SME sector around the world, explains why most countries (developed and developing) have specific programs to address SME problems and why international financial institutions devote considerable resources to address the issue of SME financing.

OECD (2006) The difficulties that SMEs encounter when trying to access financing can be due to an incomplete range of financial products and services, regulatory rigidities or gaps in the legal framework, lack of information on both the bank's and the SME's side. Banks may avoid providing financing to certain types of SMEs, in particular, start ups and very young firms that typically lack sufficient collateral, or firms whose activities offer the possibilities of high returns but at substantial risks of loss.

SMEs tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than large companies. Their survival rate is lower than for large companies. SMEs are at a particularly severe disadvantage when trying to obtain financing relative to larger and more established firms.

> "In almost every part of the world, limited access to finance is considered a key constraint to private sector growth. This is especially true of smaller firms that have minimal influence on policy reform".
>
> (IFC/World Bank, 2007)

The SME development is truly constrained by lack of financing and whether market forces do not spontaneously lead to the development of mechanism of access. There is abundant evidence that SMEs are indeed often constrained in their start-up and expansion by credit and equity rationing and/or relatively high cost of capital in most of the region. In addition the experience of several developed countries indicates that a public intervention to overcome market failure has been pervasive and its results, positive[10] .

Widespread concern exists in developing countries about the lack of access to services provided by the financial sector. In most Latin American countries, the limited access to financing is associated with specifics conditions: (a) the overall institutional and market underdevelopment in the region, which significantly limits the choices and maturities of financing to any entrepreneurs; (b) the macroeconomic instability, which leads to high death ratios and volatile cash flows, and lower growth potential of SMEs[11]; (c) the poor SME access to technological

10 This paper however does not aim at describing extensively the form, mechanisms and instruments through which such intervention takes place. This is done nonetheless in the project background and country studies.
11 More on these two natures of the problem of credit and equity rationing to SME below.

upgrading[12]; and (d)the lack of appropriate mechanisms to stimulate SME access to (domestic and particularly export) markets for their goods[13].

These dimensions are interrelated and tend to confine the growth potential and increase the mortality ratio of these companies, making financial intermediaries and investors see them as "a bad risk". The challenge in Latin America is evidently to attack these dimensions simultaneously**,** and this requires a multifaceted set of policies.

The Latin American Shadow Financial Regulatory Committee - LASFRC (2006) says that the issue of access to financial services has come to the forefront recently as a public policy problem because a positive correlation appears to exist between increased access to financial services and social inclusion. The consolidation of democratic regimes throughout the region since the early nineties has implied that sectors traditionally excluded from benefits of modernization are demanding access to them. They include the provision of financial services and credit.

In the OECD area, for instance, over 95% and up to 99% of enterprises, depending on the country are responsible for between 60-70% net job creations. Small businesses are particularly important for bringing innovative products or techniques to the market. In the US, SMEs account for over 99% of employer businesses, providing employment for over half of all private sector workers. In Japan, almost 99% of all enterprises are SMEs and account for 78% of employment. In the European Union (EU), there are almost 19 million SMEs representing 99.8% of all businesses, which provide jobs for 70 million people, which represents two-thirds of total employment in the EU. In Latin America and the Caribbean region such role is particularly pronounced: if we consider a small, albeit representative set of regional economies presented in IADB (2004)[14] small and medium-sized enterprises represent between 64% (Chile) and 96% (Argentina) of all established businesses. More importantly, they account form 35% (Mexico) to almost 50% (Venezuela) of total employment[15]**.**

CHAPTER 4 - A THEORETICAL VIEW OF THE LACK OF ACCESS TO FINANCING

In the modern theory of financing, the problem of access is often confused with that of the asymmetric information[16]. But in order to study this aspect in developing economies like those of Latin America and the Caribbean, it seems necessary to consider two apparently implicit

12 This problem in Latin America can be summarized by the motto "once a SME, always a SME". More on this below.
13 For the sake of simplicity, we name these four dimensions respectively as the problems of information asymmetry, of access to macroeconomic stability, of access to technology and of access to sales markets.

14 The countries are: Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. The dates on employment and number of firms, shown in the brackets, vary according to the availability of data sources. For production data was only available for Argentina, Brazil, Chile, Colombia, Mexico and Peru
15 On these and other data on the relevance of SMEs as job-creators, see the European Small Business Observatory (http://europa.eu.int/comm/enterprise/enterprise_policy/analysis/observatory.htm).
16 In general equilibrium models, it is assumed that in perfectly competitive markets there is price flexibility and information is perfectly distributed among the actors, and that the latter are rational and act by maximizing their utility. It is thereby shown that the resulting general equilibrium in these complete markets with perfect information is Pareto optimum, and that the resulting allocation of resources is the most efficient. The problem of asymmetric information arises when the assumption of information perfectly distributed among all the actors is not met. The consequences of this market imperfection are explained further on.

assumptions of asymmetric information models: (i) Incomplete Markets; (ii) Imperfect Information and Uncertainty; (iii) Business Cycle Volatility and, (iv) A broader framework: SMEs as a financial risk[17] .These aspects of the problem are discussed below.

4.1 INCOMPLETE MARKETS

There is strong evidence that the financing structure of the enterprise depends more on the structure and financial practices of the country where the enterprise operates than on the characteristics of the enterprise per se (for example, European Union 2001, p. 155). In Latin America, the existence of incomplete markets is therefore a key argument for explaining the problems of access to financing compared with more developed countries that have deeper financial systems.

Indeed, in early 2000, the financial systems of developing economies and those of Latin America in particular had structural problems similar to those described by Goldsmith (1969) for the 1960s: The banking sector is still relatively small and the credit supply is restricted, thereby limiting its financial operations to low-risk, short-term activities (such as discounting government debt instruments) and it remains vulnerable to external shocks.

Particular sectors suffer from the rationing of the credit supply, as is the case of the small and medium enterprise sector, consumers of scarce resources, or productive long-term investments.

- The intermediation margins of financial institutions remain higher than in more developed countries. Thus, the financing costs confronted by domestic enterprises are not very competitive and self-financing is quite common.

- The securities markets continue to be quite small and the primary markets actually shrank in the 1990s[18].

The debate over the causes of these imperfections in the financial market continues. Among the reasons most often cited are institutional problems, the inadequacy of legal and contract systems, lack of regulation and supervision, high levels of informal enterprises, along with the lack of financial futures markets. Although these factors are essential for markets to operate adequately, international experience indicates that the creation and development of markets results from an interaction of explicit policies for creating markets and market responses in an environment favorable for financial innovation (with, for example, relative macroeconomic stability)[19].

17 For a more detailed discussion of these implicit assumptions of the theory of asymmetric information, see Studart (2003)

18 See Dowers, Gomez-Acebo, and Masci (2000). Further evidence on the characteristics of financial systems in Latin America and the Caribbean may be found in Beck and others (2000) and Stallings and Studart (2002). See(table 6..3, 96) Inter-American Development Bank/FUNDES International-Developing Entrepreneurship- Experience in Latin America and Worldwide, 2005
19 Studart (2003) discusses this issue in more detail

4.2 Imperfect Information and Uncertainty

Joseph Stiglitz and other authors have focused on the analysis of problems that arise in markets with asymmetric information and, more specifically, in the process of financial intermediation[20]. Stiglitz (2001) shows that in a context of asymmetric information, actors make decisions that may result in adverse selection and/or moral hazard processes and credit and equity rationing[21].

When small enterprises seek access to financing, the high transaction costs connected with obtaining and delivering information lead to a rationing of credit and equity. However, for new enterprises the problem of access to formal financial markets is different. A newly created enterprise has no credit history, and therefore a traditional analysis of credit risk and discount of future cash flows is impossible. In this case, the problem is not asymmetric information but incomplete information or uncertainty.

To resolve the problem of lack of information, lenders may opt to request from entrepreneurs collateral, that is, a sufficiently liquid asset that may serve as a guarantee in the event of nonpayment. In Latin America, as a rule, the low development of asset markets and the obstacles of the legal system limit the types of collateral that banks consider acceptable. This sometimes leads to a problem of "over-collateralization," in which, in order to lower potential costs of executing a guarantee or collecting less liquid assets, guarantees greater than the value of the loan are sought.

4.3 Business Cycle Volatility

Finally, the most general focus of asymmetric information implicitly assumes homogeneity in macroeconomic conditions for the borrowers, that is, the risk differential is only associated with the types of project and management carried out by an individual enterprise. Nevertheless, it is important to distinguish between the settings in which Latin American entrepreneurs operate and those in more developed economies. The degree of macroeconomic volatility is one of the major differences between these settings.

Figure 1 shows average growth and the standard deviation of growth, and the volatility rate measured by the ratio of these two variables for 1992 - 2006. Although this was a period when the volatility of economic growth for Latin America and the Caribbean was relatively low, the region experienced much more significant volatility levels than did more developed economies, such as the European Union or the OECD economies. Latin America had higher interest rates, shorter maturities, and macroeconomic volatility that entailed greater risks for new enterprises. Not only are new Latin American enterprises more sensitive to business cycles, but the variations in these cycles are more pronounced than they are elsewhere in the world.

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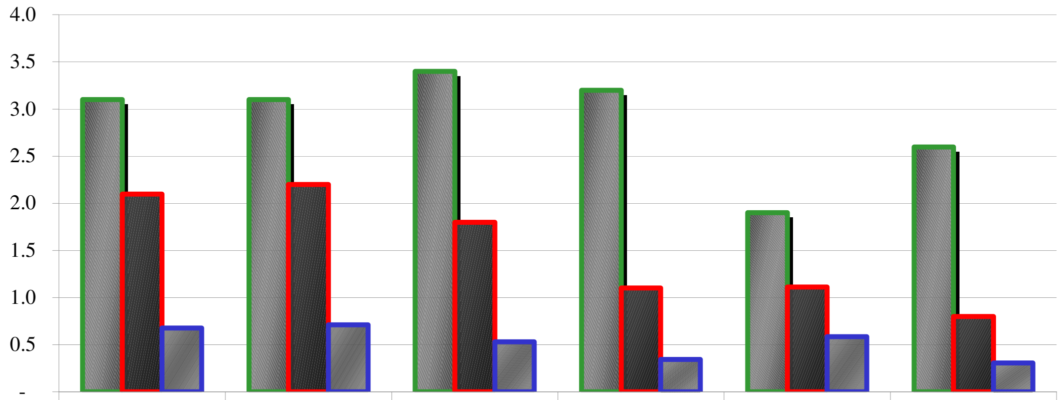
20 See, for example, Stiglitz and Weiss (1981) and Honohan and Stiglitz (2001).

21 Uncertainty is associated with the lack of past information needed to infer the probability of future events. Information asymmetries are thus associated with the lack of access to information by at least one of the actors involved. In this case, information is also necessary to infer forthcoming project results and thus, in the case of a financial transaction, default probabilities. Access to information does not assume, however, that both actors share the same view about the future; they may have different models for forming expectations or assign different probabilities to events taking place.

Figure 1 – Volatility of Economic Growth, 1992 – 2006 (In percentage of GDP)



	LAC	20 Largest LAC economies	Caribbean economies	United States	European Union	Total OECD
Average	3.1	3.1	3.4	3.2	1.9	2.6
Standard-Deviation	2.1	2.2	1.8	1.1	1.1	0.8
SD/Average	0.7	0.7	0.5	0.3	0.6	0.3

Source: Compiled by authors using data from Economic Commission on Latin America and Caribbean (ECLAC).

CHAPTER 5 - A BROADER FRAMEWORK: SMES AS A FINANCIAL RISK

The Bank credit in most of the region in developing countries is scarce and highly expensive for international standards. Lack of access to financing and credit conditions are obviously even more intensive for small and medium-sized companies than larger companies. There are ample evidence that the size of the companies may matter in determining the availability and the cost of credit and to establish whether market failure is involved.

For instance, IADB (2004: 189-191) in its analysis, highlights that access to bank financing depends on the country in which the firms are located. In USA 92% of SMEs declared to have access to bank credit – needless to say with much lower interest rates and much higher maturities than in LAC. In Latin America and the Caribbean the small firms are among the most financially constrained in the world.

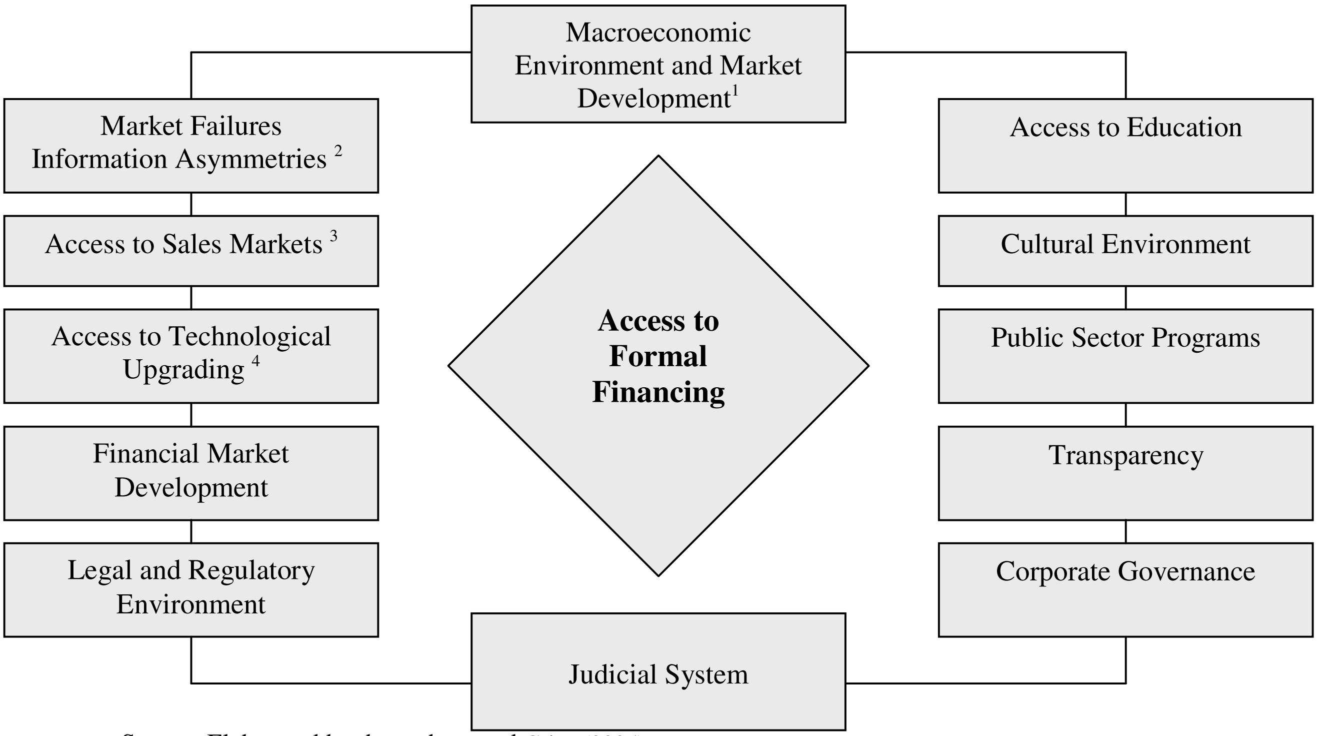
Chile and Mexico, for example, provide a contrast whereas less than a third of the small firms in Chile face major financing constraints, and these firms finance one-third of their investments with bank credit. In Mexico, nearly two-thirds of the small firms face major financing constraints, while less than five percent of their financing resources are provided by banks[22].

Evidence presented in IADB (2004: 189-191) suggests that there are four causes of credit problems for small firms: fixed lending costs; imperfect enforcement - bankruptcy costs and, asymmetric information; moral hazard and adverse selection[23]. In addition, the Griva (2005)[24]

22 For specific data of" Country Experiences in Latin America", see IADB (2004:191 - Figures 14.6 and 14.7).
23 See "Reasons for Financing Constraints" IADB (2004:190 - 195).
24 See Sonja Griva Zabert (2005). Developing a Matrix for Small and Medium Business Access to Finance.

identified eleven key factors that have recursive effect on SME access to finance Fig. 2: macroeconomic environment; financial market, development; legal and regulatory environment; judicial system; market access; access to technology; access to education; cultural environment; corporate governance; transparency and public sector programs.

FIGURE 2 – ACCESS TO FORMAL FINANCING



Source: Elaborated by the authors and Griva (2005)

Legend
1. Macroeconomic soundness to avoid excessive business cycles, Interest rates and spreads and Market-enhancing policies to promote higher levels of intermediation.
2. Appropriate regulation and supervision, Legal and tax incentives for formality; Lack of information-enhancing institutions (such as credit bureaus and other).
3. Logistics and training, Programs for marketing and access to domestic markets, Programs for marketing and access to foreign markets.
4. For financial management and programming, in management of information, production and distribution.

These recommendations are indeed relevant to the problem of SME financing, such as the problems of appropriate regulation and supervision, corporate governance, availability of information and so on, but in our view, when it comes to policy making, we need to go far beyond their original "basic" theoretical background.

The modern finance theory indicates that information problems are inversely associated with the existing supply and cost of capital intermediated through formal financial systems. Information opacity and/or high transaction costs to access needed information are central in explaining the lack of SME to private financial systems in all market economies - developed and developing, with developed and underdeveloped financial markets. The problem seems to be more acute in Latin America for several reasons, of which we can mention a few[25]:

- Financial underdevelopment caused by inadequate institutional framework, both for the financial system and the corporate sector. The development and depth of local of domestic financial systems are knowingly low in Latin America economies: all have bank-based financial systems with little development of securities markets, except for government bonds markets. And even the supply of bank credit is limited and costly, due to the high intermediation spreads. Even larger and established companies either face credit rationing or have to accept lending rates that are far above the international ones. In addition, the crowding-out effects of high public debts even some large firms have to face high costs of capital, if not credit supply rationing and for SMEs "mortality levels" are relatively high – implying higher credit and market risks.

- Informality is by itself a constraint to access to formal financial system. Inappropriate tax and regulatory environments towards SMEs make startup and running costs prohibitive, pushing most of SME into informality. This informality in turn is a major impediment to their access to formal financial systems.

- Extreme volatile macroeconomic environments create also volatile future cash flows to SMEs, increasing their risk as perceived by financial intermediaries. Those in turn accordingly tend to charge high interest premia to these companies and to only provide credit of short maturities. This in turn generates a vicious circle: high interest rates and short liability structure makes SMEs highly sensitive to business cycles.

- The risks of lending to SMEs increase due to the lack of appropriate collaterals, or because such collaterals are not fully marketable. Lack of appropriate and agile judicial systems make the recovery of collaterals in case of default a long and inefficient operation. The local judicial systems do not fully protect the access of creditors to guarantees in case of default, making collaterals almost worthless.

The lack of competitiveness has to do with the volatility of the macroeconomic environment – a quid pro quo to increase access to formal financing – and to the overwhelming informality in which SMEs operate in the region, the lack of access to technological upgrading and lack of capacity to enter and maintain sales markets (including exports).

In Latin America and the Caribbean, the lack of sound macroeconomic environment often leads to high interest rates and highly volatile business cycles. Even though this dimension affects the whole corporate sector, micro, small and medium-sized enterprises suffer the most because of: their little product diversification, which makes their income-flows very sensitive to the

25 Policies to mitigate these obstacles have been introduced in several OECD as well as in other developing economies in their history. And some of them could be used as guide to draft policies to SME in the region.

variations of demand and/price of specific products and, their lack of access to long-term financing and high levels of interest rates they are charged make them very fragile financially. Market failures associated with information asymmetries makes SMEs even more risk for financial intermediaries, because of (i) the poor quality of credit/investor information they can offer; and/or (ii) the high costs of transactions to obtain information (relative to the size of credit/investment demanded by them); and/or (iii) mere lack of information (such as in the case of startups or innovative SMEs).

Because the transaction cost of reaching markets (particularly exports) vis-à-vis the revenues of SMEs, their capacity to expand is severely impaired. Evidently firms that have little capacity to expand represent a bad financial risk. This lack of competitiveness is further aggravated by the lack of access to technological upgrading.

Thus SMEs are particularly a bad risk for financial intermediaries because, due to these dimensions, SMEs in Latin America and Caribbean, in contrast to what is observed in developed economies, have little growth potential and are condemned to a deadlock: once a SME always a SME.

Given the long list of constraints to SME access to financing, and the short-term political life cycles, in LAC policies to overcome them have often centered on special public financing programs. As usual, such short-term solutions for structural problems tend to have shortcomings: for instance, because of the immense social demands of the poor economies of the regions, such programs often represent uses of fiscal funds that could be alternatively employed in poverty-reducing initiatives. In addition, because the sustainability of such programs depend on the fiscal strength of governments, at times of fiscal retrenchment they are likely to be reduced – and even discontinued – causing severe additional shortage of financing to SME.

In sum, if these dimensions mentioned above are not fully confronted policies to increase SME access to financing will intend to be particularly costly and little effective. This explains why even in developed economies, success stories in facing the challenges of SME financing encompass different policies to deal with each of these dimensions.

Why is SME access to financing a legitimate policy issue? SMEs are critical for economic development for many reasons, they contribute to the fundamental elements of poverty reduction: job creation, added value and productivity growth in environments where economic opportunities are otherwise limited.

Even though SME are clearly central to socio-economic development, due to the complex and deep social demands in Latin America, it is legitimate to ask why governments and multilateral agencies should dedicate their resources to the development of specific types of enterprises. That is, we need to ask whether or not they are constrained by start-up and operation-related financing. Indeed they are: in a recent report, the IDB (2004:14) claims that "the major problem faced by businesses in Latin America and the Caribbean is accessing financial markets"[26].

26 The report goes on to state that " More than 2,000 firms in the survey are from 20 Latin American countries, and 80 percent are classified small and medium. Small firms in Latin America and the Caribbean are among the most financially constrained in the world covered by the World Business Environment Survey, access to credit was reported by entrepreneurs as their most serious concern".(ibid idem)

Indeed, the low financial depth and development of most financial systems in the region is a clear indication that financing is in reality a privilege of relatively few LAC firms[27.]

In sum, given the economic and social role of SMEs and their restricted access to external formal financing, SME access to finance is a legitimate policy issue[28]. In order to draw policies, we need to have a theoretical framework and build on the experiences of other economies. These are the topics of the two next sections.

CHAPTER 6 - DRAWING POLICIES TO INCREASE ACCESS OF SME TO FINANCING

In the view of the conclusions of the previous section, it is not surprising that, when it comes to the "real-life" arrangements in developed economies to deal with the problem of SME's lack of access to financing, the scope of policy intervention is significantly wider than conventional analysis implies.

Literature on the access of SME to financing has produced a number of studies one empirical investigation that help to identify specific policies directed to improve the access to finance.

Indeed in most OECD economies specific institutions were created to overcome the main problems related to the market rationing of finance to SME. In the last fifty years, OECD countries have additionally launched a variety of initiatives aimed at SME support that can be considered as a starting point in the definition of role and boundaries of Public Sector intervention. These policies can be classified in five types:

- **Policies to mitigate the lack of access to seed capital** often involve either direct financing or incentives for venture capital. This is the case of the European Technology Facility - "ETF Start-up Facility" included in the Growth and Employment Initiative put forth by the European Parliament. This initiative also includes two additional schemes: a risk capital scheme and the Joint European Venture (JEV) scheme, created to help SMEs establish transnational joint ventures within the European Union (EU hereafter). Also we find the Seed Capital Action (CREA), an EU initiative aimed at stimulating the supply of equity finance for the creation and transfer of innovative smaller businesses with growth and job-creating potential through the support of seed capital funds or similar organizations. It creates an EU-wide network for seed capital funds. Also, in order to encourage more firms to take advantage of an Initial Public Offering (IPO), the EU is helping SMEs access the appropriateness of a stock market listing as a mean of funding.

- **Collateral-substituting policies** are also common due to the fact that even in developed economies formal financial institutions often demand high collaterals, which cannot be met by them. This type of program aims at providing additional guarantees to overcome the problem. In the fourth case, the European

27 This has become an even more pronounced problem since the Asian crisis, from when the regional economies started having increasing problems of "credit stagnation". On this see Barajas and Steiner, 2002.
28 Not surprisingly policies to enhance their access to formal financial systems are so widespread, even in developed economies.

Commission has developed the SME Guarantee Facility, which "provides guarantees to support the investment activity of innovative SMEs and aims to promote an increase the number of loans to small or newly established businesses by facilitating an expansion of the activities under the guarantee schemes". The Commission also part-finances feasibility studies on the creation of mutual guarantee companies and co-finances their launch. In addition, in the US has an independent agency of the federal government the Small Business Administration (SBA) which helps Americans start, build and grow businesses. The SBA and private sector partners make available technical assistance programs including training, counseling and mentoring, and information services to more than four million existing and potential small business entrepreneurs annually.

♦ **Incentives for special private credit programs for and the acquisition of securities issued by existing SMEs,** such as tax and other types incentives to intermediaries that have special lending programs to SMEs, are also common.

♦ **Policies to stimulate and facilitate SME access to formal financial intermediation** are also common. These include the creation of specialized stock exchanges, simplified disclosure procedures, incentives for the acquisitions of SME securities by individual and institutional investors and so on. The EU is implementing the fiscal and structural reforms to promote investment in venture capital funds, amending legislation on insolvency and bankruptcy, and promoting innovative employee ownership schemes. The Commission is also proceeding with regulatory actions to facilitate venture capital investment by institutional investors, thus make it easier for SMEs to raise cross-border risk capital.

♦ **Policies to improve competitiveness, through access to technology and/or access to sales markets.** Complementary policies**:** Policies to improve the capital markets. However policies to improve access to financing may not he fully effective if not complemented with on-financial support for the functioning and expansion of SME exist in most OECD economies: there is a myriad of programs to support the technological upgrading and the access of SME to internal and export markets. These policies provide SME with a stronger competitiveness and capacity to expand, and therefore mitigates the risk perception of private investors and bankers about these enterprises. The Small Business Administration (SBA/US) has a variety of programs which combine the four categories mentioned above: plan your business, start your business, manage your business and getting out.

Another interesting aspect that comes out of the experience in developed economies is that the intensity of implementation of these five types of policies varies according to the degree of development of domestic securities markets and overall financial depth. It is clear that, for instance, policies to co-finance and increase collaterals are more popular in the bank-based European economies than in the capital-market based US economy. In contrast, policies to increase access of SME to capital markets are more common in the USA, through different types of venture capital initiatives.

Thus, when using these experiences to draw lessons to Latin American economies, one must consider the "initial conditions" in which such policies have been implemented. First, even though macroeconomic stability is not necessarily a norm in the post-war period, macroeconomic volatility has been low in relation to Latin America. This means that the business environment of OECD economies is much friendlier to the establishment and expansion of SMEs, long term interest rates tend to be much lower and the average maturity of credit much higher.

CHAPTER 7 -CONCLUSIONS AND POLICY RECOMMENDATIONS

Thru views have guided this paper: First, the survey findings indicate that the lack of access to formal financing in Latin America represents a major obstacle not only to the creation of enterprises, but also to their survival and growth. Second, policies to improve the access of SME to formal financial financing must address the causes for which SMEs constitute a bad risk for investors and banks. Third, that a good public policy in countries where fiscal resources are relatively scarce vis-à-vis the significant social demands for basic public utilities (education, health and poverty alleviation) – can only be effective if they enhance the capacity of SMEs to expand and to access sources of finance by their own means.

The Latin American entrepreneurs are forced to establish their enterprises with an initial investment that is less than that of European entrepreneurs. When resources are not available, the entrepreneur is forced to cut back on the starting size of the enterprise, look for new partners, or delay starting the business, which can lead to losing the business opportunity that had been detected. More important, the **lack** of financing contributes to the technological backwardness of new enterprises in the region.

Despite these limitations, some entrepreneurs in Latin America are able to overcome obstacles and start their businesses, although financial difficulties may continue during the early years of the enterprise. At this phase, the use of formal sources remains below that of the other regions, and dependence on informal financing sources increases. The enterprises are forced to survive by availing themselves of financing from suppliers and customers, purchasing used equipment and machinery, and using poor business practices, such as falling behind in the payment of services, salaries, or taxes. Under particular conditions of a tight credit supply, the use of these sources may be considered good entrepreneurial practice, however, it is a good idea only in the short run. The instability of these financing sources leaves enterprises in a situation of financial vulnerability that becomes problematic over the medium and long run[29].

The access to finance for SMEs is a public policy issue and it constitutes a long-term process, and not just a product of willingness, resources or policy rights. A guideline to deal with the problem should then consider a medium-term and a long-term strategy. The medium term strategy involves policies to alleviate the lack of access by introducing risk-mitigating policies, such as the creation of improving the quality and transparency of SME accounting information,

29 See Studart, R & Suaznabar, C. Access to Financing: a Challenge to Dynamic Enterprise Creation - Developing Entrepreneurship: Experience in Latin American and Worldwide, IADB,2005.

e.g. credit bureau, training SME administrators in account and financial disclosure methods; tax and other incentives to increase the formality of SMEs; building collateral-substituting mechanisms, such as credit guarantee schemes; developing direct credit schemes and supporting venture capital using earmarked public funds.

The longer-term strategy should include: (i) Policies to reduce macroeconomic instability necessary to create a more stable business environment for SME. In this context, fiscal discipline and macroeconomic soundness are crucial not only to maintain stability but also for the success of establishing a sustainable financial and capital market and, (ii) Institution building and marketing enhancing policies to foster the development of financial markets in general but also financial intermediaries specialized in granting credit to SMEs and markets specialized in dealing with SMEs. The development of an appropriate regulation, clear and transparent rules of the game and supervision is a sine qua non for the development of any market. In addition, the global environment suggests that a regional or geographically larger dimension facilitate significantly national endeavors – financial institutions and markets need economies of scale and scope in order to be able to compete internationally, and therefore, for their own sustainability.

These policies are needed to foster the process, not to substitute it. The continuous question to be addressed is what the proper role of the public policy is so that Government intervention does not overstep the role of the market, and where scarce fiscal resources are in the long run used in the most socially efficient way. A lasting way to face the problem is thus to introduce market enhancing policies, that is, policies that are meant to improve the conditions of SME to access formal financial systems as well as to increase the size and depth of financial markets – particularly those that are specifically intended for SME.

Governments or multilateral institutions have the task of supporting the establishment of the regulatory and legislative environment and its enforcement that would in turn facilitate access to financing, but also in drafting and implementing such market enhancing policies. The philosophy of the action could be that the public sector would act to facilitate the communication and find common interests among the different segments of private sector. The leadership of policy makers and the participation of the beneficiaries are crucial ingredients for success.

This paper has provided a theorethical framework to make the financing to SMEs effective. The framework implies the analyses of series of obstacles, measures of SMEs, policies directed to favor financing and complementary policies. This framework also includes appropriate measures of these variables that would allow evaluating the effectiveness of the policies.

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