



## *Focus on Enterprise*

# DEMYSTIFYING THE ROLE OF MICROFINANCE IN JOB CREATION

*The paper discusses the role of microfinance in job creation through self-employment and microenterprise. Despite high expectations, in general microenterprises have a limited however socially important contribution to job creation. It is necessary to distinguish between growth-oriented young firms that have a potential to create jobs and self-employment and microenterprises which remain small. If microfinance focuses on the latter group, its impact on job creation will remain small. It may be more economical to reposition microfinance to become a more flexible micro-venture instrument that will fund job creators while leaving support for self-employment and microenterprises to other social programs, including seed capital grant funds.*

## INTRODUCTION: BETWEEN GOOD INTENTIONS AND REALITY

Employment creation is a common objective of microfinance institutions in Europe well in line with the employment policies of the EU and national governments. According to the latest survey of microcredit providers - EMN and/or MFC members - 70% of the institutions from 22 European countries<sup>1</sup> indicated job creation as their mission. Additionally, 60% of MFIs stated that they aimed at microenterprise promotion.

This strong focus seems to be driven by the underlying assumption that job creation and reduction of unemployment can be achieved by microenterprise promotion, and that microfinance has an important role to play. However, recent

research<sup>2</sup> has uncovered a more realistic contribution of microenterprises demystifying their role as an engine of growth in job creation. Also, the effectiveness of self-employment and microenterprise development promotion programs on the reduction of unemployment has been questioned to show at best modest and often ambiguous impacts<sup>3</sup>.

Despite these findings, the disconnect between the old stylized facts about the job creation potential of micro- and small enterprises promulgated by public policies and media alike and the evidence of job creation and job retention by firms of various size and age still remains, and distorts the policy recommendations to become more effective.

<sup>1</sup> 'Microfinance in Europe: A Survey of EMN-MFC Members. Report 2014-2015', EMN and MFC, December 2016 available at <http://mfc.org.pl/microfinance-in-europe-a-survey-of-emn-mfc-members-report-2014-2015/>

<sup>2</sup> See for example, John C. Haltiwanger, Ron S. Jarmin and Javier Miranda, 'Who Creates Jobs? Small vs. Large vs. Young. NBER Working Paper, August 2010

<sup>3</sup> For a review, see Paffhausen A.L., Grimm M. 'Creating jobs in small businesses. Evidence from a systematic review', Evaluation Insights No. 9, May 2014

## STYLIZED FACTS AND EVIDENCE FROM THE EU

MFC's recent research<sup>4</sup> critically reviewed the available evidence about the job creation by the EU firms of different size, age, and sector of operations. The following is a summary of the key findings and their implications for the role of microfinance in job creation.

### Self-employment, microenterprise, and entrepreneurship

While often used interchangeably, self-employment, microenterprise and entrepreneurship are not the same. Entrepreneurship is fundamentally related to innovation and an ambition to grow a business. Self-employment activity is instead associated with flexible employment forms and an alternative to dysfunctional economic and employment systems. Microenterprises are small firms that can be younger or older, which either choose to be very small, or by their very nature of a business, remain small regardless of their age and stage of development.

Entrepreneurial firms that grow are likely to create jobs beyond the initial minimum number to start a business, and some even reach substantial levels of growth and jobs. Self-employment and microenterprises more often than not remain small, out of choice or economic necessity, and do not create any significant number of jobs.

Recognizing the differences between these types of business development, efforts should be made to analyze them separately in terms of their job creation potential. Equally important, the role of microfinance is different for each type of these businesses, being most relevant in its current form for self-employment and microenterprise development.

### Self-employment, microenterprise, and unemployment reduction

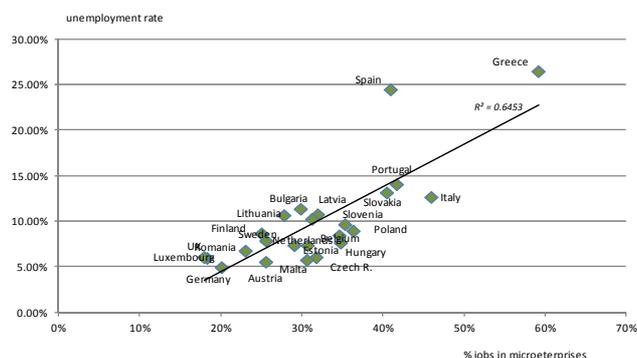
There is little evidence that self-employment is a way to significantly reduce unemployment, although it is a socially important component of active labor policies. On average, the job creation potential of self-employment is limited. For one reason, the sheer number of new enterprises entering the market

<sup>4</sup> 'Of Mice and Unemployed: Rethinking Micro-Enterprise and Small Business Policies in the EU'. Policy Note No. 3, Microfinance Centre (MFC) 2015

would be very high. To bring the unemployment rate down to the natural level of 5% in each country, the number of firms in the European Union would have to increase by over 50%, which is not realistic. Secondly, any significant unemployment reduction would require that at least 10% of the unemployed start their own businesses while the typical propensity of the unemployed to become self-employed is about 2-3%, rarely exceeding 5%.

The contribution of self-employment and microenterprises to reduce unemployment remains low in the EU. In fact, there is a correlation between unemployment and the number of jobs in microenterprises: countries with high unemployment have a high proportion of people employed in microenterprises, which invalidates the tenet that microenterprises mitigate unemployment.

**Figure 1: Microenterprise Employment and Unemployment (2014)**



Source: Own calculations based on Eurostat data

### Sales growth or job creation

As a general matter, job creation is not the purpose of any business, not all businesses even grow in terms of the volume of sales or turnover, not to mention adding new employees. However, job creation is strongly correlated with the growth of the volume of operations<sup>5</sup>. Few firms invest in expanding staff numbers without increasing sales in the same period. The data show that about 40% of small businesses increase their turnover and this rate is fairly constant over the years. However, only a quarter of firms create new job positions. Furthermore, small and medium-sized enterprises rather than microenterprises and older rather than nascent firms are more often seen among those

<sup>5</sup> Pytkowska J., Korynski P. (2015) 'Financing Gap and SME Employment Growth: Beyond Access to Finance'

increasing the number of employees. There is even a smaller number of 'gazelles' - only one in ten small businesses manages to grow their staff numbers by more than 20% for three years in a row.

### Quality of jobs created by microenterprises

It is not only the quantity of jobs created but also the quality of jobs that is troubling. The quality of jobs in microenterprises, and often in small enterprises in comparison with larger firms, is lower both in terms of the stability and economic gains. This is reflected not only by lower wages paid by microbusinesses<sup>6</sup>, especially start-ups, which cannot typically afford market wages, but equally important to lower level of social benefits such as health and pension benefits. This is driven by the need to reduce costs for the business, but it has a long-term implications for the workers employed and the overall social protection system.

Additionally, small businesses are more vulnerable to business cycles: self-employed and microenterprises are typically the first to lose in the advent of an economic crisis. This may explain partially the high volatility of employment by microenterprises mentioned earlier.

### Microfinance and job creation: a weak link

Job creation potential of microfinance is as good as the job creation capacity of firms in which microfinance invests. As already mentioned earlier, the current form of microfinance practiced in the EU area, with a strong focus on self-employment, very small and microbusinesses, does not contribute substantially to adding new jobs in the economy. Some studies show that one microenterprise creates on average 1.1 jobs, that is one in ten hires an employee beyond the self-employed founder. Even if a new firm created one additional job, the number of jobs is still small, and as already mentioned, this job may be quickly lost.

More importantly, the predominant number of new firms are started without the support from a microfinance institution. Microfinance organizations in France, for example, finance less than 3% of all

<sup>6</sup> Eurostat data (2014) from 8 countries show that annual earnings in microenterprises are 16% lower compared to small firms and 27% lower compared to medium-sized companies (own calculations)

new startups in a year, and this percentage is even lower in other countries. This shows only a marginal contribution of microfinance to job creation in general<sup>7</sup>.

### CAN MICROFINANCE BE MORE EFFECTIVE IN JOB CREATION?

Given the above considerations microfinance should not be expected to have significant impact on job creation and unemployment reduction. But it does not mean that it does not have a role to play, although this role should be redefined in the view of the evidence. The question is then what impact in the employment area can be expected and how to best leverage the resources when working with microenterprises which create a very limited number of new jobs and disbursing loans up to 25,000 Euro.

There is only a narrow segment of microenterprises which are job creators led by growth-oriented entrepreneurs. Such enterprises, if not already served by banks or other support organizations such as business incubators and accelerators, can benefit from support helping to overcome the growth obstacles.

The selective approach of financing only growth-oriented enterprises would require using better selection tools to identify the most promising enterprises and projects. This can be achieved taking the advantage of the following:

- Seeding with risk capital: MFIs can support businesses larger than micro and with bigger financing needs (above 25,000 Euro) by providing co-financing, subordinated loans that are treated as risk capital to access larger funding.
- Cooperation with banks to identify promising businesses which need financing but are not eligible for bank products. There are already examples of microfinance institutions which collaborate with banks and work with enterprises with potential but ineligible for bank financing.

<sup>7</sup> The EMN-MFC research shows that in 2015 220,305 business microloans disbursed in the EU countries. 'Microfinance in Europe: A Survey of EMN-MFC Members. Report 2014-2015', EMN and MFC, December 2016 available at <http://mfc.org.pl/microfinance-in-europe-a-survey-of-emn-mfc-members-report-2014-2015/>

- Cooperation with business incubators: MFIs can liaise with business incubators to provide complementary services to the business.
- Organizing business plan competitions: Such competitions can help to identify the most promising business plans in terms of business growth and job creation.

The vast majority of microentrepreneurs are necessity entrepreneurs or entrepreneurs who choose not to grow and usually only create their own job. Neither do they exhibit entrepreneurial ambitions, nor do they create additional employment. Addressing this group is of high social importance, however, the interventions are unlikely to create more employment. Instead, they should support this group to stabilize their incomes, retain jobs and improve the quality of employment.

Given the already low and unstable incomes of many microentrepreneurs, new types of products are needed. Many enterprises need long-term investment, so the MFIs can offer other forms of financing such as:

- Patient capital (micro-equity, micro-venture) that gives the time to grow
- Hybrid venture loans - loans combined with venture capital with long grace period
- Equity investment with revenue or profit participation

Moreover, MFIs can engage in providing non-financial services that support business development and address other growth constraints. Some microfinance institutions in Europe already provide advice and training or coaching to improve business management skills of their clients not only as a pre-loan assistance but also as a post-loan assistance such as business advice or marketing support.

## Conclusions

Like other methods in economic development, microfinance has its limitations which should be recognized and microfinance should be applied where it can contribute most in a cost-effective way from the point of view of private investments and public policy supporting microfinance in the EU. The effectiveness of microfinance as a tool for economic

growth and job creation is dependent on the growth potential of firms in which microfinance invests. As the evidence shows, self-employment and microenterprises play an important role from a social perspective but have a limited impact on the job creation and unemployment reduction.

It may be more economical to provide micro seed capital for self-employment in the form of grants, and to reposition microfinance to offer risk capital to those entrepreneurs who survive the initial stage and have potential to create economic growth and jobs in the economy. The seed grants, which have been successfully applied by some countries in the EU, are cheaper to administer than operationally expensive microcredit, and allow the potential entrepreneurs to take more risk, therefore have a large chance of creating a more sustainable enterprise. Unlike microcredit which must be repaid and leaves the entrepreneur with little of their own, the initial seed grant becomes equity in the business which then lays the ground for future larger investments.

Also, given the large variety in which entrepreneurship emerges, there should be a variety of 'micro-funding' approaches that could better match the early stage needs of micro- and small firms, recognizing that the traditional microcredit may not be the best financial solution. This includes social enterprise innovations in various forms that emerge as purely social, business or blended operations, creating more opportunities for job creation than the traditional microenterprise focusing on size rather than market opportunity and creativity of the entrepreneurs.

### Contact us to learn more:

#### Microfinance Centre (MFC)

Noakowskiego 10/38  
00-666 Warsaw, Poland  
tel: + 48 22 622 34 65  
microfinance@mfc.org.pl  
www.mfc.org.pl



This publication has received financial support from the European Union Programme for Employment and Social Innovation "EaSI" (2014-2020). For further information please consult: <http://ec.europa.eu/social/easi>. The information contained in this publication does not necessarily reflect the position or opinion of the European Commission.