



## *Focus on Enterprise*

# OF MICE AND UNEMPLOYED: RETHINKING MICRO-ENTERPRISE AND SMALL BUSINESS POLICIES IN THE EU

*Persistent high unemployment in many EU countries prompts governments to seek new job creation options. Promoting jobs through self-employment and small businesses is an alternative strategy that carries high hopes and attracts a lot of policy attention on the theory that small businesses create the majority of jobs in the economy. However, despite the widespread support for small business startups – from entry to the growth dynamics in the first years of their existence – their role for job creation is not well understood and the policies may be following the wrong prescriptions. The paper discusses the complex relationships between firms size and job creation in the EU which shows that there is a need to better understand the dynamics of the job creation and destruction process. Evidence rather than erroneous beliefs should guide small enterprise development, including financing micro and small businesses through microcredit to make them effective for job creation.*

### **SMALL BUSINESS AS AN ENGINE OF GROWTH HYPOTHESIS**

Small businesses<sup>1</sup> continue to be seen as engines of growth and creators of employment. Statements like “small businesses create the majority of our economy’s jobs” are often heard from politicians and are the basis for national strategies and EU recommendations. An implicit assumption appears to be that countries and industries with a large number of small firms and startups also tend to be those where most innovative high-growth firms emerge.

If this were to be true, and the objective was to increase employment, the simple policy prescription would be to

increase the number of micro and small enterprises. It turns out that this long-standing view may not be accurate. Policies focusing on the size of an enterprise in general do not seem to bring the desired outcomes in employment, and pro-SME policies may not be pro-employment.

The small business strategy is predicated on the belief that micro- and small businesses create the majority of the new jobs in the economy. But this does not find support in evidence. Most new businesses start small, remain small and die small. Those which create jobs also destroy jobs, and the net outcome – which is rarely mentioned in the policy rhetoric – is small and sometimes positive in some countries. Only a small percentage of the newly created businesses survive and grow to create positive additions to employment in the economy. In Europe, 50% of net jobs created by SMEs is created by 4% of the firms. Enterprises are more likely to

<sup>1</sup> A term ‘small business’, while having an official EU definition, is often a shortcut for all smaller firms, including self-employment, microenterprise and small businesses proper. This general meaning is used throughout the paper unless a specific reference is made to the size of a business.

graduate from the 10-49 employee small business class to the medium size category than from 1-9 employee micro-enterprise class to the small business size<sup>2</sup>.

Therefore, the claim that micro and small businesses create the majority of new jobs in the economy is only partially true and policies supporting micro-enterprises and SMEs need to take a broader, more accurate view of the employment potential of the small firms.

Moreover, the job creation potential of self-employment and new start-ups may be limited. In Poland, for example, in order to decrease unemployment by 1%, about 150,000 new firms would have to be created, which is 10% of all existing firms. This would also require that 10% of the unemployed pool choose self-employment, much more what practice shows is the typical propensity (3-5%) of the unemployed to become self-employed. To bring the unemployment rate down to its natural level (5%) through this strategy, the number of firms would have to double, which is clearly not a feasible solution in the immediate future.

The belief that small businesses create most jobs is based on three observations: (1) one sided view of job creation potential of small businesses: while it is true that micro- and small business create most new jobs, they also lose most of the jobs, and the net effect is often a zero sum game and sometimes weakly positive, therefore we need to look at the **net effect** and not only at the creation outcome; (2) conflating firm size and age effects: most jobs are created by new **growth-oriented firms**, which typically are small, therefore it is difficult (especially in absence of appropriate data and research methodology) to distinguish which - new or small- firms are the true job creators; (3) assumption that **self-employment** is equivalent to entrepreneurship: more often than not micro- and small businesses are not truly entrepreneurial or innovative, and do not grow, therefore applying models based on entrepreneurship theory leads to wrong conclusions and wrong policy prescription when applied to the whole universe of new start-ups and self-employed.

To complicate matters more, there is a class of new self-employed<sup>3</sup> ("NSE") independent contractors composed of two distinct groups: highly skilled professionals and unskilled laborers. While some of them are truly self-employed, a portion of the NSEs do not fully control their own work or do not bear all the risks associated with the work, which are characteristic for typical self-employed entrepreneurs. Some people become NSEs out of their own choice, but NSEs are also pushed to accept the flexible labor arrangements by employers which seek to externalize their labor costs and reduce social contributions. Therefore, in the era of flexible labor contracting not all self-employed create new jobs as they may just change the form of legal arrangement for the same job. And new forms of self-employment emerge such as prompted by the "uberization" of the economy, which do not lend themselves to the current definitions of an employed and self-employed.

These observations have important policy implications for the EU employment and enterprise policies. Targeting firms based solely on size (e.g., self-employment and micro-enterprises in particular) without taking into account the role of firm age and the growth orientation of firms and the type of self-employment arrangement are unlikely to have the desired impact on the overall job creation. Specifically, betting on the 'micro' revolution through the newly discovered microcredit in the EU may be a misguided policy. The policies need to account for complex dynamics of new and older firms of various sizes and industry sectors, and not only focus on 'small' and jobs per se. They should identify the market failures that prevent entrepreneurs from starting and growing their businesses.

While true in general for the EU, there are significant differences in job creation outcomes among the member states; in some countries microenterprises contribute positively to the net job creation, but more often than not, more microenterprise jobs disappear than are created in a given year. Clearly, one uniform policy across the varied landscape of EU member states is unlikely to produce the same results. And if sustainable job creation is the objective, the focus needs to be shifted to firms

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<sup>2</sup> Gomez G., Do Microenterprises Promote Equity or Growth? 2008

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<sup>3</sup> Mies Westerveld, The New "Self-Employed": An Issue for Social Policy? European Journal of Social Security, Volume 14 (2012), No. 3.

that lead to creation of jobs in numbers that can reduce the high unemployment levels in the EU.

## WHO CREATES JOBS? A RESEARCH PERSPECTIVE

There is growing empirical research<sup>4</sup> showing that the majority of jobs reside with the established and the larger firms, not necessarily small firms. It is the new firms – the start-ups – that contribute to the growth rate of job creation (and destruction). The inverse relationship between employment and firm size – that small firms create disproportionately more jobs than the large ones - which has been long assumed to exist, disappears when it is corrected for the age of the firms: there is no systematic relationship between size and growth when age of firms is added to the analysis.

An overwhelming majority of the self-employed are not entrepreneurial as they never bring an innovation to the market and do not plan to grow their business. In most countries the industries with the largest concentrations of self-employed men are construction, services, auto repair, restaurants, truck transportation, and farming. For women, the corresponding industries include private households (cooks and maids), child day care services, restaurants, and beauty salons. The majority of small businesses have no employees other than the owner or a few employees. Nor do most small businesses eventually grow large. Most small businesses are best described as permanently small rather than nascent entrepreneurial firms.

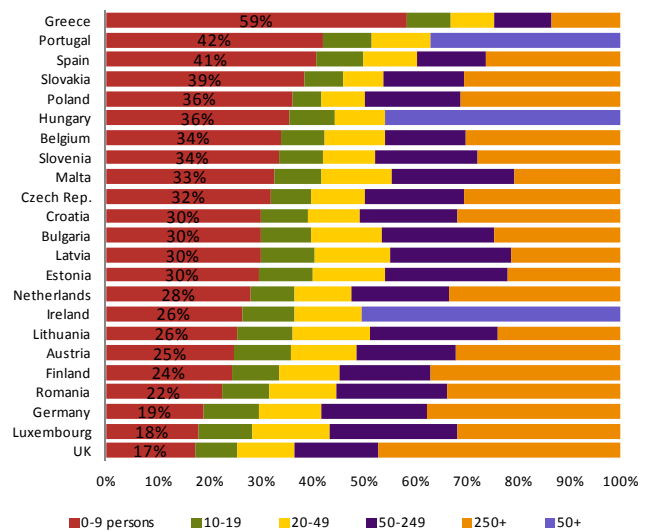
Shane<sup>5</sup> argues that necessity-driven (involuntary) and opportunity (voluntary) entrepreneurs constitute two different groups of enterprises which should be treated separately, documenting a negative cross-country correlation between having many high- and low-expectation startups. Necessity enterprise owners are under pressure to make money from the very beginning, to provide income for the owners (and repay credit if the businesses is funded by debt). Being the main source of income for the family, necessity business cannot afford

to innovate and experiment, which is more likely to take place by the opportunity driven entrepreneurs.

Baumol<sup>6</sup> distinguishes between “innovative” and “replicative” entrepreneurs, where the former are the type of entrepreneurs who are innovators and prone to growth. Both types of businesses are important for a well-functioning economy, but their workings are entirely different. Innovative and replicative businesses operate in different ways, but are not easily distinguishable in statistics, which means that special approaches must be designed for policies and programming to target the true job creators.

Hurst and Pugsley<sup>7</sup> argue against using self-employment as synonymous with entrepreneurship. They estimate that only 10–20% of small businesses report any innovative activity at all and point out that when startups were asked about growth ambitions, 75% of respondents stated that “I want a size I can manage myself or with a few key employees”.

**Figure 1: Employment Distribution by Firm Size in the EU (2012)**



Source: Own calculations based on Eurostat data

<sup>4</sup> John C. Haltiwanger, Ron S. Jarmin and Javier Miranda, Who Creates Jobs? Small vs. Large vs. Young. NBER Working Paper, August 2010.

<sup>5</sup> Scott Shane, Why encouraging more people to be entrepreneurs is bad policy. World Entrepreneurship Forum 2008.

<sup>6</sup> William J. Baumol, Formal entrepreneurship theory in economics: Existence and bounds. Journal of Business Venturing, 1993, 8.

<sup>7</sup> Erik Hurst, Benjamin P. Pugsley, What do Small Businesses Do? University of Chicago, September 2011.

A study<sup>8</sup> of self-made billionaires as a measure of innovative and growth-oriented entrepreneurship showed that the rate of billionaire entrepreneurs correlates negatively with self-employment, small business ownership, and startup rates. Countries with higher income, higher trust, lower taxes, more venture capital investment, and lower regulatory burdens have higher entrepreneurship rates but less self-employment.

While more evidence and research is needed in this area, especially in the EU context, this short overview shows that the job creation by small businesses cannot be assumed as a canonical law and that care must be exercised in supporting policies to stimulate more start-ups. Since a high percentage of new start-ups disappear within a few years, starting a business may be a high stake gamble. Many ill-advised entrepreneurs end up ruining themselves in the process of pursuing a business opportunity. Vulnerable groups with low assets stand to lose most from business failure. Ironically, these are the groups with the highest failure rates, and yet are nonetheless the most commonly targeted by entrepreneurship promotion policies<sup>9</sup>.

## EMPLOYMENT AND JOB CREATION BY FIRMS IN THE EU: FACTS AND FIGURES

Employment in the EU is highly varied by firm size and age, showing that focusing on the size alone provides a limited and potentially misleading guidance for policies.

### Employment by Firm Size

There are significant differences in employment by firm size in the member states, as shown in Figure 1. On average, **31%** of the working population in the EU countries is employed in microenterprises, including self-employed who constitute, on average, **9%** of all employed by private businesses.

The share of the population employed by microenterprises in the EU countries varies greatly. The

<sup>8</sup> Magnus Henrekson and Tino Sanandaji, Small business activity does not measure entrepreneurship, 2014.

<http://www.pnas.org/content/111/5/1760.full>

<sup>9</sup> Simon C. Parker, The Economics of Entrepreneurship: What We Know and What We Don't. University of Durham. 2010

bigger and stronger economies such as Germany and the UK have a relatively low percentage of microenterprise employment and higher average per firm employment. In Germany, only 19% of people work in microenterprises and the average firm employment is a little over 12 persons. Greece, on the other hand, which is experiencing one of the deepest economic and social crisis in the EU, shows the opposite results: almost 60% of the population is working in microenterprises and the average firm employment is only 3 people. That means that microenterprise employment is more than three times bigger in Greece than it is in Germany, the average size of a Greek firm is four times smaller (see Table 1).

**Table 1: Employment in Microenterprises in Selected EU Countries**

Country	Population employed in microenterprises	Average employment per firm (persons)
Germany	<b>19%</b>	<b>12.1</b>
UK	17%	10.4
Luxembourg	18%	8.3
Poland	36%	5.5
Spain	41%	4.6
Greece	<b>59%</b>	<b>3.0</b>

*Source: Own calculations based on Eurostat data*

These relations point to an important observation: if indeed microenterprise and small business were the engines of growth and employment, Greece should be an economic tiger and Germany an economic laggard, which is not the case.

Despite the differences by countries, if we look at the firm size only, it remains true that at least half of the jobs are in small businesses that employ less than 50 employees. However, the situation looks quite different when employment is analyzed by the age of the employers.

## Employment by Firm Age

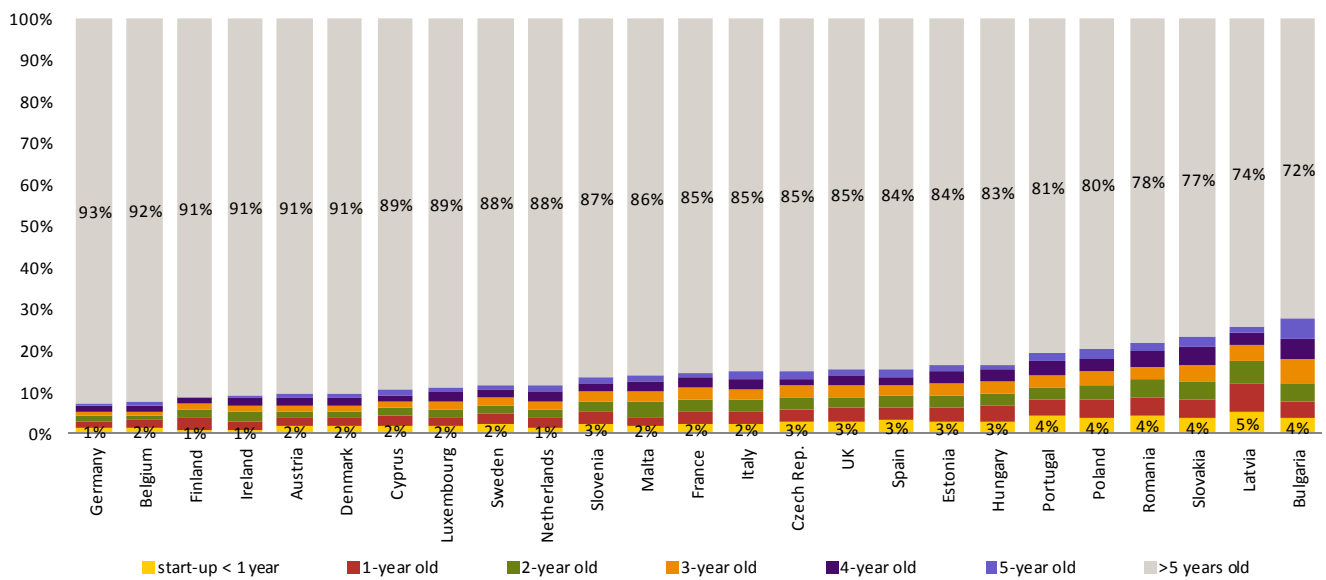
The majority of the employed (average per country **85%**) work in old firms established more than 5 years ago, not new firms. Start-ups in the EU employ on average **3%** of the workers and firms between 1 and 4 years of operations employ the remaining **12%**.

As Figure 2 shows the jobs are with older firms which are older than five years although there are differences between regions and countries. The Western economies

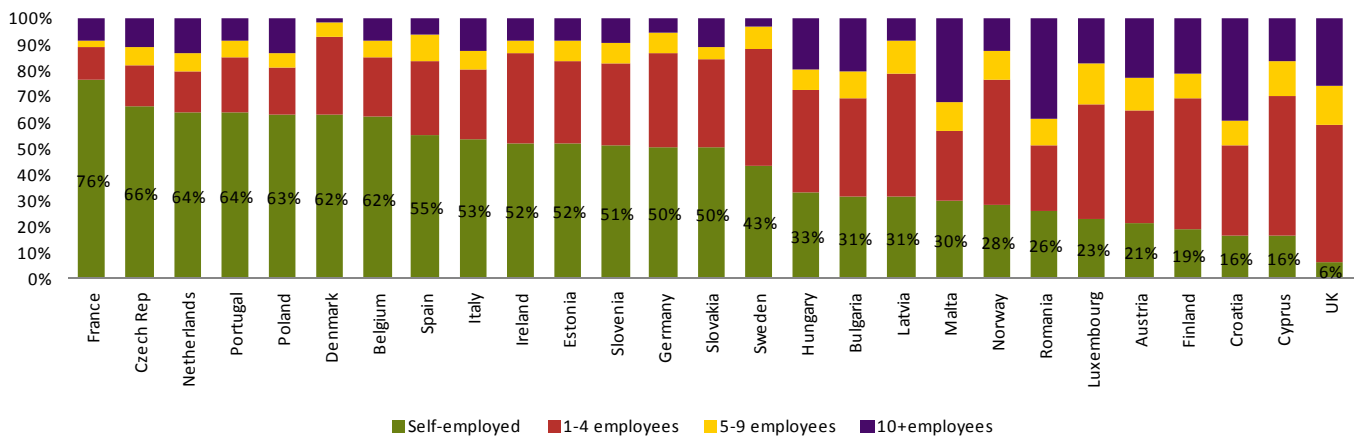
show employment around 90% (Germany – 93%) while for the new member states from Eastern Europe fewer people work in older firms (Bulgaria – 72%). This can be explained by the economic changes that took place in the past three decades when old firms ceased to exist or were substantially restructured, and new firms were created. The process of new firm creation continues in these countries more than in the Western more established economies.

Some Western states such as Spain created a lot

**Figure 2: Employment by Firm Age (2012)**



**Figure 3: Employment and Start-ups (2012)**



Source: Own calculations based on Eurostat data

enterprises in recent years and lost a lot of them during the recent recession, which can explain the lower percentage of employment in older firms as compared to other Western countries such as Belgium.

### Job Creation by Start-ups

The majority of new jobs created by start-up enterprises are in SMEs, but in particular they take the form of self-employment - on average, **42%** of start-up employees are self-employed and another **33%** are employees of very small enterprises employing between 1 and 4 people (see Figure 3).

There are big differences in size of employment by start-ups across member states. Start-ups are larger in the UK and only 6% of all start-ups are self-employed while in France 76% of start-ups are self-employed (see Table 2). These differences need to be better understood although the available data does not allow deeper analysis at this point. More self-employment in France may be caused by the legal definition of 'auto-entrepreneuriat' and new self-employed, and not necessarily by innovative entrepreneurship, when in the UK the dominance of firms with a few employees at the outset may have more chances for survival and growth. These conjectures need further research.

**Table 2: Share of Employment at Start-up by Firm Size (as % of all Employment by Start-ups)**

Employment at Start-up	Min	Max	Mean
Self-employed	6% (UK)	76% (France)	42%
1-4 employees	12% (France)	54% (Cyprus)	33%
5-9 employees	3% (France)	15% (Luxembourg)	9%
10+ employees	2% (Denmark)	39% (Romania)	15%

Source: Own calculations based on Eurostat data

### Net Job Creation and Firm Size

As argued earlier, it is not the job creation as such that matters, rather the net job outcome of start-ups that must be considered in terms of its impact of unemployment and economic growth.

Net changes in the number of employees between 2011 and 2012 differ from country to country and the

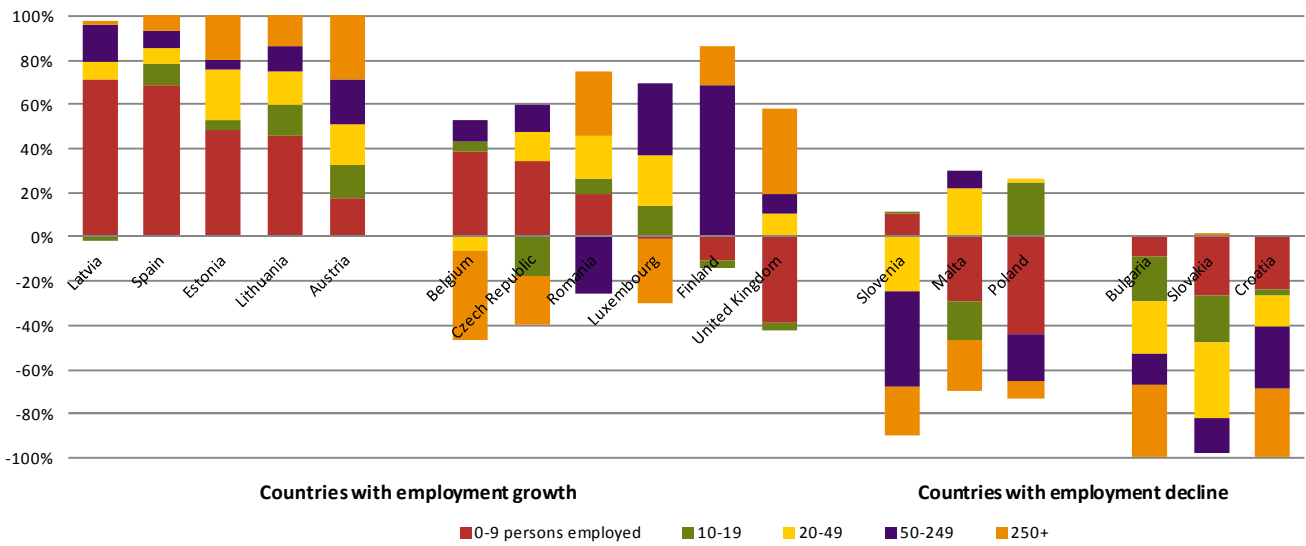
contribution of microenterprises to net job creation is mixed (Figure 4).

In 11 countries with overall net employment growth, microenterprises were the largest contributors to job creation in 6 countries but in 4 of them all types of enterprises created new jobs, although to lesser extent than microenterprises. Among the remaining countries with positive growth of jobs medium-sized firms (50-249 employees) were the largest contributor in 2 countries and large companies (250+ employees) were the largest contributor in 3 countries. Belgium and Czech Republic are the notable examples where microenterprise employment growth offset the decline in the number of jobs in large enterprises.

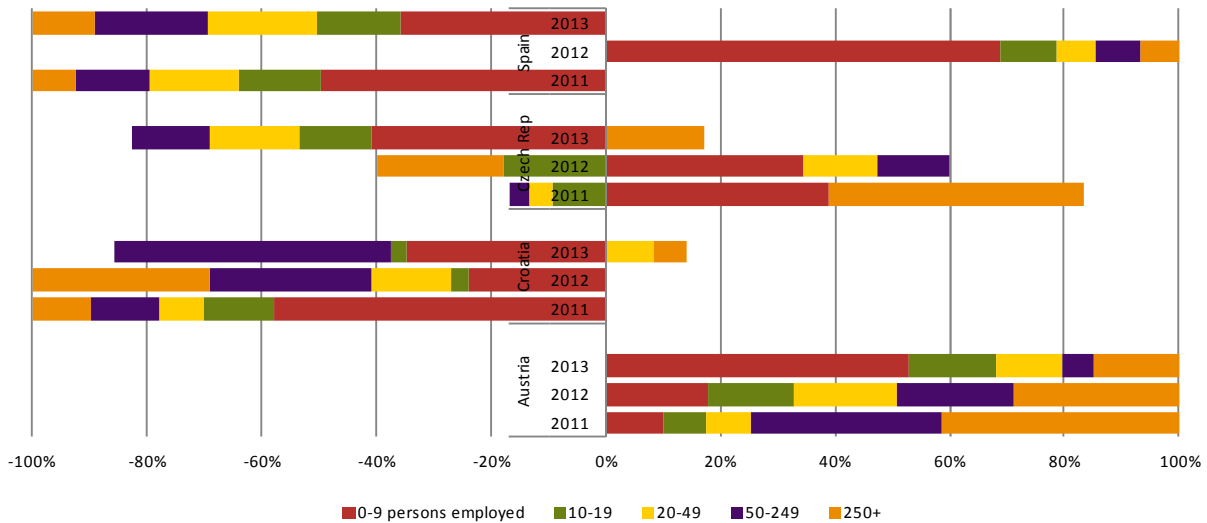
However, in almost all countries with negative job creation (except for Slovenia) employment in microenterprises shrank - to lesser extent than in other types of firms in 3 countries but to larger extent in the remaining 2 countries. Only in Slovenia, among all countries with job cuts, microenterprises managed to increase the number of employees.

Also, the intertemporal changes between countries are significant and it is difficult to interpret the differences without appropriate granularity of data (Figure 5). For instance, over the years, microenterprises increased their contribution to job creation in Austria while the opposite trend was seen in Czech Republic. The diversity of impacts of various firm sizes supports the lead argument of the paper that different countries need to focus on different types of firms to achieve positive employment outcomes, and that it is not always the small firms that drive the employment growth.

**Figure 4: Job Creation by Firm Size (2012)**



**Figure 5: Intertemporal Dynamics of Net Job Creation by Firm Size for Selected Countries**



Source: Own calculations based on Eurostat data

### Self-Employment, Microenterprises and Unemployment

It is also interesting to note that in the countries of higher unemployment rate more people work in microenterprises. While it is not possible to establish the causality of this relationship, the mere fact that existence of a strong relationship questions the ability of microenterprise creation to combat unemployment. It may well be that lack of employment opportunities forces people to become self-employed or start micro-

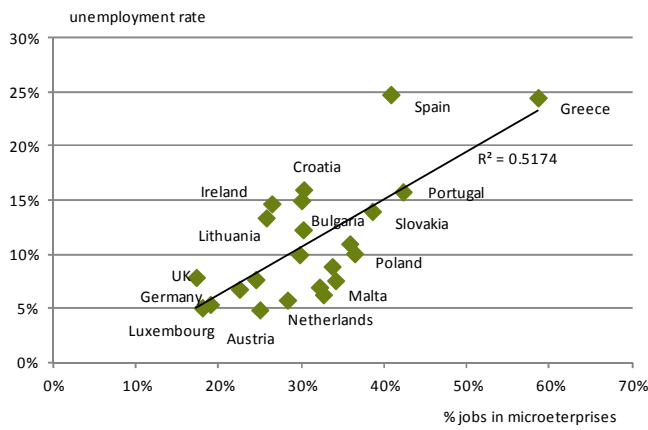
enterprises which have none or very low job creation potential.

It is also possible that promoting more self-employment and low growth microenterprises may have a perverse outcome: more very small businesses may dampen the growth potential of the economy and does not lead to higher employment. This may be due to lower earnings of these businesses and lower wages for the employees, which is typical for small businesses. The growth



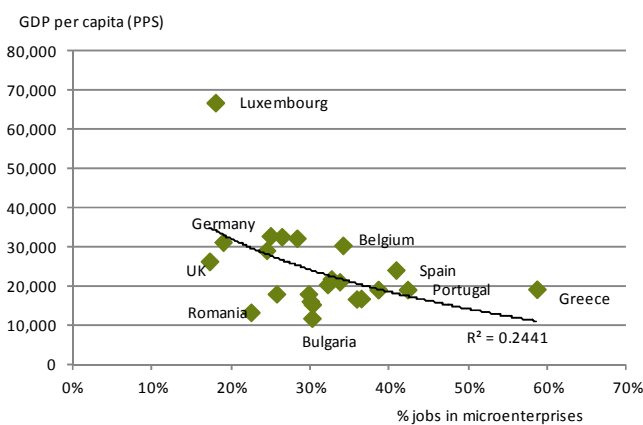
limitations of small businesses can be overcome by creation horizontal collaboration between the firms and clusters, as has been demonstrated by Italian industrial clusters. However, such strategies requires specific efforts to create horizontal cooperation and inter-firm contracting that allow the small firms to create economies of scale and scope comparable to larger firms, but such programs are typically beyond the individualistic approach to small business development.

**Figure 6: Microenterprise Employment and Unemployment**



More people employed in microenterprises are seen in the countries with lower GDP per capita although there is no correlation between GDP growth and microenterprise employment.

**Figure 7: Microenterprise Employment and GDP**



### Small Business Employment and Job Quality

Even if small businesses created jobs, the quality of jobs may be lower compared to larger and more established firms. This is reflected not only by lower wages paid by small businesses, 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 by the small businesses 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. There may explain partially the high volatility of employment by microenterprises mentioned earlier.

### DATA LIMITATIONS ON EMPLOYMENT AND FIRM CHARACTERISTICS

The above observations and conjectures are drawn from the general research results and the available data, but there are important limitations to the current data both on the individual country level and the EU level. One of the most important drawbacks is lack of data on the size of firms and employment by age (years in existence). Therefore, it is not possible to precisely show the job creation and job holding by firms of various sizes and ages to clearly understand which firms contribute most to job creation and reduction of unemployment. However, even from the available data presented here it becomes clear that the relationship between firm creation and jobs is not an obvious one, and that the small business myth as the job creator may not hold true equally.

An additional weakness of the current data are the different definitions of self-employment, which constitutes a large part of new business creation in the EU. Understanding and definitions of self-employment vary across countries, with a number of different sub-categories which are not easily comparable. This lack of clarity complicates the understanding who creates jobs in the EU, and in particular who is a true self-employed



person and just a dependent self-employed worker with one client, as is the case in Belgium.

## KEY OBSERVATIONS

The above analysis points to several important observations:

- Not all small businesses create jobs, therefore focusing on a small business in general is not likely to substantially increase employment and decrease unemployment
- There are substantial differences in the relation between self-employment and unemployment across the EU member states
- Self-employment and creation of small businesses does not mean entrepreneurship: many micro- and small businesses are of the subsistence type started as a response to the lack of jobs, and not in pursuit of opportunities
- Credit induced start-ups may be ill-fated as starting a business on credit is a risky proposition, the borrowers may be worse off as a result especially when they do not have assets and alternative sources of income to mitigate the risks of business failures
- There is no evidence that people create too few businesses or the wrong businesses in the absence of policy intervention, however, there is evidence that some self-employment and micro-enterprise policies lead people to start marginal businesses that are likely to fail, have little economic impact, and generate little employment
- Since the majority of jobs are held by the older existing firms, investing resources in the expansion of an existing business may be a better strategy than to support the creation of many weak and short-lived new small businesses
- Controlling for other differences across countries, the number of people who run their own businesses is negatively associated with economic growth and positively correlated to unemployment. People in places with high rates of unemployment are more likely to start businesses than people in places with low rates of unemployment

- New firms don't create more jobs than existing firms; only a small percentage of new growth-oriented gazelles bring new jobs on a scale comparable to the existing firms
- All of the job growth created by a given cohort of new firms comes in its first year; in every subsequent year, the cohort loses more jobs through company failure than it adds through company expansion
- The jobs in start-ups pay less, offer fewer benefits, and are more likely to disappear over time than jobs in existing companies.

## POLICY IMPLICATIONS

Policymakers generally aim to encourage firms that grow, create many jobs, and contribute to innovation; that is to say, high impact growth-oriented entrepreneurs. In most cases, support policies are operationalized using one or more of the following measures: self-employment, small business ownership, and the startup rate. However if such measures are used, the impact of policies on rates of self-employment and entrepreneurship is likely to produce misleading results.

In particular, treating all self-employed as entrepreneurs is a misguided policy. The self-employed tend to earn less than their salaried workers, whereas entrepreneurs earn more. Immigrants (although not all types) tend to have higher rates of self-employment than natives, but similar rates of entrepreneurship.

When entrepreneurship is defined as self-employment or small business ownership, it makes sense to view entrepreneurship policy and small business policies—which seek to encourage the formation of small and medium-sized enterprises (SMEs)—as essentially interchangeable terms. We argue that such an approach obscures a potentially important policy tradeoff; some policies may well encourage the formation of small businesses, while simultaneously dampening entrepreneurship rates.

These findings suggest that small business activity and entrepreneurship are two distinct phenomena, explained by different forces and associated with different outcomes.

Entrepreneurship is fundamentally related to innovation and an ambition to grow a business. Self-employment and small business activity is instead associated with flexible employment forms and an alternative to dysfunctional economic and employment systems. Recognizing the differences between the two types of businesses, more effort should go into analyzing them separately.

The above analysis does not imply by any means that self-employment and micro-enterprise development projects should be abandoned or discouraged. The fundamental conclusion is that development interventions should be clear about the instruments they can use for micro-enterprise promotion and for innovation-oriented enterprises that are likely to create jobs and economic growth. In particular, policies need to be clear about the potential results they can expect to yield. Targeting micro-enterprises can be divided in three groups for which very different policies and support programs should be designed<sup>10</sup>:

- **Necessity (or involuntary) entrepreneurs** should be targeted through social programs for poverty alleviation. Most necessity entrepreneurs usually only create their own job. Neither do they exhibit entrepreneurial ambitions, nor do they create additional employment. Projects addressing this group are of high social importance, but can neither expect much self-financing nor sustainability of the approach. Specifically, it is unlikely to build sustainable microfinance institutions on the basis of this client group alone.
- **Entrepreneurs who choose not to grow**, as e.g. lifestyle and professional firms. This group usually only needs a little support to make their life easier, e.g., through addressing external factors. Development interventions are unlikely to create more employment, but should support this group to stabilize their incomes.
- **Growth-oriented entrepreneurs**. This group is likely to create additional jobs and economic growth, and should receive targeted support to help it overcome

the growth obstacles. Only when targeting this group can projects expect significant additions to economic growth and job creation in the long-run.

Finally, when supporting start-ups, it would be best to focus on businesses that already start with 10 or more employees, and not commence as micro businesses.

## WHAT COULD BE DONE?

A more clear understanding of job creation potential is warranted to design more effective policies and support instruments, including financing for small businesses. Some of the options include the following:

### Data

- There is a need for more clarity in data in relation to small firms' age and size, and their contribution to job creation. More clarity in data is also needed to understand the ever expanding concept of self-employment in the member states.
- Using the improved and more complete data, it would be useful to develop an annual *Who Creates Jobs in the EU* report that would provide evidence in support for appropriate employment and small business development policies.

### Policy choices

- There is scope to support self-employment, including among the unemployed and the vulnerable groups, but this should be viewed as a social program distinct from support for more risky but potentially more innovative and growth oriented entrepreneurship projects. Focusing on small size is a limiting factor for enterprise growth. While only a small number of new start-ups will leap forward to become larger employers, they need continued support in terms of financing and business support services, which may not be readily available if the main focus is on micro and small businesses in their early stages.
- Business support policies should take into account the real potential of employment creation beyond the rhetoric and convenient political statements, and develop a balanced approach to firm growth appropriate for each stage of a firm's existence. In

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<sup>10</sup> UNDP Private Sector Brief, May 2012: Micro-enterprise growth: evidence-based policy implications

particular, business policies should not focus on creating a lot of mice, but strongly focus on supporting gazelles and also larger businesses that will create significant numbers of jobs and absorb the unemployed pool of workers.

### Financing

- Not all new firms have to start as very small or as self-employment initiatives. Limited financing available to entrepreneurs for example by offering microcredit, may limit the growth potential of new ventures. Financing should follow, not lead enterprise creation. The idea that all low income and vulnerable individuals are entrepreneurs at heart is a misguided one, and largely a false proposition. People should be able to realize their true creative potential and capability but not everyone is likely to succeed even if financing is available.
- Financial support for business enterprises should be refocused on the provision of risk capital and growth capital for firms that offer the largest

potential of development. While funding for new start-ups is warranted and needed, it should be more selective and steer away from creation of subsistence firms and self-employment arrangements which can be funded through social programs.

### Linkage with other development strategies

- When supporting self-employment and micro-enterprises, policies should consider taking a broader view of enterprise development within value chains, inter-firm horizontal flexible cooperation and spatial concentration of businesses, to link small firms with larger economic ecosystems. Such strategies may help overcome the drawbacks of the current individualistic entrepreneurship and create synergies between smaller firms and larger firms, leading to more sustainable employment and economic growth outcomes.

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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.

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