

## **Best Practices in Micro, Small, and Medium Enterprise (MSME) Promotion**

Christoph Kneiding<sup>1</sup> and Alexander Kritikos<sup>2</sup>

**This Draft: April 10, 2008**

### **Abstract**

Micro, small and medium enterprises (MSMEs) are the backbone of every economy. They create the bulk of new jobs and account for most of the growth in output and employment. At the same time, they face several disadvantages when competing with larger companies. It is therefore essential to design appropriate policies that are directed at reducing the disadvantages and promoting this sector. This paper outlines best practices in MSME promotion by first identifying its four main components: (i) regulatory environment, (ii) enterprise culture, (iii) financial environment, and (iv) financial support for the sector are highlighted. We proceed to take a closer look at two of these components, namely the design of an enabling regulatory environment, and improving the access to finance for MSMEs. In this context, the important role of Microfinance Institutions is accentuated.

---

<sup>1</sup> GfA - Gesellschaft für Arbeitsmarktaktivierung, Kufsteinerstr. 7, 10825 Berlin, Germany.

<sup>2</sup> GfA - Gesellschaft für Arbeitsmarktaktivierung, Kufsteinerstr. 7, 10825 Berlin, and Private Hanseuniversität Rostock, Friedrich-Barnewitz-Straße 7, 18119 Rostock.



# CHABALEU

Using the **Character Based Lending** approach as a tool  
of a market oriented MSME-financing system in the **EU**

---

"The contents of this publication reflect the views of the authors. The European Commission is not responsible for any use that may be made thereof."



Co-financed by the  
EUROPEAN UNION  
European Social Fund  
Article 6 Innovative Measures

## 1. Introduction

The development of a vibrant private sector, focusing on micro, small and medium-sized enterprises (MSMEs) and the creation of culture of entrepreneurship is at the forefront of policy attention. MSMEs are usually defined as those businesses employing less than 250 employees (in this connection, businesses with up to 9 employees are referred to as micro, and businesses employing between 10 and 49 people as small businesses). Public programmes that support the development of this sector are vast; still, there is a lot of obscurity concerning best practices in MSME development. This paper aims to shed some light on this topic.

There is no lack of documents on the promotion of MSMEs. Most of them focus on one specific aspect of public programs, like access to finance, deregulation, or science parks. As a rule, they are authored by regional development banks, public agencies, or national research institutions, and often take a rather unilateral view on this issue. Our analysis will dispose of these blinders and provides a bird's eye view on best practices in MSME promotion. It does not claim, though, to be exhaustive and it is impossible cover every detail of this vast topic. Rather, its aim is to highlight the most important facets of policy design and deepen those issues that we consider crucial for a successful MSME sector in Western Europe.

The remainder of the paper is structured as follows: Section 2 presents the main building blocks of an effective government policy that promotes the creation and growth of MSMEs. It details the necessity of monitoring the needs of the sector, as well as the roles that different federal authorities have to play in this process. The following sections take a closer look at two of the main components: While Section 3 sets out the role of a supportive regulatory environment, Section 4 details the different forms of financial support that are necessary for a thriving MSME sector. Section 5 concludes by deriving some concrete policy recommendations for the case of Germany.

## 2. Effective Government Policy



Creating supportive environments for entrepreneurship and MSME development has become a top policy priority in almost every country around the world. This development is mainly driven by the understanding that the MSME sector produces most of the domestic jobs, new jobs in particular, but faces several disadvantages when competing with larger firms such as for instance access to financial means.<sup>3</sup> Furthermore, the structural changes on the labour markets (especially in developed economies) have forced more and more individuals to consider self-employment as their occupational choice due to a lack of fixed-term employment alternatives. In this section, we will therefore (i) identify the main components of a government policy which address these challenges; (ii) emphasize the need of effectively monitoring the needs of the MSME sector; and (iii) detail the role that central, local and regional governments play in this process.

## 2.1. Main Components

Figure 1 depicts the four main components of an effective government policy for MSME promotion. These include:

1. The creation of an appropriate *enabling regulatory environment* for MSME development. Its aim should be to encourage individuals to start their own business and remove as many barriers to entry into business as possible. The regulations set up should be enforceable on the ground, be easily understandable for all relevant parties, and bear in mind the costs of compliance. The latter issue is of special importance, as oppressive regulations can encourage many small businesses to move to the informal sector (cf. Section 3).
2. The promotion of an *enterprise culture* at all levels in the education system. The European Commission has coined the definition of entrepreneurship as ‘the mindset and process to create and develop economic activity by blending risk taking, creativity and/or innovation with sound management, within a new or an existing organisation’ (EC, 2003). It is the entrepreneurial culture

---

<sup>3</sup> Empirical evidence on this subject is vast. See for example EC (2003); Audretsch et. al. (2006); and Lerner (2004).



that defines this ‘mindset’ for developing entrepreneurial activity, establishing a set of values, beliefs, and attitudes that promote personal responsibility and a risk taker attitude.

3. The development of a *favourable financial environment* for independent business creation, survival and growth. Access to sufficient capital to either start operations or grow and further develop their activities is a difficulty faced by many small businesses in Europe (Eurobarometer, 2005). Most financial providers consider small business finance a high-risk activity that generates high transaction costs and/or low returns on investment, and therefore refrain from extending loans to this potential client group. Solving this dilemma has become a major concern to entrepreneurs, financial institutions, and public policymakers. Moreover, it is also important to note that among owners of micro and small businesses there is a large share persons who are either afraid of taking loans or do not consider it worth to invest the effort of asking for a loan at a bank. Microfinance approaches aiming to improve the situation for these kinds of businesses have to take these limitations into serious consideration when developing a favourable financial environment.
4. Finding *innovative means to positively support MSME development*, including public support for incubation, technology transfer, clusters and networking, internationalisation, training and counselling and specialist finance, guarantee and equity programmes. The question is important because very often there is a lack of coherence in policy with development activity and projects driven by donor intervention rather than being led by the country’s priority agenda (cf. Section 4).



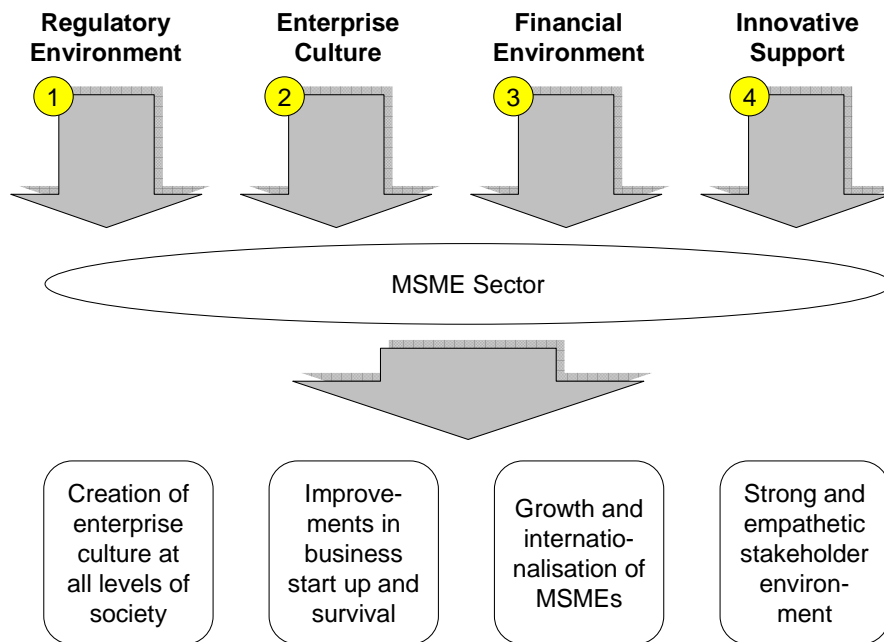


Figure 1: Components and Effects of an Effective MSME Policy.

Overall, it is recognised that policy will be effective when it lends strong support to:

- the creation of an enterprise culture at all levels of society;
- the process of business start-up and survival;
- the process of growth and internationalisation of MSMEs;
- the creation of a strong and empathetic stakeholder environment.

## 2.2. Monitoring the Needs of the MSME sector

Monitoring the health of the sector and its needs at the macro level requires agreement on definitions. Definitions are of value in the preparation of statistics and the monitoring of the health of the sector over time; benchmarking against other economies and between regions within an economy; providing arbitrary thresholds for imposing tax or other regulations; and determining eligibility for particular forms of public support. In general, the needs to be monitored can be categorised as follows:

1. Monitoring the development of the *MSME sector in general* over time. Three key indicators should be watched closely on a national, sectoral, and regional level: (i) new business starts; (ii) business survival rates; and (iii) business growth not only in terms of sales but also in terms of capital



invested or further direct employment effects.<sup>4</sup> It is important to understand what drives the changes in the sector in order to define the right policies. For example, sector growth could be driven by a favourable macroeconomic environment, or be a result of restructuring processes on the labour markets, pushing scores of people into self-employment. Different policy measures are needed to specifically address each of these scenarios.

2. Monitoring the *impact of government regulation*. It is not sufficient to enforce regulations; their impacts also have to be monitored. The aim of overall regulatory policy should be to create a ‘level playing field’ for all types of business. Therefore, it is important to understand if MSMEs can profit from new regulations the way it was anticipated, or if there are side effects that weaken the aspired results.
3. *Evaluation of policies* designed to support the development of the sector. The aim is to assess the impact of policies and incentives given to MSMEs in the fields of finance and financial support; advising and consulting; training and education; information provision; technology and innovation; provision of premises; and special access to government contracts, among others. Two groups of evaluation measures should be distinguished. *Summative* measures aim to examine the impact of any particular measure linking inputs to outputs (such as it was done in Germany for instance with the evaluation of the so called “Hartz-Laws”), whereas *formative* evaluation examines the process of management of the support system. The latter obviously impacts on the former.
4. Monitoring of the *development of the enterprise culture* in society over time. This is a rather difficult task, the most obvious solution being to count the numbers of programmes offered on a national level, for example in the school and college curriculum, and the numbers of students involved. The Global Entrepreneurship Monitor (GEM) survey has attempted to create an international benchmark for the monitoring of enterprise culture focused on the business initiation process (Bosma and Harding, 2006). It now operates in over twenty countries throughout the world based on a combination of

---

<sup>4</sup> For a description how these indicators are measured cf. UNDP(2005).



national opinion poll surveys and ‘Delphi’ techniques (procedures for obtaining reliable consensus of opinion by a series of questionnaires interspersed with opinion feedback) applied to the harvesting of expert opinions.

### 2.3. Roles of Central, Regional, and Local Governments

Supporting the MSME sector is a credo that has by now been embraced by most central governments around the world. In practice this entails not only ensuring appropriate regulatory frameworks and developing methods of communicating with, and monitoring the health of the sector. It inevitably involves government in processes of influencing and amending the existing public and private organisational and institutional infrastructure for economic and social development – a task that has been traditionally fulfilled by local authorities. It is therefore important to define which tasks should be adopted by the central government, and which tasks can be delegated to the regional and local level. This should be done in a strict way, also excluding that the same measures are non-exclusively applied by different levels.

There are some specific steps that can be taken by central government in order to support local initiative:

1. Facilitating local and regional *experience exchange*.
2. Supporting local agencies in *networking internationally*.
3. *Harmonising* the local work of central ministries.
4. Finding mechanisms to ensure that local needs are *adequately represented* on a national level.

Local authorities, in turn, should have the capacity to clearly identify, define and prioritise development problems and opportunities. Some recommendations for local and regional strategies for action include:

1. Establishing the priority areas for local economic and social development;
2. Determining where and how MSMEs and entrepreneurship can contribute to solving the problems and grasping the opportunities identified;



3. Identifying the appropriate range of approaches to be taken in support MSME and entrepreneurship development;
4. Determining where and how the local/regional authority can support the process of MSME development, given their resource and legal constraints;
5. Identifying and exploiting the partnership potential in the community;
6. Setting out strategies for action.

### **3. Creating a Supportive Regulatory Environment**

A government's central role as far as MSME development is concerned is to create a regulatory environment that maximises the potential of the sector to survive and grow, thus impacting on wealth and employment creation. As has been stated above in Section 2.2, regulatory policy should aim at creating a 'level playing field' for all types of businesses. The fundamental problem of all regulatory activities is their disparate effects on different types of businesses: generally, MSMEs have greater problems in accessing information and complying with regulations than large companies do. This may result in many MSMEs drifting to the informal sector – a development any government should be concerned about.

#### **3.1. Best Practice in MSME Regulation**

The question that arises is: How can 'good' legislation and regulation be defined? Contrary to a widespread opinion in the population, less regulation does not necessarily equal better regulation. Many laws that might appear to hinder the growth of the MSME sector are in fact essential for the sector's growth. For example, laws which clearly establish land and property rights and the right of transfer of property are of major importance to small firms in providing the basis for them attracting financial and other resources. Labour law regulation which might seem as a burden for many MSMEs to comply with, in fact promote legal security within employer-employee relationships and therefore stabilise these businesses from a long-term perspective. A key challenge for policy makers is, therefore, that of developing appropriate and sound legislation, sensitive to the existing ways of doing things of



the MSME and to the compliance costs of organisations with very limited resources. To meet this objective a number of criteria can be established for the development of effective regulation. These include the following:

1. Legislation must have *broad public support*. Without such support compliance is likely to be low.
2. Regulation must be *enforceable on the ground*. It must not conflict too much with existing ways of doing things.
3. Regulations must be *easily understood by all relevant parties*. Complexity in regulation undermines its effectiveness and leads to difficulty in compliance.
4. Regulation must be *balanced* and there should be awareness of the possible costs of compliance. Oppressive regulations can encourage many small businesses to move to the informal sector or drive them out of business.
5. Legislation should *not be overly paternalistic* and should not remove decisions from individuals that could decide for themselves.
6. Regulations should seek to *reconcile potentially conflicting policy objectives*, for example encouraging the growth of employment in MSMEs but at the same time protecting the rights and working conditions of labour.
7. Legislation must provide *clear and identifiable accountability* when things go wrong. This is particularly important when private companies are given responsibility for the operation of former public services.
8. Regulations should be designed in a way that competitive disadvantages are reduced in favour of MSMEs without creating new disadvantages.

### 3.2. Engaging the MSME Community

It goes without saying that regulatory efforts have to engage those (natural or legal) persons that are affected by these new laws. For the case of the corporate world, large companies have at their disposal a vast array of lobbying power through which they are able to influence the legislative procedure at all stages and they have an individual incentive to do so. This is not the case for MSMEs, though. The following list provides a set of reasons and proposes how these issues could be addressed:



- The MSME sector is very *heterogeneous* and involves a large number of different kinds of firms. The challenge for policy makers here is to segment or cluster the sector wherever possible, so that communication takes place with those most likely to be able to contribute precisely to shaping the regulation. For example, a legislative procedure on sanitation standards in the gastronomy sector should involve MSME representation through food stalls, boarding houses, street vendors, and so on. It is these businesses that are able to pinpoint the difficulties for MSMEs in complying with these new regulations.
- The voice of the small business community is generally *inadequately represented* by business associations which are often weak in resource, numbers and representation. Moreover, many MSMEs feel alienated from the formal channels such as the Chambers of Commerce networks, which are generally dominated by larger businesses, which dispose of the resources enabling them to engage in these networks. Public policy should therefore systematically subsidize institutions that act as the voice for the small business community.
- Differences in educational levels and language between civil servants and MSME representatives often lead to a certain *hostility of many MSMEs towards government*, thereby complicating a constructive dialogue between the two. Intermediaries that ‘speak both languages’ could be used in order to facilitate this communication process. This task could also be carried out by small business associations, which underlines the need for public support of these institutions.
- MSMEs have *little time* and *no individual incentive* to engage in lobbying issues that are not directly related to their immediate business needs. They rarely read documentation provided by public authorities, trusting mainly in ‘word of mouth’. This is a crucial issue which has to be understood by policy makers. Communication with the MSME community has to be less formal and should involve a stakeholder environment composed of regional and local governments (s. also Section 2.3), local development agencies, small business associations, etc.



Engaging the MSME community has to go along with policies and programmes to deal with the *informal sector*. The question is important because the informal sector is too frequently seen as criminal and to be coerced into formalisation when, in fact, its existence often reflects the inadequacy and inappropriateness of the design of the regulatory and institutional environment. Without going further into detail, two central challenges shall be highlighted. First, it should be recognised how things are done at the moment in the informal sector; imposing regulations that don't fit the *modus operandi* will not lure many businesses away from their informality. Second, the advantages of formalizing should be made clearer: Opportunities to grow the business; the ability to deal with a wider range of customers and suppliers; the chance to raise finance from the formal sector; and the recourse to the legal system are all examples that convincingly illustrate the advantages of formalising.<sup>5</sup>

### 3.3. Managing the Regulatory Process Within Government

A major problem especially in highly developed economies is the fact that *legislation frequently does not emanate from one source*. Rather, different government ministries and departments independently address the same issues through different rules and regulations. This is not only confusing for MSMEs, it also undermines their belief in the predictability of legal decisions, and even drives them further away from the state. The main goals are thus to ensure that different government departments apply the same basic principles when drawing up new laws; that mechanisms are found to deal with cross-departmental issues; and that channels are open for business, commerce and other interests to express their concern about regulatory matters. There are different possibilities to organise and manage processes these regulatory processes:

- By all means, it will be important to *allocate ministerial responsibility* in each department for scrutinising the quality of regulatory proposals.

---

<sup>5</sup> The introduction of the so called "Me-Inc" in Germany is certainly a positive example of giving incentives to companies working in the informal sector to change to the formal sector (for more details, cf. Forschungsverbund IAB, DIW, GfA, sinus and infas (2006).



- An *interdepartmental committee* can be organised to provide an overall review of the implications for small enterprise of any regulations relating to the governments' legislative programmes. Such a committee can press departments to justify or abandon regulations that are likely to cause problems and act as a broker to resolve differences between departments. It can also establish criteria for encouraging deregulation and/or improving regulation where desirable and possible. This is a role often performed by the SME agencies that are increasingly being established.
- *Control mechanisms* can be established for examining the potential for deregulation; providing for processes of appeal against regulation (or instance by limiting any regulatory law to five years and parallel evaluating whether it is worth of being continued; initiating and reviewing new legislation; setting up impact evaluation measures; establishing appropriate forms of self regulation; and finding means of harnessing the informal sector.

In some countries these procedures are reinforced by the establishment of an *independent Deregulation Authority or Better Regulation Unit* or the setting up of an independent task force to review and report on key areas of regulatory impact. Such a unit may be independent of government, with members recruited from a variety of backgrounds: large and small businesses, business associations and consumer groups, trade unions, the voluntary sector and those responsible for enforcing regulations. It should ideally include those who have experience of regulatory issues and, in the case of MSMEs, understand their culture and ways of doing things.

#### 4. Providing Financial Support to MSMEs

According to a recent study<sup>6</sup>, more than three out of four European SMEs have sufficient financing to see their projects through (77%). However, as Figure 2 shows,

---

<sup>6</sup> Cf. Eurobarometer (2005).



there are large differences in the financing situation of SMEs between the EU Member States included in the survey. While Finnish businesses report virtually no difficulties in accessing sufficient finance, one third of Italian SMEs could not realise certain projects due to financing bottlenecks. It is proximate to suggest that these differences are rooted in the different banking systems predominant in these countries. This last section will therefore assess two different ways of accessing finance for MSMEs: either through banks (Section 4.1), or through non-bank institutions like credit unions and micro-lenders (Section 4.2).

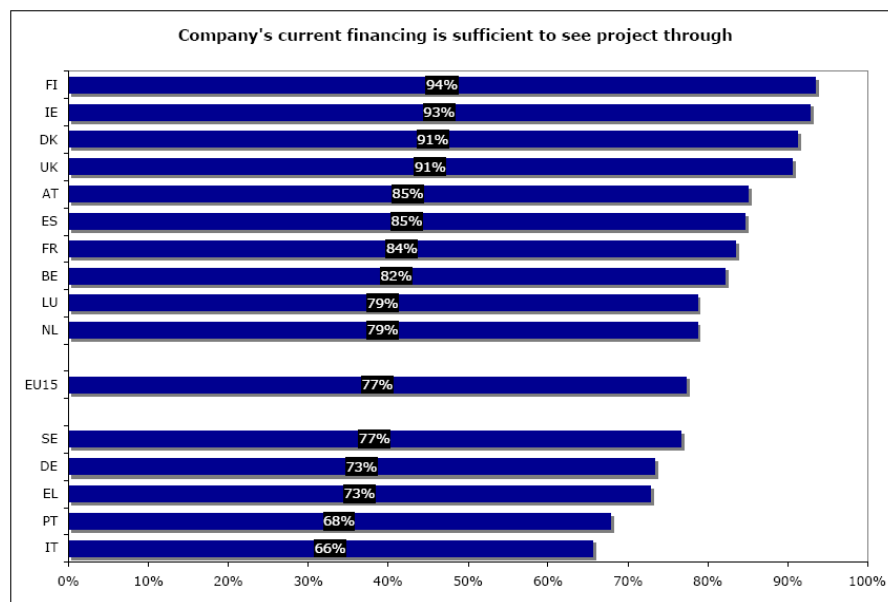


Figure 2: Percentage of companies that have sufficient financing to see their projects through.

## 4.1. Access to Finance Through Banks

Banks still are the premier source of financing for (M)SMEs in Europe (cf. Figure 3): Close to 80% of the companies surveyed contacted a bank in order to obtain adequate funding. Though banks are the most approached institution in all the EU member states that were included in the survey, the extent to which SMEs obtain financing from banks varies substantially. In Finland, just over half of the SMEs surveyed went to a bank (52%), compared with 91% in Ireland and 92% in Austria.



# CHABALEU

Using the **Character Based Lending** approach as a tool  
of a market oriented MSME-financing system in the EU

---

A healthy banking sector is a prerequisite for providing access to finance for small enterprises; however, the depth of reform which has been carried out varies from country to country. The mono-bank systems have generally been dismantled; most countries have cleaned-up bad loans through recapitalisation; privatisation and Foreign Direct Investment (FDI) have led to restructuring; and the legal, supervisory and regulatory framework is in the process of being improved, in some cases dramatically. However, stronger capitalisation, improved banking practices, higher profitability and intensifying levels of competition have increased risk aversion and thus affected lending activity. When bank lending does resume, the beneficiaries tend to be households, blue chip companies and large, usually foreign owned enterprises, rather than MSMEs.

In order to avoid the above problems, broad guidelines are often established for the design of SME credit lines, namely that they should be:

- ***Demand-driven*** and respond to demands from the recipient countries, not imposed;
- ***Justified*** on economic grounds;
- ***Limited in size*** due to the availability of funds;
- ***Additional and complementary*** to private and public sources;
- ***Catalytic*** so as to achieve leverage via multiplier and demonstration effects;
- ***Avoid distortions*** of markets and not crowd out other initiatives, etc.



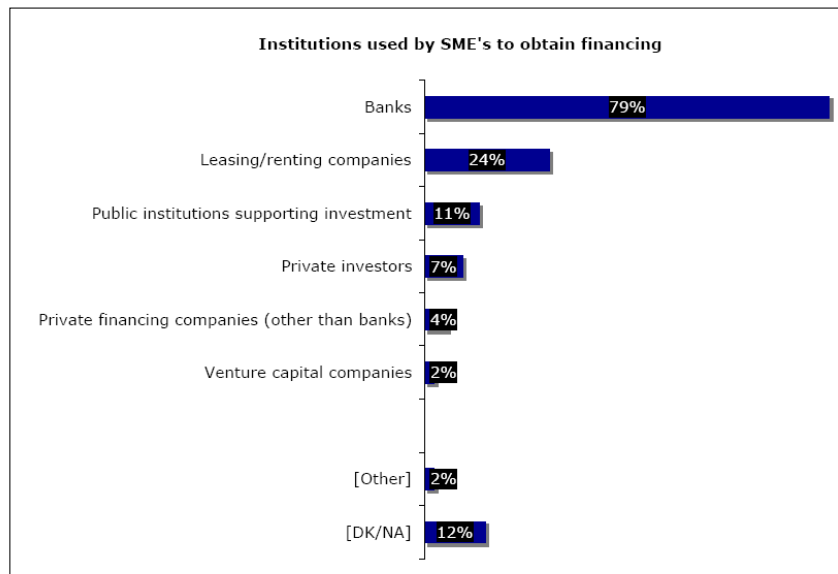


Figure 3: Institutions Used by SMEs to Obtain Financing (in per cent).

## 4.2. Access to Finance Through Non-Banks

Credit restrictions hamper MSMEs from developing their full economic and social potential, thus adversely effecting economic growth. There are four main reasons why commercial banks are reluctant to lend to MSMEs: (i) the relatively high administrative costs of small scale lending; (ii) the high risk perception; (iii) asymmetric information; and (iv) a lack of collateral. The lack of formal credit is partly the result of imperfections in the market for credit to MSMEs, thus justifying public intervention. This last section, therefore, focuses on two forms of non-bank intermediated finance, namely credit guarantee schemes, and credit unions/microlenders, as possible remedial measures to counteract the lack of access to bank intermediated finance.

It is argued that well-implemented *credit guarantee schemes* can improve small enterprises' access to credit and assist the integration of small enterprises in the formal financial market. This will ultimately translate into improved business performance and job creation. However, in spite of their potential as development engines, it remains doubtful if credit guarantee schemes are indeed efficient mechanisms to promote private sector-led growth. Critics do not see sufficient reason for government intervention by means of publicly-funded schemes and question the



cost-effectiveness of such schemes. Firstly, it is doubtful whether guarantee schemes are a first-best measure to address the market failures identified in the credit market. Establishing credit bureaus and initiating legal reforms may be better suited to overcome asymmetric information and small firms' difficulties in pledging their property as collateral. Secondly, it is unclear if guarantee schemes accomplish the financial sector changes as well as the financial and economic additionality they are designed to achieve. Little conclusive evidence on the benefits of guarantee schemes exists. Many schemes, particularly in developing and emerging economies, have achieved only limited outreach. On the other hand, some well-established schemes both in emerging and industrialised countries have been able to reach a large number of small firms.<sup>7</sup>

**Credit unions**, also known as savings and credit cooperatives, are member-owned financial institutions that offer both savings and credit services. Members of a credit union are both net savers and net borrowers and are often from a community, organisation or employer group. Depending on a country's legal framework, credit unions may be authorized to mobilize member-client savings by the Supervisory Body for Banks, the Central Bank, or the Ministry of Finance. Westley (2000) defines several propositions with respect to credit union design and implementation.<sup>8</sup>

The most important ones are:

- ***Avoid reliance on donor funding***, which builds a dependency on outside programmes and may jeopardize long-term sustainability. Instead, credit unions should provide a good service to depositors, control the quality of the loan portfolio and seek operational efficiency. Deposit mobilization should be stressed and is an important financial service in its own right.
- ***Provide unambiguous and transparent financial information***. There are various schools of thought but no consensus on how to treat share capital and set capital adequacy ratios. For example, the World Council of Credit Unions suggest counting as capital only institutional capital and for maintaining it equal to at least 10% of total assets.

---

<sup>7</sup> Cf. UNIDO (2003).

<sup>8</sup> Though his focus is solely on the Latin American context we believe that some general insights are also applicable to Western Europe.



- There is a need to clearly specify and enforce the rules that *distinguish the oversight role of the board* from the day-to-day administrative role of management, *set qualification criteria for board members*, and *specify ethical behaviour*, controls on insider loans, and penalties for failing to exercise fiduciary responsibility.

*Microfinance Institutions (MFIs)* have long been a domain of developing countries. By providing small, uncollateralised loans to the working poor, some of these institutions, especially in Latin America and South Asia, have shown that lending in this market segment can be a profitable business. Only in recent years has the attempt been made to put these technologies to use in European countries as well. Since then, successes have been reported especially by Eastern European MFIs - for example, in Poland, Russia, and Georgia. Experiences in Western European countries, in turn, have not been overly encouraging.<sup>9</sup>

Kritikos et al. (2006) therefore suggest that Western European MFIs should focus not only on the supply side by designing products that mitigate problems of information asymmetries, but also on the demand side through products responding to customers' needs. Their empirical study focused on small business owners' disposition towards microloans. By presenting a typical microloan to the interviewees, it was possible to differentiate between those people that were interested in these products (referred to as 'target group') and those that were not (referred to as 'non-target group').

---

<sup>9</sup> Cf. EMN (2006).



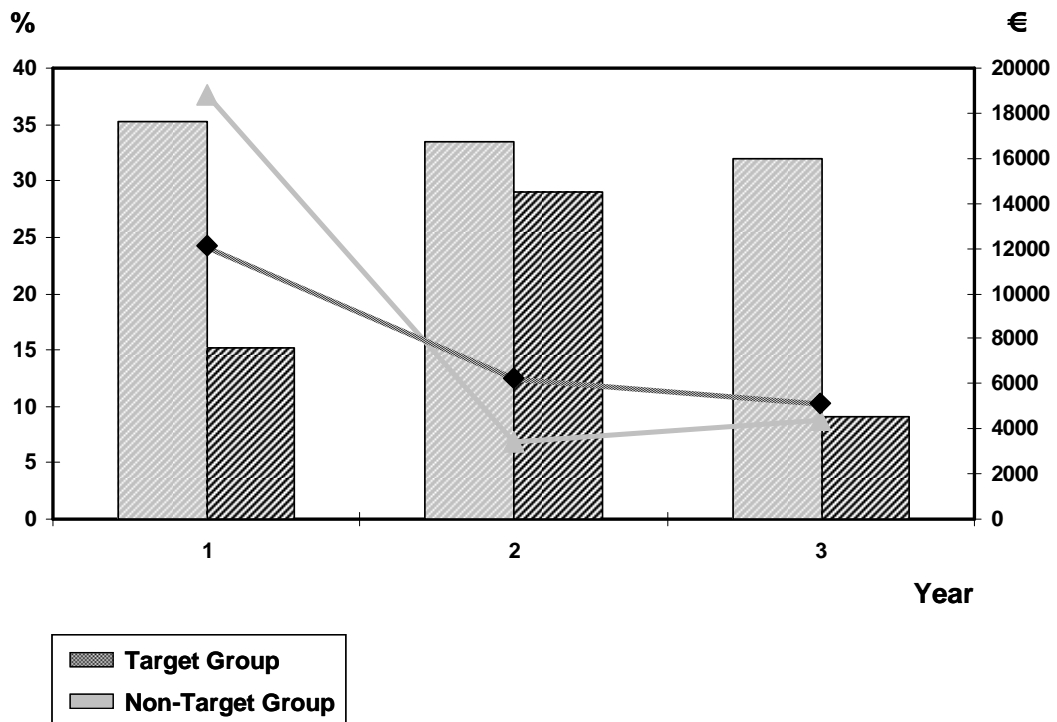


Figure 4: Funding needs (lines, right scale) and equity ratios (bars, left scale) of target group and non-target group members adjusted for outliers with funding needs exceeding €50,000 (N=69).

Figure 4 depicts the financing patterns for target group and non-target group members, showing a clear discrepancy between the funding needs of the two groups in year one. Looking at the three-year trend, the target group exhibits fairly constant funding needs, while the other group reports higher funding needs in the first year and rather low needs in years two and three. It is therefore presumed that a lower level of start-up finance is a distinguishing feature of the target group. Borrowers interested in microloan products obviously exhibit a specific financing pattern characterized by a fairly constant need for funding. Unlike non-target group members, these clients reported needing an average of between €6,000 and €12,000 per year over the three-year period. This is a possible benchmark loan size for microloans. Funding needs of non-target group clients, in contrast, average €19,000 in year one and drop to far below €5,000 in the subsequent two years. Microloans should therefore be *targeted towards existing businesses*, and take the form of an *overdraft facility* that is accessible when needed. Public support of these institutions should encourage such a product design.



## 5. Conclusion and Policy Recommendations

This analysis has highlighted four components of an effective MSME policy: (i) creating an enabling regulatory environment; (ii) promoting a veritable enterprise culture; (iii) developing a favourable financial environment for MSMEs; and (iv) finding innovative means to support positively MSME development. These measures will only be successful, though, if the needs of the sector are constantly monitored (e.g. through impact evaluation and evaluation of policies), and the roles of central, regional, and local government in this process are clearly defined and connected to each other.

The paper proceeded to highlight two issues that we consider pivotal within a successful MSME promotion strategy. First, policy makers have to understand the importance of a well-managed regulatory process. Legislation must have a broad public support and be enforceable on the ground. It should be easily understandable for all relevant parties, and not be overly paternalistic. It should also be mainly guided by the question whether existing disadvantages for smaller firms in the competition with larger companies could be effectively reduced by corresponding regulatory or discrete public policies. The MSME community has to be engaged in the regulatory process in order to understand the particularity of their needs. Confusing signals caused by ‘double regulation’ have to be avoided by all means. Legislation has to emanate from one source within government in order to strengthen the belief in the predictability of legal decisions and encourage the formalisation of businesses that have hitherto been operating in the informal sector.

Second, improving the access to finance has to be at the heart of any MSME policy. SME credit lines should be demand-driven, additional and complementary to private and public sources, and avoid distortions of markets in order to prevent a crowding out of other initiatives. Credit unions and Microfinance Institutions (MFIs) should be recognised as important actors in a market where finance through commercial banks is no longer available to MSMEs. Empirical evidence suggests that the target group for MFIs are businesses already operating in the market, with a constant need for



# CHABALEU

Using the **Character Based Lending** approach as a tool  
of a market oriented MSME-financing system in the **EU**

---

funding. Public support to these institutions should allow for the design of appropriate products that address this market. It is up to individual MFIs to communicate their important role to public policy makers and establish their role within a government's MSME promotion strategy.



## References

- Audretsch, David B., Max C. Keilbach and Eric E. Lehmann, 2006. *Entrepreneurship and Growth*. New York: Oxford University Press.
- Bosma, N. and Harding, R. (2006). 'Global Entrepreneurship Monitor 2006 Results', London and Boston.
- Copisarow, R. (2000). 'The Application of Microcredit Technology to the UK – Key Commercial and Policy Issues', *Journal of Microfinance*, Vol. 2(1), pp. 13-42.
- Eurobarometer (2005). 'SME Access to Finance', *Flash Eurobarometer* 174.
- European Commission (EC) (2003): Green Paper Entrepreneurship in Europe. COM(2003) 27 final, Brussels.
- European Microfinance Network (EMN) (2006). 'Overview of the Microcredit Sector in Europe 2004-2005', EMN Working Paper No. 4, Paris.
- Forschungsverbund IAB, DIW, GfA, sinus and infas (2007): „Evaluation der Maßnahmen zur Umsetzung der Vorschläge der Hartz – Kommission – Modul 1e: Existenzgründungen, Abschlußbericht 2006“, BMAS Berlin.
- Forster, S., Greene, S. and Pytkowska, J. (2003). 'The State of Microfinance in Central and Eastern Europe and the New Independent States', Washington D.C.
- Kritikos, A., Kneiding, C., and Germelmann, C. (2006). 'Is There a Market for Micro-Lending in Industrialized Countries? – Evidence from Germany', *GfA Discussion Paper* No. 02/2006.
- Lerner, J., 1994. A note on the venture capital industry. Havard Business School Case #9-295-065.
- UNDP (2005). 'MSME Dialogue Series: Creating and Implementing Micro, Small and Medium Enterprise Support Policies and Initiatives', Briefing Papers.
- UNIDO (2003). 'Credit Guarantee Schemes for Small Enterprises: An Effective Instrument to Promote Private Sector-Led Growth?', Vienna.



# CHABALEU

Using the **Character Based Lending** approach as a tool  
of a market oriented MSME-financing system in the **EU**

---

Westley, G. (2000) 'Reform and Rehabilitation of Credit Unions: A way to expand microfinance', *Microenterprise Development Review*, Volume 2, Number 2.

