

The Importance of SMEs in the Economy

1. Introduction.

SMEs are important to almost all economies in the world, but especially to those in developing countries and, within that broad category, especially to those with major employment and income distribution challenges. On what we may call the “static” front, SMEs contribute to output and to the creation of “decent” jobs¹; on the dynamic front they are a nursery for the larger firms of the future, are the next (and important) step up for expanding micro enterprises, they contribute directly and often significantly to aggregate savings and investment, and they are involved in the development of appropriate technology. In asking ourselves how “important” the SME sector is we must of course go beyond simply looking at its share of output, employment or any other aggregate variable to the key question--

“how much difference does it make to overall economic performance whether the SME sector is large or small, or whether it grows rapidly or slowly?”

A sector might have considerable weight in GDP, say, but be easily substituted by other sectors, in which case its share of GDP could greatly overstate its true importance; in other cases the opposite might be true.

It is a fact of life, at any level of a country’s development, that some needed activities involve few or no economies of scale while others involve considerable economies of that sort. The size distribution of firms within a country, and the associated combination of technologies--from the very labour intensive to the very capital intensive is of course influenced by these “givens”. That distribution can also be influenced by international trade. An important challenge in many countries is to assure that a significant share of output takes place outside the overly capital intensive large scale sector. Achievement of this goal is more difficult if SME activity in general is discouraged by policy or setting. It can be facilitated when large firms (whose size may be necessary because some parts of the process leading to their final goods have economies of scale) subcontract other parts of that process to smaller more labour intensive firms. It can also be facilitated by the phenomenon referred to as "clusters" in which small firms collaborate together to handle those aspects of the business that are indeed characterized by economies of scale. The ideal setting within which SMEs can play their positive contribution to the maximum thus includes these structures and their advantages.

In developing countries with large informal or micro enterprise sectors, SMEs constitute the middle of the size range, a fact that explains much of their strategic importance. In terms of organizational structure, SMEs are, on average, considerably more complicated

¹ The term “decent jobs” has been popularized recently, by the International Labour Office among others, and refers to jobs characterized by adequate wages, acceptable working conditions, and such other positive features as may be important to the employee. It has gained currency because of the importance of distinguishing between situations in which the same number of people are employed but the quality of those jobs differs markedly. In other words, number of jobs created is not a good indicator of a successful labour market outcome. Since many fewer jobs fail the “decency” test in industrial countries, the concept is much less important there.

than microenterprise, which involve largely the self-employed, sometimes accompanied on the job by a few family workers and hence usually having under 5 workers. On the other hand SMEs are, on average, a good deal less complicated structurally than are corporations and other large firms, with their layers of management, high division of labour, etc. In the past the weight of the non-agricultural SME sector in output and employment has traditionally reached its peak in the upper income tier of developing countries, where agriculture no longer constitutes a large part of the economy. At still higher levels of development its share tended to wane in favour of larger firms (and the public sector), but the last 2-3 decades appear to have seen an alteration in this pattern, at least as far as employment is concerned associated partly with an at times dramatic fall in the share of total employment found in the manufacturing sector (Palma, 2005) in both industrial and (nearly all) developing countries.

Depending on the case, the output share of SMEs may be greater or smaller than its employment share. Labour productivity rises monotonically with size across broad groups of firms, so whether the SME sector has above or below average labor productivity depends, among other things, on the relative size of the large firm and micro enterprise sectors.

As with any other component of an economy, the size and importance of the SME sector varies from country to country; the last few decades have seen an increasing recognition of the role it plays in industrial countries, something already more obvious for developing nations from the 1970s or so. The SME sector, of course, includes firms in all of the major types of economic activity outside agriculture, from manufacturing to services. Despite the natural differences associated with the nature of the final product, SMES across these activities still share quite a few features.

Policy, including tax policy, can make a considerable difference to how well the SME sector fulfils its potential role in contributing to a healthy economy.

2. Summarizing the Strong Points of the SME Sector

The importance and potential contribution of the SME sector are supported by both theoretical and empirical arguments and evidence. We turn first to the former.

Part of the contribution of the SME sector both to the overall total factor productivity (efficiency, as usually defined) of an economy and to employment generation and distributional equality comes by virtue of its pattern of technology choice. SME technology tends to be intermediate between the highly labour intensive technologies of micro enterprise, which as a result achieve only low average labour productivity, and the highly capital intensive technologies of large firms which thereby achieve high labour productivity, but use more capital per worker than is available for the economy as a whole. Given this correlation between size and capital intensity, it becomes a foregone conclusion that an economy that applies a high share of its capital to a small group of workers must necessarily have, as the other side of the coin, a large informal or microenterprise sector that uses very little capital (the bit not used by the large-scale

sector) with the large amount of labour not employed by the large firms. A larger SME sector is best thought of as the alternative to a highly dualistic economy with most of the capital in the large scale sector and most of the workers in the very small-scale sector. An economy which is dominated by SMEs, as Taiwan's has been, can generate a low level of inequality in the distribution of primary income (before tax and transfer) whereas the dualistic economy characterized by the combination of much large enterprise and much micro enterprise typically generates a high level of primary inequality.

Its intermediate technology characteristic is what gives the SME sector a special role (together with small-scale agriculture) in the generation of adequate or decent employment. When most jobs are in the micro enterprise sector, too many of them are destined to be low productivity and hence low income in character. SME firms can be substantially more productive, so in terms of the potential to generate "decent" jobs this sector competes with large private firms and the government, but it has the advantage of being able to generate many more such jobs for a modest input of capital. The key mechanism in generating decent employment in most developing countries involves the expansion of this sector fast enough to absorb people previously unemployed (a few) or engaged in low productivity informal sector jobs (the bulk).

Developing countries without substantial SME sectors (hence often described as having a "missing middle" in their firm size structure) tend not only to have capital and the income from it concentrated in the larger firms but also to have a "labour elite" in that sector, able to bargain for wages much higher than elsewhere in the economy. With the economy's capital stock almost completely used up by the large firms (usually a result of capital market imperfections), there is little remaining capital to be distributed among the many workers not hired by large firms; this produces a large micro enterprise sector with the SME sector squeezed out for lack of capital. The equilibrium wage in the micro enterprise sector is very low and capital incomes are low there as well. In short, income is very unequally distributed. When the SME sector is large, these extremes in the distribution of both capital income and labour income are avoided.

Apart from being the sector to which one would like to see a high share of resources allocated at a given point of time, for the above reasons, the SME sector also plays a key dynamic role in generating growth, especially pro-poor growth. Nearly all developing economies have large micro enterprise sectors that, like the SME sector itself, are highly heterogeneous in many respects--the goods or services produced, the entrepreneurial capacity of the owner, and the potential for growth, etc. Many are survivalist in character but others have dynamic potential. In most countries for which such data are available it appears that most small firms (of say 6-25 workers) began their lives as microenterprises and then grew. Thus the SME sector is to a considerable extent the place where successful micro enterprises wind up, through a process which is at least in part one of survival and growth of the fittest. This positive selection process will of course be less prominent if for policy or other reasons it is hard to operate SMEs in a given country. At the other end of the size spectrum, most large firms have grown out of the SME sector, so its health helps to determine the future supply of large firms. Possibly those large firms

with an SME background will be more likely to engage in subcontracting with other SMEs, an additional benefit to overall economic efficiency.

SMEs tend to dominate a country's new and fast growing industries. Economies which discourage SMEs in any general sense are therefore likely to discourage some newer dynamic industries from putting down the roots they might otherwise do. In this respect, and in others, SMEs are associated with dynamism. An economy composed essentially of older larger firms runs the risk of becoming arteriosclerotic.

Economists emphasize, with the good reason, the importance of competition for efficiency. Except in large markets (whether defined by country, by region/ metropolitan area or whatever) there is not enough "space" for many large firms, perhaps only for a couple or perhaps only for one. In such cases the large firm or firms can exercise monopoly or oligopoly power. If there is to be price-lowering and quality-improving competition, it will come from SMEs. Often, given the relative scarcity of capital in the country, large firms achieve lower total factor productivity (TFP) than do SMEs. But even when they do have an advantage on that count, there remains the serious possibility that they will lower GNP and social welfare by engaging in monopoly (or monopsony) pricing and practices. It is not infrequent to see the potential of smaller firms strangled by the monopsony position of large buyers in the intermediary chain.

Globalization brings the threat of a weakened SME sector, since its role in (direct) exporting is less than proportional to its size; in other words one activity in which economies of scale (based partly on oligopoly positions, brand loyalties, etc) are important is international commerce. But globalization may also increase the importance of keeping the SME sector strong since its role in providing subcontractors for large exporters may be quite important in cases where transportation costs are not low. In a globalizing world it is naturally important that as many major categories of firms as possible have the capacity to compete in world markets. The importance of an efficient collaboration between large firms and SMEs through subcontracting is at its peak in outward oriented countries especially those competing in international markets in products involving a good deal of labour. Being able to rely on efficient low-cost subcontractors can substantially increase the competitiveness of the large exporters, and has been an important factor underpinning the successes of Japan, Taiwan and Korea.

On the empirical side, some features are common to nearly all SME sectors. The most important positive features have, naturally, gone with those cases where SMEs have made the biggest positive contribution. Broad empirical evidence highlighting the importance of SMEs includes the facts that:

- i) The most successful developing country over the last 50 years, Taiwan, is built on a dynamic SME sector. This has produced both (for its time) record breaking growth and a quite low level of inequality, by comparative standards. The experience of Korea, Taiwan's partner among the Asian Tigers and a more or less equally fast grower, has provided the laboratory to illustrate another point—inequality can fall significantly when the weight of the SME sector rises quickly, as it did for a period after the mid-1970s in Korea.

Colombia's golden age of growth, from the late 1960s through the 1970s, coincided with very fast expansion of the manufacturing SME sector and with an apparent decline in urban inequality.

- ii) SMEs tend to use medium-sophistication technology, which is approximately consistent with the factor endowment ratios in most developing countries.
- iii) Many firms "grow into" or "grow out of" the SME size range, with both of these transitions having something positive to be said for them.
- iv) The SME size range is where many important entrepreneurs and firms of the future get their start.

Weak points of SMEs and Related Challenges

The frequency with which SMEs manifest a capacity to grow fast and to innovate has, partly as the other side of the same coin, higher failure and exit rates than do large firms. In part this reflects a "survival of the fittest" process in which firms lacking strong entrepreneurial skills or simply in bad market niches do not survive. Few estimates have been made of the sort of deadweight loss associated with firm failure and the extent to which it lowers the average efficiency in resource utilization of the SME sector as a whole. The issue is complicated, since sometimes failure is a factor contributing to the longer run development of entrepreneurial capacity, since some of the physical capital of failing firms is not wasted but purchased and used by other firms, etc.

Even short of actual exit, many small firms suffer significant shrinkage at certain points in their lives, with negative implications for the job security of their employees. The costs of such insecurity are hard to tote up and the difference vis a vis large firms is one of degree.

Getting the most from the SME sector requires better support systems, either from government or collective action by the SMEs themselves, than those required by larger firms. This is essentially because some needs of SMEs are in effect public goods while the parallel needs of larger firms can be effectively handled privately. The implication is that in countries with governments of limited competence the SME sector will not perform to its real potential.

Finally, SMEs are simply not an efficient way to produce goods and services characterized by large economies of scale. This places an upper limit on the share of GDP that they can produce effectively. In some cases, where economies of scale are present but not strong, the SMEs constitute the better option because their production cost disadvantage is more than offset by the advantages of having a competitive rather than a monopoly price in the market.

3. Conditions for the Maximization of the SME Contribution: Policy Considerations

The ultimately interesting question for economists is "Under what conditions (including those affected by policy) can SMEs make their biggest potential contribution to a healthy economy?" One ideal condition is well-functioning markets. SMEs are often

disadvantaged vis a vis large firms by market imperfections, especially in the capital and product goods markets. In contrast, labour market imperfections, including labour legislation, tend to favour them. Public policies in other areas more often favour large firms. Since most market imperfections cannot be fully, often not even partially, removed, policy analysis must be carried out in the context of the “economics of the second best.” It is interesting to consider the role of tax policy in this light.

A background observation is that the microenterprise (or informal) sector is usually thought of and sometimes even defined as the sector to which rules and regulations do not apply. This is a matter of degree, but it does capture the important point that many policies are not likely to have much if any direct impact on this sector. At the other extreme, large firms have to respond to virtually all laws and regulations, even if they are able to avoid those regulations in part. The SME sector, intermediate in so many other respects, is also intermediate in that many regulations and aspects of public policy, including many taxes and much labour legalisation are partially applied here. Should they be fully applied or not? Should policy and regulations be designed differently for this sector than for others?

One vantage point to ask the question “what should policy—including tax policy, towards the SME sector be?” is to identify and to the extent possible quantify the effects of the market imperfections impinging on the sector’s capacity to fulfil its potential role. Four areas are labour legislation, the capital market, which is almost by definition very imperfect, anti-trust, which usually fails to rein in the depredations of large firms with market power, and tax policy, which introduces a wedge between gross and net income of the firm, a wedge that can have negative incentive effects on each of SME creation, output, and labour intensity. To some extent, the cross-size group biases of these policy areas offset each other. On the one hand the tax burden and labour costs typically rise by firm size; on the other access to low cost capital and ability to exercise market power also rise. Other considerations in thinking about overall SME policy are the matter of whether (as is usually assumed) it tends to be smaller than would be desirable from a social point of view and by how much, and with respect to which other sector (large firms/government or micro enterprise) it is mainly in competition with. Unlike large firms, but somewhat parallel to micro enterprise, SMEs are not normally in a position to undertake their own R&D or much of their own human capital formation. This creates a logic, parallel to that for small agriculture (or rather for agriculture in general) that the state be heavily involved in the R&D function.

These issues affect the optimal design of tax policy in several ways. First, seen as one of several factors that may create biases for or against SME activity, one should in principle strive for a tax burden relative to large firms that tends to keep the overall incentive for the two sectors fairly close (i.e. creates a “level playing field”), though somewhat stronger for SMEs because of their advantage on the employment and distributional fronts. Second, one should keep in mind the technology choice impacts of the structure of taxes. It is arguable, though seldom studied in enough detail to confirm the hypothesis, that it is within the SME sector that things like tax policy and labour legislation are most likely to have an impact on technology choice and hence on decent employment creation.

In general, the large firm sector is likely to employ quite capital intensive technologies in most countries regardless of legislation in either of these areas, even though they may have some impact in some industries and in some countries. At the micro enterprise level they have little or no impact. But the SME sector is the one which does create many decent jobs and where technology choice is likely to be more sensitive to the incentives created by the details of legislation in these two areas. Tax and import tariff treatment of the purchase of used machinery have at times illustrated the danger of misconceived policy that raises the price of appropriate technologies. Much legislation is conceived with large firms in mind; some is borrowed from industrial countries where those firms dominate. In general, too little legislation is crafted on the basis of a good understanding of the SME sector where its impacts may in fact be the greatest.

Tax policy, labour policy and other policy areas should also be designed as much as possible in such a way as not to obstruct and hopefully to facilitate firm growth, especially from the micro enterprise level into the SME size range but also within that range, and to ease graduation on out of it. This is another tricky challenge. Onerous taxes or labour legislation can keep some firms at below economically optimal size levels. When a firm chooses to remain at the micro level in order to avoid either taxes or labour legislation, this decision may also keep it from having access to some of the benefits of public policy support and, more generally, may cancel out whatever future growth potential it had. Finally, where relevant, tax policy should encourage/not discourage R&D and technology upgrading, especially since in most countries the state does not fulfil its role as generator of new technologies for small firms—in effect a public good.

There has, I believe, been more microeconomic analysis and debate around the impact of cost-raising and flexibility-reducing labour legislation than around taxation systems as they affect SMEs. In the former case it seems likely that there could be major impacts both on SME creation (or graduation from micro enterprise) and growth, and also on technology choice. It has often been argued that the negative impact on flexibility (to raise and lower the work force) is the most damaging aspect of labour legislation from the firm's perspective. There would not appear to be a comparable effect from taxes. Much of our uncertainty with respect to how these policies affect SME development relates to a lack of knowledge of the degree and form of their application and coverage. It is obvious, and widely known, that this application is incomplete and often somewhat erratic.

Broadly speaking, tax policy for SMEs should be designed to further any positive element of that sector, not only growth potential and employment creation, but also efficient links with larger firms, capacity to enter export markets etc. In terms of employment creation, the issue of labour (payroll) taxes arises. Such taxes contradict the general principle that employment should not be discouraged. To that considerable extent to which they are in fact a form of worker pension managed by the firm, it may be that they do not significantly increase total labour costs. But this is an empirical question that deserves more analysis.

4. Future Importance of SMEs?

What do present trends in the world and in developing countries suggest about the future role of SMEs? There are several reasons to think that this role will not wane in most developing countries, at least in the short and medium term. These include:

- i) The end, at least in some parts of the world, of the observed upward trend in the share of employment found in large private firms plus the government in those countries achieving healthy GDP growth; (such increase has rarely occurred in slow growing countries). For reasons still in need of further research, it appears that this gradual increase, once thought of as a stylized aspect of the development process and a process by which the employment structure of developing countries would gradually approach that of developed ones, may no longer be present. When this is the case, we know that the share of employment found either in the informal or the SME sector is not falling, so unless the SME employment share is rising, that of the informal sector cannot be falling, though that decline is an important goal if employment quality is to rise in a country. To illustrate the problem, in Latin America, even after the return to modest growth in the 1990s, the informal sector's share of employment had not fallen as of about 2003, nor that of the large scale sector risen. Probably the reasons for the levelling off or decline of the large firm employment share include the near worldwide trend towards more flexible labour contracts and towards subcontracting out of some auxiliary functions previously carried out within the large firm. The falling role of manufacturing employment probably also plays a role since the large firms account for a higher share of manufacturing employment than that in most other sectors of the economy. Globalization may be playing a role by inducing increases in labour productivity in large firms operating in international markets or having access to very low cost capital in the international market; that increase in labour productivity accounts for the case in which this sector's output has grown at a good clip but employment has stagnated or fallen. Chilean manufacturing was a notable case of this during its 1990s boom as has been the non-maquiladora part of Mexican manufacturing.
- ii) The information revolution may increase the relative competitiveness of smaller firms. Informational monopolies often underpin large size and monopoly. Some, of course, are based on patents. We know that the accoutrements of information technology have diffused first among larger, more sophisticated firms, then among SMEs. What we cannot yet judge is how this revolution will have affected relative competitive positions after the dust has settled and the diffusion is more nearly complete.
- iii) More generally, it may be that small firms will play a larger role in technological advance in the context of the information revolution and the rising role of services than was earlier the case under the dominance of manufacturing.

- iv) Most developing countries have achieved large increases in the share of the population completing primary education and in the share with a considerable amount of secondary as well. This, together with the large microenterprise sectors that server as a training ground in business management for some of those located there, suggests a widening of the pool of entrepreneurial talent. Healthy SME sectors require such a pool (for which Taiwan, for example, has always been noted).

Reference

Palma, Gabriel (2005) "Four Sources of De-industrialization and a New Concept of the 'Dutch Disease'" in Jose Antonio Ocampo (editor) *Beyond Reform: Structural Dynamics and Macroeconomic Vulnerability*. Stanford, Calif.: Stanford University Press.