

The Importance of SMEs in the Economy

Definitions

- Refers to non-agricultural activities
- The middle of three size categories, between microenterprise and large scale
- Most often defined in terms of workers, with lower limit usually 5-10 and upper limit usually 100-200
- Alternative definitions can involve sales, capital, and (in developing countries) degree to which legislation is applied

Why Size Varies

- Economies/diseconomies of scale
- Advantage of market power
- Market imperfections that favour firm growth

Changing Role of SMEs in the Evolution of an Economy

- Share of output and employment historically tended to rise, as economies became less agricultural, but then fall as higher levels of industrialization were reached
- This historical pattern appears to have changed as the large firm share has levelled off or fallen in many countries, especially in terms of employment

Strong SME sector the Opposite of Dualism in Developing Countries

- A defining characteristic of developing countries is the lack of enough capital to achieve a high average capital/labor ratio
- SMEs are characterized by intermediate levels of K/L
- Dualism refers to the situation where a high share of capital is applied to a few workers, leaving many workers with very little capital; also described as the condition of the “missing middle”
- A strong SME sector means that a high share of workers use intermediate technologies, with smaller shares of factors at the two technological extremes
- This arrangement usually implies higher total output and always implies a more equal distribution of income

Role of SMEs in Economic Growth

- Aggregate economic growth usually involves both an increase in the number of firms and an increase in the size of some firms
- In developing countries most successful SMEs have graduated up from the microenterprise category
- Most large firms have graduated up from the SME category
- Success of and hence facilitation of both processes is very important, albeit in different ways
- Often artificial barriers stifle some of the potential growth involved in moving between categories
- The breadth of the SME category both reflects and helps to create a strong and deep entrepreneurial culture

SMEs in Dynamic Industries

- SMEs tend to dominate a country's new and fast growing industries.
- Thus settings unconducive to SMEs in general are likely to discourage some newer dynamic industries.
- An economy composed essentially of older larger firms runs the risk of becoming arteriosclerotic.

SMEs as a Source of Competition

- Competition is important for efficiency.
- Many markets are too small to have enough large firms to curtail the use of monopoly/monopsony and oligopoly oligopsony power, so price-lowering and quality-improving competition tends to come from SMEs.
- Too frequently the potential of smaller firms is strangled by the monopsony position of large buyers in the intermediary chain.

SMEs in Successful Globalization

- Globalization brings the threat of a weakened SME sector, since its role in (direct) exporting is less than proportional to its size; this reflects the economies of scale characterizing big markets
- But globalization can also increase the importance a strong SME sector, either where direct SME exports are feasible or where SME subcontractors help keep the country's large exporters competitive.
- 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 (as witness Japan, Taiwan and Korea).

Empirical Evidence

- The most successful developing country over the last 50 years, Taiwan, is built on a dynamic SME sector. For decades Japan was the most successful industrial country, also relying heavily on SMEs.
- Consistent with the theory, these are cases of strong employment growth and relative equity. Colombia's strongest growth period, with falling urban inequality, coincided with fast SME growth.
- Such successes involve, among other things many firms "growing into" or "growing out of" the SME size range.
- The SME size range is indeed where many important entrepreneurs and firms of the future get their start.

Broad Policy Issues

- Policy to induce optimal SME contribution to economic performance involves some standard forms of support (e.g. infrastructure, R&D, education/ training).
- It should also take account of the usually serious market imperfections that affect SME performance, especially in the capital and labour markets, but often also product markets
- Too often public policy favours large firms

Tax Policy as part of an Overall Policy Balancing Act

- Tax policy, as with other policy areas, should be designed with the intent of providing an approximately level playing field among categories of firms.
- This means it should sometimes be tilted in favour of certain categories (often SMEs) because other imperfections are tilted against them
- It should also strive to facilitate rather than to block firm growth, especially into the SME category
- The SME size category appears to be the most sensitive (i.e. more than either large firms or micro enterprise) to imperfections in the capital and labour markets and to tax structure.

Future of SMEs

- The SME sector appears likely to remain very important in most developed and developing countries, judging in part by recent trends in both these groups of countries.
- This may be fostered by fuller diffusion of the information revolution, which reduces economies of scale in some industries.
- Much will also depend on how globalization affects size structure; there are factors working in both directions