

# **The Role of Small and Medium Size Enterprises in Economic Development**

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## **1. Introduction**

Improvements in the cost reducing industries, changes in the industrial structure and development of new markets renewed interest in the small and medium size enterprises (SME) as engines of growth and employment. Industrial development earlier believed to occur with large enterprises undertaking large investments and creating scale economies. Even Schumpeter proclaimed that the future growth would come from large enterprises.

However, starting in the late 70s and early 80s, SMEs started to become more innovative and were flexible in terms of reducing costs. Thus, they started providing intermediate goods more efficiently than large enterprises. Furthermore, due to the increases in education levels, business skills and reduction in job security, entrepreneurial activities increased worldwide. While SME growth occurred due to relaxation of labor laws, and incentives in most developed and emerging markets, in transition countries SME development was as a result of the break up large enterprises and the privatization of state-owned enterprises. However, it should be noted that there were some experiments in the 1980s in the form of establishment of business cooperatives. It should also be noted that SME development remained less than expected in transition countries until the end of 1990s.

However, SMEs are also criticized for their high rate of bankruptcy. While they SMEs create many jobs, they also destroy a lot of jobs. Furthermore, they were criticized on the grounds that they provide low value added goods and services and have short life. In developed countries, SME growth depends on the business cycles. When the economy is booming the number of new firms is larger than the number of dying firms. However, in emerging markets SME growth depends on crisis cycles.

## **2. SME Development**

SMEs official or unregistered (shadow economy) have become significant sources in providing employment as well as value added. One can highlight the long-term economic effects of SMEs as:

- As per capita income increases contribution of SMEs to GDP and employment increases.
- As per capita income increases contribution of the unregistered economy decreases.
- Registered and unregistered SMEs together contribute about 60%-70% to GDP on average.
- However, as GDP increases share of the unregistered economy decreases.

SME development depends on a number of factors. In broad terms they can be outlined as:

- Macroeconomic factors
- Business environment
- Growth opportunities
- Historical determinants

### **2.1 Macroeconomic Factors**

Among the main macroeconomic factors that contribute to the growth of SMEs are the government expenditures. Government procurement assists the development of registered SMEs while discouraging the unregistered SMEs. Due to the legal requirements of government contracts, SMEs hiring unreported labor and evading taxes would not be able to participate in bids for procurement contracts issued by the government.

Low inflation economic environment help the growth of registered SMEs while high inflation moves businesses to operate in the unregistered economy. So, monetary policy plays a crucial role in the development and organization of SMEs. Furthermore, a stable exchange rate is very important for SMEs for they may make most of their contracts in more stable currencies exposing themselves to exchange rate risk. The level and quality of education in a country is

also important in the development of registered SMEs. SMEs operating in the unregistered economy tend to use less productive labor with lesser skills.

An increasingly important factor in the development of SMEs is the private credit market. Access to credit for investment and working capital allows registered SMEs to grow while discouraging unregistered SMEs at the same time. A banking sector providing loans at low cost is probably the most important factor in the development of SMEs. Furthermore, the size of the black market premium is also important for SME development. Large premiums in the form of illegal economic rents encourage small enterprises to operate in the shadow economy.

## **2.2 Business Environment**

Cost of entry, that is start up costs including registration, license fees and the processing time, is very important for the development of SMEs for these are sunk costs that cannot be recovered during the operations of the businesses.

Contract enforcement and the protection of property rights at low cost are very important for SMEs to start and survive. If contract enforcement costs are too high SMEs may prefer to operate in the unregistered economy rather than engage in economic activities legally. Existence of credit registries can help SMEs to establish credible financial history. This way they can seek funds as well as defend their property rights at low cost. So, an equitable and efficient judicial system is essential for SME growth. Existence of a sound judicial system would also discourage corruption which is a burden on SMEs.

The level of regulatory environment is another factor contributing to the development of SMEs because it provides certainty for businesses operating in their respective industries. In particular, labor market regulations play a significant role in the cost structure of SMEs. Strict labor laws on the hiring and firing decisions of the firm can make it costly for the SMEs and encourage them to employ workers without proper registration.

## **2.3 SMEs Growth Opportunities**

SMEs at their early stages of activity are subject to bankruptcy risks. Survival rates of SMEs are not high particularly after the first year. So, it is essential for SMEs to obtain sufficient financing at their early stages of growth. SMEs, often lacking their own funds, have to resort to

borrowing. So, for long-term growth they have to rely on the banking sector to obtain funds for investment purposes at reasonable costs.

A sufficiently well functioning infrastructure in terms of providing services such as policing, power is another factor that contributes to SME growth. SMEs cannot be expected to provide basic services privately unlike large enterprises because it would be too expensive.

Political stability is essential for entrepreneurs to commit their funds as well as their human capital into their businesses. SMEs expect stability for future development for their investments are highly illiquid with a very shallow secondary market.

High crime rates in a country SMEs would increase the cost of protection and discourage SMEs from expanding further eventually leading to their demise. So, good public safety enforcement provides a safe environment for SMEs to establish and grow.

Taxes while not a major factor can deter SMEs from growth and encourage them to operate in the unregistered economy. In particular, transaction taxes and high tax rates and accounting requirements can discourage SMEs to grow.

## **2.4 SME Development and Historical Determinants**

Historically businesses located in favorable geographic locations tend to survive and grow. Furthermore, the fertility of land plays a crucial role as well. Businesses established in favorable environments where mortality rates are low tend to grow and prosper over time. Demographics is also a determining factor. In areas where there are ethnic fractionalizations SMEs are negatively affected since this introduces political instability. As part of demographics religion play a role in the growth and development of SMEs. For example, in muslim countries there are a lot of SMEs but operate in the unregistered economy.

Legal system is another determinant of the SME development. For example, common law vs. French or German or Socialist law has an institutional advantage over the development of SMEs. In countries practicing common law SMEs tend to flourish more quickly and success in the long run.

## **3. Government Policies on SMEs**

SMEs cannot generate economies of scale as a result, their transaction costs as share of total costs or revenues are higher relative to large businesses. Government policies aimed at reducing transaction costs can stimulate growth of SMEs. Government policies in support of SMEs should focus on creating positive externalities for SMEs as discussed earlier in the form of level credit markets, security, competition and a low-cost equitable legal system. These policies can be implemented in the long run and their impact would also be in the long run. However, most government policies in the past focused on different set of incentives.

Government policies focus on investment and tax incentives. However, these policies are not effective in the long run and do not meet the expectations of the businesses. Such efforts tend to support unprofitable activities and are inefficient. On the other hand, governments can create an environment which will be effective in the long run such as improving education, training and development of SME clusters.