Importance of SMEs and the Role of Public Support in Promoting SME Development

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I. Who are SMEs

- Different countries use different definitions
- Lack of consistent cross-country data
- IFC definition

**Mi** (Micro enterprise)
(a) Employees < 10
(b) Total Assets < US$ 100 000
(c) Total Annual Sales < US$ 100 000

**S** (Small enterprise)
(a) 10 < Employees < 50
(b) US$100 000 < Total Assets < US$ 3 million
(c) US$ 100 000 < Total Annual Sales < US$ 3 million

**M** (Medium enterprise)
(a) 50 < Employees < 300
(b) US$ 3 million < Total Assets < US$ 15 million
(c) US$ 3 million < Total Annual Sales < US$ 15 million
II. Importance of SMEs

- SMEs are the Engine of Growth
- SMEs are Essential for a Competitive and Efficient Market
- SMEs are Critical for Poverty Reduction
- SMEs Play a Particularly Important Role in Developing Countries
SMEs are the Engine of Growth

- SME sector is the largest provider of employment in most countries, especially of new jobs
- SMEs are a major source of technological innovation and new products
SMEs are the Engine of Growth

Distribution of Firms in the Economy by Employment Size (1999 or nearest year)

Czech Republic | France | Italy | United Kingdom | United States

0-499

99.8% | 99.7% | 99.9% | 99.3% | 98.5%

0.3% | 0.4% | 0.1% | 0.7% | 1.5%

500+

0.0% | 0.0% | 0.0% | 0.0% | 0.0%
SMEs are the Engine of Growth

Distribution of Employment in the Manufacturing Sector by Firm Size (1999 or nearest year)

- Czech Republic: 62.6% (0-499), 37.5% (500+)
- France: 63.5% (0-499), 36.5% (500+)
- Italy: 79.7% (0-499), 20.3% (500+)
- United Kingdom: 66.3% (0-499), 33.6% (500+)
- United States: 58.9% (0-499), 41.1% (500+)
SMEs are the Engine of Growth

• SMEs in Russia
  – SMEs (with up to 250 employees) account for about 90% of the total number of firms
  – SMEs provide 45% of total employment
  – SMEs account for 40% of total sales

• SMEs in China
  – SMEs account for 99.9% of the total number of firms
  – SMEs provide 84% of total employment
  – SMEs account for 71% of total sales
SMEs are Essential for a Competitive and Efficient Market

• SMEs with high turnover and adaptability play a major role in removing regional and sector imbalances in the economy
• Easy entry and exit of SMEs make economies more flexible and more competitive
• Large number of SMEs creates competitive market pressure
• SMEs also play an essential role as subcontractors in the downsizing, privatization and restructuring of large companies
SMEs are Important for Poverty Reduction

• SMEs tend to employ poor and low-income workers
• SMEs are sometimes the only source of employment in poor regions and rural areas
• Self-employment is the only source of income for many poor
• SMEs play a particularly important role in developing countries where poverty is most severe
SMEs are Important for Poverty Reduction
SMEs Play a Particularly Important Role in Developing Countries
III. Characteristics of SMEs and Rationale for Public Support

- Lack of economies of scale and high cost of information
- Lack of collective voice and influence on policies
- Limited in management capability
Rationale for Public Support for SMEs

- Market failures cause biases against SMEs
- Small size creates cost disadvantages for SMEs
- SMEs are limited in capability development
Market Failures Cause Biases Against SMEs

- Asymmetric information on SME borrowers and imperfect competition in credit market
- Higher cost of R&D and training for SMEs, in addition to their inability to appropriate the full benefits of the investment
  
  • Restricts SMEs’ access to the credit market
  
  • Causes under-investment for technology transfer and training
Small Size Creates Cost Disadvantages for SMEs

- SMEs do not have the same capacity to influence the environment in their favor as larger firms
- Regulations impose disproportional costs on SMEs
- Private institutional agreements are more costly to SMEs due to their lack of economies of scale

- Raise SMEs’ transaction costs
- Limit SMEs’ ability to take advantage of economic opportunities
SMEs are Limited in Capability Development

• Because of their small size, SMEs usually lack management capacity
• SMEs cannot afford costly support services (e.g., financial, human resources, legal, training)
• Ability to access and analyze information is particularly weak for SMEs
• SMEs often “don’t know what they don’t know”, and their absorptive capacity is poor

• Impacts negatively on SME’s productivity
• Hampers their ability to achieve their business objective
IV. Role of the Public Sector

**Public Support Needed in**

- **Regulatory Environment**
  - Address market failures to open market access
  - Improve transaction efficiency and reduce risk
  - Reduce fixed cost

- **Access to Finance**
  - Increase competitive pressure in financial markets
  - Reduce risks and transaction costs
  - Strengthen financial institutions’ capacity to serve small clients

- **Business Development Services**
  - Provide market support structure to help build SME competitiveness
  - Foster markets for services fit for and demanded by SMEs
  - Develop low-cost service “products” and delivery mechanisms needed by SMEs

**Objectives**
## Role of the Public Sector in Creating an Enabling Regulatory Environment: Basic Principles

<table>
<thead>
<tr>
<th>Stability of the legal, political and policy framework</th>
<th>Provides SMEs assurance that the Government will not unfavorably change the basic conditions underlying their business decisions</th>
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<tbody>
<tr>
<td>Publicity of the rules and laws</td>
<td>Enables SMEs to have access to applicable law</td>
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<tr>
<td>Clarity and certainty of the legal framework</td>
<td>Allows SMEs to understand which laws are applicable to their situation, and their specific meaning</td>
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<tr>
<td>Predictability in the application of the law</td>
<td>Reduces the risks linked to changing interpretation, implementation or enforcement of the law</td>
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<tr>
<td>Fairness, possibility of legal options, and due process</td>
<td>Provides access to independent recourse and mechanism for the settlement of disputes</td>
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Role of the Public Sector in Creating an Enabling Regulatory Environment: Appropriate for SMEs

- Leaves businesses free to decide how best to achieve their objectives, wherever possible
- Focuses on procedures that simplify regulations
- Has fewer and simpler regulations
- Pursues a strategy that focuses on facilitation and compliance rather than control and punishment
- Ensures fair competition
# Role of the Public Sector in Creating an Enabling Regulatory Environment: Strategic Focus and Key Issues

<table>
<thead>
<tr>
<th><strong>Strategic Focus</strong></th>
<th><strong>Key Issues to be Addressed</strong></th>
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<tbody>
<tr>
<td>• Open Access to Markets and Accelerate Market Development</td>
<td>• Reform policies and amend laws and regulations with bias against SMEs in competition, commercial transaction, intellectual and commercial property rights, tax, labor, government procurement, etc.</td>
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<tr>
<td>• Invest in Public Goods, Build Institutional Capability</td>
<td>• Eliminate certain expensive regulatory requirements</td>
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<td>• Reduce and Rationalize Traditional Public Interventions</td>
<td>• Add flexibility in the implementation of regulations</td>
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<td>• Build infrastructure</td>
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<td>• Facilitate information access</td>
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<td>• Monitor SME performance and policy impact</td>
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<td>• Create public/private partnership at local level</td>
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<td>• Reconsider policies that grant SMEs special protection</td>
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<td>• Seek great neutrality across firm size in tax and labor legislation and enforcement</td>
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Role of the Public Sector: Access to Finance

- SMEs are a special risk group (vulnerability, insufficient funds of their own, dependence on a few clients, lack of collateral or credit history)
- SMEs are costly customers (ratio between the amount of financing and the cost of the administrative work)

- Bankers offer higher interest rates reflecting the cost of risk and management
- No lending services provided to SMEs
SME Access to Finance: A Market-Oriented Strategy

- **Accelerates Market Development by**
  - promoting financial sector competition
  - reforming collateral legislation
  - reforming regulations governing leasing, venture capital, equity markets

- **Builds Institutional Capacity by**
  - developing innovations in loan products, lending methodologies, delivery mechanisms, risk assessment methodologies (e.g. credit scoring)
  - providing training and TA to financial institutions serving SMEs
SME Access to Finance: Examples

The Planters Bank Experience (Philippines)

During the past 40 years it has successfully financed more than 15,000 SMEs through:

- Commitment to and focus on its defined market – SMEs
- Profit consciousness to ensure sustainability in its operations
- Innovative approaches in credit risk management
- Simplification of operations, while remaining focused on what it does best

SOFARIS Experience (France)

Since 1982, SOFARIS has provided guarantees for bank loans to SMEs

- The share of SOFARIS guarantees has covered: 40% for investment in existing firms, and up to 70% for start-ups, or higher if complemented by contributions from the regions
Role of Public Sector: Business Development Services

- Direct provision of services
- Facilitation of demand and supply

Achieving high reach to SMEs and institutional sustainability
# Role of the Public Sector in Supporting SME Development: Best Practices

<table>
<thead>
<tr>
<th>Open Access to Markets, Accelerate Market Development</th>
<th>Invest in Public Goods, Build Institutional Capacity</th>
<th>Reduce and Rationalize Traditional Public Interventions (when sustainable)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Environment</strong></td>
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<tr>
<td>· Competition policy</td>
<td>· Infrastructure (transport, ports, market facilities, communications, information technology)</td>
<td>· Reconsider policies that reserve certain sectors for small-scale enterprises or grant them special protection</td>
</tr>
<tr>
<td>· Licensing and registration requirements, administrative fees</td>
<td>· Information (markets, standards, technologies)</td>
<td>· Seek greater neutrality across firm sizes in tax and labor legislation and enforcement</td>
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<tr>
<td>· Commercial transaction law</td>
<td>· Monitoring of SME performance and impact of policies and interventions</td>
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<tr>
<td>· Intellectual and commercial property rights</td>
<td>· Public/private partnerships at local level to improve business environment</td>
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<tr>
<td>· Tax, labor legislation</td>
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<tr>
<td>· Government procurement</td>
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<tr>
<td>· Flexibility in the implementation of regulations</td>
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<tr>
<td><strong>Financial Services</strong></td>
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<tr>
<td>· Financial sector competition policy</td>
<td>· Innovation in loan products, lending methodologies, delivery mechanisms, risk assessment methodologies (e.g. credit scoring)</td>
<td>· Reduce direct lending through public financial institutions</td>
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<tr>
<td>· Collateral legislation</td>
<td>· Credit bureaus, registries</td>
<td>· Reduce SME lending (portfolio) requirements on financial institutions</td>
</tr>
<tr>
<td>· Prudential regulation and supervision</td>
<td>· Training and TA to financial institutions serving SMEs</td>
<td>· Eliminate subsidized credit lines and credit guarantee scheme</td>
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<tr>
<td>· Regulations governing leasing, venture capital, equity markets</td>
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<tr>
<td><strong>Business Development Services</strong></td>
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<tr>
<td>· Target subsidies for market development to specific market failures</td>
<td>· Innovation in products (especially for the smallest firms), delivery mechanisms</td>
<td>· Increase cost recovery for publicly-provided or subsidized services</td>
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<tr>
<td>· Information on service providers, impact of services</td>
<td>· Development of performance and impact indicators</td>
<td>· Improve management and cost control in public BDS institutions</td>
</tr>
<tr>
<td>· Enforce competition in service markets</td>
<td>· Training and TA to private BDS providers</td>
<td>· Condition budgetary allocations to the achievement of impact</td>
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<td></td>
<td>· Limit long-term subsidies for BDS to public goods (e.g. information, labor and management training)</td>
<td>· Reduce duplication across agencies in services provided</td>
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<td>· Use the private sector to delivery services</td>
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<td>· Privatize service providers when financially sustainable</td>
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Role of the Public Sector: Public Programs to Assist SMEs and Enhance Entrepreneurship

<table>
<thead>
<tr>
<th>Focus</th>
<th>Programs</th>
<th>Countries</th>
<th>Experience</th>
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<tbody>
<tr>
<td>Access to Financing</td>
<td>Loan Guarantee Scheme, SMEs without access to own collateral obtain access to bank loans by state acting as guarantor</td>
<td>UK, USA, Canada, France, Netherlands</td>
<td>Generally viewed as helpful, but small scale impact on the overall financing of SMEs in most countries</td>
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<tr>
<td>Access to Markets</td>
<td>Europartenariat, Organization of Trade Fairs to encourage cross-border trade between SMEs</td>
<td>EU</td>
<td>General satisfaction amongst firms that participated</td>
</tr>
<tr>
<td>Administrative Burdens</td>
<td>Units established within government to seek to minimize administrative burdens on smaller firms, deregulation Units</td>
<td>Netherlands, Portugal, UK</td>
<td>The view of small firms themselves is that bureaucratic burdens have increased markedly in recent years</td>
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<tr>
<td>Science Parks</td>
<td>Property based developments adjacent to Universities</td>
<td>UK, France, Italy and Sweden</td>
<td>Conflicting findings on impact of SPs on performance of firms</td>
</tr>
<tr>
<td>Managed Workspace</td>
<td>Property provision to assist new and very small firms. Provide premises for new and small firms on “easy- terms”</td>
<td>World-wide</td>
<td>General recognition that such initiatives are of value</td>
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<td>of business incubators</td>
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<tr>
<td>Stimulating Innovation</td>
<td>Small Business Innovation Research Program, $1 billion per year is allocated via competition to small firms to stimulate additional R&amp;D activity</td>
<td>USA</td>
<td>Studies imply SBIR enhances small firm performance, but are unable to show that firm performance leads to additional R&amp;D</td>
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<tr>
<td>and R&amp;D in small firms</td>
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<tr>
<td>Stimulating Training</td>
<td>Japan Small Business Corporation (JSBC) and local governments provide training for owners and managers of small firms</td>
<td>Japan</td>
<td>Unknown</td>
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<td>in small firms</td>
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<tr>
<td>Entrepreneurial Skills</td>
<td>Small Business Development Corporations (SBDCs) Counseling is provided by SBDC mentors to small business clients who may be starting a business or be already trading</td>
<td>USA</td>
<td>Studies find SBDC clients have higher rates of survival and growth than might be expected, but reservations over these findings are found in other studies</td>
</tr>
<tr>
<td>Entrepreneurial Awareness</td>
<td>Entrepreneurship Education, to develop awareness of enterprise and/or entrepreneurial spirit in society by incorporating enterprise into the school and college curriculum</td>
<td>Atlantic Canada, Australia, Netherlands</td>
<td>Conventional assessments are particularly difficult here because of the long “lead times”</td>
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<tr>
<td>Special Groups</td>
<td>Law 44 provides finance and mentoring advice to young people in Southern Italy, where enterprise creation rates were very low</td>
<td>Southern Italy</td>
<td>Most studies show the survival rates of assisted firms to be well above those of “spontaneous” firms, but this is an expensive program</td>
</tr>
</tbody>
</table>

Source: Storey (2003) modified