THE ROLE OF SMALL-MEDIUM ENTERPRISE DEVELOPMENT UNDER GLOBALIZATION, LIBERALIZATION, AND THE INFORMATION REVOLUTION

A RESEARCH PROPOSAL

Albert Berry
Department of Economics
and
Centre for International Studies
University of Toronto

Toronto, Canada

Para presentación en la IV reunión Anual de la Red de Economía Social

Panamá City

July 17-20, 2000
1. The Core Hypotheses

The central ideas to be tested in the research proposed here can be broken into two categories, which related to:
(i) the frequently posited characteristics of the SMF sector which, according to supporters, allow it to make major contributions to the creation of productive employment and to equitable growth in general. Most of the analysis pointing to this conclusion has been undertaken in economies with considerable trade protection and other important market interventions; and
(ii) the more specific question of what role the SME sector can play under conditions of globalization, and the information revolution (GLI), the contextual changes which have most clearly characterized the last decade or so.

The second area will be the ultimate focus of the project, though category (i) issues remain relevant. Since the propositions that underpin the positive overall view of SMEs are not all themselves beyond dispute, some of those propositions will be considered both in general and specifically in the context of globalization-liberalization setting.

Both with respect to the general hypotheses on SMEs and to what is special about its role in the present GLI context, there is a set of policy questions as to how governments may best support the SME sector in the fulfillment of its potential. The three contextual changes identified alter the policy environment facing SMEs, so it is logical to presume that they also alter the optimal policy package.

A number of pieces of evidence have contributed to the hypothesis that a sizeable and growing SME sector can contribute importantly to fast and equitable overall growth. Major elements of this body of evidence include the following core ideas related to category (i) above:

a) SMEs tend to be intermediate in factor proportions (capital/labor ratio) and in technology employed between the large (on average) capital intensive firms and the very small microenterprises implies that allocation of a higher share of resources to them could raise the average productivity of the economy; it could also improve income distribution, since the differences in factor proportions are typically related to differences in wages;

b) The SME sector often acts as a seed-bed for entrepreneurial skills, with people who learn how to run businesses in the SME sector growing their firms to large size in some cases or taking over large firms in other cases;

c) The fact that SMEs often show considerable flexibility and agility suggests they may be
able
to help an economy as a whole to weather exogenous shocks, to take advantage of
fluctuations in world markets, etc.;

d) SMEs appear to undertake a good deal of saving (partly since their access to other
sources can be limited), thus contributing to total national savings;

e) The success of SMEs in improving their technology has naturally been harder to measure,
so there is less presumption one way or the other as to whether this is easy and/or
constitutes a point of strength for them. While they are usually given credit for employing
technologies which are more or less appropriate to the country, it is sometimes questioned
whether they are able to adopt new technologies easily when they need to. Their
performance on the technology front is, therefore, and especially important research
issue.

e*) It has been argued that acting as subcontractors for large firms (perhaps exporters, perhaps not)
provides a valuable channel for technological up-grading (including improvement of managerial capacity) of SMEs.

f) There are enough sectors/activities in which these and any other advantages of SMES can
manifest themselves such that the sector’s overall impact on economic performance is significant. Overall performance includes the impact on growth, on productive
employment and income distribution; SME’s role would be considered important if the
fulfilment of its potential can have a significant impact on one or more of these variables;
in the case of productive employment the presumption is that a contribution here shows
up also in the rate of growth and perhaps in greater equality. A significant effect on growth
would be, say, anything above 1% per year and on income distribution an impact on the
Gini coefficient of perhaps three points or more when one compares high and low
fulfilment of the potential of the SME sector.

The optimistic view of the potential role of Smes tends to be positive on each of these
points, or at least in terms of the overall balance, since for the sector to be a really important one
in the promotion of growth with equity, it must be characterized by “more appropriate” factor
proportions than either large or very small enterprise (its static advantage), must be able to
contribute adequately to growth through savings, technological change and the development of
entrepreneurial skills (the dynamic advantages/contribution) and it must be able to manifest these
advantages in a large enough share of the economy as a whole so that its quantitative impact is
significant.
An extension of the above general arguments to the open-economy context is the argument that a strong SME sector can help keep the country’s tradables sector competitive and agile. As discussed below, there is no single model or view with respect to how SMEs contribute to growth in an open economy, but important hypotheses, each applicable at least in some cases, include:

**g)** Most direct exporting is done by large firms because of economies of scale in the trade, finance and other non-production stages of the process; but if the export-related set of activities are to be reasonably labour intensive in an average or overall sense, then SMEs (or microenterprise) must be involved somehow, e.g. through subcontracting with the exporters; ¹

**h)** Their greater flexibility (related to smaller size, simpler organizational structure, and greater ease of hiring workers and letting them go) should allow SMEs to do better than their larger counterparts in export and import competing markets characterized by much volatility. But,

**h*)** A competing view is that SMEs may be more vulnerable to market instability related to an economy’s openness than their larger counterparts. It is widely commented (Though with what accuracy is not know) that SMEs suffer severely at times of macroeconomic downturns (as currently in Korea) and/or import surges (e.g. Mexico in the 1980s)

In support of hypotheses (g) and (h) is the fact that most competitive exporting countries rely to a considerable extent on SMEs through the mechanism of subcontracting with larger exporters (Japan and Korea most notably) and to a lesser extent on clusters of smaller which are able to conquer foreign markets (many countries). There appears to be a clear contradiction between the view that a strong point of SMEs in open economies is their flexibility and related capacity to weather exogenous shocks in general (Hypothesis h) and the idea that they are the first and most vulnerable victims of trade shocks (Hypothesis h*). The contradiction is probably only apparent, in the sense that some SMEs may in fact be among the best of all firms at dealing with certain changes of context while others may be among the worst: or the difference may depend on the type of shock. In any case, it is of great importance to clarify the potential of various categories of SMEs, or more likely, the potential of combinations of large and small firms which interact closely with each other.

¹ Exporting firms and governements often see the benefits to SME involvment in terms its lowering the costs of exports because of the lower labour costs of SMEs, and the greater ease of displacing workers when necessary. This perception is to a large degree an illusion; the theory of comparative advantage highlights the fact that what will be exported and imported does not depend on absolute costs or productivity but on relative costs (or productivity). Balance is maintained by the exchange rate. What makes individual firms competitive (low absolute costs) is not what makes a country’s overall export sector competitive. Under special circumstances (e.g. fixed exchange rate and inflexible prices) the popular view may have some validity.
The issue of the extent to which SMEs take advantage of flexibility has not been studied in the systematic way which would be necessary to make either quantitative judgments as to whether this is an important issue or to assess the situations under which the flexibility can be expected to pay off and those others (perhaps involving more extreme exogenous shocks) where they will not.

i) SME involvement in trade may be important to an economy’s overall success, as the above hypotheses suggest. Involvement in trade may also be important if SMEs are not to lose ground technologically. It has recently been argued that firms engaging in export activities achieve faster growth of total factor productivity (Pack, 1992; Isgut, 1998; others). Since large firms engage disproportionately in exports in most countries, this suggests that a more outward orientation will, at least initially, raise or create a productivity gap between the large and the SME firms. The general validity of this contention and its implications for the SME sector and overall development need to be assessed.

2. Other Issues

2a. Types of SMEs

Given the range of productive activities in which small and medium enterprises are engaged, it would be surprising if the firms did not differ among themselves in many respects beyond that activity itself. They also vary substantially by size if, as is the custom, we define the SME sector as a size range something like 5-100 or 5-200 workers. Many are quite young while some have been in existence for many years.

Two distinctions will be given special emphasis here—that by size and that by nature of the relationship with other firms. The first is relevant since many performance variables are likely to be correlated with size within the broad SME category, just as, albeit less extremely than, they are correlated with size across the whole range from microenterprise to large enterprise. Since the hypotheses about SME behaviour which suggest that its advantages over large and microenterprise imply that behaviour varies by size, it is important to know whether the relationship with size is a more or less continuous one or involves demarcation lines, and if the latter, where those lines (if any) are located within the SME range itself. In most countries access to formal sector credit changed substantially.

Most analysts recognize the importance of how SMEs interact with larger and smaller firms, i.e., their place in the matrix or chain of firms within which they operate. The three-way categorization of SMEs into those that are primarily subcontractors for larger firms, those that are parts of mainly SME clusters, and those that are neither is a first step. Within the last category, some SMEs deal primarily with other SMEs and some primarily with larger firms. Others are in more mixed situations. While it is reasonably clear why these various patterns emerge and what underlies the differences in the web of market relationships an SME may have, the extent to
which they yield benefits and create risks for SMEs have been little studied. It is a rather widely held view that clusters are a phenomenon to be desired, so the questions which have received most attention about them relate to the conditions under which they can arise and flourish, and the extent to which policy support can be beneficial. With respect to subcontracting, the prevalent view at present is that this arrangement too is generally beneficial both to the subcontractors and to the economy’s overall performance. Much discussion surrounds the policy question of what conditions and types of support may facilitate the development of effective subcontracting systems.

j) One currently important hypothesis is that to be involved successfully in the export chain, SMEs usually must be either part of a cluster or be subcontractors. This is more likely to be true of smaller firms than of medium-sized ones.

2b. Firm Dynamics

The high entry and exit rates for smaller firms (including microenterprise but also the small firms included in the SME sector) have been widely commented upon, and their efficiency implications speculated on. Here a null hypothesis is:

k) Under most circumstances firms which should survive do and vice versa, i.e. the market is sorting out those firms with the potential a positive contribution to the economy’s performance.

Evidently, however, this hypothesis is less likely to be if there are serious market imperfections (policy induced or otherwise). At present very little is understood about the efficiency of the entry and exit processes. One relevant study is that by Liu(1995??).

Only a small share of microenterprises graduate to the SME size range (this is inevitable given the large numbers of microenterprises) and in most cases only a modest share of employment creation in the SME range comes from microenterprises which move up to the SME size category. Within SMEs, by contrast, it appears that firm growth is much more frequent and can in the aggregate be rapid. The determinants of such growth and its implications on the overall performance of the SME sector are not yet well understood. This suggests the value of assessing:

l) The determinants of microenterprise graduation to the SME category and of firm-level growth rates among SMEs, with particular attention to the effect on these processes of trade and technology-related phenomena, e.g. chance to act subcontractor to an exporting firm.

Past research (e.g. Liedholm and Mead, 1999) has confirmed the typically high mortality rates of very small firms in their first ears under nearly all (perhaps all) circumstances, and the high
birth rates under most circumstances. The proximate causes of the mortality patterns among smaller firms are increasingly known and appear to be similar across countries; what is not clear are the socio-economic implications of mortality, which may at the one extreme be deemed an efficient selection process which weeds out the less efficient firms or, at the other extreme, a costly learning process in which many resources are lost with few resulting benefits. One type of firm exit which is cause for concern is the demise of healthy firms which occurs when the entrepreneur retires and has no one to pass the business along to. Anecdotal evidence suggests that in societies where the entrepreneur keeps close control of all aspects of the business, it is less likely that he/she will be able to transfer it easily to someone else. Often entrepreneurs educate their children on the expectation that they will take over; in some cases this does occur. At present, however, it is unclear what share of healthy survive the transfer from their founder and in the case of those which do not, how much is lost when the business dies. It is possible that intergenerational patterns depend mainly on cultural features of the society, but they may also depend substantially on the legal or more generally the institutional framework and the difficulty or ease it presents to the transfer of property. The null hypothesis parallel to (k) above is:

p) Under most circumstances, healthy firms survive the transfer between owners without significant loss of productive potential, except where the loss of that potential is an inevitable result of the fact that such potential is a direct reflection of the special skills and knowledge of the entrepreneur.

P*) Efficient selection of firms between survival and exit under structural adjustment is an especially relevant aspect of the general issue of whether the right firms survive. Policy change and more open markets may also increase the fluctuations to which firms are subjected, which in turn may highlight the efficiency of survival issue.

Even if loss of potential at transfer is hard to avoid, an interesting question is how steps taken in advance by the entrepreneur would increase the likelihood of successful transfer to another entrepreneur. A related issue can be captured by the hypothesis that

q) For the most part neither rates of firm survival nor rates of firm-level growth have much impact on an economy’s performance because differences