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"Thought Paper": The Role of Small and Medium Enterprises in Frontier Capital Markets

#1: "What defines a Small and Medium Enterprise?"

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This is the first in a series of "thought papers" published by the Network Science Center at West Point. As our team conducts their analyses, certain findings and insights might arise that are not directly related to the research question at hand but, we believe, are important to both the academic and policy communities. This particular series of "thought papers" will address insights concerning economic development issues.

The Network Science Center at West Point has been involved in ongoing research exploring the network topologies of Capital Markets in Frontier Capital Markets. Frontier Markets are essentially a subset of Emerging Markets with lower market capitalization and liquidity. This term was coined in 1992 by the International Finance Corporation. Our team's research has involved extensive data collection including numerous interviews with financial leaders and innovators in these emerging economies.

During the course of this data collection and the subsequent analysis, the research team has identified additional topics that we believe are ripe for analysis. We believe that addressing these research topics is vital to understanding and devising potential innovations in economic development.

Our initial visits to these Frontier Markets focused on larger firms, financial institutions, and macro-economic issues. During the course of these visits, especially in Africa, our teams observed a culture of vibrant entrepreneurship as we met with owners and founders of Small and Medium Enterprises (SMEs). Because of the impact of our discussions with these entrepreneurs, we have decided to explore the importance of these SMEs and their potential impact of economic development, at large, and their potential contribution to the development of these frontier capital markets.

Introduction

It is commonly agreed by economic development practitioners that SMEs are pivotal to encouraging and ensuring economic growth. In OECD countries, SMEs make up over 95% and up to 99% of enterprises and are responsible for between 60-70% of the job creation.[1] While they may be important to developed countries, they are even more important to the developing world where abysmal employment rates and huge gaps between the rich and the poor create desperate living situations. Not only do SMEs help create "decent jobs" that the poor would not otherwise have (in fact, they are often the largest provider of jobs, especially new jobs), SMEs also "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."[2]

As a result of their proven track record in countries around the globe, many governments are now taking steps to encourage the growth of SMEs in an effort to create jobs, improve their economy, and encourage larger businesses to take root. It is the general consensus that high-performing SMEs are important for developing countries, both economically and socially – they improve the economy and raise the ability of the people to live decent lives.

What is an SME?

According to United States Agency for International Development **(**USAID), there are a variety of different definitions that can be given to SMEs around the world. According to the Organization for Economic Cooperation and Development (OECD), the characteristics of SMEs not only reflect the economic patterns of a country but also the social and cultural dimensions. Therefore, it should be unsurprising that definitions are not consistent across countries; in fact, they often are not consistent within them.[3] Although there have been attempts to create a definition of what an SME is that would be applicable across the world, there has been little success as SMEs change depending on their home country and the economy they operate within. An SME molds to the country.[4]

How SMEs are classified also depends on the level of development of businesses and the economy within each individual country. When looking at definitions of SMEs across the world, the most commonly used indicator is the number of individuals employed by an enterprise as it is one of the easiest measures to collect. The other measures that are commonly used to define SMEs tend to be more difficult to calculate such as business assets and turnover in employment. A general distinction

[1] OECD. (2006). Financing SMEs and Entrepreneurs. *Policy Brief.* Retrieved from http://www.oecd.org/dataoecd/53/27/37704120.pdf.
[2] Berry, A. (2007). University of Toronto. The Importance of SMEs in the Economy. ITD Global Conference on Taxation of Small and Medium Enterprises. Retrieved September 12, 2011. http://www.itdweb.org/smeconference/documents/plenary/PI%20Berry%20ENG.pdf
[3] USAID. (2007). Booklet of Standardized Small and Medium Enterprises. Retrieved from http://pdf.usaid.gov/pdf_docs/PNADM845.pdf.
[4] Ardic, O. P., Mylenko, N., and Saltane, V. (2011). Small and Medium Enterprises: A Cross-Country Analysis with a New Data Set. *The World Bank: Policy Research Working Paper 5538.*

can be made between different types of businesses – the European Union focuses on the following distinction:

Number of employees	*Type of Business*
0	Self employed
2-9	Micro
10-49	Small
50-249	Medium[5]

It is also understood that these businesses have to be independent, which means that no more than 25% of any of these businesses can be owned by an enterprise which does not meet the definition of an SME or micro-enterprise.[6] However, it is not always easy to make this distinction as it depends on when and from which level the data is collected. Therefore, data and hence classification may not always be correct.[7]

According to Ardic, Mylenko, and Saltane, most definitions focus on the amount of sales, number of employees, and/or the loan size, although, as stated above, it is most common to classify based on the business' number of employees. These authors conducted a study on 68 countries and analyzed how SMEs were defined within their borders – 50 out of the 68 used the number of employees to define an SME and 29 of these 50 also used the amount of sales and the loan size. Forty-one of the 60 businesses only used sales while only 15 relied solely on the loan size.[8]

While the most accurate way to classify an SME is to focus on the number of employees and the amount of sales, this information is not always available. Since this is the case, there are many countries that instead turn to collecting information on the size of loans that are taken out by enterprises of a certain size from banking institutions. While this information is not as valid, it still provides a relatively good measure of SME activity within the country. *Financial Access 2010* stated that 15 countries around the world use the size of a loan as a way to define an SME. Yet, there is still a large amount of variation among the countries as to what size loan actually determines whether an enterprise will be classified as an SME.[9]

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[5] OECD-UNIDO. (2004). Effective Policies for Small Businesses: A Guide for the Policy Review Process and Strategic Plans for Micro, Small, and Medium Enterprise Development. Retrieved from http://www.unido.org/fileadmin/media/documents/pdf/Ammended_pdfs/33163_EffectivePoliciesforSmallBusiness.pdf.

[6] JETRO. (2007). Access to Finance: Profiles of African SMEs. Retrieved from www.africapractice.com/uploads/JETRO.pdf.

[7] OECD-UNIDO. (2004). Effective Policies for Small Businesses: A Guide for the Policy Review Process and Strategic Plans for Micro, Small, and Medium Enterprise Development. Retrieved from http://www.unido.org/fileadmin/media/documents/pdf/Ammended_pdfs/33163_EffectivePoliciesforSmallBusiness.pdf.

[8] Ardic, O. P., Mylenko, N., and Saltane, V. (2011). Small and Medium Enterprises: A Cross-Country Analysis with a New Data Set. *The World Bank: Policy Research Working Paper 5538.*

[9] Ibid.

While it may not be possible to have a global SME definition, Ardic et al. believe that it would be beneficial for countries to create a single "domestic definition" so that reliable and accurate information can be collected from all enterprises within their borders. Such information is necessary in order to more accurately monitor SMEs, their impact on the economy, and the volume of business that they conduct within their respective countries. This would require, in accordance with the current definition of an SME, the collection and maintenance of information on the number of employees in these businesses as well as the volume of sales that each conducts at regular intervals. However, as this would take a great deal of coordination and effort on the part of financial institutions and credit registries, the collection of loan size data is a "reasonable proxy of SME volumes."[10] (TABLE 1)

	Description
Commonalities	▪ Staff headcount is a major indicator that is used in most definitions.
	▪ Most SMEs classification criteria were based on a maximum of two indicators
	▪ Most regional countries define SMEs as those enterprises that employ between 10 and 99 employees
Shortcomings	▪ Little emphasis was given to sectoral based definitions. Instead a generic definition was used.
	▪ Few local definitions were established for specific sector(s) which made it difficult to generalize the definition's criteria across the entire market. One such example is the MIT definition of Industrial SMEs.
	▪ Few definitions were developed for certain purposes that do not follow the common logic of establishing an SME definition. As an example, the definition of the CBJ (in accordance with BASEL II) was developed for capital adequacy and risk calculation purposes.
	▪ Despite the fact that UNIDO highlighted the importance of including qualitative indicators in SME's classification criteria, qualitative measures were often neglected.

Source:UNIDO

TABLE 1

As noted above, there are a variety of definitions for SMEs around the world; the following is a discussion of these definitions from a variety of leading economic development organizations:

According to the International Finance Corporation (IFC), small and medium enterprises (SMEs) are commonly defined as registered businesses with less than 250 employees, which contribute heavily to employment and GDP, grow in ways linked to the formalization of an economy, and often have great difficulty accessing financial services in many emerging markets.

[10] Ibid.

The European Commission (EC) considers three different measures when it is determining whether or not an entity should be labeled as an SME: (1) number of staff, (2) annual sales, and (3) assets. The first measure, the ability to meet the staff threshold amount, is a mandatory requirement for any enterprise to be considered an SME. However, after meeting this requirement, the EC allows SMEs to qualify by meeting either the second or third measures – they do not have to meet both. The EC introduced this variation in order to ensure that the type of economic activity that an enterprise engaged in did not disadvantage it. Some industries will not have annual sales figures that are high enough when compared to other industries but will meet the asset requirement. The EC felt that this would ensure fair treatment to a variety of different economic activities and ensure that enterprises would not lose their SME label. According to the EC, SMEs have fewer than 250 people in their employ, have annual sales not to exceed $67 million and/or assets that do not exceed $56 million.[11]

Interestingly, The Multilateral Investment Guarantee Agency (MIGA) and the IFC, both members of the World Bank Group define small enterprises and medium enterprises with different thresholds. Note that MIGA does not consider the number of staff in their classification of enterprises as a mandatory requirement unlike the EC definition. Small enterprises must meet two of three conditions: (1) employ less than 50 employees, (2) make less than $3 million in annual sales, and (3) hold less than $3 million in assets. To be classified as a medium enterprise, businesses must meet two of these three conditions: (1) employ less than 300 employees, (2) make less than $15 million in annual sales, and (3) hold less than $15 million in assets.[12]

The Asia Pacific Economic Cooperation (APEC) focuses most on the number of employees. Under this definition SMEs employ less than 100 individuals. A medium sized business employs between 20 and 99 people and a small business employs between 5 and 19.[13]

The United Nations Industrial Development Organization (UNIDO) definition of an SME depends on a variety of factors. According to UNIDO, SME definition depends on the purpose of the classification as it is considered to be "a significant issue for policy development and implementation." As a result, the definition of an SME varies among the different countries and can even change over time within a country. As UNIDO focuses on policy development, the advisory for countries is to consider both qualitative and quantitative factors when creating a definition for SMEs within their borders.[14] (Table 2)

[11] USAID. (2007). Booklet of Standardized Small and Medium Enterprises. Retrieved from http://pdf.usaid.gov/pdf_docs/PNADM845.pdf.
[12] Ibid.
[13] Ibid.
[14] Ibid.

Why SMEs are Important

At the African Investor CEO Institutional Summit held at the New York Stock Exchange in September of 2011. A Vice President from State Street Global Advisors VP stated that the informal economy in Sub-Saharan Africa is approximately 50% of the overall economy. All participants in this informal economy are essentially SMEs.

Category	SMEs	Large Companies
Management	▪ Proprietor-entrepreneurship ▪ Functions linked to personalities	▪ Manager-entrepreneurship ▪ Division of labor by subject matters
Personnel	▪ Lack of university graduates ▪ All-round Knowledge	▪ Dominance of university graduates ▪ Specialization
Organization	▪ Highly personalized contacts	▪ Highly formalized communication
Sales	▪ Competitive position not defined and uncertain	▪ Strong competitive position
Buyer's Relationships	▪ Unstable	▪ Based on long-term contracts
Production	▪ Labor intensive	▪ Capital intensive, economies of scale
Research Development	▪ Following the market, intuitive approach	▪ Institutionalized
Finance	▪ Role of family funds, self financing	▪ Diversified ownership structure , access to anonymous capital market

Source: UNIDO

TABLE 2

Additionally, the World Economic Forum Launched the Missing Middle Initiative at Davos, Switzerland in January 2010. This initiative announced that "establishing a large and robust SME base has a significant positive impact on the economic and social health of countries and is a key driver in developing emerging markets."[15] The initiative states that growth in the number of SMEs increases the size of the middle class and alleviates poverty through "job creation and sustainable growth."[16] The initiative also cites other positive economic impacts such as "robust and stable GDP growth through the diversification of business sectors and sizes, the promotion of innovation, and the priming for larger investment into SMEs to grow their businesses."[17]

SMEs are more adaptable than their larger counterparts. They are flexible and dynamic and therefore are able to withstand economic downturns better than larger

[15] World Economic Forum. (2010). The Missing Middle Initiative: A YGL-Global Redesign Initiative. Retrieved from http://www.sacca.biz/backend/media/2272010113630PM/MissingMiddleInitiativeYGLGRI.pdf.
[16] Ibid.
[17] Ibid.

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firms. They require less capital to start and maintain themselves and, as they are more labor intensive, than a large firm they are more likely to succeed in "smaller urban centers and rural areas, where they can contribute to a more even distribution of economic activity in a region and can help to slow the flow of migration to large cities." This allows for more income equality across the region.[18]

One of the best ways to improve the percentage of unemployed in Africa is to "leverage the employment creation potential of small businesses and to promote small business development."[19] In order to achieve this and to create a strong SME based economy new firms must be created.

Over the past 50 years, Taiwan has become one of the most successful developing countries in the world and it has been built on a vibrant SME sector. According to Professor Albert Berry of the University of Toronto[20], it is important for an economy to be efficient, to have a relatively equal distribution of capital and labor incomes, to ensure low prices, high levels of quality, and a healthy level of economic competition; all of these things will come from having SMEs as a large part of the economy. An SME rich economy will ensure a more equitable distribution of income in comparison to other economies. SMEs are also productive enough to compete with larger firms but have the advantage of being able to create more jobs for a smaller amount of investment capital.[21]

SME Challenges

Economic development experts are generally in agreement that the growth and development of SMEs is a vital component of policy to encourage economic growth in the developing world. However there are many challenges to the creation of and the long-term sustaining of SMEs across Africa.[22] A majority of these challenges are finance-related. During our team's travels, we have had the unique opportunity to meet first-hand with the leaders of numerous SMEs in West Africa and to understand the daily challenges that they face. These financial challenges will be the focus of the team's next "thought paper."

[18] Abor, J. and Quartey, P. (2010). Issues in SME Development in Ghana and South Africa. *International Research Journal of Finance and Economics,* 39. Retrieved from http://www.eurojournals.com/finance.htm.

[19] Fatoki, O. and Odeyemi, A. (2010). Which New Small and Medium Enterprises in South Africa have access to Bank Credit? *International Journal of Business and Management,* 5 (10). Retrieved from www.ccsenet.org/ijbm.

[20] Albert Berry is Professor Emeritus of Economics and Research Director of the Program on Latin America and the Caribbean at the Centre for International Studies at the University of Toronto. His areas of expertise are: labor markets and income distribution, the economics of small and medium enterprise, and agrarian structure and policy. He has worked with the Ford Foundation, the Colombian Planning Commission, and the World Bank, and acted as consultant for a number of international and other agencies. He is the author of more than 100 papers and the editor of more than seven books.

[21] Berry, A. (2007). University of Toronto. The Importance of SMEs in the Economy. ITD Global Conference on Taxation of Small and Medium Enterprises. Retrieved September 12, 2011. http://www.itdweb.org/smeconference/documents/plenary/PI%20Berry%20ENG.pdf

[22] Fatoki, O. and Odeyemi, A. (2010). Which New Small and Medium Enterprises in South Africa have access to Bank Credit? *International Journal of Business and Management,* 5 (10). Retrieved from www.ccsenet.org/ijbm.