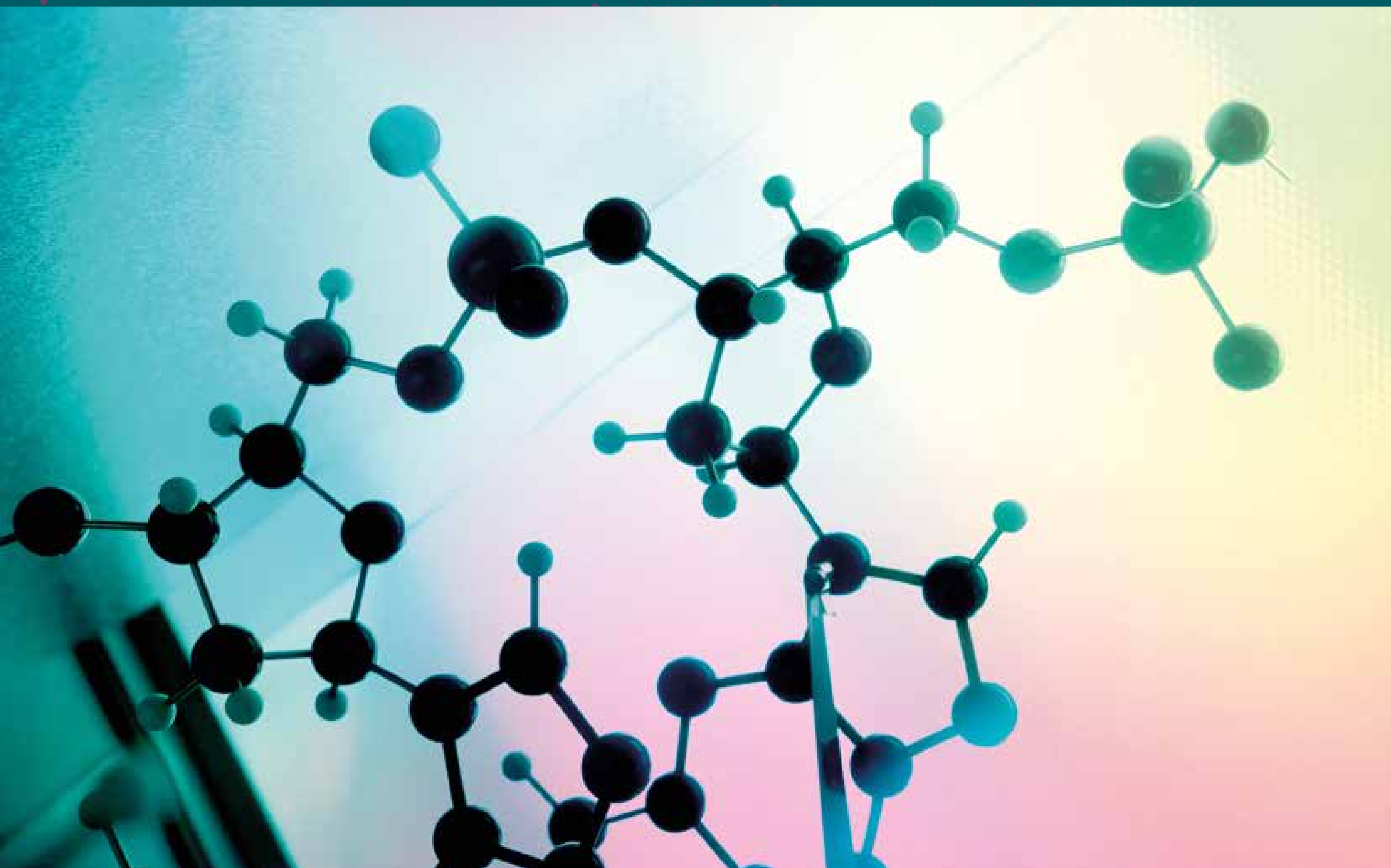
SME COMPETITIVENESS OUTLOOK 2015

Executive Summary

Connect, compete and change for inclusive growth



International Trade Centre

TRADE IMPACT FOR GOOD

The International Trade Centre (ITC) is the joint agency of the World Trade Organization and the United Nations.

Street address: ITC
54-56, rue de Montbrillant
1202 Geneva, Switzerland

Postal address: ITC
Palais des Nations
1211 Geneva 10, Switzerland

Telephone: +41-22 730 0111

Fax: +41-22 733 4439

E-mail: itcreg@intracen.org

Internet: http://www.intracen.org

Printed by ITC Digital Printing Service.

A free pdf is available on ITC's website at: www.intracen.org/publications.

Executive Summary

Connect, compete and change for inclusive growth

Contents

Executive Summary

SMEs are the missing link to inclusive growth. SMEs account for approximately 60-70% of total employment. The wages paid by SMEs are significantly lower than those paid by large firms. This is largely because their productivity lags behind large firm productivity. Addressing the 'productivity gap' is crucial for inclusive growth. This report argues that to increase productivity, firms must connect, compete and change.

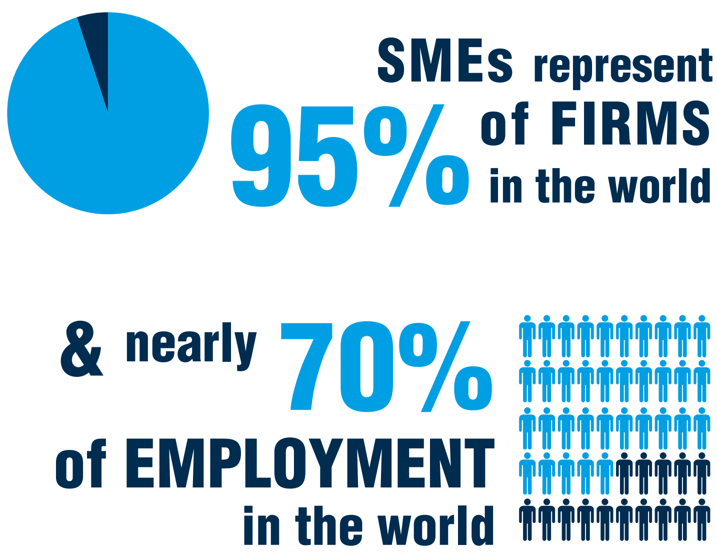
Part I. SMEs and global markets: The missing link for inclusive growth

1. Understanding SMEs

SMEs contribute significantly to employment, GDP and exports

SMEs constitute the overwhelming majority of firms. Globally, SMEs make up over 95% of all firms, account for approximately 50% of GDP and 60%–70% of total employment, when both formal and informal SMEs are taken into account. This amounts to between 420 million and 510 million SMEs, 310 million of which are in emerging markets.

INFOGRAPHIC SMEs are the backbone of the global economy.



Many shapes and sizes

The term 'SME' encompasses a broad range of definitions, which differ according to factors such as country, geographic region, level of development and business culture. Even within countries, definitions may vary or be non-existent. In addition, the definition itself is often linked to national support programmes and other regulations, making the adoption of a single definition difficult.

Firm size and the structural make-up of economies

The importance of the SME sector has changed over time, reflecting the impact of technological change, changing market conditions and rising standards of living.

Before the industrial revolution, production was dominated by what today we might call SMEs. Small workshops and self-employed farmers employed few people and produced bespoke specifications. As the industrial revolution picked up steam, firm sizes began to increase steadily. For example, the median number of workers in cotton firms in Manchester, England more than tripled between 1815 and 1841. This increase was linked to the integration and emergence of national markets, which functioned as important sources of demand, encouraging production of large volumes of goods. Technological innovation and mechanization contributed to radical changes in modes of production. The advent of factories often required high levels of fixed investment, forcing firms to expand to benefit from economies of scale. This reorganization of production, alongside the expansion of firm sizes, grew apace well into the 20th century.

Since the 1970s, the trend has been changing. Increased concentration of employment and value added in large firms reversed in a number of OECD countries, and SMEs began to be viewed as sources of nimble innovation and job creation. Partly fuelled by a desire to outsource non-core competencies, the trend allowed firms to focus on their core competencies – resulting in horizontal (cluster) and vertical (value chain) production systems.

While the historical experience is interesting, it may also be of relevance for the near future. With increased market integration and expansion in recent decades, conditions may once again be in favour of large firms. On the other hand, factors like information and communications technology (ICT) create an environment that may be conducive for the re-emergence of SMEs. The spread of ICTs has led to the phenomenon of 'born globals': SMEs which, from day one of operations, sell or intend to sell to a global client base via e-platforms, blurring the traditional picture of the internationalization process.

2. Why the 'middle' matters

It is hard to grow up

The overwhelming majority of SMEs in the developing world are micro enterprises with fewer than ten employees. In many economies, the private sector is split into two segments: small – often micro – enterprises on the one hand, and a few very large enterprises on the other hand. This phenomenon is called the 'missing middle'. Among the explanations for the 'missing middle' is the central tenet that small firms have few incentives to growth, because they are adversely affected by taxes and access to finance policies once they are medium-sized.

A balanced firm size distribution stimulates competition

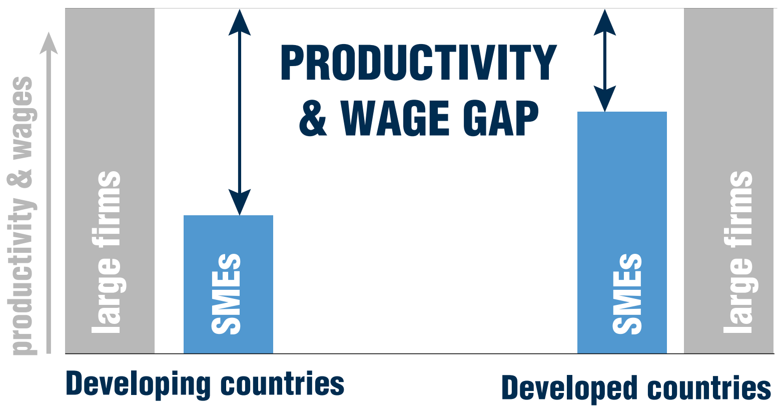
Domination by a few large players with significant market power tends to make economies less dynamic, in particular if small firms are too small to challenge the big players in the market and when lobbying for policy reforms. A balanced firm size distribution instead, stimulates competition within the economy and puts more firms in a position to also compete internationally.

3. SMEs, the missing link for inclusive growth

SMEs tend to be less productive than large firms…

It is well known from the trade literature – both theoretical and empirical – that larger firms are more productive, more likely to export and pay higher wages. What is less well known is that the productivity gap between small and large firms tends to be much more pronounced in developing countries than in industrialized countries. In Germany, productivity of small firms is some 70% that of large firms. In Argentina, by contrast, the productivity of small firms is less than 40% that of large firms; in Brazil, the figure is below 30% (OECD-ECLAC, 2013). In some countries, the productivity gap between small and large companies is even greater: in India, for instance, enterprises with more than 200 employees have been found to be ten times more productive than enterprises with five to 49 employees.

INFOGRAPHIC The productivity and wage gap between small and large firms in developing countries is twice that of developed countries.



…and as a result pay lower wages

SMEs account for a considerable share of total employment. They employ an even larger share of the most vulnerable sections of the workforce, namely less experienced and less educated workers belonging to poorer households. Due to their lower productivity, SMEs also tend to pay lower wages. This is partly a reflection of the sectors SMEs tend to operate in: low value-added, labour intensive, low productivity sectors.

Significant inclusive growth opportunities are possible if the productivity gap can be closed …

Closing the productivity gap between SMEs and larger firms in developing countries is likely to have two direct effects: it would contribute to GDP growth, because of increased SME productivity; and lead to higher wages in the low-wage segment of the economy, with positive and equitable distributional effects.

This latter effect points to the inclusiveness of the growth potential generated by the rise in SME productivity. Those effects are likely to go beyond the immediate income effect on poor households. Higher wages for female employees are likely to have knock-on effects on the wider economy, as women in developing countries are known to have a higher propensity than men to invest in their families and in the community at large, leading to a positive impact for the country as a whole.

… for example via internationalization, as international firms are more productive

It has long been clear that internationally active firms tend to pay higher wages, employ more people and have higher productivity levels. Only the most productive and large firms are able to internationalize, as they are the firms able to afford the costs involved, such as fixed costs related to regulatory compliance or to identifying profitable markets and reliable partners. At the same time, internationalization can increase competitiveness through learning by doing and exposure to increased quality standards, superior technology and superior competition. There are significant gains to be made from internationalization – once firms have the capacity to do so.

4. Being part of international value chains

Stepping stones to internationalization

The potential advantages for SMEs to participate in international value chains (IVCs) are numerous, with some authors writing of a 'laundry list of benefits'. On the macro level, there are opportunities to create jobs, increase income, improve working conditions and diversify production and exports. On the micro level, IVCs can help increase access to finance, shorten lead times, reduce operational disruptions, cut inventory, improve quality and customer service, speed innovation and reduce risk.

SME chances to begin exporting increase when they participate in both local and international production chains. A study on Italian firms found that the probability of exporting for firms employing 1–9, 10–49 and 50–249 persons, increased by 98%, 34% and 34%, respectively, if they were part of a supply chain. This suggests that especially small firms can benefit from the reduced costs of entry and economies of scales by engaging in IVCs.