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REDUCING TRADE COSTS FOR INCLUSIVE, SUSTAINABLE GROWTH

HOW AID FOR TRADE HELPS REDUCE THE BURDEN OF TRADE COSTS ON SMEs

Chapter contributed by the International Trade Centre (ITC)

International Trade Centre

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CHAPTER 7

HOW AID FOR TRADE HELPS REDUCE THE BURDEN OF TRADE COSTS ON SMEs

Contributed by the International Trade Centre

Abstract: *Small and medium-sized enterprises (SMEs) represent the backbone of economic activity in both developed and developing country economies. SMEs tend to be less productive than large firms, and the productivity gap is particularly pronounced in developing countries. Evidence shows that SMEs that are integrated in global markets – whether directly or indirectly – are more productive than those that do not participate in trade. Integration into global and regional markets is thus likely to contribute to closing the productivity gap between SMEs and large enterprises, with positive repercussions on the inclusiveness of growth.*

SMEs suffer disproportionally from trade-related fixed costs, which create a bias in favour of large firms that find it easier to overcome fixed costs. A reduction of fixed costs to trade can therefore contribute to making trade more inclusive. Survey evidence reported in this chapter shows that costs related to access to information, access to trade finance or regulatory burdens are particularly important for private sector activity. In order to design effective solutions to reduce relevant costs, in particular those occurring at the border, collaboration between the public and the private sector is useful.

INTRODUCTION

Small and medium-sized enterprises (SMEs) are integral to economic development, particularly in LDCs, and are an essential component of inclusive, sustainable development. In most countries, SMEs represent well above 90% of all private enterprises and over 60% of employment. As such it is fair to say that they represent the backbone of economic activity in most economies. Not surprisingly, therefore, the health of an economy's SME sector is a good barometer of the well-being of a country's economy.

Evidence shows that SMEs are in general less productive than large firms and pay lower wages. But the size of the productivity gap between SMEs and large firms differs across countries and tends to be larger in the developing world. This productivity gap is likely to be a determinant of economic and social cohesion within an economy, which is likely to determine income distribution and the probability of SMEs to grow.

SMEs are by definition small, yet how small they are differs across countries, with the overwhelming bulk of firms being micro-firms in much of the developing world. Some countries, especially LDCs are characterised by a so-called missing middle, i.e. the absence of a healthy segment of middle-sized enterprises. This again may imply that large firms remain largely unchallenged by internal competitors, which may open the door to inefficiencies and non-competitive behaviour.

SMEs that are either indirectly or directly integrated into regional or global markets tend to be more productive and larger in size than SMEs that do not trade. The relationship between trade on the one hand and productivity and firm size on the other hand is multifaceted and multidirectional, with more productive firms finding it easier to trade, which in turn contributes to productivity increases. Lower trade costs can therefore contribute to higher integration of SMEs in regional and global markets and to productivity increases among SMEs, with positive effects on inclusive growth.

What is an SME?

The term SME encompasses a broad spectrum of definitions which vary across countries and regions. International organisations and financial institutions use their own guidelines for defining an SME. However, almost all definitions are based on some combination of the number of employees, turnover and assets. Regarding the maximum number of employees, the World Bank applies a cut-off value of 300 employees per firm, the Inter-American Development Bank a value of 100 employees and the Asian and African Development Banks a value of 50 employees.

Definitions also vary widely across countries and do not necessarily follow the expected pattern that richer countries allow for higher maximum numbers of employees. This is, for instance, reflected in the following Table 7.1 based on Gibson and van der Vaart (2008). It shows that In Viet Nam, companies with up to 300 employees qualify as small and medium sized, whereas in Norway firms with more than 100 employees are considered large.

TABLE 7.1 Maximum number of employees according to national SME definitions, selected countries.

Country (ordered by per capita GNI)	Maximum no. of employees to meet SME definition	Country (ordered by per capita GNI)	Maximum no. of employees to meet SME definition
Norway	100	**Viet Nam**	300
Switzerland	250	**Bangladesh**	100
Brazil	100	**Ghana**	100
Thailand	200	**Tanzania**	20
Moldova	250	**Malawi**	50
Egypt	50		

Source: Gibson and van der Vaart (2008).

How do SMEs perform?

The literature suggests that SMEs tend to be less productive than large companies, partly because they tend to be engaged in more labour-intensive sectors and do not benefit from economies of scale (Wymenga et al. 2011). This is especially true in developing countries, where advanced manufacturing techniques may not be used due to insufficient financing, a poor regulatory environment or other market failures. Lower productivity is born out in the statistics presented in Table 7.2, where the share of employment and the contribution to GDP are shown for a select number of countries. In most cases, the share of employment is higher than the share of GDP, implying the average productivity of an employee working for an SME is lower than that found for large firms. An exception is the United States, where employees working for SMEs appear to be as productive as those working for large firms.

TABLE 7.2 The importance of SMEs for trade and economic activity

Country	Share of firms (%)	Share of employment (%)	GDP Value Added (%)	Share of SMEs Exporting (%)
Brazil	99.9	77	61	11 (S)
Canada	99.7	60	-	-
Chile	98.9	80	25	15
China	99.0	73	60	40-60 (M)
Columbia	96.4	84	-	20
EU	99.8	70	61	-
India	95.0	80	40	32 (M)
Japan	99.0	72	52	14 (M)
Mexico	99.8	74	52	-
New Zealand	99.8	75	-	-
Sweden	96.3	60	57	24 (M)
Taiwan	96.3	80	-	56 (M)
US	99.9	50	50	31 (M)

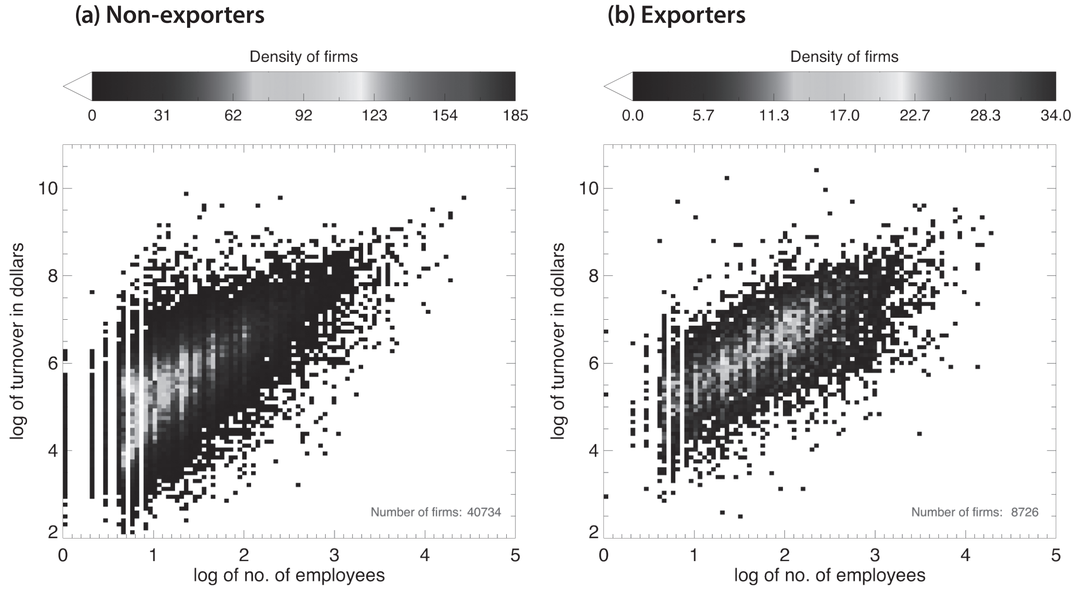
Note: SME share of firms, employment and GDP; fraction of SMEs engaged in export activities (M) and (S) denote data for manufacturing and services data only.

Source: OECD (2014).

The productivity differences between small and large firms tend to be more pronounced in developing countries than in industrialised countries. OECD-ECLAC (2013) reports that in Germany the productivity of small firms is around 70% of the productivity of large firms. In Argentina, in contrast, the productivity of small firms is less than 40% that of large firms, and in Brazil that percentage is below 30%. In some countries, the productivity gap between small and large companies is substantial. In India, for instance, enterprises with more than 200 employees are ten times more productive than enterprises with five to 49 employees (Abe et al., 2014). SME productivity also differs widely across Asian countries, with labour productivity in Indonesia being double that of India and Thailand being more than double that of Indonesia (Abe et al., 2014).

Smaller and less productive firms may find it harder to connect to global markets. The heat charts in Figure 7.1 below reveal that small firms with high turnover and high exports exist (notably in the services industry), but that it is much more frequent for exporters to have a size of around 100 employees (red dots are at a value of two on the horizontal axis). This evidence based on data from the World Bank's Enterprise Surveys is in line with findings from more sophisticated empirical studies showing that exporters tend to be larger in size and more productive than firms that do not trade (e.g. Bernard et al., 2007).

Figure 7.1 Firm level turnover versus number of employees: densities according to export status



Source: ITC calculations based on World Bank Enterprise Survey data.

Why trade-related fixed costs matter more for SMEs

The existence of trade-related fixed costs is likely to be one of the main reasons why smaller, less productive firms find it difficult to export. Indeed, in Melitz's (2003) seminal paper, trade-related fixed costs create a wedge between larger and smaller firms, as only the former manage to make profits while paying the fixed costs to export. Those firms that manage to export are more productive at the outset but become even more productive thanks to their ability to export.

The finding that fixed costs disproportionally affect SMEs is also reflected in case studies and business literature. Lattimore et al. (1998) cite evidence indicating that, in 1994-95, SMEs bore around 85 % of the regulatory compliance burden, while their share in GDP was only around 30%. Unlike large companies, most SMEs do not possess in-house trade or international departments with experts who know how to efficiently overcome relevant trade costs. SMEs tend to have limited resources and a lower threshold to absorbing risks, especially when operating in intensely competitive markets (OECD, 2006). In addition, the fact that SMEs tend to trade smaller quantities implies that fixed trade costs often make up a larger share of the unit cost of their goods and services when compared to rivals exporting larger volumes.

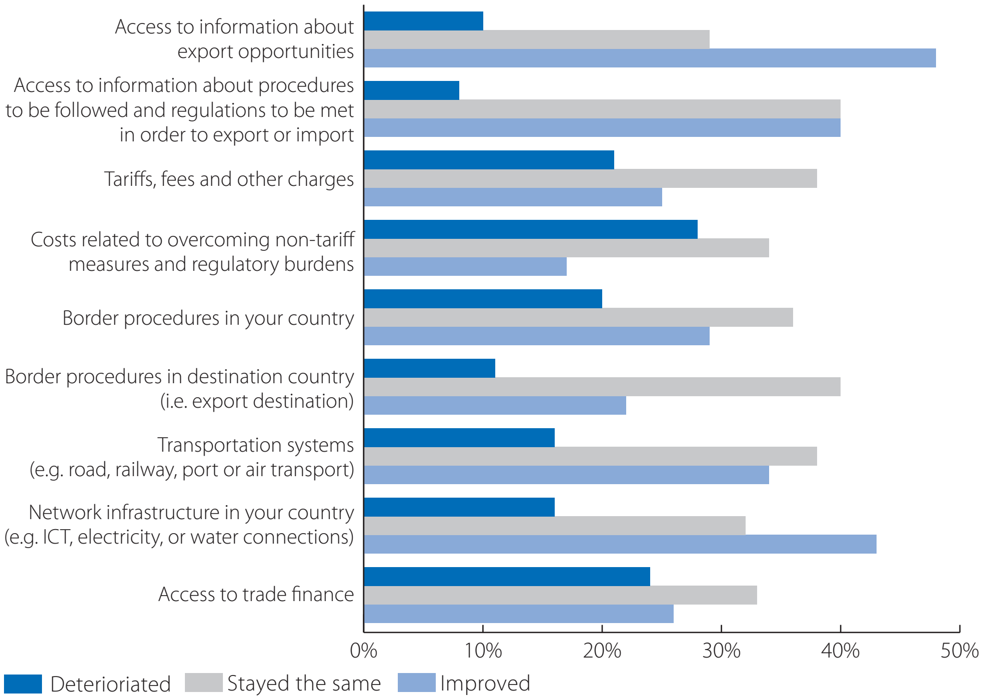
Trade-related fixed costs therefore greatly matter for SMEs and may hamper their opportunities to increase productivity through trade. SMEs are therefore likely to be among the main beneficiaries of efforts to address such costs in the context of aid for trade.

THE PRIVATE SECTOR VIEW ON TRADE COSTS

As part of the monitoring and evaluation exercise conducted under the Fifth Global Review of Aid for Trade, private companies were asked about their experience with trade costs and about their priorities for future trade costs reductions, notably in the area of border procedures. Responses were received from 521 firms, of which 103 were large firms (>250 employees), 94 medium sized (between 50 and 250 employees), 161 small (between 10 and 50 employees) and 158 were micro firms (less than 10 employees).

When asked about their experience with trade costs over the past five years, a relatively positive picture arises, in the sense that few respondents had observed a deterioration of the situation. The responses were similar for companies of different sizes.

Figure 7.2 How have the following aspects of trade costs evolved over the past five years?



Source: ITC Monitoring Survey (2015).

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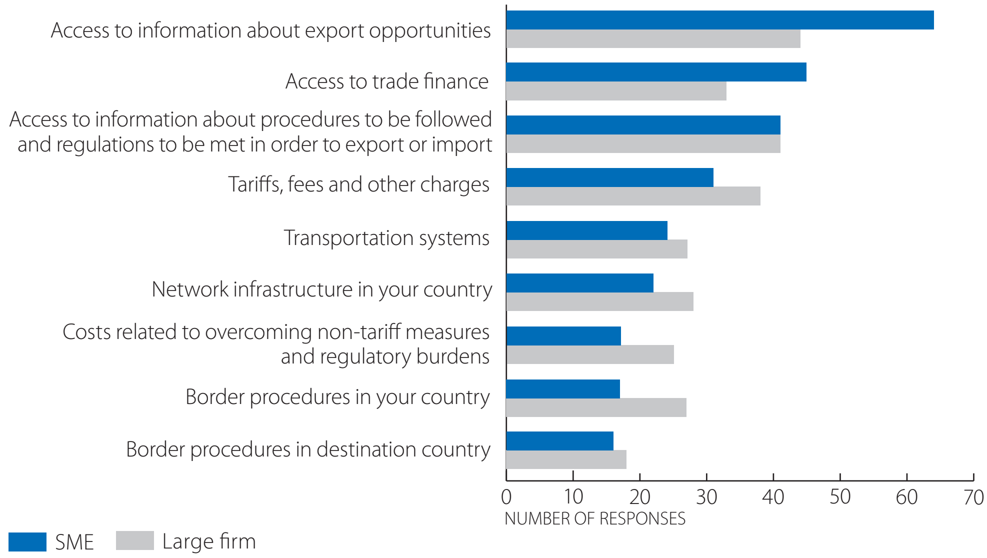
In this survey, a distinction was made between the costs firms have to incur to gain information on procedures and regulations and costs they have to incur to overcome non-tariff measures and regulatory burdens. The latter refers to costs to actually meet standards and regulations and costs incurred to prove that those standards and regulations are met, i.e. so-called certification costs.

Companies were also asked in which aspects of trade costs they would most value improvement. Respondents were asked to indicate the three factors of highest priority. Findings are reflected in Figure 7.3 and are grouped by respondents' size, with SMEs and large firms being reflected separately.

The following results are worth highlighting:

- The top priority for improvement for both large firms and SMEs is access to information about export opportunities. This reflects that exporters first need to be able to identify potential buyers before concerns about bottlenecks for the delivery of goods or services enter into the picture.
- The need for improvements in access to information on export opportunities has a significantly higher weight for SMEs (over 60% of responses) than for large firms (over 40%). More generally, the responses of large firms are relatively equally distributed across different aspects of trade costs, while the responses of SMEs are clearly concentrated around three top priorities.
- For SMEs, access to trade finance is the second most important priority for improvement and access to information about procedures and regulations is priority number three. For large firms, access to information about procedures and regulations weights second and improvements in tariffs fees and other charges weights third.

Figure 7.3 What are the three factors in which you would most value improvements: SMEs versus large firms



Note: SMEs are defined as firms with less than 250 employees. The chart reflects responses of 418 SMEs and 103 large firms.
Source: ITC Monitoring Survey (2015).

StatLink http://dx.doi.org/10.1787/888933241425

- For both SMEs and large firms, costs related to access to information on processes and regulations are highlighted more frequently in the survey than costs to actually overcome regulatory burdens. This is in line with findings from more in-depth surveys on non-tariff measures conducted by the International Trade Centre [ITC] in recent years as described in the following section.

Exporters were also asked about the relevance of different aspects of border procedure facilitation for their performance. Questions and related explanations followed closely the terminology of the Trade Facilitation Agreement. Figure 7.4 illustrates the findings, again decomposed in findings for SMEs and findings for large firms. When it comes to border procedures, differences in views between SMEs and large firms are less apparent than in the case of the more general trade costs reported in Figure 7.4.

Large firms and SMEs identify the same four priorities when it comes to improvements in border procedures:

i. Publication and availability of information regarding clearance for exporting and importing is ranked first by SMEs and second by large firms.

ii. Transparency of controls and inspections ranks second for SMEs and first for large firms.