The Role of SMEs in Employment Creation and Economic Growth in Selected Countries

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Abstract

The SME sector has widely been accepted as the engine of economic growth and poverty eradication in the world. However the meaning of an SME has remained different across countries and to different sectors in the same country. This article seeks to explore the definition of SMEs across selected countries. It further explores the role of SMEs in economic development and employment creation in the selected countries. The article also provides a brief discussion of the challenges facing SMEs and offers some solutions to the challenges.

Key words: Small business, job creation, economic development, poverty alleviation.

INTRODUCTION

This paper begins by defining the Small and Medium Enterprises (SMEs) and then gives a brief background of SMEs in Kenya. It then explores the roles of the SMEs in economic development and employment generation and the challenges faced by the SME sector broadly. A conclusion is the presented based on the reviewed literature. The study finally offers some recommendations that will help in increasing the contribution of SMEs to economic growth and employment creation.

METHODOLOGY

This article is a secondary research based on a review of existing literature (from books and journals) in the area of SMEs in various countries. The researcher first explored the definition of SMEs in some countries with the intention of getting to understand its meaning and application in different countries. A comparison was then offered on the role of SMEs in employment creation and economic growth in some selected countries. This helps the researcher to generalize on the contribution of SMEs to global economic growth and generation of employment opportunities.

LITERATURE REVIEW

Background of SME Definitions

The abbreviation SME stands for Small to Medium Enterprise. Almost every company we know of today began as an SME. SMEs globally have a very significant contribution to the provision of goods and services to the society. Without SMEs, big companies may not be able to meet the demand for goods and services in an expanding customer base. Currently there is no accepted worldwide definition of SMEs (Omar, Arokiasamy & Ismail, 2009; Hooi, 2006). An analysis of the definition of an SME shows that it depends on who is defining it and from where they are defining it. The same person will define an SME differently depending on where they are. According to Garikai (2011) SMEs are defined by number of workers employed, capital employed and sales turnover. SMEs are thus classified by the number of employees and/or by the value of their assets.

The classification of SMEs by size is relevant to sector. A firm of a given size could be small in relation to one sector where the market is large and there are many competitors; whereas a firm of similar proportions may be considered large in another sector with fewer players and/or generally smaller firms within it. It may be appropriate to define size by the number of employees in some sectors but more appropriate to use turnover in others. Across governments, it is most usual to measure size according to numbers of full-time employees or their equivalent.

Different countries define SMEs differently for example; in Canada the term SME refers to businesses with fewer than 500 employees. They further define a small business as one that has fewer than 100 employees (if the business is a goods-producing business) or fewer than 50 employees (if the business is a service-based business). A firm that has more employees than these cut-offs but fewer than 500 employees is classified as a medium-sized business. Generally in Canada an SME is any business establishment with 1 to 499 employees and less than $50 million in gross revenues. In Germany an SME has a limit of 250 employees, while, in Belgium it has a limit of 100 employees. In New Zealand a small business has 19 employees or fewer. In the United States (U.S.A) a small business refers to those with fewer than 100 employees, while medium-sized business refers to those with fewer than 500 employees.

In China SMEs have been defined using various criteria, such as number of people employed, volume of sales or output, and value of assets (Zheng, O'Neill & Morrison, 2009; Cunningham & Rowley, 2007). In the EU, a business with fewer than 250 employees is classified as medium-sized; a business with less than 50 employees is classified as small, and a business with fewer than 10 employees is considered a micro business. The European system also takes into account a business's turnover rate and its balance sheet.

According to Hashim and Abdullah, (2000) in Malaysia, the definitions are solely based on a fixed quantitative measure: the total number of workers, the total number of capital, total assets and sales turnover. Thus in Malaysia SMEs are grouped into Micro, Small, or Medium based on either the numbers of people a business employs or on the total sales or revenue generated by a business in a year. This is illustrated below:

a. Based on the number of full-time employees:

	Agriculture	**Manufacturing**	**Services**
Micro	Less than 5	Less than 5	Less than 5
Small	5-19	5-50	5-19
Medium	20-50	51-150	20-50

b. Based on annual sales turnover:

	Agriculture	**Manufacturing**	**Services**
Micro	Less than RM200,000	Less than RM250,000	Less than RM200,000
Small	RM200,000 - RM 1M	RM250,000 - RM 10M	RM200,000 - RM 1M
Medium	RM 1M - RM 5M	RM 10M - RM 25M	RM 1M - RM 5M

The Companies Act in the UK of 1985 states that a company is ‘small’ if it satisfies at least two of the following criteria: a turnover of not more than £5.6 million; a balance sheet total of not more than £2.8 million; and/or not more than 50 employees (Small Business Service, UK). A medium sized company must satisfy at least two of the following criteria: a turnover of not more than £22.8 million; a balance sheet total of not more than £11.4 million; and/or not more than 250 employees

In general, definitions of a small to medium sized enterprise (SME) globally use one or other of three defining measurements: number of employees, turnover, or the size of the balance sheet. However the difference arises from the limits imposed by each country.

Common definition

In 2005, the National SME Development Council (NSDC) in Malaysia approved the use of common definitions for SMEs in the manufacturing, agriculture and services sectors by all Government Ministries and Agencies involved in SME development, as well as by the financial institutions. This was an attempt to ensure that enterprises that were part of a larger grouping did not benefit from SME support schemes. An increase in the financial ceilings was also designed to avoid penalizing enterprises that were ready to invest. This was aimed at encouraging people to start new businesses hence increase the number of SMEs. The use of common definitions for SMEs was aimed at strengthening government efforts to create effective policies and support programmes for specific targets; making it easier to provide technical and financial assistance to SMEs; and allowing for the identification of SMEs in the various categories and levels. The application of a common definition also ensures consistency and effectiveness of those policies targeting SMEs and, therefore, limits the risk of distortions of competition in the single market.

The EU has tried to standardize the SME concept. The Department of Trade and Industry in the UK and governments all around EU usually uses the following definitions: micro firm: 0 - 9 employees; small firm: 10 - 49 employees; medium firm: 50 - 249 employees and large firm: over 250 employees. Internationally the most commonly used method to define SMEs globally is the number of employees (Zheng, O'Neill, & Morrison, 2009; Dixon et al., 1991; APEC, 1997; OECD, 1998; Wilkinson, 1999).

Role in economic growth

Recently the role of SMEs in economic development and employment creation has occupied most of the discussions among government, policy makers, academicians/ researchers/ scholars and economists in Kenya and other countries. A study by Kongolo (2010) established that small business owners globally have the same characteristics, face the same obstacles but differ in their understanding of how small businesses assist in economic growth. SMEs have ability to fuel economic growth because they create new jobs, expand the tax base, and are drivers of innovation. According to Beck and Levin, (2005) SMEs enhance competition and entrepreneurship hence have external benefits on economy wide efficiency, innovation and aggregate productivity. They are the primary vehicles by which new entrepreneurs provide the economy with a continuous supply of ideas, skills, and innovations (CACCI, 2003). Globally there is an agreement that MSMEs hold the key to economic growth based on the fast growth of enterprises and the role of SMEs in generation of employment. According to Normah (2007) the concentration of SMEs has a close relationship with the dominant economic activities. SMEs dominate the world economies in terms of employment and number of companies, yet their full potential remains remarkably untapped (Schlogl, 2004; Omar, Arokiasamy & Ismail, 2009). This is due to a number of reasons (e.g. legal, institutional, cultural, societal etc.) which make the role of SMEs on economic development different across countries.

Unless and until the SMEs in Kenya are promoted, the Vision 2030 may never be a reality. Research has shown that new firms formation is an important indicator of entrepreneurial activity and economic development (Fritsch & Mueller, 2004, Venesaar & Loomets, 2006). In Kenya the rate of formation of new firms has stagnated for long and besides that most new firms do not grow to maturity since they collapse before the fifth year. SMEs contribute to economic development by virtue of their sheer numbers and increasing share in employment and Gross Domestic Product (GDP).

In recent years the SME sector has consistently registered higher growth rate compared to the overall industrial sector globally. There is a general agreement among scholars and policy makers that the major advantage of the sector is its employment potential at low capital cost. According to EU, Micro, Small and Medium-sized enterprises are socially and economically important, since they represent 99 % of all enterprises in the EU. They provide around 90 million jobs and contribute to entrepreneurship and innovation. However, SMEs face particular difficulties which the EU and

national legislation try to address by granting them various advantages. In the Netherlands, SMEs account 98.8% of all private sector companies, contribute 31.6% to Gross Domestic Product (GDP), and employ 55% of total workforce (EIM Business & Policy Research, 1999; Indarti, & Langenberg, 2004). In Australia Small businesses account for approximately 97 percent of all private sector businesses, and 51 percent of private sector employment (Australian Bureau of Statistics 1996; Wijewardena, & Tibbits, 1999). In Italy, SMEs contribute to USD 35 million in exports and absorb 2.2 million of national labors (Patrianila, 2003; Indarti, & Langenberg, 2004).
Recent evidence shows that SMEs contribute to 32 percent to Gross Domestic Product, 56.4 percent to employment opportunities and 19 percent to export in Malaysia (SMIDEC, 2008; Omar, Arokiasamy & Ismail, 2009). A survey conducted in Malaysia, in 2010 to assess the performance of SMEs, established that more than three-quarters (76%) of the SMEs across all sectors of the economy experienced better performance in 2010. Indicators such as production and profit margin also showed an increase of up to 5% (Malaysia Government, 2010).
In India, the Micro and Small Enterprises (MSEs) sector accounts for about 39% of the manufacturing output and around 33% of the total export of the country. It is estimated that in terms of value, MSME sector in India accounts for about 45% of the manufacturing output and around 40% of the total export of the country (India government, 2007). In Thailand the number of SMEs is increasing at a very fast rate. Thai SMEs are increasingly seen as creators of new jobs (Swierczek & Ha, 2003) and Vietnamese SMEs employ 64% of industrial workforce. According to Indonesian statistics, in 2003, the number of Indonesian SMEs was 42.4 million and they contribute to 56.7% of GDP, account 19.4% of total export, and employ 79 millions of work force (BPS & KUKM, 2003; Indarti, & Langenberg, 2004).

Economic growth in developed countries such as Japan, Korea, Taiwan and many others, was significantly generated by SME activities. The percentage contribution of SMEs to Gross Domestic Product (GDP)/total value added ranges from 60.0 percent in China, 57.0 percent in Germany, 55.3 percent in Japan and 50.0 percent in Korea, compared to 47.3 percent attained by Malaysia. SMEs have also played a very important role in the economic development of China. At present, there are more than 10 million of SMEs comprising 99 per cent of the total number of enterprises in China. SMEs contribute 60 per cent of industrial output volume and 40 per cent of the total taxes and profits realized by enterprises in China. The contribution of SMEs in output in Japan is 65 per cent, Germany 48 per cent while in USA its 45 per cent. SMEs in the US generate more than half of the nation's gross domestic product (GDP).

Role in employment creation

SMEs are important drivers of innovation and competition. The SME sector has remained very innovative and adaptable in order to survive the recent economic downturn and recession. Empirical studies show that new firms play a significant role in employment generation (e.g. Garikai 2011, Baptista et al, 2005; Stel & Suddle, 2005), innovation (e.g. Fritsch & Mueller, 2005), economic growth and reduction of unemployment (Garikai, 2011). There is a high correlation between the degree of poverty hunger, unemployment, economic well being /standard of living of the citizens of countries and the degree of vibrancy of the respective country's SMEs. In most economies, SMEs occupy the greatest proportion of enterprises. The SMEs constitute over 90% of total enterprises in most of the economies and are credited with generating the highest rates of employment growth and account for a major share of industrial production and exports. In the EU, SMEs comprise approximately 99% of all firms and employ between them about 65 million people. In China SMEs provide 75 per cent of the total township and urban employment and as such they play an important role in releasing the employment pressure and maintaining social stability. A study done by the Federal Office of Statistics shows that 97% of all businesses in Nigeria are SMEs. According to Ariyo (2011) the SME sector provides, on average, 50% of Nigeria's employment, and 50% of its industrial output.

SMEs account for between 55 per cent and 80 per cent of total employment in Western Europe, Japan and USA. There are approximately 23 million SMEs in the US which employ more than 50 % of the private workforce, and generate more than half of the nation's gross domestic product (GDP). According to Muragia (2008) entrepreneurs in America are respected for their role in creating new jobs, providing competition to existing businesses, improving product quality, reducing prices, introducing new goods and services through innovation and technology advancement. In the European Union, SMEs are seen as largely essential for European employment. Each year, one million new SMEs set up in the European Union. SMEs account for 99.8% of all companies and 65% of business turnover in the European Union.

In the UK at the start of 1997, 99% of all businesses were SMEs. In India, the SMEs play a pivotal role in the overall industrial economy. Recently the sector has consistently registered higher growth rate compared to the overall industrial sector. In India the SME sector employs an estimated 31 million persons spread over 12.8 million enterprises and the labour intensity in the SME sector was estimated to be almost 4 times higher than the large enterprises in 2003. Currently this sector employs an estimated 59.7 million persons spread over 26.1 million enterprises.

In the European Union, SMEs are economically important with 98% of an estimated 19.3 million enterprises defined as SMEs, providing around 65 million jobs. The average European business provides employment for four people, including the owner/manager. SMEs account for roughly two thirds (66%) of employment within the EU, with micro enterprises accounting for 34%, small enterprises accounting for 19% and medium-sized enterprises accounting for 13%. Ninety three percent (93 %) of all European enterprises have less than 10 employees. There are 20.5 million enterprises in the European Economic Area (EEA) and Switzerland, providing employment for 122 million people. Two thirds of all jobs are in SMEs, so only one third of all jobs are provided by large enterprises.

In Pakistan, SMEs provide employment to about 65 per cent of work force in the industrial sector. According to the economic survey of 1998-99, SMEs with a mere 20 per cent investment and resource to less than 10 per cent of the total formal credit generated 80 per cent of the total employment in Pakistan. They contribute to the GDP around four times as much as the large scale industries. The share of micro enterprises in total employment is 48 % in Italy, and 57 % in Greece. On the other hand, the share of large enterprises in total employment is over 45 % in Ireland and the United Kingdom. SMEs in Kenya employed some 3.2 million people in 2003 and accounted for 18 per cent of national GDP. In Kenya 90% of all enterprises are SMEs providing employment to over 60% of the total employed population. Micro and very small businesses in South Africa provided more than 55 per cent of total employment and 22 per cent of GDP in 2003. Small firms accounted for 16 per cent of both jobs and production and medium and large firms 26 per cent of jobs and 62 per cent of production. In Zimbabwe 15% of the total formal employment is in the SME sector.

On a global scale, small and medium-sized enterprises provide some 66% of jobs in the European Union (EU) - a percentage which is rising as SMEs face challenges and utilise the opportunities associated with increased globalisation, largely through e-commerce and greater internet usage by entrepreneurs. In the last decade, SMEs were the principle creators of new jobs, whilst on average; big industries downsized; retrenched employees and reduced employment. EU SMEs currently generate 56.2% of the private sector turnover. However the role of SMEs in generation of employment has in most cases been temporary since most new businesses die out before their fifth birthday further contributing to unemployment. SMEs have been criticized for their high rate of bankruptcy. While they create many jobs, they also destroy a lot of jobs. SMEs have also been criticized on the grounds that they provide low value added goods and services and have short life.

Challenges Facing SMEs

SMEs face a lot of challenges that substantially hinder their progress, growth and subsequently their contribution to economic development. SMEs face the unique problems of uncertainty, innovation and evolution. The most important problems are: political instability, law and order situation, financial constraints, energy crisis, taxation problems, labour issues, lack of coordination and regular information exchange mechanisms among institutions.

SMEs lack the research capacity and ability to take substantial risks or any other advantage of expansion. Most SMEs also lack the capacity to take insurance covers to cushion them against risks. SMEs due to their small size lack sound experiences and financial position are less capable of adjusting and carrying on successful businesses. SMEs are also subject to unequal treatment which distorts the competitive environment of the business.

CONCLUSIONS AND RECOMMENDATIONS

A small industry can be set up with small capital, and can produce goods for domestic consumption by using labour intensive technology. SMEs play a significant role in the development and growth of various economies as illustrated by the few examples discussed above. SMEs are vital for world prosperity. Success of the SME sector will help the country to achieve Vision 2030 and face a competitive, dynamic and challenging global environment. Collectively SMEs are the largest employers and greatest creators of wealth. Through job and wealth creation SMEs help alleviate poverty which in turn has a positive effect on the fight against diseases. SMEs therefore hold the key to achievement of national economic objectives of employment generation and poverty reduction at low investment cost as well as the development of entrepreneurial capabilities including indigenous technology. The labour intensity of the MSME sector is much higher than that of the large enterprises therefore SMEs have a great potential in contributing to the achievement of Vision 2030 in Kenya.

SMEs are also important traders and service providers to primary industries. In addition SMEs are also producers of finished goods and services. Collectively, SMEs have contributed to the growth of manufacturing, services and agricultural sectors, as well as ICT services, in terms of output, value-addition, employment and exports. (Industrial Malaysia Plan, 2006; Omar, Arokiasamy & Ismail, 2009). SMEs also ensure access to the infrastructural facilities occasioned by their existence, the stimulation of economic activities such as suppliers of various items and distributive trades for items produced and or needed by the SMEs, stemming from rural urban migration, enhancement of standard of living of the employees of the SMEs and their dependents as well as those who are directly or indirectly associated with them. SMEs are important for poverty reduction as they tend to employ poor and low income workers and sometimes they are the only source of employment in rural areas and poor regions (Garikai, 2011). The long-term economic effects of SMEs as: increased income, increased GDP and increased employment opportunities. Overall economic growth influences strongly the growth of MSMEs just like growth of MSMEs influences economic growth. Thus there is a reciprocal relationship between the two i.e., economic growth and MSME growth.

Most businesses in Kenya are SMEs and most employment opportunities are provided by SMEs. Besides the highest contributor to GDP is the SME sector. Based on the significant role of SMEs in economic growth and creation of employment the researcher recommends the following:

a. **Policies to support SME development**

It is important for the business environment to be conducive for all businesses, big and small. Low entry and exit barriers, well defined property rights and effective contract enforcement characterizes a business environment that is conducive to competition and private commercial transactions (Beck & Levin, 2005).

b. SME Act

The government should establish an SME Act to help protect the SMEs and encourage formation of more SMEs. The government should also open an institution specifically to help in training of entrepreneurs. This will offer them the appropriate skills hence lead to improved performance of the SMEs.

c. Foreign assistance/ donors

The government should source foreign aid to help the SME sector. It should also allocate some funds in its budget for the SME sector. Besides that the central bank should develop policies that will help other commercial banks to develop credit policies that promote the SMEs.

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