

FOSTERING SMALL AND MEDIUM ENTERPRISES IS THE BEST OPTION FOR SUSTAINABLE DEVELOPMENT

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An entrepreneur in general and a small scale industrialist in particular is used to read the fine print, for the headlines often lead you away from the truth. For example, we see advertisements screaming 50% off on say, polymer products but the small fine print tucked away in a corner marked by an ubiquitous asterisk, reveals the 'truth' viz. 'applicable only on bulk orders on select brands whose MRP is in the highest price bandwidth'.

Now, here is a real demonstrative example. Global wealth has almost doubled since 1990, makes for breaking news. But read the fine print, viz. nearly half the World's population manage to survive on less than 2 US dollars per day. That is a billion people make both ends meet in a day in the sum it takes another billion to just commute in a day!

So Poverty is not just an unreal slogan but too real, too scary and truly detrimental to sustainable development, environmental security, global stability and a genuinely global market. But how can we make economic growth inclusive? It's not rocket science, and we have known the answer for so long, though we keep coming back to this question again and again. The key to root out poverty is improving the performance and sustainability of local entrepreneurs and SMEs, who represent the backbone of global economic activity.

This paper attempts to explain how governments can help alleviate poverty by focusing on SMEs and how larger corporations can also collaborate and help themselves by including SMEs in their value chains. It describes some of the comparative advantages of SMEs and the challenges they face in developing countries. "Wealth creation, one of the core competencies of the private sector, is a vital part of the poverty alleviation process".

In OECD economies SMEs¹ and micro enterprises² account for over 95% of firms, 60-70% of employment, 55% of GDP and a lion's share of new jobs. In developing countries, more than 90% of all firms outside the agricultural sector are SMEs and micro enterprises³, generating a significant portion of GDP. For example, in India, this vibrant sector of the economy has been contributing over 39% of the manufacturing sector output, 33% of the national exports and providing employment to nearly 312 lakh people through 128 lakh units, located in both rural and urban areas across the country⁴.

It only goes to show that for economic growth to be inclusive, for poverty to be eradicated, the key is in co-opting the SMEs for sustainable development on a long term and arguably, for all times.

WHY WE REALLY NEED SMES?

1. FOR GOVERNMENTS

Tax revenues are the topmost priority for any government. Accordingly, their approach is guided by a show-me-the-money principle.

Now, who do you presume is among the biggest contributors to taxes? Big Businesses? Large Industry Houses? The Ambanis? The Tatas? The answer is a real surprise, I dare say, perhaps even to some knowledgeable people. It is actually a small manufacturer unseen, unheard and unsung, toiling away in a place with an infrastructure that contrives, with all the forces at its command to keep him or her small, at any cost.

Fact: Nearly 6,000 SMEs in Peenya, one of the biggest industrial estates in South East Asia contributes approximately Rs 12-15 thousand crores by way of various taxes, etc to the exchequer while providing employment (skilled 25% and unskilled 75%) to nearly 5 lakh people. Of which, nearly three lakh are women.

Cynics might point out that this is in aggregate and the comparison of SMEs with a single large Industry House is odious, but does it matter to the Government really from how many the money comes from so long as it does, and that too, without any requirement of pandering to it! (An unfortunate reality, which desperately needs correction immediately).

Well managed and healthy SMEs are a source of employment and wealth creation. They can contribute to social stability and generate tax revenues. According to the International Finance Corporation⁵, there is a positive relationship between a country's overall level of income and the number of SMEs per 1000 people. The World Bank's reports indicate that a healthy SME sector corresponds with a reduced level of informal or "black market" activities.

1. **FOR LARGE COMPANIES**

Value optimization is the jargon for the old fashioned 'cheap and best' industry practice. MNCs and large companies like Toyota for example are able to optimize value across the manufacturing and supply chain by outsourcing – or collaborating with – small and micro enterprises that as their vendors are the brawn behind their brain so to say. Hundreds of automobile parts of the world's best cars and planes are made thousands of miles away from the world's best manufacturing plant. That is how and why SMEs are playing a crucial and strategic role in their collaboration with large companies.

SMEs constitute an important source of local supply and service provision to large corporations. They usually have extensive knowledge of resources, supply patterns and purchasing trends. Developing countries also represent a huge, largely untapped market for large corporations. By working closely with SMEs, large corporations can develop a new customer base that may not be accessible to the traditional distribution networks of large corporations.

SMEs also represent a source of 'innovation'. They tend to occupy specialised market "niches" and follow competitive strategies that set them apart from other companies. This might include reengineering product or services to meet market demands, exploring innovative distribution or sales techniques, or developing new or untapped markets. This often makes them good partners for large industries.

2. FOR LOCAL COMMUNITY

Urban sprawl, chaotic cities, the migration of village youth to urban cities is a modern challenge in the 21st century. Surprisingly, the solution is right before us: Empower SMEs in the villages and towns of India. And see how easily one can check the pressure on urban cities, while adding new lines of prosperity and expanding the market elsewhere!

SMEs have actually a vested interest in community development. Being local, they draw upon the community for their workforce and rely on it to do business. For the communities, they provide goods and services tailored to meet local needs and at costs affordable to local people. They are an important source of employment, particularly for low-skilled workers, as well as women and young people, who usually make up the greatest proportion of the unemployed in emerging economies. Their flat management structures mean that their personnel must fulfil multiple roles, which makes them less vulnerable to unemployment during the periods of economic downturn. Their small size and flexibility allow them to adjust to the local market fluctuations and to weather local market shocks more comfortably.

INFORMAL OR FORMAL: DOES IT MATTER?

Countries with poor business environments – costly regulations, heavy bureaucracy, poor credit and banking systems – tend to have large “informal” sectors. These are economic activities that are conducted outside the formal regulatory environment. They include everything from casual labour to thriving SMEs and occasionally illegal activities.

For many SMEs the decision to remain informal is deliberate, because the costs and procedural burden of joining the formal sector outweigh the benefits staying in the informal sector. In many developing countries the informal economy accounts for a significant, but hidden, portion of GDP – anywhere between 30 % and 70%⁶.

Informal sectors make large contributions to nations' economies, in both human and financial terms. But being invisible to government agencies and formal sector companies, they cannot be easily reached with capacity building improvement schemes, and they cannot compete for business with larger companies. Workers in the informal sector lack job protection and benefits such as access to health and safety provisions, wage protection, insurances, pensions and unions. Informal SMEs also have restricted access to investment and credit facilities. Being outside the formal regulatory framework, informal sector activities cannot be taxed, which represent lost revenues to the governments. As such informal sectors can be an obstacle to broader economic development.

➤ **Building Better SMEs**

SMEs can play a much bigger role in developing national economies, alleviating poverty, participating in the global economy and partnering with larger corporations. They do, however, need to be promoted. Such supports require commitments by and between governments, business and civil society.

➤ **The Government Contribution**

Like bigger companies, SMEs require a favourable institutional framework. Most are overlooked by policy-makers and legislators, who tend to target larger companies. SMEs often miss out on tax incentives and business subsidies. They suffer more than big companies from the large burden and cost of bureaucracy, as few SMEs possess the necessary financial or human resources to deal with this.

➤ **Implement Inclusive Reforms**

Governments need to create the necessary enabling frameworks and relax the burden of regulatory measures. They must simplify business registration procedures and paper work to make them cheaper, simpler and speedier. Efforts are also required to tackle corruption. The World Bank report quoted below notes “reform expands the reach of regulation by bringing businesses and employees into the formal sector”. The same report also infers that the greater a country’s ease of doing business, the greater the number of jobs created in the formal sector “because the benefits of being formal (such as easier access to credit and better utility services) often outweigh the costs (such as taxes)”.

➤ **Provide Financial and Tax Incentives**

To encourage SMEs to join the formal sector, governments need to provide tax incentives for SMEs and subsidies similar to those available to large companies or micro entrepreneurs, and to make provisions for start-up funds for SMEs.

➤ **Encourage Friendly Regulatory Environments**

Governments should promote public-private partnerships to attract venture capital funds and higher levels of investment, and put in place measures to create investor-friendly environments. Big corporations and potential investors need guarantees that their investment and infrastructure are not going to be expropriated.

➤ **Involve Business In Identifying Reforms**

Increasingly the business voice is being listened to in decisions aimed at effecting change. “In several countries, such as Mali and Mozambique, private businesses now participate in identifying the most needed reforms.....The culture of bureaucrats telling bureaucrats what is good for business is disappearing”.

➤ **Build Capacity**

Governments can contribute to capacity building through the provision of vocational training, by creating municipal-level agencies for SME start up development and management, such as “Enterprise Advice Bureaus”, by encouraging SMEs to engage with large companies.

➤ **Produce More Goods and Services For Public Sector From SMEs**

Reverse trade fairs are held where municipalities market their needs – such as meals for hospitals and schools, cleaning of public buildings – to prospective SMEs who can then bid for business. The high number of days required to start a business is a disincentive to the formalisation of SMEs and micro enterprises in many parts of the World. Countries with long registration procedures tend to have large informal sectors while those with shorter procedures tend to have correspondingly smaller informal sectors.

➤ **The Business Contribution - Building Supply Chain Capacity**

The many large corporations that source their supplies from developing countries require reliable suppliers. Large corporations can help SMEs become more viable partners by providing training in basic skills such as management, book-keeping, business planning, marketing, distribution, and quality control. They assist in technology transfers, direct investment in infrastructure, and the sharing of knowledge. This makes SMEs more competitive and facilitates access to credit. All of this can benefit the large corporations by creating more effective and inclusive supply chains.

➤ **Rationalising Procurement Procedures**

Many global companies use intermediaries to identify local suppliers. This can add extra layer of cost to operation, a financial outlay that rarely goes to the originator of goods. It also adds time. By building relationship with SMEs, large companies can out the middlemen. This helps drive down costs, hastens delivery and improves quality.

➤ **Strengthening Local Distribution Networks**

SMEs have local knowledge, understand domestic consumer needs, and have access to remote regions. By contracting local SMEs to sell and distribute their products in these markets, large companies can help strengthen sales capacity and income of local SMEs. At the same time, they can strengthen their own distribution networks and open up new markets for their products.

➤ **Improving Standards**

Global companies are asked about the operations of their suppliers, and thus can offer transparency along their supply chains. Large companies can help SMEs comply with international standards such as ISO 9001, 14,001 etc. Such compliances can enable SMEs to compete in international markets while at the same time improving overall quality of suppliers to large companies.

➤ **Improving Environmental Performance**

“Business is the most important driver of economic change. It brings employment, goods, revenues, knowledge, and skills development. We must also recognise that the most important role is probably not played by MNCs, but by the small and medium enterprise sector, the SMEs. We as global companies can provide the catalyst to partner with SMEs to mutual benefit. We can access their local expertise and markets; they can access our technologies and business skills for local momentum.”⁷

Collectively SMEs have considerable environmental impact. However, given the various challenges with which they are confronted, and the perception that their individual impact is not significant, it is unlikely that environmental concerns figure high on their business agendas. By engaging with SMEs, assisting them with capacity building, and supporting them with compliance, particularly with environmental standards, large companies’ help SMEs integrate sustainable development thinking into their production processes and operations.

➤ Providing Access To Financial Services

SMEs require greater access to financial services and investment capital. Large companies have little difficulty securing sizeable bank loans and private investments. At the same time, micro finance, consisting of very small loans tends to benefit individual entrepreneurs.

Many financial institutions in the developed and developing nations are unwilling to fund SMEs because of perceived risks and high transaction costs. SMEs in the developing world are considered high risk as their managers are perceived as lacking managerial expertise, credit history, and/or tangible assets to secure loans. Thus loans to SMEs, when they are able to obtain them, tend to carry high interest rates and shorter pay-back times.

“While SMEs are critical to a country’s long term development, sustainable access to finance and inclusive business design are fundamental to ensuring long term and equitable poverty reduction business profitability”⁸.

Conclusion

The only thing constant is constant change – and change is coming. Many large banks are now partnering with development agencies and NGOs to serve the SME market. The CGTSME loan facility of GOI to MSMEs is an example of how this risk sharing facility is a demonstration of how development finance institutions and commercial banks can work together to promote sustainable growth in developing countries. Gerard Kliesterlee, President and CEO, Royal Philips Electronics, has observed: “Industry, government, non-governmental organisations need to work together, leveraging competencies each brings to the table. Most importantly, this should include local production, local talent development and local entrepreneurship”⁹.

Notes and References:

1. There is no universally agreed definition of SMEs. It differs from country to country based on various factors. The SME definition in India is quite different from SME definitions in the EU or USA.
2. In the EU economy, roughly 93% of SMEs are micro enterprises (see <http://www.unece.org/indust/sme/sme-role.html>).
3. According to UNECE, the majority of SMEs in countries in transition are micro enterprises employing family members or close relatives.
4. Report of RBI's Standing Advisory Committee working group on rehabilitation of sick MSMEs.
5. Source: IFC 2006. "Micro, Small and Medium Enterprises: A collection of public data", in Newberry, Dereck, 2006.
6. World Bank. Development Outreach (see <http://www1.worldbank.org/devoutreach/article.asp?id=287>).
7. Remarks delivered by Michael Pragnell at the launch of the publication "Going for growth: Science, technology and innovation in Africa", at the Smith Institute in London, on November 30, 2005.
8. Remarks by Robert de Jongh, Regional Director, SNV (international development organisation), Netherlands
9. Speech titled "Business growth and value creation through sustainable solutions", delivered by Gerard Kliesterlee, President and CEO, Royal Philips Electronics, on 27 June 2006 at the Sustainability Forum Dialogue in Zurich.