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Small and Medium-Sized Enterprises

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Relevance for the UK Economy

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1. Introduction

It is the aim of this essay to give a brief exposition of some arguments in favour of and against the economic importance of the small business sector (=SME) to the UK economy. First of all, a definition of 'SME' is needed: SME stands for 'Small or Medium-sized Enterprise'. There are several definitions of what a small or medium-sized enterprise is, but the most commonly accepted one has been devised by the European Commission¹ (2003). According to this definition, every enterprise with fewer than 250 employees is classified as an SME (note that the Commission's turnover criterion is not considered here since most publications in this area concentrate on the employment). Later in this text, the terms 'small business sector' and 'small businesses' will be used in place of 'SME' for the purpose of variety but without a different meaning. The discussion will start with a short look at the general significance of SMEs for the UK economy. Then, since 'economic importance' may be measured by various aspects, this essay will focus on two particular aspects: employment and GDP growth. Finally, as enterprises in the SME sector undertake innovative activity, the impact of this activity on the UK economy will be analysed.

2. Discussion

The SMEs' significance for the UK economy in general

To begin with a basic fact, SMEs dominate the total business stock of the United Kingdom: they account for a compelling 99.8 per cent of the enterprises in the private sector (including public corporations and nationalised bodies/ Small Business Service, 2005²). In general, the role of SMEs within the industrialised western economies and therefore within the UK economy has won importance continuously over the past decades.

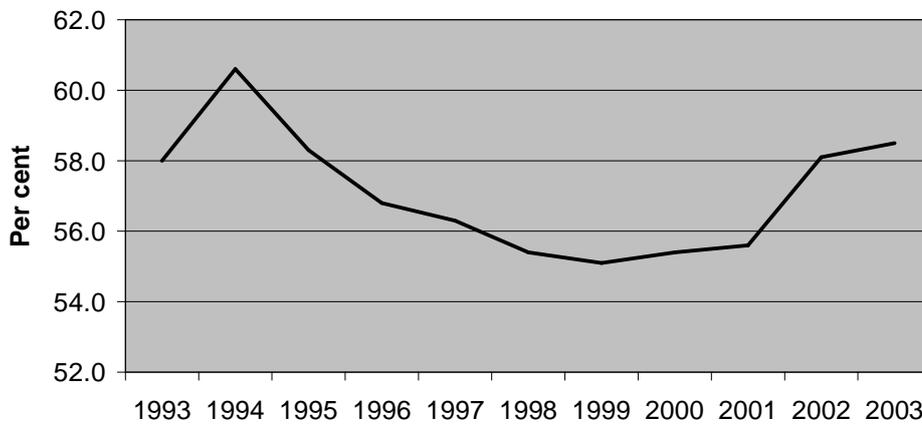
This growing importance of the small business sector is the result of three developments which have been taking place simultaneously: Firstly, the contribution of the service sector to the United Kingdom's GDP has risen from 59 to 72 per cent

over the last three decades of the 20th century (Deakins and Freel, 2006, p. 40³), and firms in the service sector tend to be SMEs because their minimum size in order to operate profitably is smaller than that in the manufacturing sector. Secondly, specialisation in the manufacturing sector, which comprises outsourcing and the resulting concentration on core business, has resulted in a downsizing of existing companies. Thirdly, the increasing use of information technology has reduced the importance of economies of scale and thus has led to an increase of the number of SME start-ups in the manufacturing sector (Deakins and Freel, 2006³). But the mere domination of the total business stock alone is not sufficient to establish the small businesses' actual significance for the economy in terms of economic growth and employment, for example.

The SMEs' contribution to job market and economic growth

Indeed, the small business sector also has a significant share in the employment of the UK. Firstly, according to the Small Business Service², it provided 58.5 per cent of the jobs in this country's economy at the beginning of 2004 (private sector and public corporations, company owners and partners included). The SMEs' part of the employment was declining between 1993 and 1999 but is now rising again (see chart next page); it also has never plunged below 50 per cent. Secondly, the small business sector is the main contributor of new jobs, too. Gallagher and Stewart⁴ (1986) as well as Storey and Johnson⁵ (1987) found that small enterprises account for the lion's share of new jobs confirming for the UK the results from David Birch's groundbreaking work for the USA from 1979⁶.

SMEs' share in employment in the UK
(private sector and public corporations, company owners and partners included)



Source: Small Business Service (www.sbs.gov.uk, SME Statistics)

But what about the survival rate of small and young businesses? Certainly, there is no great economic significance in all the new jobs small businesses create when they are likely to go bust just after one year. The recordings for the UK Value Added Tax (VAT) register, however, do not support the expectation of a low business survival rate: 66.5 per cent of the businesses which appeared in the VAT register in 1999 survived at least three years (Small Business Service, 2004⁷). This rate has been quite stable since 1993. Thus, the argument that SMEs are the main contributors to new jobs is not mitigated by empirical business survival rate data; instead, it is also in net terms (employment added minus employment lost) that SMEs are commonly regarded as the most important job creators (Deakins and Freel, 2006³).

This finding comprises innovative and non-innovative small enterprises. Intuitively, high-growth innovative firms contribute comparatively more to job creation. The imaginative example of a firm in the car-component subcontractor industry shall make this point clearer: Suppose the firm has developed a revolutionary substitute for the plastics used for a car's dashboard. Soon, demand for the material will explode causing the firm to grow rapidly and to hire many workers (even if it uses comparatively more machines per worker while growing, which is very likely in this industry). Such an enterprise obviously creates more jobs in the same period of time as the new retail store in the neighbourhood. The direct impact of innovative SMEs on GDP growth is yet difficult to measure (although this problem does not

affect the certainty of their valuable contribution to one of the most powerful indirect factors for GDP growth, knowledge, which is analysed below). Moreover, not every high-growth firm in the SME sector has necessarily to be innovative: a franchisee entering a locally unsaturated market of a lifestyle product is a good example for this category.

Turning to the link between small businesses and economic growth now, one may expect a well developed SME sector to increase GDP growth. In fact, the Global Entrepreneurship Monitor⁸ (GEM, 2003) established a statistically significant positive relationship between high entrepreneurial activity in a country and its growth rate of GDP (it did so by using an index called 'Total Entrepreneurship Activity' or 'TEA'; the TEA index measures 'the proportion of individuals in the working age population who are actively trying to start their own business, including self-employment, or running their own business that is less than 3½ years old'^a). Unfortunately, the relationship is not as evident as the GEM presents it. Another approach using numbers of start-up businesses registering for the Value Added Tax and GDP growth suggests that high economic growth is rather the cause of a strong SME sector than the consequence of it (Deakins and Freel, 2006³). So far, economists may therefore only agree on the term 'virtuous circle'^b describing the positive impact of economic growth and a well developed small business sector on each other.

The SMEs' contribution to innovation

Considering Joseph Alois Schumpeter's famous theory (1934)⁹ which says that only the entrepreneur's courage and risk-preparedness lead to radical new products and ways of thinking, one should expect the small business sector being the main acting scene of entrepreneurs to contribute vitally to innovation in the UK.

^a Levie, J., Brown, W. and Cooper, S. (2003) *Global Entrepreneurship Monitor: Scotland 2003*, Hunter Centre for Entrepreneurship, University of Strathclyde, p. 4 as presented in Deakins, D. and Freel, M. (2006) *Entrepreneurship and Small Firms*, 4th edition, McGraw-Hill, Maidenhead, p. 34.

^b Acs, Zoltan J., Arenius, P., Hay, M. and Minniti, M. (2004) *Global Entrepreneurship Monitor, 2004 Executive Report*, GEM, Babson College and London Business School, p. 38. [<http://www.gemconsortium.org> ó Documents ó 2004 GEM Global Report(s) ó GEM 2004 Global Report]

However, Schumpeter surprisingly contradicted his first theory at a later stage of his research (1950)¹⁰, now stating a comparative innovative advantage on the side of large companies (in the 1970s, this view was very popular, too). At this point, it is necessary to define innovation. In this essay, the term innovation applies not to research and development expenditures (R&D) as mere innovational input (where large companies dominate); instead, it describes actual innovational output being either a new product, process etc., or a new idea which has not been commercialised yet. The reason for this definition is that in terms of R&D, small businesses seem not to innovate at all, since they mostly create non-R&D related innovations.

Some theoretical support for the SME sector's importance regarding its innovative activity and even comparative innovative advantage in some industries has been produced by Abernathy and Utterback¹¹ (1978). They wrote that the very beginning of an innovational process features most likely small and very small firms, regarding the size of a new market. Particularly in the service sector, demand is often not uniform giving only small firms a profitable opportunity to serve this demand. Hence, SMEs are the key innovators in these markets.

Supplementing this argumentation, Pavitt et al.¹² (1987) delivered empirical evidence that the relationship between innovation intensity (ratio of share of innovative output to share in employment; i.e., grosso modo, innovations per employee) and firm size may well be U-shaped. In other words, innovation intensity is high among small and very small firms, decreases when looking at medium sized enterprises, and rises among large and very large companies. But the innovative activity of SMEs is not limited to the small business sector: often, the resulting ideas and knowledge become available and are commercialised by large companies (Observatory of European SMEs, 2003¹³). That is, innovative SMEs have a fruitful impact on non-SME enterprises and therefore the economy of the United Kingdom as a whole; this process is called spillovers in the innovation economics jargon. Romer¹⁴ (1986) and Lucas (1988¹⁵ and 1993¹⁶) described these spillovers as one of the main elements of endogenous growth (growth resulting from gains in productivity rather than from a mere increase of factor inputs). Thus, innovative SMEs make a most valuable indirect, i.e., not measurable contribution to GDP growth.

3. Conclusion

The overall importance of small businesses to the UK economy is certain. But although most economists dealing with the subject agree on the fact that a healthy SME sector is essential for a developed and modern economy, it has been shown that there is a considerable discussion about the specific manifestations of the influence of small businesses. To start the summary with the uncertain aspects, the directly measurable contribution of the small business sector to GDP growth is anything but proved. Instead, currently the term 'virtuous circle' is used to describe the positive impact of high GDP growth and a strong SME sector on each other. Secondly, a short but quite important new point should be introduced here: The Observatory of European SMEs¹⁷ (2003) has published an index of the value added per occupied person stating a value of 69 for the small business sector which compares with an index value of 100 for the UK economy as a whole. In other words, the labour productivity of the SME sector is fairly poor, and it has to be considerably improved in order to make better use of the SMEs' potential for the United Kingdom's economy.

Nonetheless, SMEs are undoubtedly relevant to the job market. They have a share of more than 50% in employment and contribute vitally to the creation of new jobs. The Observatory of European SMEs writes in its annual report (2003): 'Small and new enterprises serve as an engine of employment creation on both sides of the Atlantic.' Moreover, innovative SMEs are said to produce so called knowledge 'spillovers' (describing the influence of new ideas from within the SME sector on the whole economy) which have been identified as a crucial mechanism of endogenous growth. It seems adequate to regard this indirect contribution to the UK economy's strength as outranking the presented aspects impairing the economic significance of SMEs, since modern economies like that of the United Kingdom have to rely more and more on knowledge as their primary resource of competitiveness.

^c Observatory of European SMEs (2003) *SMEs in Europe 2003*, p. 17.
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