The importance of SMEs in economic development of developing countries

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Abstract: Small- and medium-sized enterprises (SMEs) have a crucial role in economic development, especially in the development of developing countries. They represent about 90% of businesses and more than 50% of employment worldwide. Formal SMEs contribute up to 40% of national income (GDP) in emerging economies. This study will discuss how SMEs help building economic stability, their role in creating labor market, and fighting the monopoly. The aim of this research is to identify key issues relating to the role of SMEs in country development. The paper uses different research methods, and it strives to help people with entrepreneurial mindset to obtain deep understanding of the SME market. The results showed the complexity of this issue, different angles and perspectives can be seen on the analysis of different countries. However, from the results it is clear how beneficial the development of SME market is in the developing countries.

Keywords: Developing countries, Emerging economies, GDP, Innovation, Monopoly, SME, Sustainability, Workplace,

1 Introduction

SMEs are considered to be the engine of an economic development, they provide new workplaces, solve unemployment issues, furthermore, SMEs contribute a lot also in the sustainability growth. The reasons behind SMESs being the driving force in a country's development are different. Private ownership is a starting point, where individuals can make their own decisions. The idea of entrepreneurship is connected with risks and flexibility, which lead to innovations. Statistics from developed countries can help emerging economies to understand the role of SMEs in their economic development.

Throughout the paper different questions will be raised aiming to give answers to these questions related especially to the ones connected to the role of SMEs in various countries' economic development. The research raises the questions how SMEs help economic development, what different roles SMEs have in developed and developing countries. Furthermore, the paper aims to answer how SMEs deal with unemployment and contribute to the creation of new workplaces, what the role of SMEs is in creating innovative businesses. Finally, the research argues what governments should and could do to encourage the SME market.

The paper has the following chapters. Following the introduction, the paper outlines the research aims and objectives and research methods, then analyses the background of the research, namely the importance and role of SMEs in various economies by giving examples for illustration. In the literature review, the importance of SMEs is also evaluated by reviewing research papers and available secondary data. Later it analyses the selected countries' economic development from the aspect of the SME sector importance, it discusses the factors, incentives and public administration tools that contribute to the success of the SME sector in the selected countries. Then in the Results section some barriers to SME development and then SMEs' contribution to added-value is under scrutiny, which is followed by the conclusion and recommendations what and how governments can help to boost the numbers and the operation of SMEs in developing countries.

1.1 The research aims and objectives

The research strives to help individuals, groups and enterprises gain deep knowledge and understanding of the importance of SMEs in economic development and stability. It will cover different topics around the SME market. The paper's central objectives are to identify the role of SMEs in economic development, to understand the benefits of small and medium enterprises in achieving economic sustainability of developing countries and to show how SMEs can help in creating workplaces and labor market. The research focuses on the developing countries from Africa and Central Asia and gives examples of the importance of SMEs in these countries' development while compares these SME sectors and its role to the SME market in the EU and Japan. The research has its limitations since it presents scarce cases, example countries from some developing countries from Africa, the Balkan area or Central Asia – e.g. Georgia, Hungary, Serbia, Ghana, Nigeria and South Africa. Consequently, the research has a future potential to include other countries' data on SME market in the research and to present how SMEs contribute to the economic development in those countries.

1.2 Research Method and Data

Various research methods were used in this paper, such as observation, data and statistics analysis, documentation analysis method, method of studying and summarizing experience. It is necessary to identify the main trends and issues, opportunities, and problems for the observation of the countries. Both, statistics from developed and developing countries will be taken into consideration, based on this data, the main differences will be shown and analyzed. The practical significance of the study will reveal what small and medium-sized businesses mean for the economic development of developing countries.

The above main study areas and questions will be answered using different research methods based on secondary data analysis. The methodological choice for this research is a mixed research design which consists of mixed simple and complex methods. The characteristics are realistic philosophy and inductive methodology. The strategy is focused on economic data from different countries and SME statistics which actually occurred and have a real background. It is crucial to explain the interaction between a case study and its context, its influence and consequences. An internet- or intranet-mediated approach is decided to be used, collecting data from worldwide acknowledged data think tanks and from open access datasets and statistical and economic analysis of world leading economic and financial institutions such as World bank. Due to the nature of secondary literature review and secondary research methods bias and information distortion can influence the research objectivity, however the authors strived to focus on information and data as relevant as possible. Methods to study the role of SMEs in economic development are empirical research methods, documentation analysis method, method of studying and summarizing experience, and comparative methods can also be traced in the research project. In the case of sampling methods this study uses secondary data to answer research questions.

2 Literature Review

SMEs perform a crucial position within the financial improvement of a country. They represent about 90% of businesses and more than 50% of employment worldwide [1]. Formal SMEs contribute up to 40% of national income (GDP) in emerging economies [1]. Their position in phases of manufacturing, employment generation, contribution to exports and facilitating equitable distribution of earnings may be very critical.

Small and medium enterprises are considered to be the key factor of *solving unemployment problems* and to be the accelerator of economic development, especially in developing countries. SMEs contribute to *the growth of GDP*, they are considered as the *cradle of innovation*, which could also generate *added value* in the economies and SMEs have a special role when clean market operations are expected, i.e. *fighting with monopoly*. Different studies and research have been made to explain the importance of SMES, to analyze advantages and disadvantages. These roles of SMEs will be discussed in the following subchapters.

2.1 SME standardized categories

Definitions of SME are different based on the regions. According to EU recommendations [2], the most commonly used definitions are:

1. The category of small and medium-sized enterprises (SMEs) is made up of enterprises which employ fewer than 250 persons and which have an annual

turnover not exceeding EUR 50 million, and/or an annual balance sheet total not exceeding EUR 43 million [2].

2. Within the SME category, a small enterprise is defined as an enterprise which employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 10 million [2].

3. Within the SME category, a microenterprise is defined as an enterprise which employs fewer than 10 persons and whose annual turnover and/or annual balance sheet total does not exceed EUR 2 million [2].

Table 2 shows the categories of SMEs by number of employees, turnover and balance sheet.

Table 2

SME categories defined by size, turnover and balance sheet volume

Company category	**Staff headcount**	**Turnover**	**Balance sheet**
Medium-sized	<250	≤ € 50 m	≤ € 43 m
Small	<50	≤ € 10 m	≤ € 10 m
Micro	<10	≤ € 2 m	≤ € 2 m

2.2 SME contribution to GDP

Recent empirical studies show that SMEs contribute to over 55% of GDP and over 65% of total employment in high-income countries [3]**.** SMEs and informal enterprises, account for over 60% of GDP and over 70% of total employment in low-income countries, while they contribute over 95% of total employment and about 70% of GDP in middle-income countries. In the European Union countries, for example, there are some 25 million small businesses, constituting 99% of all businesses (Table 3). They employ almost 95 million people, providing 55% of total jobs in the private sector. Important contribution is also on exports and on productivity growth [4].

Table 3.

SMEs in developed countries

	SME Companies (%)	Employees in SME (%)	Value added (%)
Japan	99	66	55
USA	99	53	51
Germany	99	68	45

SMEs are combining different business fields; the most popular ones are conventional cottage and family industries including village industries and handicrafts. The conventional village and cottage industries are prominent forms in present days. SMEs are usually unorganized and placed in rural regions and semi city regions. These SMEs commonly do not use strength-operated machines/appliances because of the low budget, but they offer component time employment to a totally massive wide variety of poorer sections of the society. They additionally deliver crucial merchandise for mass consumption and exports.

Government is extending diverse steps in the direction of SMEs. SMEs have been supported and recommended through diverse authority's regulations for infrastructure support, generation up-gradation, to have easy access for bank loans and credit, and preferential coverage support, etc. Improving SMEs' access to credit and finding creative solutions to unlock sources of capital is a crucial area of the World Bank Group's activity. Diagnostics, implementation help, worldwide lobbying, and knowledge sharing of best practices are all part of the Advisory and Policy Support for SME Finance. Some examples are (1) Assessments of the financial sector to identify areas where regulatory and policy aspects should be improved to enable more responsible SME access to capital [1]; (2) Support for activities such as the creation of an enabling environment and the design and implementation of credit guarantee systems [1]; (3) Improving credit infrastructure (credit reporting systems, secured transactions and collateral registries, and insolvency regimes) can help SMEs get more funding [1]; (4) Using e-lending platforms, alternative data for credit decisioning, e-invoicing, e-factoring, and supply chain financing to introduce innovation in SME finance [1].

The contribution of small-scale region to the producing region and GDP as an entire is full-size in phrases of its percentage in general cost added. SMEs can play a position in mitigating the hassle of imbalance withinside the stability of charge debts through their export promotion.

SMEs are very important to fight against monopoly as well. Having a lot of different companies in business sector gives flexibility and choice to the customers, which helps companies to be always on the edge and to concentrate on progress and growth.

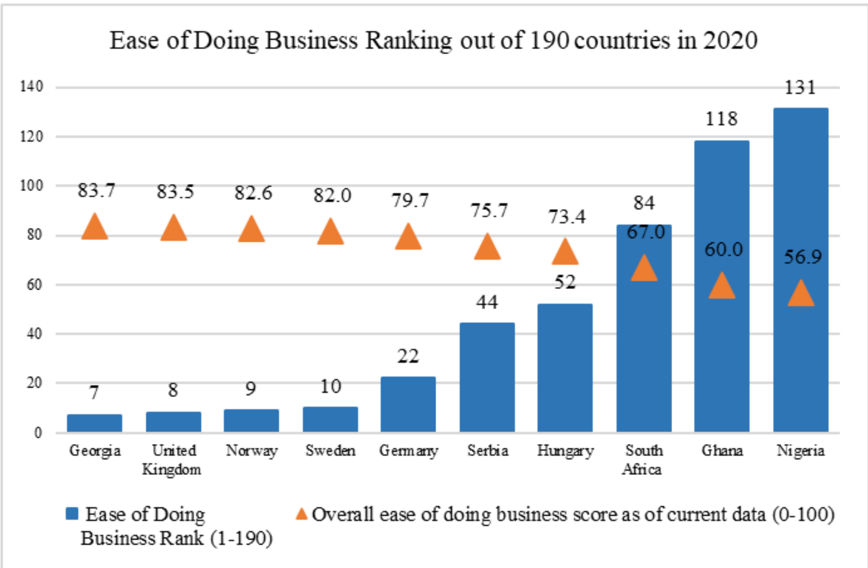
2.3 Government aid to SMEs

Governments should make a lot of reforms in order to achieve growth in economy and to create safe operational environment for SMEs. Through the *liberalization of the economy, deregulation* and *decentralization* it can be accomplished. Reconstruction of the system will bring a lot more foreign direct investments (FDI) to the country, which will help private sector to start operating. *Tax system* needs to be customized upon the needs of start-ups. All these steps will push people to start their own businesses and based on this, the number of SMEs will rise in the country. For example, Georgia implemented lot of changes in their tax system after the year 2005. Most of the changes were beneficial for the private sector and the aim was to create safe and free environment for businesses including SMEs and start-ups. Based on these changes, Georgia has ranked 7th among 190 countries in the World Bank Doing Business 2020 ranking, preceding the states like the UK, Norway and Sweden [5]. At the same time the government of Hungary eased on corporate tax rates striving to help SMEs and private businesses to run and operate. At present the corporate tax rate is 9% in Hungary [6]. Figure 11 displays some selected countries according to the ranking and the overall score of Ease of Doing Business in 2020 [5]. The graph lists the countries mentioned, evaluated and analyzed in the research paper.

The best performing country in 2020 was New Zealand being the first in the list and having earned 86.8 out of 100. The worst performing country was Somalia in Africa, which had 20 scores out of 100. The countries selected for the study performed well in 2020, Ghana and Nigeria gained scores a bit beneath the average 63.6, while South Africa, finished near the average with 67 and while Hungary and Serbia created business friendly environment in a similar way there were 8 other countries between them in the rank. Apart from Belgium, which is a developed country and Armenia, which is a developing country located in Central Asia, all the other countries between Hungary and Serbia are from the Central-Eastern European region (the Slovak Republic, Moldova, Belarus, Montenegro and Croatia. It implies that the post-Soviet countries follow similar strategy in creating SME friendly business environment and do it at a similar pace. Georgia with its 7th place earned 83.7 points, well above the average.

Figure 11

Ease of Doing Business ranking and overall score out of 190 countries in 2020 [5]



2.4 SME as catalyst and source of innovation

Peter Drucker claims that small enterprises are the main catalyst of economic development [7]. Small and medium-sized enterprises are “the heart of the global economy” [8]. The probable main reasons are innovation and productivity, which make SMEs so unique. Involving corporate strategy and organizational structure in companies lead to innovations, this can be done through offering training for SMEs, so that firms can become informed about possible organizational and corporate structures, trends and strategies [9]. Narrowing the scope to less developed and developing countries the following can be stated.

Wellalagea [10], in his paper about *innovation* and SME finance, claims that “evidence from developing countries describes the relationships between firm-level innovation and external finance for small and medium enterprises (SMEs)”. His research also outlined the importance of innovations as a critical factor of economic development. The highest innovation level is achieved by Serbia, above 35% of Serbian SMEs introduced new products, while 28% introduced new processes [10].

Having formal finance is positively associated with firm-level product innovation (4–8%) and process innovation (3–6%). This effect is higher for young firms' product innovation (7–10%) and process innovation (3–4%) compared to mature firms' product innovation (3–5%) and process innovation (2–3%). Wellalagea also claims that less innovative firms are more likely to get external funding [10].

Among SMEs the main external financing source was bank financing (28%). The second major source of external financing for the sampled SMEs was trade credit (26%). Furthermore, from the statistics we can see that non-bank loans and informal credit were, on average, 9% and 12%, respectively. That is, over 40% of financing for the sampled SMEs comes from nonbank sources [10].

Considering developing countries, in Ghana and South Africa for instance, SMEs represent a big portion of businesses. They make about 92% of Ghanaian businesses and contribute about 70% to Ghana’s GDP and over 80% to employment. SMEs also account for about 91% of the formal business entities in South Africa, contributing between 52% and 57% of GDP and providing about 61% of employment [11]. However, the number of SMEs does not necessarily affect the country’s GDP. In Nigeria, for instance, over 90% of businesses are SMEs, 95% of formal manufacturing activities and 70% of industrial businesses. In spite of this dominance of the Nigerian economy by the operating SMEs, their contribution to the GDP is below 5% [12], which fact is mainly connected with *business procedures, corruption* and *bureaucracy*.

UNCTAD confirmed, however, that countries with a high rate of small industrial enterprises have succeeded in making the income distribution more equitable [13].

3 Results

3.1 Barriers to SME development

Results of our research showed the differences of SMEs' impact and importance on the countries' economic sustainability mainly in the developing countries, based on their geographical location and economic situation. Developed and developing countries show different results while speaking about SMEs. Even the countries in the same geographical area have different results, for example SMEs contribute 70% to Ghana's economy and 52-57% to the South African economy, while in Nigeria it contributes with only 5% [11]. This kind of difference can be connected to different factors, such as *corruption, bureaucracy, high tax rate*. All of them have influence on economic environment of the country.

Concerning corruption, Nigeria, for example, ranked 144th out of 180 countries listed in Transparency International's Corruption Index in 2018 [14]. In 2020 Nigeria fell two positions and was ranked 149. In 2020, Ghana was ranked 75 and South Africa achieved the 69th place. In the meantime, Serbia, where SMEs contribute by their innovativeness ranked 94th.

As of bureaucracy, several indicators are calculated. Figure 12 displays the size of the public sector and the wage as percentage of the public budget in the selected countries for the survey. According to the Wordwide Bureaucracy Indicators, Nigeria has 84% formal employment rate in public sector, which is almost 3 times higher compared to Ghana, Hungary, Serbia and South Africa, which phenomenon definitely leads to high bureaucracy [15]. In Serbia and South Africa this level is 22%, in Hungary it equals 29%, while in Ghana it is higher and reaches 31%. No data was revealed for Georgia for the indicator. Considering wage bills as percentage of Public Expenditure, no data was displayed for Nigeria, Georgia with its 14% figure has the lowest percentage among the countries observed, Hungary and Serbia with 22% and 23%, respectively, are following Georgia, while in Ghana and South Africa these percentages are relatively high, equaling 30% and 35% respectively.

Figure 12

The size of the public sector in the selected countries in concern [15]

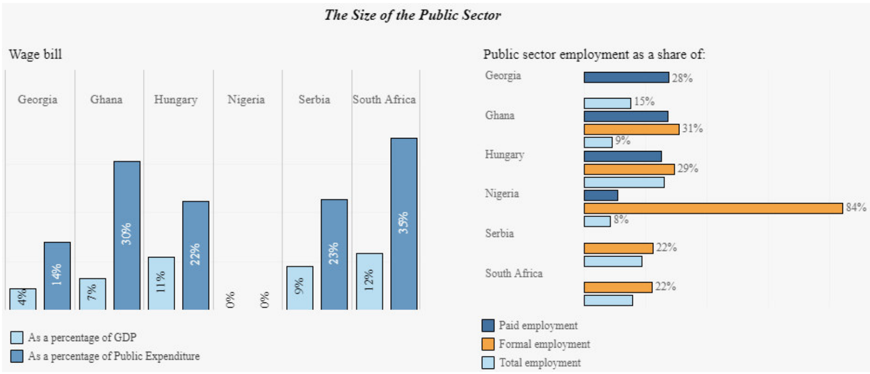
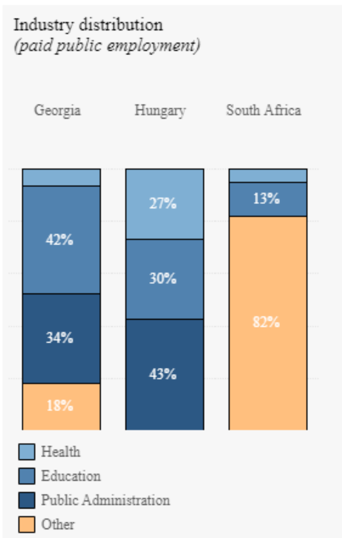


Figure 13 displays the distribution of public employment in the selected countries. Data for Ghana and Nigeria were not accessible, according to the data provided by the World Bank [15] the size of the public administration is the largest in Hungary (43%) among the selected countries, while in Georgia this size is 34%. In South Africa the "other" public employment takes 82% of all paid public employment.

Figure 13

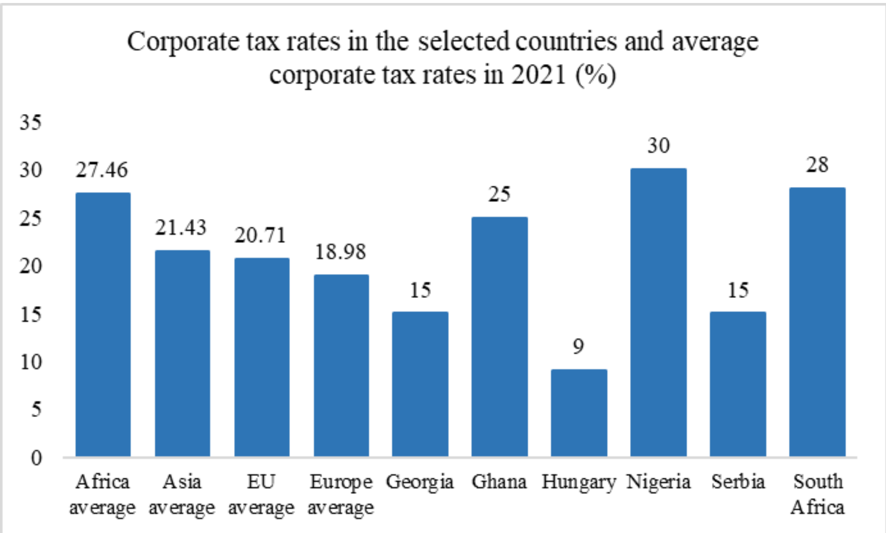
Distribution of Public Employment



Apart from corruption and high bureaucracy rate taxation system also hinder SME developments. High corporate tax rates set back SMEs' profitability and curtail them of expanding, investing in developments and innovation since high corporate taxes lower profits. According to [16, 6] as presented on Figure 14 amongst the countries observed the lowest corporate tax is used in Hungary (9%), the second lowest is imposed in Serbia (15%) and Georgia (15%) while corporate tax rates are high compared to these three countries in Ghana (25%), South Africa (28%) and in Nigeria [16, 6]. In the developing countries where SMEs could contribute the most to GDP growth, employment, added value and innovation the corporate tax rates imposed on SMEs are very high. Even South Africa, which is a country of two extremes showing the features of developed and developing countries, uses high corporate tax rate. In these countries Hungary lowered its corporate tax rate from 19% to 9% in 2017 and South Africa lowered it from 34.55% to 28% on 2013. On average, European OECD countries currently levy a corporate income tax rate of 21.7 percent [16], while the European average was 18.98% and the EU average 20.71% in 2020. The African average equaled 27.46% and the Asian average reached 21.43%. Surprisingly, while Hungary and Serbia use low corporate tax rates, the European and the EU average is around 20% implying that in the more developed countries the government levy higher corporate taxes. Comparing the averages, the African average (27.46%) is the highest with lots of developing countries, Asia follows with 21.34% where some emerging countries, the small tigers and some developed countries can be found. Then comes the EU average with a relatively high number of developed countries (20.17%) and the European average is the lowest in the list with 18.98% where most of the post-communist countries can be found and where SMEs contribute significantly to the GDP.

Figure 14

Corporate tax rates in 2021 (%)



Small and medium enterprises tend to be innovative, 35% from Serbian SMEs introduce new products on the market and 28% introduced new business processes [10]. Governments of developing countries must support to achieve stable economic environment and help SME market growth in emerging economies, with guidance and assistance of the World Bank and developed countries. Especially, they need financial and consulting services which will help them to overcome difficulties during the start-up phase or to carry out their normal business activities.

3.2 SME contribution to added value globally

Number of SMEs and large enterprises in the EU-28 NFBS (non-financial business sector) in 2018 and their value added, and employment is shown in Table 4 [2]. The table presents the number of SMEs, their added value to the number of employments.

In 2018, there were slightly more than 25 million SMEs in the EU-28, of which 93% were micro-SMEs [2]. SMEs accounted for 99.8% of all enterprises in the EU-28 non-financial business sector (NFBS), generating 56.4 % of value added and 66.6% of employment in NFBS [2]. According to the Annual Report on European SMEs 2018/2019 by the European Commission [2], SMEs account for most of the increase in added value (60%). Micro SMEs generated 28.5% of this increase, while small and medium-sized SMEs accounted for 16.9% and 14.1%, respectively [2]. SMEs have made a much stronger contribution to the growth in value added in recent years (i.e. from 2016 to 2018) compared to the longer period of 2013 to 2018. The increase in the SME contribution is almost entirely due to successful operation of micro-SMEs [2]. Almost 50% of EU SMEs undertook some innovation activity over the period 2014-16, the last years for which such data are available. Some of these SMEs developed disruptive innovation or breakthrough innovation, while others have focused on more incremental innovation [2].

Table 4

EU-28 SME Contribution

	Micro SMEs	Small SMEs	Medium-sized SMEs	All SMEs	Large enterprises	TOTAL - All enterprises
Enterprises						
Number	23,323,938	1,472,402	235,668	25,032,008	47,299	25,079,312
%	93.0%	5.9%	0.9%	99.8%	0.2%	100%
Value added						
Value in € (million)	1,610,134	1,358,496	1,388,416	4,357,046	3,367,321	7,723,625
%	20.8%	17.6%	18.0%	56.4%	43.6%	100.0%
Employment						
Number	43,527,668	29,541,260	24,670,024	97,738,952	49,045,644	146,784,592
%	29.7%	20.1%	16.8%	66.6%	33.4%	100.0%

Note: Large enterprises are enterprises with 250 or more employees.
Source: Eurostat, National Statistical Offices, DIW Econ

SMEs have more elasticity in terms of *production, marketing,* and *operation* than large corporations because they pay close attention to the consumer, understand customer needs better, and have close relationships with their employees. Since this elasticity allows SMEs to adapt to changes in the environment over time and on-site, they are able to avoid many problems and cause less harm. SMEs, despite their flaws, are less affected by economic crises due to their versatility and ability to adapt to changing circumstances [17]. They also absorb the consequences of economic crises and function as a "compressor." Small and medium-sized enterprises are critical in this regard, especially for developing countries. Innovative SMEs are critical players in the ecoindustry and clean-tech industries in many OECD countries. Openness to trade and investment, intellectual property security, infrastructure, and institutional efficiency all play a role in SMEs' commitment to global markets [17]. To sum up, from the data given by the World Bank [1] and from the economic data of different developing countries [1], it confirms the important role of SMEs in countries' development. There is yearly growth rate in created workplaces, percentage to GDP contribution and total added value benefits of SMEs. Governments should try to implement a lot of changes into their tax system and economic environment to ease start of the new business. Liberalization of the economic environment is a starting point to make important changes in the system, which will lead to higher growth rate of SME. In summary it can be argued that governments should fight against corruption and strive to clean economy, need to reduce bureaucracy to ease doing businesses in developing countries and they need to implement changes in tax system to boost SME operations and leave funds at the SMEs to support investments, developments and innovation.

Conclusion

This paper discussed the role of SME in economic development of developing countries by bringing examples and comparing to the European practices and developed countries. With the help of secondary data and given statistics it has become clear that SMEs are one of the key players in the countries' economic growth and stability. In most cases they produce more than 60% of total workplaces, which is connected directly with fighting poverty in the country.

Small and medium -sized enterprises are the main contributors to the GDP of such developing countries. Developed countries such as Germany, USA, Japan, have already proved the important role of SMEs and with the help of the World Bank these countries continuously introduce and implement changes in countries with emerging economies. On analyzing different data and research papers and official publications and documents, the strategic importance of SMEs became more understandable.

Small and medium -sized enterprises are contributing to employment growth at a higher rate than larger firms, both in developed and developing countries. *Fighting with the monopoly* is one of the core functions of SMEs, it brings variety inside the business sector and fair competition. Innovation should be also mentioned, a high number of SMEs are startups or based on entrepreneurship, and in most of the cases in order to gain competitive advantage they need to be innovative and have to have a well-organized operational structure.

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