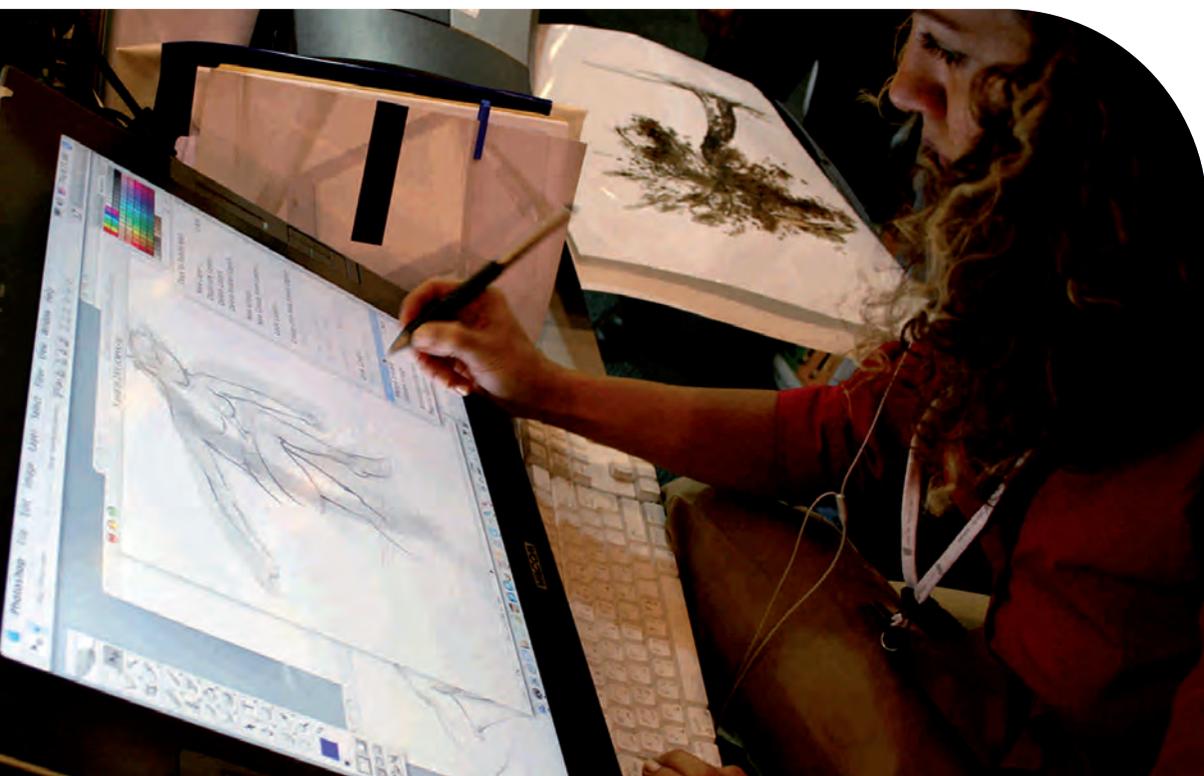


Powerhouses of Recovery:

Small and Medium Enterprises
During and After the Financial
and Economic Crisis

By Fredrik Erixon
October 2009



Powerhouses of Recovery:

Small and Medium Enterprises
During and After the Financial
and Economic Crisis

By Fredrik Erixon
October 2009

CREDITS

Centre for European Studies
Design: RARO
Printed in Brussels by Drukkerij Jo Vandenbulcke
Brussels, 2009
Centre for European Studies
Rue du Commerce 10
Brussels, BE – 1000

The Centre for European Studies (CES) is the official think-tank of the European People's Party (EPP) dedicated to the promotion of Christian democrat, conservative and like-minded political values.

For more information please visit:

www.thinkingeurope.eu

This publication receives funding from the European Parliament.

© Centre for European Studies 2009

Photos used in this publication: Centre for European Studies 2009

The European Parliament assumes no responsibility for facts or opinions expressed in this publication or their subsequent use. Sole responsibility lies on the author of this publication.

Table of Contents

Executive Summary	6
1. Introduction	7
2. The Role of SMEs in Europe's Economy	11
3. SMEs as a 'Cushion' in Times of Crisis	18
Case Studies of Selected Countries	18
4. SMEs in Times of Recovery and Economic Growth	25
5. Conclusions and Policy Recommendations	31
References	35

Executive Summary

Small and medium-sized enterprises (SMEs) are the backbone of Europe's economies. They represent an increasing share of all enterprises, production and employment. They also represent the future: innovations tend to spring from SMEs, which thus act as agents of change. There are big differences among the roles of SMEs in Europe's economies—as there are major differences overall among SMEs—but the pattern of growth is distinctly clear.

SMEs are important in cyclical downturns and recessions. They cushion the impact on economies that more often than not comes from large enterprises. SMEs tend to be more oriented toward the domestic economy than are large enterprises, which is why the SME sector does not contract as much as large enterprises do when the global economy slows down. SMEs are also more service oriented, which is why big shifts in manufacturing output—due to cyclical effects or to relocation of production—are felt more strongly among large multinationals than in the SME sector. Overall, SMEs are more sensitive to changes in demand and tend to be more flexible. SMEs are also important in economic recoveries. Countercyclical measures tend to favour domestic consumption rather than having an outward orientation and thus have a disproportionate effect on SMEs.

There are several issues facing SMEs. Red tape hinders their growth and export potential. Punitive taxes prevent SME entrepreneurs from building up a capital base for new ventures and expansion. Despite decades of political enthusiasm for SMEs, governments still tend to be insensitive to the limited capacity of entrepreneurs to handle administrative burdens. A zero-tolerance policy towards unnecessary red tape should be introduced.

1. Introduction

Few ideas in political life are so widely shared as the support for small and medium-sized enterprises (SMEs)¹. They are embraced by most if not all parties, politicians and opinion formers. In many countries, even parties that cherish their Communist past and still hold up Karl Marx as a revered figure believe that SMEs are legitimate and merit political support. This is in sharp contrast to stances toward large and multinational enterprises. They are often lambasted or ridiculed in political discourse. Many see in them the pure incarnation of capitalism—indeed, brutal capitalism. Authors like Naomi Klein accuse them of being great manipulators, poisoning the public mind with their crass commercial strategies and their logotypes. Others criticise them for their size and inefficiency: many large multinational companies have become giant bureaucracies with little feeling for genuine entrepreneurship. Very few people seem to have a natural political affinity with them. The grand coalitions in many European countries in the past between the big firms and the big dominating catch-all parties on the left and the right have been deteriorating for decades (Esping-Anderson 1990). The views and values embedded in post-war corporate and management strategies merged easily with the political views of the time, especially an excessive Cartesian view of regulating and organising all aspects of the life and commerce of society. The result was societal Taylorism: governments could operate as big companies and vice versa.

It is easy to understand the popularity of entrepreneurs and SMEs. Many of them are perceived to embody values that most cultures and societies seek to foster. The traditional bourgeois virtues are part of it: thrift, honesty and uprightness are some values that often are associated with entrepreneurship in multinational surveys. But there is also an affinity for the more

¹ In this paper the author uses the EU definition of an SME: annual turnover of less than €50 million, balance sheet no bigger than €43 million, and fewer than 250 employees.

adventurous character of the entrepreneur who innovates and takes economic and financial risks. These two types of values thus represent two types of characters. By contrast, the early literature on the sociology of entrepreneurship often portrayed the entrepreneur as someone socially and ethically unbound; a person with little regard—perhaps even disrespect—for community and communitarian values. The entrepreneur was seen to embody the same sociology as a class traveller. When the description of an entrepreneur was taken to extremes, which many were inclined to do in the 1960s and 1970s, the entrepreneur was described as resembling a sociopath.

We have travelled far since then. The grand discourse of entrepreneurship is completely different today. Not only is there a different appraisal of entrepreneurs; the political, ethical and sociological context is no longer the same. The sociology of risk has also changed. What previously was perceived as an almost sociopathic trait is today considered to be part of the broader ethical and communitarian texture: calculated risk, which entrepreneurship is about, is rather a product of bourgeois virtues. Culturally, scholars like Robert Putnam view successful entrepreneurship as a consequence of the societal fabric rather than a product of solitary confinement. It is in communities with vibrant civil societies that entrepreneurship is developed the most. One should not take this discourse too far; entrepreneurship and SMEs come in different shapes and colours. Yet one cannot escape the fact that some sociological contexts are more conducive to entrepreneurship than others.²

There has been a vibrant political and sociological discourse about entrepreneurship and companies (big and small). Today there is also a developed economic discourse on entrepreneurship and SMEs. Since the late 1970s, the interest in small businesses has

² For further reading and data on the discourse on entrepreneurship, see Erixon & Uddhammar (2009), Erixon & Uddhammar (2002), Erixon et al (2001), Mueller (1999), Fukuyama (1995) and McCloskey (2006).

grown rapidly. Small business research is increasingly becoming an established field of scholarship. Behind this development are a number of factors that have increased the material role of SMEs in the economy. Entrepreneurship and small firms have experienced a global resurgence after decades in which it was the large enterprises that were growing. This development is due to many factors:

- Technological development has reduced transaction costs and increased the focus on specialisation and the focus on the core activity of a firm. Outsourcing and corporate downsizing have been consequences of technological development.
- The profile of production in Western economies has shifted away from the sectors that were characterised by and conducive to large entities. This shift is partly one of a transfer of production from traditional manufacturing to services. The latter is much more conducive to small businesses.
- The demand pattern has shifted from demand for standardised goods to demand for diversified goods.
- Large firms are skilled at increasing the productivity of manufacturing, but tend to be less skilled at innovation. This is partly a function of sunk costs. Innovation and new products tend to emerge from smaller companies. Hence small firms are often agents of change. Smaller companies also tend to be new companies, and they are less bureaucratic than older companies. They tend to have a stronger focus on innovation as a core strategy for growth.

But two immediate observations confront every scholar of SMEs and entrepreneurs:

1. We know very little about SMEs and how they operate. There is not much available data that is of sufficient quality to be suitable for comparative and comprehensive analysis. Existing data is often scant and based on surveys.

2. There are many problems associated with the category ‘SME’. SMEs represent companies that are vastly different—in size as well as ambitions and opportunities. Many SMEs are owner-operated shops with no employees, no interest in expanding, no interest in or need for research and development (R&D), no competition from foreign competitors and no experience of foreign trade. Other SMEs are highly innovative, financed by venture capital, fully oriented toward global markets and having ambitions to expand from 5 to 500 people within a few years. Approximately 90% of all SMEs in Europe are microfirms, employing no more than 10 people. The realities these firms confront are entirely different from those faced by the innovative start-up. Materially, microfirms and larger SMEs have little in common.

As a consequence of our limited knowledge, it is difficult for policymakers to obtain a proper account of the role of SMEs in Europe’s economy. This paper aims to address some of the questions and concerns that surround SMEs—especially those related to the role of SMEs during economic contractions and in recovery cycles. The paper is subject, however, to the same limitations that other scholars encounter. With data that is far from satisfactory, and with many unexplored aspects in the research literature, the emphasis has to be put on interpretation and contextual analysis.

2. The Role of SMEs in Europe's Economy

Small and medium-sized enterprises are of considerable importance to Europe's economy. As shown in Table 1, they represent the vast majority of all firms in Europe. Of the existing 20,500,000 companies in Europe in 2007, all but 43,000 were SMEs. The number of SMEs is also growing more quickly than the number of large enterprises. None of this is surprising. It takes a good deal more time and resources to become a large company than to run an SME.

Table 1. Number of enterprises by size in EU-27, 2002–2007

	No. of enterprises 2002	Change 2002-2007	No. of enterprises 2007
SME	18,348,000	2,062,000	20,409,000
Large	41,000	2,000	43,000
Total	18,389,000	2,064,000	20,452,000

Source: EIM (2009) based on Eurostat

Table 2 conveys the same picture, but also presents the data on individual countries. The rate of growth in the number of SMEs has varied considerably between 1999 and 2006. New members of the EU have experienced much faster growth in the number of SMEs, with Lithuania and Slovakia on top with average annual growth exceeding 15%. Poland is the only exception to this rule—indeed the only exception to the overall picture of pan-European growth in the number of SMEs. In the EU-15 group, it is Portugal and Ireland that have experienced the fastest rates of increase.

Table 2. Number of SMEs per country

	1999	2000	2001	2002	2003	2004	2005	2006	Average growth rate per year
Austria	192,210	200,013	208,002	246,315	259,560	263,844	272,724	282,086	5.76%
Belgium	370,873	373,588	378,967	380,940	382,917	394,192	395,369	401,183	1.13%
Czech Rep.	714,673	797,837	740,419	875,121	875,230	878,273	854,595	855,111	2.91%
Germany	1,640 924	1,614 076	1,640 129	1,621,357	1,698,559	1,687 253	1,657 189	1,765 127	1.09%
Denmark	193,656	197,164	195,954	187,744	187,124	191,677	201,580	206,634	0.97%
Estonia	25,848	27,438	29,330	31,026	31,621	35,628	38,034	42,977	7.60%
Spain	2,084 470	2,206 788	2,230 285	2,287,824	2,360,618	2,451 851	2,542 020	2,628 506	3.38%
Finland	180,663	182,478	183,217	184,154	177,275	185,557	190,021	202,950	1.72%
France	1,971 865	1,937 821	1,975 515	2,023,002	2,166,342	2,221 912	2,274 299	2,327 471	2.42%
Hungary	49,052	51,910	528,344	556,661	554,516	545,956	556,376	542,316	1.44%
Ireland	52,912	64,394	71,332	78,559	85,569	86,967	85,134	92,155	8.47%
Italy	3,542 220	3,617 571	3,686 726	3,720,363	3,701,026	3,737 054	3,818 745	3,844 204	1.18%
Lithuania	53,594	52,956	57,363	56,126	54,883	53,091	103,621	125,595	16.55%
Latvia	33,244	37,659	35,837	49,691	54,198	58,180	61,933	67,144	11.20%
Netherlands	456,915	469,220	475,920	473,730	472,950	483,630	492,250	515,480	1.75%
Poland	1,576 927	1,530 955	1,414 404	1,495,456	1,454,945	1,454 462	1,404 669	1,443 246	-1.17%
Portugal	514,026	518,274	498,159	543,437	567,447	583,184	849,501	860,669	8.60%
Sweden	422,112	441,342	455,082	466,619	320,343	503,233	522,895	541,438	6.20%
Slovenia	67,873	69,097	71,216	85,219	86,469	88,813	88,340	96,053	5.27%
Slovakia	4,739	24,192	35,888	28,389	36,706	35,175	41,714	51,844	15.91%
UK	1,450 227	1,473 791	1,488 174	1,485,153	1,520,285	1,524 089	1,582 568	1,618 137	1.59%
All Countries	15,599 023	15,888 564	16,400 263	16,876,886	17,048 583	17,464 021	18,033 577	18,510 326	2.48%

Source: Eurostat; author's calculations

Explanation: Does not take into account GR99-00 for Slovakia and GR00-01 for Hungary. Does not include BL, CY, GR, LU, MT and RO.

There are also differences between sectors in the economy. The SME ratio varies—indeed quite significantly. The retail sector has the greatest number of SMEs (slightly more than 30% of SMEs are found in this sector), followed by the construction and manufacturing subsectors.

The fastest growth has been experienced in the real estate sector and among suppliers of electricity, gas and water. This is an interesting pattern. The high growth in the number of SMEs in real estate can be explained by increased economic activity in that sector, which in turn is partly explained by the housing boom many European countries have experienced in the recent past. It is also a sector characterised by small companies. And there tends to be a 'path-dependant' pattern: sectors with a high

proportion of small businesses expand through the entry of new small firms or through firms that grow while remaining small. Hence, high SME growth is more plausible than expansion of big real estate chains.

The growth among typical public utilities (electricity, gas and water supply) is more surprising. Some of these markets have experienced deregulation in the past, which might explain the increasing presence of private companies. But the sector itself is also prone to large companies as the products they sell have typical network properties. However, part of the increase can be explained by the increasing number of SMEs that service investments in these sectors—i.e., through the outsourcing of servicing functions that traditionally have been kept in-house.

It is also worth noting the low growth rate in the manufacturing sector—which is far below the average. At a time when many large manufacturing companies have outsourced production to other countries within Europe, one would expect a bigger increase. Although outsourcing activity typically has a multiplier effect—the number of companies that expand or start up as a consequence of a foreign direct investment (FDI) is higher than the number of companies that close due to emigration of production—these expectations have certainly not been met.

Table 3. Number of SMEs by sector, 1999-2006

	1999	2000	2001	2002	2003	2004	2005	2006	Average growth rate per year
C - Mining and quarrying	18 263	18 750	19 383	19,549	18,809	19 282	19 456	19 402	0.89%
D - Manufacturing	2,071 422	2,127 979	2,132 154	2,138 048	2,118 188	2,115 207	2,117 401	2,100 927	0.21%
E - Electricity, gas and water supply	20 518	21 105	22 020	23,528	23,618	24 598	26 224	29 532	5.40%
F - Construction	2,194 011	2,265 974	2,294 495	2,402 650	2,474 114	2,539 813	2,626 202	2,728 166	3.17%
G - Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	5,410 512	5,411 803	5,425 567	5,482 167	5,551 684	5,532 287	5,580 022	5,655 573	0.64%
H - Hotels and restaurants	1,349 983	1,360 601	1,393 384	1,406 814	1,430 886	1,457 361	1,491 735	1,522 409	1.73%
I - Transport, storage and communication	1,016 020	1,030 011	1,030 824	1,069 604	1,051 211	1,062 670	1,069 029	1,077 915	0.86%
K - Real estate, renting and related business activities	3,518 494	3,652 571	4,082 715	4,334 867	4,380 540	4,713 387	5104 150	5,377 109	6.29%
All Sectors	15 599 223	15 888 794	16 400 542	16,877 227	17,049 050	17 464 605	18 034 219	18 511 033	2.48%

Source: Eurostat; author's calculations.

Explanation: Does not include BL, CY, GR, LU, MT and RO

The picture changes somewhat if we consider the role of SMEs in employment: the SME ratio is not as high as it is for the SME share of the number of firms. Still, SMEs are of considerable importance. Table 4 gives some key indicators of the importance of SMEs for employment. About two-thirds of the people employed in the private sector in Europe work in an SME. Microfirms with an average of two workers represent roughly 30% of total employment in the private sector. The average number of employees in an SME, however, is four.

The differences among sectors are considerable. The construction sector has the highest share of employment provided by SMEs. Close to 90% of all workers in the construction sector work in an SME. Hotels and restaurants rank second, followed by wholesale and retail trade. All these sectors are service sectors. Overall, the service sector has a higher SME ratio in almost all aspects.

Table 4. Number of persons employed by sector (EU-27)

Industry	SMEs	LSEs (large-scale enterprise)	Total	Share of SMEs	Share of persons employed in SMEs	Share of persons employed in LSEs	Share of persons employed (total)
Mining and quarrying	245,000	564,000	809,000	30.28%	0.28%	1.31%	0.62%
Manufacturing	21,059,000	14,447,000	35,505,000	59.31%	23.96%	33.68%	27.14%
Electricity, gas and water supply	352,000	1,319,000	1,671,000	21.07%	0.40%	3.07%	1.28%
Construction	12,275,000	1,690,000	13,965,000	87.90%	13.96%	3.94%	10.68%
Wholesale and retail trade; repair of motor vehicles, motorcycles and personal and household goods	23,448,000	8,542,000	31,990,000	73.30%	26.67%	19.91%	24.46%
Hotels and restaurants	7,669,000	1,655,000	9,324,000	82.25%	8.72%	3.86%	7.13%
Transport, storage and communication	5,650,000	6,459,000	12,110,000	46.66%	6.43%	15.06%	9.26%
Real estate, renting and business activities	17,210,000	9,220,000	25,430,000	67.68%	19.58%	21.49%	19.44%
Total	87,909,000	42,895,000	130,800,000	67.21%	100.00%	100.00%	100.00%
Average size of enterprise	4	1 003	6				

Source: Eurostat; author's calculations

There are many variations in the employment share of SMEs across countries. Portugal and Italy are the two countries with the highest share of private employment represented by SMEs. They both score 81%. On the other side of the spectrum we find the United Kingdom and Finland; both score below 60%. The majority of EU members, however, have an SME employment share between 60% and 70%.

Countries with a high employment share represented by SMEs do not seem to add many new jobs to the SME sector. This is somewhat surprising. In Italy, for instance, the employment share of SMEs is declining. In Portugal the average growth rate has been 0.02% in the past eight years. In fact, a pattern analysis suggests that the higher the employment share the lower the rate of employment growth is. The United Kingdom is the exception; it has a comparatively low employment share represented by SMEs, and the share has fallen. Hungary and Romania (both transition countries) have the highest growth rate.

One explanation for the falling or low growth rates in countries like Italy and Portugal can be found in the profile of SMEs in these countries. In small business research, many scholars talk about two different kinds of SMEs: gazelles and mice. A 'gazelle' is a small but rapidly growing SME. According to several scholars of small-scale entrepreneurship, it is this type of company that has contributed to the net growth of jobs in the past 20 years. While the large companies, the 'elephants', have declined in the past 20 years and contracted the number of jobs, job creation has been represented by the gazelles. A 'mouse', by contrast, is an SME that starts small, grows slowly (if at all) and hence contributes only marginally to job creation. Italy and Portugal are both countries with SMEs that resemble the mouse type rather than the gazelle type. There are plenty of SMEs, but they are found in sectors with limited growth opportunities and, more often than in other countries, they are structured around the family. Many of them are service-oriented firms, not least in the tourism sector. Job creation in SMEs such as these will typically not grow much. There is one pattern in Italy's enterprises that seemingly contradicts this portrait, however. According to a study of high-growth enterprises, Italy has been found to have a high share of gazelles (Verhoeven et al. 2008). The study, however, uses other definitions and takes into account companies with between 50 and 1000 employees (i.e., companies that are bigger than those in the standard definitions of SMEs); the employment effect among fast-growers tends to be larger in companies that have graduated from the SME category but are not yet considered to be large enterprises.

Table 5. Share of labour force employed by SMEs per country

	1999	2000	2001	2002	2003	2004	2005	2006	Average growth rate per year
Austria	67%	67%	67%	68%	68%	68%	68%	68%	0.17%
Belgium	67%	66%	66%	67%	67%	66%	67%	67%	0.04%
Czech Rep	66%	67%	68%	68%	69%	69%	68%	68%	0.38%
Germany	60%	60%	60%	59%	60%	60%	60%	60%	0.20%
Denmark	65%	66%	65%	65%	66%	66%	66%	66%	0.13%
Spain	80%	79%	79%	79%	79%	79%	79%	78%	-0.29%
Finland	59%	58%	59%	59%	59%	59%	59%	59%	0.18%
France	61%	61%	60%	60%	61%	61%	61%	62%	0.06%
Hungary	51%	53%	69%	70%	71%	72%	71%	71%	5.19%
Italy	82%	81%	81%	81%	82%	81%	81%	81%	-0.16%
Latvia	77%	78%	72%	73%	74%	75%	76%	76%	-0.08%
Netherlands	61%	62%	63%	65%	68%	67%	67%	67%	1.47%
Poland	64%	66%	68%	70%	70%	70%	70%	69%	1.04%
Portugal	81%	80%	80%	81%	81%	81%	82%	81%	0.02%
Romania	48%	50%	50%	52%	55%	58%	61%	64%	4.09%
Sweden	62%	63%	63%	63%	62%	64%	63%	64%	0.37%
UK	55%	55%	55%	53%	54%	54%	54%	55%	-0.08%
All Countries	65%	65%	65%	66%	66%	67%	67%	67%	0.57%

Source: Eurostat; author's calculations.

Explanation: Does not include CY, EE, GR, IE, LT, LU, MT, SI and SK

There are other aspects of SMEs in Europe that are changing. New start-ups are typically started by people in the younger generation – on average 30–40 years old – and the ‘SME deaths’ are typically among companies run by older people. New companies have a stronger emphasis on research and development (R&D), computer and related activities and real estate activities (Schrör 2008). Employment effects also tend to be strong in financial services, construction, hotels and restaurants, and business services.

The age of an organisation is important. New companies are often more interested in innovation. This is partly a consequence of the age of the entrepreneurs (younger entrepreneurs are typically more innovative than older entrepreneurs). Some of these companies are start-ups based on university research; others are start-ups by former colleagues at an older and larger firm where the innovative spirit could not be accommodated or sufficiently cared for. There is also a good deal of risk in innovation-oriented SMEs.

3. SMEs as a 'Cushion' in Times of Crisis

There are interesting cyclical effects of the structure of enterprises. Policy responses to cyclical downturns or a crisis of the kind the world recently has experienced tend to focus on the financial fragility of SMEs. In contrast to large enterprises, SMEs tend to be in a weaker financial position. They have difficulty negotiating contracts with banks for short or long-term loans. At a time of credit contraction, the problems of access to credit can become acute for a large portion of SMEs. They typically have fewer internal resources and less liquidity. Their financial position is weaker (i.e., lower capitalisation). They are more sensitive to late payments from customers. They have fewer financing options (OECD 2009).

Given the importance of SMEs for employment, governments often tend to respond relatively quickly to deteriorating cyclical conditions, on behalf of SMEs (though seldom with effective policies). The current recession is no exception (OECD 2009). Let us look at some of the actions taken by selected governments to ease the conditions for business.

Case Studies of Selected Countries

Germany

Of the total €115 billion envisaged in Germany's January 2009 recovery plan, €15 billion were reserved for SMEs. But the largest slice of the pie— €75 billion—went to large companies, including the much-debated auto bailout plan, bank subsidies and nationalisations. The package included a scheme aimed at easing credit access for SMEs and offering a special fund for start-ups. The sums are managed by the state-owned development bank KfW (Kreditanstalt für Wiederaufbau [Bank for Reconstruction]). Under the 'credit and guarantee programme' companies with an

annual turnover of less than €500 million can could obtain low-cost loans for investments. However, the KfW explained that companies facing bankruptcy were excluded from funding, as bailouts were already included in the larger part of the fund. The extent to which SME funding will impact on the economy remains unclear. Small businesses' interest in the programme is limited, as requests for funding have to be filed with retail banks, which are said to be ill-informed about the funding schemes. So far, only about €2 billion worth of loans have been successfully granted, or less than 15% of the €15 billion funding scheme for SMEs.

France

The French government launched a detailed plan in October 2008 that included €22 billion for SMEs. Of this, €17 billion has been channelled through banks, which have signed a deal with the government agreeing to use the funds to finance SMEs. Banks will have to produce monthly reports to demonstrate that they have fulfilled their obligations. A further €5 billion has been earmarked for the OSEO—a state body charged with boosting innovation and SME development—which will use the money to guarantee funding from banks and equity capital investors. The OSEO has received requests for assistance from 5,500 SMEs in the past five months and has granted loans totalling €450 million. In addition, the French government has decided to abolish a minimum annual tax for SMEs with a turnover of less than €1.5 million by the end of 2011 and will waive business tax on equipment and property purchased before 31 December 2009.

United Kingdom

Stimulus plans for the economy in the UK centre on cutting business 'rates', a form of local taxation. A number of schemes have been rolled out across the UK's regions, with devolved governments in Scotland and Northern Ireland announcing measures to cut rates for some SMEs. The Scottish government has scrapped business rates altogether for companies whose premises have a 'rateable value' of less than £8,000. On top of

this, there are discounts available for all firms whose premises have a combined rateable value of less than £15,000. A scheme of this nature is not yet available to small businesses in England or Wales, but the Northern Ireland Executive has unveiled a plan to introduce Automatic Rate Relief within the next financial year. The government has reduced the rate of VAT from 17.5% to 15% in an effort to stimulate business activity and consumer confidence. A new £1.3 billion Enterprise Finance Guarantee has also been announced, which will support bank loans of between £1,000 and £1 million until 31 March 2010. The guarantee can be used to support new loans, to refinance existing loans where the loan is at risk due to deteriorating quality of security, or to convert an existing overdraft into a loan in order to release capacity to meet working capital requirements.

Italy

In April the Italian government approved a plan to increase the budget of the Fondo di Garanzia (a warranty fund for grants) from €500,000 to €1.5 million. The decision is part of an emergency decree aimed at helping enterprises avoid bankruptcy. Measures designed to streamline VAT payments and tackle late payments are also in the pipeline. SME lobby groups have asked for more credit, less red tape and accelerated implementation of existing pro-business laws. The government is working to simplify the job market and to boost workers' vocational training through a €8 billion fund for updating skills, counselling and wage support. Evidence is emerging in Italy that shows businesses led by women are faring better during the crisis than companies run by men. An Italian study published in March shows that a higher number of male managers closed their business compared with their female colleagues.

Ireland

Irish exporters are facing a combination of challenges, as the impact of the global credit crunch is compounded by the reduced value of the British pound. The UK remains the largest export

market for Irish SMEs, and consumers in the Republic of Ireland are increasingly shopping in Northern Ireland, where goods are relatively cheaper due to the price of sterling and lower VAT rates. The Irish government put together an emergency budget last month in which it announced a €100 million Enterprise Stabilisation Fund, which will make up to €500,000 available to help viable firms combat the financial crisis. SME lobby groups have called on the Irish government to guarantee up to 50% of loans to SMEs in order to insure banks against the risk of business default. The government has already guaranteed deposits in Irish banks and established a 'bad bank' to buy toxic assets from financial institutions in order to get credit flowing to businesses and consumers.

Czech Republic

The Czech government is focusing its efforts on improving the business environment rather than targeting particular types of companies or individual industries. The government has already abolished regulations that required trades workers to pay some taxes in advance. To get credit flowing to exporting companies, loans are being made available through commercial banks and the Czech Export Bank. The government is also making it easier for SMEs to access EU funds. The new Czech government is expected to cut social insurance paid by employers as part of its efforts to reduce the cost of labour for employers. Meanwhile, the parliament has lowered the tax base for companies. In a move designed to boost entrepreneurship, accounting requirements for microenterprises such as trades workers have been reduced, and companies can now be formed within 24 days by following a streamlined set of ten administrative procedures.

Romania

The Romanian government has published a three-year macroeconomic plan to tackle the crisis, which includes settling central and local government debts to private companies. It has also announced plans to recapitalise the state-owned banks CEC

and EximBank as part of its efforts to boost credit activity. Unemployment assistance has been extended by three months and health contributions by employers have been suspended. Employees in ‘technical unemployment’, such as those working part-time due to production suspensions by some factories, can earn 75% of their wage tax-free for a maximum of three months. SME groups were up in arms last month following the introduction of a tax for all small firms. The National Council for SMEs stressed that the law is against the spirit of the Small Business Act, and the move was roundly criticised by economic commentators and tax consultants. The government is aiming to cut the number of taxes companies must pay in order to reduce red tape for SMEs. A report by PricewaterhouseCoopers said companies in Romania spend 202 hours per year working to comply with tax requirements.

Slovakia

In Slovakia, €33 million has been provided to increase the basic capital of the Slovak Guarantee and Development Bank (Slovenská Záručná a Rozvojová banka—SZRB), which provides specialist support for SMEs. A further €11.5 million has been made available to Eximbanka SR, which is extending loans to exporting SMEs, and €5 million has been earmarked to support between 500 and 750 entrepreneurs through a microloan programme. Relaxed state aid rules have enabled the Slovak authorities to channel more resources to SMEs from European structural funds. The government is seeking to link its support to energy-efficient innovations and technology transfer, and has begun to establish clusters of SMEs which can access major European funding programmes. As part of a plan to cut red tape—which was already well underway before the crisis began—Slovakia is exempting microenterprises from accounting requirements in cases where entrepreneurs do not have any direct employees and have a turnover of no more than €170,000. Retraining schemes for workers laid off are also part of the government’s response to the crisis, since Slovakia was hit particularly hard by the downturn in the automotive sector.

Short-term cyclical support to SMEs does not tend to be an effective tool for stimulating growth. The same verdict applies to support for large enterprises. Understandably, governments want to take action to ease conditions for companies during times of economic stress. But support often tends to come too late to have the intended effect on companies. Many forms of support have also become permanent and have market-distorting effects—often to the detriment of SMEs. Effective support for SMEs rather requires reinforcing long-term structures that facilitate the growth and expansion of SMEs, especially in clusters of many innovative firms.

The focus on short-term cyclical support also hides one cyclically important aspect of SMEs, and having a high percentage of SMEs among all enterprises and in terms of their total employment. Cyclical downturns typically have smaller effects on SMEs than on large enterprises. Output and employment among SMEs tend to contract by a smaller factor than among large enterprises. Hence, SMEs can act as cushions in downturns, easing the adverse implications for employment and output.

There are three important aspects of SMEs that makes them different from large enterprises in downturns.

1. First, a smaller share of SMEs is export oriented. Contractions in global demand thus affect SMEs to a lesser extent than they affect larger enterprises. There is a long-term concern associated with the fact that SMEs are less oriented towards global markets, but in a recession they have the effect of slowing down output and employment contraction. The opposite side of this coin is that a greater proportion of the SMEs than of large enterprises basically cater to domestic demand. This is particularly true for the service sector, which is more dominated by SMEs than is the manufacturing sector. In any normal recession, domestic demand does not contract as much as production, especially manufacturing. Domestic demand can also be

stimulated by measures such as VAT reduction—a measure the UK government, for instance, has deployed in the current recession—or special tax breaks (e.g., for construction work on housing estates). Governments tend to prefer to target their measures at domestic demand directed at local suppliers; hence SMEs tend to feel the cushioning effect of counter-cyclical policy measures more than do large enterprises.

2. Second, it is difficult for SMEs to downsize employment as they are already small. The choice is often not between keeping or reducing employment—it is between keeping employees or going out of business. As SMEs typically have lower wages than the norm in larger enterprises, the need to cut employment is also less. Small enterprises can also regulate cyclical effects by the amount of time the entrepreneur puts into business.
3. Thirdly, many SMEs are family based and thus do not want to cut down on employment. Such companies can also use other means to control labour costs in downturns. The entrepreneur and the family members active in the firm are more open to accept a salary cut. The wage structure is thus more elastic to demand.

What complicates this analysis, however, is that not all recessions have this effect. Recessions, such as the current one, that are caused by or associated with financial and banking turbulence can have disproportionate negative impacts on SMEs. Small businesses are more sensitive to changed financial conditions. Tougher conditions for accessing bank credit affects SMEs more than it affects large enterprises since SMEs do not have the same access to non-bank financing, especially the corporate debt market.

The current recession does not appear to be having effects on SMEs as worrisome as those previous local financial crises had in countries such as Sweden in the 1990s when many SMEs went

bankrupt due to lack of access to bank credit. The credit crunch in the autumn of 2008 had visible effects on access to credit, but it is too early to tell what proportions these problems will take (OECD 2009). As interest rates have fallen during the crisis, SMEs with a viable revenue model have also got a considerably improved financial situation. Indicators such as filings for bankruptcy suggest that this recession has had a more pronounced effect on SMEs than a normal cyclical recession. It is notoriously difficult to gain access to data, especially comparative data, on filings for bankruptcy in Europe. Yet national indicators suggest there has been a sharp increase. In the Netherlands, for instance, the number of bankruptcy filings in the first six months of 2009 was twice as high as in the same period in 2008. A big proportion of these bankruptcies involve SMEs. Simply put: the bigger the share of enterprises, the bigger the share of bankruptcies.

It is safe to say that the net flow of SMEs in 2009 will be on the negative side: more companies will die than will be born. Yet one should be cautious with estimates at this point as many of the effects of the crisis have not fully unfolded.

4. SMEs in Times of Recovery and Economic Growth

There is a long-term trend towards a greater share for SMEs in the number of enterprises, output and employment. It is principally structural factors that lie behind this development. Cyclical effects sometimes matter, but only at the margins. Given these structural patterns, the role of SMEs in recovery, and for economic growth generally, is becoming more important. There

do not exist any data for previous recessions of this kind, but circumstantial evidence suggests recessions only marginally affect the long-term pattern.

It is interesting to reflect on how these marginal effects manifest themselves. Two scenarios are of particular interest.

Firstly, a recession is by definition a contraction of output and value added. It is principally the production sector of an economy that is affected: production for home and/or foreign markets slows down. Production tends to slow down disproportionately in the manufacturing and the export-oriented sectors, which have a higher share of large enterprises. In the current recession, there has been a sharp contraction in industrial production and manufacturing export. In a recovery free from structural change, recovery would be characterised by the return of production that was lost during the recession. Hence, in the coming recovery industrial output and manufacturing export would be expected to return to pre-crisis levels. Furthermore, the return of production would be the engine of growth in the recovery cycle.

This scenario, however, does not correspond with lessons from previous recessions. A recovery is characterised by the return of production lost during the recession, but only up to a point. Recessions are also characterised by intensified structural change. Recessions are periods when economies undergo considerable changes. Differently put, a significant portion of the contraction in output will not return. Such patterns are particularly present in large enterprises. It is such firms that are on the receiving end of structural change. They tend to be oriented towards manufacturing and their prime method of dealing with changes in competitiveness is to relocate production—either for reasons of cost competitiveness or in order to move closer to markets of growing demand. Large enterprises often also use recessions for structural change. It is a convenient time to pursue corporate strategies that would be more cumbersome and costly in the growth phase of a business cycle. It is easier to justify relocation of production in a time of economic distress.

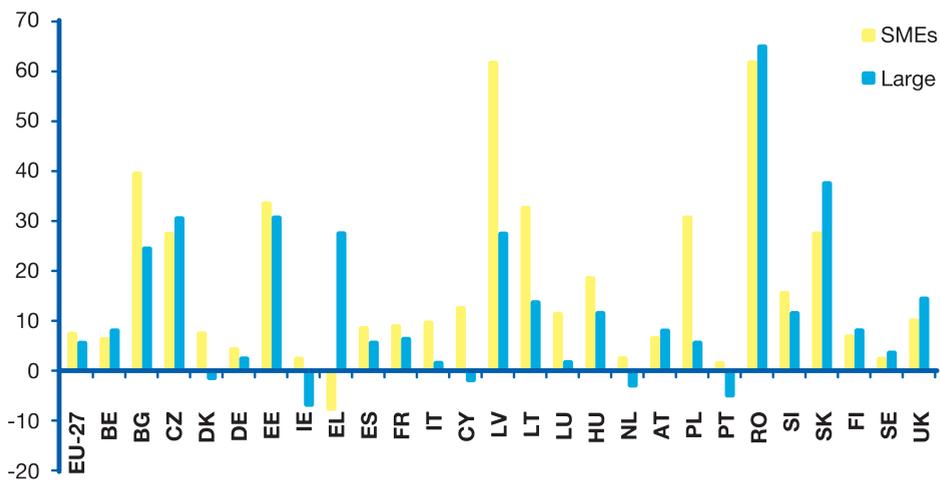
SMEs are also affected by such strategies, but the effects tend not to have a large impact. Individual SMEs can be badly affected, but the general pattern is one of modest effects.

Second, the corporate strategy of large enterprises during an economic recession is to quickly reduce output and factors of production. SMEs in affected sectors also act quickly—in fact they tend to be much more responsive to changes in demand. But they do not reduce employment as ‘fast and furious’ as many large companies do. Moreover, there tends to be a qualitative difference in the way large enterprises and SMEs approach reduction strategies. Large enterprises have few options than to follow a sleight-of-hand approach: a model-based approach to reduction that organisationally works in large corporate bureaucracies. SMEs can be more sensitive to local differences and respond more to actual circumstances.

There is one factor of interest behind reduction strategies in large companies: they are one proven way to achieve increased labour productivity. This effect is achieved in two ways. One is to reduce staff that is less productive and competitive; putting people in early retirement is one common approach. The effect of such reductions can be quickly seen. The other way is to increase production and value added in the recovery without adding more staff: output/value added per labour unit increases. Such an increase tends to represent the major productivity effect of a crisis. It also affects positively future competitiveness and value added in these companies. How will this play out in the coming recovery cycle? The balance in productivity growth will probably shift in favour of a greater relative importance for productivity growth in large enterprises. This is partly an effect of the structure of the economy. But it is also an effect of the relative deterioration in productivity growth in large enterprises in recent years. The long-term trend has been one of higher productivity and productivity growth in large enterprises than in smaller businesses. In recent years, that trend has shifted in favour of SMEs. As Figure 1 shows, productivity growth in EU-27 has been higher in SMEs than in large enterprises in recent years. This is an

effect of increased productivity growth in SMEs, but declining productivity in large enterprises has also played a part. The trend of higher productivity growth in SMEs is likely to continue in the medium to long term, but the short-term cyclical effect is likely to tilt the balance in favour of large enterprises.

Figure 1. Apparent labour productivity of enterprises in the non-financial business economy. Rate of change between 2004 and 2006, by size of enterprise (%)



Source: Eurostat.

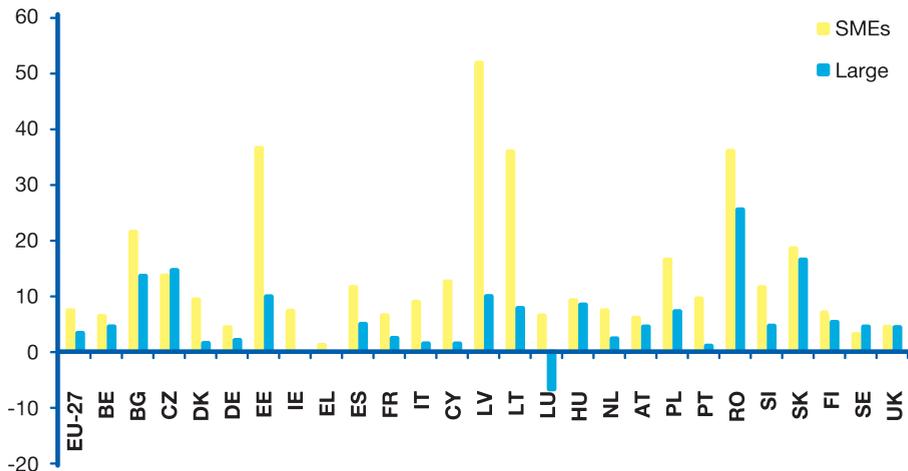
Explanation: EU27 includes rounded estimates based on non-confidential data; data for the 26 Member States for which data were available are based on the sum of available non-confidential data, partly including rates of change between 2003 and 2005.

Improvements in productivity are central to the expansion of value added. But far from the only factor that determines economic growth in the short- to medium-term perspective. As Figure 2 shows, there has been a clear trend towards an increasing role for SMEs in recent years. Value added has expanded much more quickly among SMEs than among large enterprises. The net contribution to value added from SMEs has

grown twice as fast in EU-27 as from large enterprises. The ratio has been much larger in some countries, such as the Baltic States. It is only in two countries—the Czech Republic and Sweden—where the net contribution from large enterprises has been larger than from SMEs.

This pattern is long-term and is not likely to change. Nor is there likely to be a big change in the short term, despite the prognosis that productivity growth is likely to change in favour of large enterprises. This will be discussed later, but let us first also consider recent changes in the contribution to employment. Figure 3 demonstrates as clearly as Figure 2 that there has been a marked increase in the growth of the contribution from SMEs in recent years. Again, the Baltic countries show the most distinct development in that direction, with a clear emphasis on the role of SMEs.

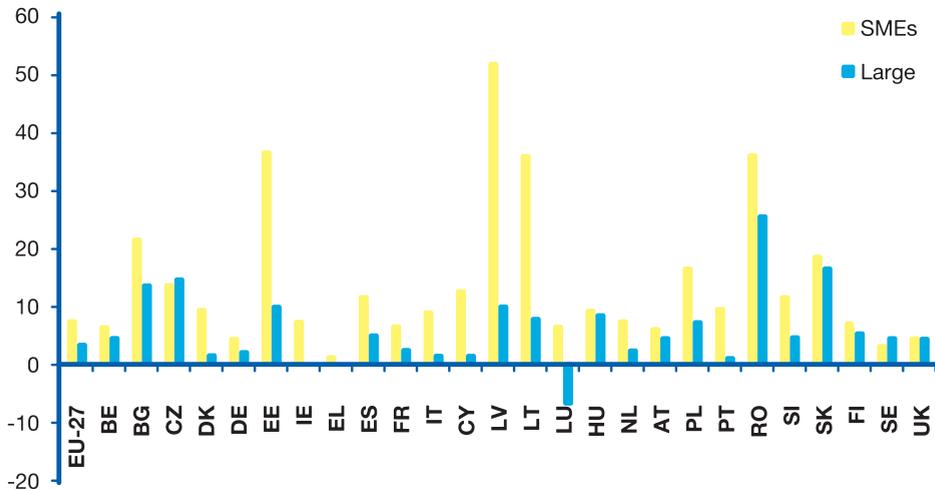
Figure 2. Net contribution of SMEs and large enterprises to the rate of change of the value added of the total non-financial business economy between 2004 and 2006 (%)



Source: Eurostat.

Explanation: EU27 includes rounded estimates based on non-confidential data; data for the 26 Member States for which data were available are based on the sum of available non-confidential data, partly including rates of change between 2003 and 2005.

Figure 3. Net contribution of SMEs and large enterprises to the rate of change of employment in non-financial business economy between 2004 and 2006 (%)



Source: Eurostat.

Explanation: EU27 includes rounded estimates based on non-confidential data; data for the 25 Member States for which data were available are based on the sum of available non-confidential data, partly including rates of change between 2003 and 2005.

The structural factors behind the increasing role for SMEs are deeply rooted and will not change—neither in the short term nor in the long run. There will be an increase of production lost during the economic crisis. As large enterprises have cut output and employment more than SMEs, the recovery is likely to be proportionally larger in large enterprises than in SMEs. But this will not alter the overall picture. Not all of the lost production will return. Industrial contraction has been sharp in some sectors that are subject to long-term structural changes in Europe—especially a relocation of production from Western to Eastern Europe or from Europe to the Far East. The automotive sector is one example. This is also a sector that was characterised by considerable overproduction in the years prior to the crisis—in Europe as well as globally. The crisis has corrected the balance

between supply and demand, and companies will now be more cautious than before not to produce more than is possible to sell. Furthermore, as the global demand profile is shifting markedly towards Asia, production intended for the fast-growing markets will have to move closer to them. Without any cost advantage in Europe, it is difficult to economically justify downstream production of goods in Europe for export to Asia.

Recessions and crises are a time of major structural changes in the economy. Many factors speak in favour of such change during this recession also. Changes due to altered demand profiles and cost advantages have already been discussed. What remains to be explored, however, are the changes that are derived from innovation and from new start-ups that gain market share from older firms. Such structural change also intensifies during times of economic distress. And such structural change is biased in favour of a greater role for SMEs in periods of recovery.

5. Conclusions and Policy Recommendations

This paper has discussed assorted aspects of the role of SMEs in Europe's economy and growth patterns. As has been demonstrated in some of the other sections, there is a long-term trend towards greater reliance on SMEs for output, value added and employment. The current crisis might slow down that trend somewhat, but it is unlikely to change the trend fundamentally. The coming recovery in Europe will rely very much on SMEs, probably to a greater extent than in previous recovery cycles. There are, however, profound uncertainties surrounding the effect on SMEs of the credit collapse last autumn.

Thematically, how can one understand the shift towards a greater role for SMEs? Previous sections have emphasised some factors: technological development, a focus on the core parts of a firm, SMEs and innovators as agents of change. But there are a few other factors that also merit attention.

- SMEs tend to be more flexible, and sensitive to declining demand. While large enterprises often take a sleight-of-hand approach, SMEs are more sensitive to local variations and medium-term development.
- SMEs are considerably more entrepreneurial than large enterprises. Having an entrepreneurial bent is key to the long-term survival of a firm. SMEs can survive in much tougher conditions of international competitiveness than large enterprises can. There has been, for instance, a successive relocation of manufacturing production from large enterprises in Europe. This trend is particularly pronounced in sectors where Europe has a declining or negative comparative advantage. Large enterprises in these sectors cannot survive if production is not relocated to exploit cost advantages. SMEs, however, are in a different position. They have a greater propensity to innovate and can thus remain competitive despite cost disadvantages.
- SMEs tend to have more flexible salary structures. Wages in SMEs are lower than in large enterprises, but the element of flexibility adds another dimension to the competitiveness of SMEs: there is a direct link between productivity of output and demand constraints.
- Innovations tend to start in SMEs. As the economy becomes even more based on innovation, SMEs will continue to play a more significant role.
- SMEs are more focused on domestic demand than are large enterprises. This implies less volatility in the demand for their products compared to the demand for the products of large

enterprises. The concentration on domestic demand is, however, a clear limitation on the growth potential of groups of SMEs. With lower participation in the global economy, SMEs are missing the sales potential of rapidly growing foreign markets. There has been a significant globalisation of SMEs in recent years, but it has come about mainly through SMEs that supply large enterprises with input or complimentary products.

There are also some concerns facing SMEs.

- The unexploited growth potential of SMEs in global markets is limited by a combination of market and policy barriers. The most significant market barriers are lack of knowledge about foreign markets and lack of capital to finance international expansion and export. The main policy barriers are concerns about the enforceability of contracts in foreign countries and the plethora of regulations and non-tariff barriers. The export potential of SMEs is not hindered primarily by tariffs; this limitation is rather a consequence of regulatory differences and red tape. That is not good news. The latter barriers will not go away anytime soon. It is much easier to reduce tariffs and non-tariff barriers to trade. But the focus of an SME-oriented trade policy should be clear: cut red tape—at home as well as abroad!
- Capital supply and liquidity will remain a problem even after this crisis has ended. Government programmes to support SMEs with capital can be of help, but only at the margins. Rather, what are missing in Europe are a well-functioning credit market and a greater number of venture capitalists. Competition in the bank market is too limited in most European countries. Rules for starting small exchanges (bourses) for SMEs tend to be too onerous and should be eased to enable many more SMEs to go public to raise capital.
- Europe's tax structure remains unfavourable to SMEs—especially entrepreneurs. This also affects capital supply; the most common method for small business to expand is to use private capital. The comparative lack of financial assets for

European entrepreneurs is best addressed through tax reforms that reduce marginal taxes and corporate taxes. Hence taxes should be cut to enable entrepreneurs to build up their own capital base to finance new ventures and expansion.

- The administrative burden is significant for entrepreneurs. A large portion of administration for entrepreneurs is red tape. Europe is notorious for its lax discipline with respect to new bureaucratic innovations that increase the amount of time and resources entrepreneurs need to spend just to make sure they follow the laws and regulations. This culture has to be rooted out from bureaucracies. Europe should adopt a zero-tolerance policy on all the unnecessary red tape.

References

- **EIM. 2009.**
First section of the annual report on EU small and medium-sized enterprises. Zoetermeer: EIM.
- **Erixon, Fredrik, et al. 2001.**
Dygder som drivkraft och föredöme. Stockholm: City University Press.
- **Erixon, Fredrik, & Uddhammar, Emil. 2002.**
Kapitalism, nätverk och demokrati. Stockholm: City University Press.
- **Erixon, Fredrik, & Uddhammar, Emil. 2009.**
Om komparativa och absoluta fördelar.
- **In Ekerlid et al. eds.,**
Med öppet visir: en vänbok till Janerik Larsson. Stockholm: Ekerlids Förlag.
- **Esping-Andersen, Gösta. 1990.**
The three worlds of welfare capitalism. Princeton: Princeton University Press.
- **Fukuyama, Francis. 1995.**
Trust: The social virtues and the creation of prosperity. London: Penguin Books.
- **McCloskey, Deirdre. 2006.**
The bourgeois virtues: Ethics for an age of commerce. Chicago: University of Chicago Press.
- **Mueller, John. 1999.**
Capitalism, democracy, and Ralph's pretty good grocery. Princeton: Princeton University Press.
- **OECD. 2009.**
The impact of the global crisis on SME and entrepreneurship financing and policy responses. Paris: Organisation for Economic Co-operation and Development.
- **Schrör, Helmuth. 2008.**
Enterprise births, survivals, and deaths—employment effects. Eurostat Statistics in Focus, No. 44/2008.
- **Verhoeven, W.H.J., et al. 2008.**
International benchmark entrepreneurship. Zoetermeer: EIM.

Fredrik Erixon

Fredrik Erixon is a Director and cofounder of the European Centre for International Political Economy (ECIPE), a world economy think tank based in Brussels. Previously he was the Chief Economist of Timbro, the leading Swedish think tank. He has been a macro-analyst at JP Morgan and a consultant to governments, ministries and international organisations on many economic matters.

