SME Development Programs: A Critical Review

Charles Harvie  
*University of Wollongong, charvie@uow.edu.au*

Boon-Chye Lee  
*University of Wollongong, boon@uow.edu.au*

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Abstract
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SME Development Programs: A Critical Review

Charles Harvie
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This paper reviews and examines the arguments for government intervention in markets with the purpose of providing assistance to SMEs in a range of activities. This review suggests that many of the arguments put forward for subsidising SME activities (as distinct from some activities of firms regardless of size) are not economically justified. Nonetheless, it is widely acknowledged that SMEs suffer from disadvantage relative to large firms, principally in the areas of access to finance, information and technology. Innovative measures aimed at alleviating such disadvantages require particular attention by government.

Introduction

Policies to promote the development of SMEs are common in both developed and developing countries (Storey, 1994; Levitsky, 1996; Hallberg, 2000). In the case of developed countries, it has become common place for governments during the last two or three decades to implement policies or programs designed to promote aspects of small and medium-sized enterprises (SMEs). This has coincided with an increase in the importance, in terms of contribution to employment and GDP growth, of SMEs in most of the developed economies (Storey, 1994). In the OECD countries, SMEs currently account for more than 95 percent of firms and 60-70 percent of employment (OECD, 2000). This is in part the result of an ongoing process of industrial restructuring that began in the late 1970s which saw large firms substantially reduce their output and labour, creating large pools of unemployed workers, a proportion of whom were motivated to start their own businesses (Storey, 1982). That process was given added impetus with the move towards privatisation and market deregulation in the late 1980s and 1990s, resulting in broad organisational trends that have included outsourcing and downsizing (Parker, 2000). Developments in information and communications technology, rising affluence and the development of niche markets, as well as the declining importance of economies of scale as the key source of competitiveness, have also contributed to the growth of the SME sector in developed economies.
In the case of developing economies, policies designed to assist SMEs have been an important aspect of industrial policy and multilateral aid programs such as those of the United Nations since the 1950s (Levitsky, 1996). Micro and small businesses are also playing an important social role, such as in the alleviation of poverty and empowering certain groups including that of women. Moreover, the movement by some formerly centrally planned developing economies (such as Vietnam and China) and highly regulated economies such as India towards deregulated and market oriented economies, with the emphasis on developing a vibrant private sector oriented economy, have given further impetus to the development of small businesses in many developing economies. However, while there are wide variations across countries the traditional picture is one where the relative importance of SMEs tends to decline as a country moves up the developmental ladder (see for example Hallberg, (2000) and Liedholm and Meade, 1999). The process of globalisation, characterised by increasing trade and capital flows, market opening and liberalisation and knowledge flows, has resulted in global sourcing and marketing for large enterprises. Outsourcing and the increasing involvement of small businesses in the supply chains of large transnational corporations has presented them with many business opportunities. Hence the traditional decline in the role and importance of SMEs in developing countries may likely change in the future.

As the available data for the Asia-Pacific Economic Cooperation (APEC) economies indicate, SMEs account for a significant proportion of the labour force in both developed and developing economies (see Table 1). In addition, they also comprise a significant proportion of the business enterprises (see Table 2). It may therefore be argued that, purely from the viewpoint of their significance in their economies, SMEs warrant attention from governments. Storey (1994) has argued, in the UK context, that the increased importance of SMEs means that public policies towards them cannot be considered in isolation from other influences in the economy and cannot be left to those with a particular interest in SMEs. The significance of SMEs in their economies makes it important for policymakers to ensure that these enterprises do not face impediments that hamper their ability to operate efficiently and do not face onerous administrative compliance costs. We should be careful, however, not to conclude from this that it necessarily follows that policies specifically favouring SMEs over larger firms should be implemented. As Lattimore et al. (1998) note, “while economic importance provides a strong basis for public policy consultation with small business, in itself it provides little justification for specific interventions.”

Many policies relating to SMEs are based on the perceived weaknesses or disadvantages that they suffer relative to large firms. Studies of the problems faced by SMEs have concluded that they suffer from similar weaknesses in developing countries as they do in developed countries (Levitsky, 1996). However, a problem with government policies with respect to SMEs is that they have tended to be characterised by a lack of coherence, as Storey (1994) observed in
Table 1: Contribution of Micro, Small and Medium Sized Enterprises to Private Non-Agricultural Employment, Selected APEC Countries (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Micro (&lt;5 employees)</th>
<th>Small (5-19 employees)</th>
<th>Medium (20-99 employees)</th>
<th>All SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>25.9</td>
<td>20.9</td>
<td>19.2</td>
<td>66.0</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>31.1</td>
<td>13.0</td>
<td>24.8</td>
<td>59.4</td>
</tr>
<tr>
<td>Japan</td>
<td>13.1</td>
<td>29.9</td>
<td>26.9</td>
<td>69.9</td>
</tr>
<tr>
<td>Korea</td>
<td>31.2</td>
<td>11.3</td>
<td>36.2</td>
<td>78.7</td>
</tr>
<tr>
<td>Mexico</td>
<td>36.2</td>
<td>13.9</td>
<td>15.2</td>
<td>65.2</td>
</tr>
<tr>
<td>New Zealand</td>
<td>23.0</td>
<td>18.0</td>
<td>19.0</td>
<td>60.0</td>
</tr>
<tr>
<td>Peru</td>
<td>62.5</td>
<td>16.6</td>
<td>8.8</td>
<td>87.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>36.7</td>
<td>25.8</td>
<td>7.1</td>
<td>69.5</td>
</tr>
<tr>
<td>Singapore</td>
<td>7.1</td>
<td>16.8</td>
<td>19.2</td>
<td>43.1</td>
</tr>
<tr>
<td>USA</td>
<td>5.2</td>
<td>13.6</td>
<td>17.9</td>
<td>36.7</td>
</tr>
</tbody>
</table>

Source: Hall (2002)

Table 2: Number of Private Non-Agricultural SMEs as a Percentage of Firms, Selected APEC Countries (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Micro (&lt;5 employees)</th>
<th>Small (5-19 employees)</th>
<th>Medium (20-99 employees)</th>
<th>All SMEs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>69.9</td>
<td>24.3</td>
<td>4.9</td>
<td>99.0</td>
</tr>
<tr>
<td>Chile</td>
<td>82.1</td>
<td>15.0</td>
<td>2.1</td>
<td>99.1</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>86.8</td>
<td>7.6</td>
<td>4.9</td>
<td>99.3</td>
</tr>
<tr>
<td>Japan</td>
<td>56.5</td>
<td>34.7</td>
<td>7.4</td>
<td>98.7</td>
</tr>
<tr>
<td>Korea</td>
<td>72.7</td>
<td>17.8</td>
<td>8.6</td>
<td>99.1</td>
</tr>
<tr>
<td>Mexico</td>
<td>91.7</td>
<td>6.3</td>
<td>1.6</td>
<td>99.6</td>
</tr>
<tr>
<td>New Zealand</td>
<td>84.2</td>
<td>7.1</td>
<td>8.0</td>
<td>99.4</td>
</tr>
<tr>
<td>Peru</td>
<td>96.5</td>
<td>3.1</td>
<td>0.3</td>
<td>99.9</td>
</tr>
<tr>
<td>Philippines</td>
<td>91.1</td>
<td>8.2</td>
<td>0.4</td>
<td>99.6</td>
</tr>
<tr>
<td>Singapore</td>
<td>67.4</td>
<td>24.3</td>
<td>6.1</td>
<td>97.8</td>
</tr>
<tr>
<td>Thailand</td>
<td>79.0</td>
<td>18.4</td>
<td>2.0</td>
<td>99.4</td>
</tr>
<tr>
<td>USA</td>
<td>60.5</td>
<td>28.9</td>
<td>8.9</td>
<td>98.3</td>
</tr>
</tbody>
</table>

Source: Hall (2002)
the context of European countries, where "public policies have been developed, jettisoned, and often reintroduced on a piecemeal basis." Second, as Hallberg (2000: 1) noted, of developing country SMEs, they are:

... a very heterogeneous group. They include a wide variety of firms — village handicraft makers, small machine shops, restaurants, and computer software firms — that possess a wide range of sophistication and skills, and operate in very different markets and social environments. Their owners may or may not be poor. Some are dynamic, innovative and growth oriented; others are traditional 'lifestyle' enterprises that are satisfied to remain small.

These observations are largely pertinent also to SMEs in developed countries and point to a key difficulty in policies designed to cater to such a diverse grouping of enterprises. However, recent trends, in both developed and developing countries, suggest that public policy is increasingly being focused more upon market oriented strategies and the establishment of a level playing field for all enterprises, rather than, as in the past, direct measures aimed at, for example, reducing the cost of credit. The microenterprise literature is particularly pertinent in explaining this change of emphasis.

In section 2 we offer a categorisation and critical appraisal of the various policies. As Storey (1994) has argued, "The prime objective of macroeconomic policy is not solely to assist smaller firms, but rather to provide a framework for all sizes of enterprise in the economy to flourish." Thus, the test that a policy or program favouring SMEs must pass is that it not only must have a sound economic rationale but also, given the costs of design and implementation of such programs and the possibility of distortions to business incentives, demonstrate that it is capable of delivering net welfare benefits to society as a whole. We examine each policy argument from this viewpoint. Finally, we summarise our main conclusions in section 3.

Categories of Government Support Policies for SMEs

Policies in support of SMEs may generally be categorised according to their objectives (see Table 3): broad macroeconomic objectives, such as the creation of jobs or the reduction of unemployment; social or equity objectives such as the redistribution of income; market failure or efficiency arguments, which relate essentially to considerations of static efficiency; and dynamic efficiency arguments, in particular the promotion of innovative activities. It is apparent that there are broad areas where these policies overlap with those in other areas of concern, in particular with competition policy.
Table 3: Categories of SME Support Policies

<table>
<thead>
<tr>
<th>Category</th>
<th>Objectives</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Macro objectives</strong></td>
<td>• Creation of employment</td>
</tr>
<tr>
<td></td>
<td>• Economic development</td>
</tr>
<tr>
<td></td>
<td>• Export growth</td>
</tr>
<tr>
<td><strong>Social objectives</strong></td>
<td>• Income redistribution</td>
</tr>
<tr>
<td></td>
<td>• Poverty alleviation in developing countries</td>
</tr>
<tr>
<td><strong>Correction of Market failure/insufficiency (static efficiency objectives)</strong></td>
<td>• Presence of externalities</td>
</tr>
<tr>
<td></td>
<td>• Market access barriers</td>
</tr>
<tr>
<td></td>
<td>• Asymmetric information</td>
</tr>
<tr>
<td></td>
<td>• Small number of competitors</td>
</tr>
<tr>
<td></td>
<td>• Information imperfection (lack of access to information about potential markets)</td>
</tr>
<tr>
<td></td>
<td>• Levelling the playing field</td>
</tr>
<tr>
<td><strong>Dynamic efficiency objectives</strong></td>
<td>• Promotion of innovation</td>
</tr>
</tbody>
</table>

Source: Authors

Each of these categories of SME support policies is now discussed in turn.

**Macroeconomic Objectives**

The broadest objectives of SME policy are macroeconomic in nature. These include the creation of employment (or the reduction of unemployment) (although the first may not achieve the second if participation rates rise) and, in the case of developing countries, developmental objectives. As Levitsky (1996) noted in the case of donor aid programs targeting SMEs in developing countries, “all programmes were justified by arguing that small enterprises generated more employment for a given investment of scarce capital… Donors also looked to small enterprises as a way of dispersing economic development and of raising the standard of living of the rural sectors of the population.” Employment creation is also a major objective of many SME policies in developed countries (de Koning et al., 1992; Revez and Lattimore, 1997).

**Creation of Employment**

Because SMEs account for a significant proportion of employment in their economies, it is argued that selective policies aimed at creating employment in small business should be pursued. More recent analyses have pointed out flaws in the rationale for such an objective. Revez and Lattimore (1997), for example, argue against adopting such an approach on several grounds. Although their arguments relate to the Australian case, they are largely applicable to other countries as well.
Revesz and Lattimore (1997) note that the argument that small firms are a major source of new jobs is based on inconclusive cross-sectional data, pointing out that no long-term longitudinal study of job creation has yet been undertaken. Further, even if it is true that small business has been responsible for more than a proportionate amount of net new jobs, it does not follow that policies to promote the SME sector are justified. First, they note that although the SME sector may be where many of the new jobs have been created, this does not mean that they are responsible for their creation and, indeed, they argue that many of the new jobs were created in this sector not because SMEs are better able to generate new jobs but because the products for which demand has increased are largely supplied by SMEs. That is, the recent trends in employment shares reflect changes in demand patterns in the economy (Lattimore et al., 1998) – and there is what Revesz and Lattimore (1997) term a "confusion of medium and cause". By implication, policies promoting SMEs will be misconceived if the pattern of demand shifts in the future.

Second, Revesz and Lattimore (1997) argue that, given that the optimal size of the business unit is determined by technology and transaction costs, government intervention may serve to distort the optimal distribution of firm sizes. Third, they argue that small firm survival rates are far lower than those for large firms, so that selective policies favouring small firm start-ups may increase turbulence, with attendant social and economic costs. Fourth, subsidies imply higher taxes, which may reduce incentives to work in addition to creating distortions in other sectors of the economy. Further, any subsidies to one sector of the economy at the expense of other sectors, or financed by additional taxes, should be justified on the basis that the net welfare benefits to society of such subsidies are positive (Storey, 1994; Belli, 1997).

Fifth, Revesz and Lattimore (1997) point out the arbitrariness of the focus on job creation rather than job destruction – arguing that an equally arbitrary (and unsatisfactory) approach would be for an advocate of big business to argue for policies to stop job destruction on the basis that saving a job from being lost in a large firm is as valuable as creating one in a small firm; or for an advocate of a large public sector to argue against public sector rationalisation on the same grounds.

Sixth, most small firms do not grow much or contribute significantly to net job creation. Job creation policies are therefore better targeted at those firms that do grow rapidly, but this would require unusual facility on the part of policymakers in picking winners. A program to create jobs in SMEs is therefore not likely to be very successful in achieving its objective (Lattimore et al., 1998).

Seventh, even if it is true that SMEs have been responsible for most of the new jobs created in their economies in the recent past, a policy of assisting SMEs would not necessarily be the most effective way of creating new jobs. For example, a subsidy to SMEs to employ a previously unemployed person would not necessarily be more effective at eliciting a positive response from SMEs.
than it would from large firms along a range of dimensions such as the initial recruitment response, the duration of employment of any subsidised worker, the quality of the job and any associated training, and the extent to which participating firms would get a subsidy for a worker they would have hired anyway.

Finally, Revesz and Lattimore (1997) argue that government assistance programs for "small" firms can be counterproductive if they reduce the incentive for growth of businesses that are about to exceed the threshold definition of a small firm. Levitsky (1996) reports evidence from India in the 1980s indicating that the government's policies of concessional assistance to SMEs was "constraining the growth of many enterprises that preferred to stay small rather than lose their privileged status" and indeed may have reduced the competitiveness of industry as a whole.

**Social Objectives**

*Income redistribution*

Assistance to SMEs is sometimes justified by governments on the basis that the existing distribution of income is less than socially equitable. Aid agencies operating in developing countries have been drawn to provide assistance to small enterprises as a means of poverty alleviation and of improving the distribution of income (Levitsky, 1996). This is often tied in with other objectives such as creating employment, training, dispersing the benefits of development to rural areas and catering for rural markets through rural small enterprise programs, and promoting indigenous entrepreneurship. However, as Hallberg (2000) points out, "SME owners and workers are unlikely to be the poorest of the poor, so that SME promotion may not be the most effective poverty alleviation instrument."

For developed countries, the income redistribution justification may be even less compelling. Storey (1982) has argued, in the UK context, that financial assistance to small firms would most benefit the relatively wealthy who are more able to start new businesses – citing evidence that although there were more "working class" entrepreneurs than "middle class" ones, small firms were much more likely to be started up by people from middle-class backgrounds than by those with working class backgrounds.

In addition, there are more direct methods – such as income transfers – to achieve income redistribution objectives that are likely to be more effective than SME support policies (Hallberg, 2000).

**Market Failure or Inefficiency**

The conventional economic rationale for government intervention in markets based on market failure derives from the insight that competitive markets deliver
optimal outcomes. According to the neoclassical economic paradigm, consumer welfare is maximised under conditions of perfect competition, and this outcome is Pareto-optimal, or ideal, in that no other outcome can achieve the same level of welfare for society as a whole (Van Cayseele and Van den Bergh, 2000). The conditions for markets to deliver Pareto-optimal outcomes are well known: many buyers and sellers in the market; a homogeneous product; perfect information regarding the availability of goods and services and the state of the technology; freedom of entry and exit by producers; and the absence of “spillover” or external effects. Under these stringent conditions, unencumbered markets represent the best way of organising the allocation of scarce resources.

Failure of the market to deliver competitive outcomes results when any of these conditions is not met to a significant degree, and may therefore warrant government intervention. From this perspective, perfectly competitive markets may be regarded as an ideal that, while unattainable by and large, can be approximated by a judicious mix of market-oriented policies and government intervention. However, the presence of market failure does not in itself justify government intervention. A market failure argument for government policy in favour of SMEs must demonstrate not only that there is a failure of the market in some sense but also — since, in general, subsidies to one sector of the economy have to be provided at the expense of other sectors or by way of additional taxes raised for the purpose — that such a policy is capable of delivering net welfare benefits to society as a whole.³

A related set of arguments pertains to competitive conditions that, for various reasons, may be a source of disadvantage to smaller firms relative to larger ones. We call attempts to remove these sources of disadvantage “levelling the playing field” so that SMEs can compete on a more equal footing with their larger counterparts. These are discussed below.

Presence of externalities

The presence of positive externalities or spillover effects from a particular activity is often taken as a justification for government involvement in that activity. Research and development activities, because they generate positive effects for external parties that are not fully appropriable by those undertaking the activities, fall into this category and government subsidies or direct grants are commonly employed to encourage them. From the viewpoint of SME policy, however, there is no particular reason why R&D that is undertaken by SMEs should be treated more favourably than if it is undertaken by large firms. The available research on the relative innovativeness of small versus large firms has been inconclusive despite extensive research into this issue since the 1950s.⁴ Other instances of externalities are discussed below.

Subsidies for small firm startups is sometimes justified on the basis that they create more employment than comparable assistance to large firms (Storey,
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1982). We examine this argument and discuss the issue of employment creation below.

Number of competitors

Competition is an area where SME policy overlaps with other policy concerns. Firm start-ups are sometimes encouraged on the basis that they result in net additions to the existing stock of firms in an industry, and this is therefore a good thing if the number of the existing firms is too “small” (market concentration is “high”) so that there is an insufficient degree of competition in that industry. However, a policy aiming to achieve a particular size distribution of firms in any industry would be misconceived. As Hallberg (2000) points out, there is in fact no optimal or ideal size distribution of firms, but rather an “equilibrium” size distribution determined by “resource endowments, technology, markets, laws, and institutions.” Indeed, some of the factors that determine the equilibrium size distribution of firms—technology-determined economies of scale, resource endowments, and consumption patterns—are in a sense “natural” determinants of firm size (Hallberg, 2000) that are arguably best left to the determination of market forces.

Further, although a high market concentration has traditionally been regarded as conducive to the abuse of market power by firms, this is not necessarily the case: the opposite may be true, with more intense competition reducing profit margins and the number of firms that can survive in an industry (Symeonidis, 2000). Symeonidis (2000: 22) argues that “[i]t this means that concerns with the level of concentration need not take precedence over the need to ensure that competition remains effective, i.e., firms do not engage in collusive practices and no barriers to entry are created.”

Information imperfection

A commonly cited disadvantage that SMEs are said to suffer is lack of information about potential or current markets, which hampers their ability to compete effectively and/or exploit potential market opportunities. Lattimore et al. (1998) cite evidence indicating that small firms experience greater difficulties than large ones establishing a distribution network in export markets and that they suffer more from lack of information. However, they argue that:

... greater difficulty is not, by itself, a good basis for policy intervention. An economic rationale for assistance to small firms to commence exporting would require that there was some failure which led to firms not exporting when the benefits of exporting—either private benefits or the sum of private benefits and other benefits to the rest of the economy—were greater than its costs. (Lattimore et al., 1998: 76)
Lattimore et al. (1998) list three types of externalities that may justify government intervention in the form of export assistance to SMEs. First, reputational externalities may exist in the form of a firm’s marketing building up product reputations and market presence for other competitors from the same country as well as for itself — for example, Australian wines. Second, firms may learn a lot from leading-edge customers overseas and from the mere challenges of exporting, and there may be knowledge spillovers to other firms in the same country as the exporting firms. Third, firms entering new markets learn about how to sell in those markets and there may again be knowledge spillovers. The presence of spillovers, or externalities, Lattimore et al. (1998) argue, would provide the most durable theoretical case for export subsidies. However, it is likely that the size of the spillovers is relatively small, which would imply that any assistance should be correspondingly small.

Levelling the playing field

SMEs operate at a disadvantage relative to larger firms in a number of areas. Lack of access to finance and to technology are commonly cited as key areas of disadvantage suffered by smaller firms and constitute significant hurdles faced by SMEs.

Disadvantage resulting from government policies

In some cases the disadvantage may be the result of government policies that generate fixed costs that create a competitive disadvantage for smaller firms, or otherwise tilt the playing field against them. In particular, the cost of regulatory compliance may be more onerous for small firms than for larger ones. Smaller businesses may experience greater difficulties for a number of reasons (Lattimore et al., 1998). First, if there are fixed costs in compliance, such as learning about the regulations and putting in place systems to ensure compliance, these costs are likely to represent a higher proportion of turnover for SMEs than for large firms. Second, smaller firms are less likely to have the resources to employ staff to deal with regulatory matters, forcing a larger proportion of managers’ time to be devoted to these issues and diverting attention away from the job of running the business. Lattimore et al. (1998) cite Australian evidence indicating that, in 1994-95, although SMEs’ share of economic activity was around one third, they bore around 85 percent of the total paperwork compliance burden.

Recognition of the relatively higher burden on SMEs with regard to compliance costs has turned much recent policy attention to the question of regulatory reform. Many aspects of this — including the elimination of unnecessary regulations, more simple compliance, easier access to information about regulatory requirements and the elimination of inconsistencies in regulations between different jurisdictions and/or agencies — are relevant to firms of all sizes (Lattimore et al., 1998). These reforms are desirable from the viewpoint of removing regulatory hurdles to the efficient operation of all businesses regardless of their size.
Other government policies may have the effect, albeit unintended, of discriminating against smaller firms. These include the following (see Hallberg, 2000):

- Official and unofficial levies that discourage small firms from growing and becoming formal
- Tax structures that distort incentives and discriminate against small firms
- Government procurement procedures that discourage successful bidding by small firms
- Zoning regulations that restrict SME operations and entry into high-income markets
- Labour market rigidities that make hiring and firing workers difficult and expensive, and limit the flexibility and mobility of the labour force

However, it is not always clear that policies — e.g., labour market regulations such as redundancy payments or provisions against unfair dismissals — which are claimed to disadvantage smaller firms proportionately more than larger ones should be removed for the former in what is sometimes known as “regulatory tiering”. This is the term used to describe the practice of applying more lenient regulations to small businesses or exempting them altogether from regulations judged to be overly burdensome to them (Lattimore et al., 1998). While governments are aware of the impact that regulatory tiering can have on the small business vote, they also need to take into account the interests of the wider community, the employment conditions of employees generally, and the impact on overall economic efficiency. As Storey (1994: 267) has expressed it, “the entrepreneur’s ‘red tape’ is often the same as a worker’s ‘right’ or a neighbour’s ‘environment’.”

Bickertlyke and Lattimore (1997: 55-56) make the same point:

What [regulatory tiering] does is lower standards in order to lower the costs of compliance for owner-managers. And it is other people (workers and consumers in the broader community) who bear the costs of such lower standards. So any attempts to alleviate the apparently unfair burden on small business owner-managers occasion other re-distributions, which may also be regarded as unfair.

Achieving an appropriate balance between the overall interests and welfare of the community and those of the SME sector is likely to remain a difficult task.

Lack of access to finance

Lack of access to finance has been one of the more pervasive problems faced by SMEs in both developed and developing countries. It represents a major constraint which can significantly affect the ability of a firm to grow, upgrade its technology, expand its markets, improve its management capabilities, raise productivity, or
simply to survive (Levitsky, 1996). Lack of access to finance by SMEs is generally attributed to capital market imperfections which have resulted in financial institutions being less skilled at servicing the financial needs of SMEs and the lack of nonbank capital markets that SMEs can tap into (Hawtrey, 1996).

With respect to the difficulties that SMEs encounter in gaining access to debt financing, a recent conference of the Pacific Economic Cooperation Council (PECC) concluded that the reasons typically relate to:

"... firm size, risk, knowledge, and flexibility. SME borrowing requirements are small and frequently do not appeal to financial institutions. More collateral may be required than SMEs can pledge. Financial institutions may lack expertise in understanding small and medium knowledge-based business. The flexibility in terms and conditions of financing that SMEs require may not be available." (PECC, 2003)

In addition, banks generally have difficulty assessing loans to SMEs because of the lack of accurate and reliable information on their financial condition and performance, unconvincing and weak business plans, all of which imply higher transaction costs in the processing of such loans. As a result, SMEs generally find themselves faced with higher interest rates for any loans they are able to secure, as well as more stringent requirements for collateral (Lattimore et al., 1998).

The alternatives to debt financing involve equity capital but the problems are even more pronounced, particularly for SMEs in developing countries which tend to be undercapitalised. Equity capital would allow firms to spread and share the risk of high growth strategies by sharing equity ownership, but attempts to develop capital markets geared to small firms have not proved successful (PECC, 2003). The high fixed costs involved in stock exchange listing and the ongoing requirements for continuing disclosure act as a disincentive to SMEs. In turn, the higher risk profiles of these firms and the limited information they can provide means that they do not represent very attractive propositions to the banking community (PECC, 2003).

Hall (2000) reports evidence for some APEC economies suggesting that the proportion of bank loans to SMEs has declined in the last decade: from 39 percent in 1994 to 19 percent in 2000 in Australia; from 40 percent in 1992 to 27 percent in 1999 in Chinese Taipei; and a less pronounced but similar downward trend in Canada, Indonesia, Japan and Korea. The only exception to this pattern for APEC countries, for which comparable data were available, is the US. While the reasons for the decline (in both relative and absolute terms) in funds available to SMEs are unclear, Hall (2000) postulates three possible explanations: (1) some statistical anomaly such as bracket creep as borrowers seek larger loans to offset the effects of inflation; (2) other more attractive sources of finance such as venture capital becoming available to SMEs; and (3) banks tightened their lending to SMEs, either as a result of regulatory changes (e.g., BIS requirements).
or because of the banks' perception of SME loans as less attractive, Hall concludes that the third explanation is the most likely. If correct, this may have long-term consequences for the number of new firm start-ups and for SME growth.

Hall's (2002) study also reports an apparent trend in the APEC economies towards policies that positively discriminate in favour of smaller firms gaining better access to finance (see Table 4). Between the periods 1994/1996 and 2000/2001, for example, the proportion of APEC economies that provided discriminatory tax rates favouring SMEs increased from 18 percent to 60 percent, while the proportion of countries with programs to provide financial support for start-ups increased from 6 percent to 60 percent.

Table 4: Finance Policies in Support of SMEs in APEC Countries
(\% of APEC Countries)

<table>
<thead>
<tr>
<th>Policy</th>
<th>1994/95</th>
<th>2000/01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government underwriting of credit guarantee for SMEs in domestic operations</td>
<td>47</td>
<td>45</td>
</tr>
<tr>
<td>Government support for SMEs engaged in exports</td>
<td>53</td>
<td>70</td>
</tr>
<tr>
<td>Venture capital support</td>
<td>41</td>
<td>70</td>
</tr>
<tr>
<td>General finance support (e.g., subsidised or regulated interest rates)</td>
<td>65</td>
<td>50</td>
</tr>
<tr>
<td>Support program to provide micro finance for start-ups</td>
<td>6</td>
<td>60</td>
</tr>
<tr>
<td>Concessionary tax rates or favourable tax treatments for SMEs</td>
<td>18</td>
<td>60</td>
</tr>
</tbody>
</table>

*Source: Adapted from Hall (2002, Table 7.3.1)*

In contrast to the observed trends in recent years that appear to favour policies actively favouring SMEs through policies such as subsidised loans and exports assistance, subsidies for start-ups and concessionary tax rates, Hawtrey (1997) argues for more market-oriented policies that aim for greater diversity and depth in the capital markets for the small business sector. He notes a number of developments arising from increased competition which indicate that the problems faced by SMEs in Australia are being alleviated. The developments include an increase in the availability of finance for SMEs, a decrease in interest margins, an increase in willingness to lend on the basis of cash flow, and innovations in loan schemes tailored to the requirements of SMEs. He suggests that policies should have three main objectives: (1) genuine competition between the various strata of the financial sector, from banks to non-bank financial intermediaries to foreign banks; (2) the removal of artificial disadvantages to SME financing such as the lack of advocacy (i.e., expanding the powers of the Banking Ombudsman to
allow representation for not just individuals but also small businesses) and the absence of national codes of behaviour for the extension of credit; and (3) actively nurturing the growth of open (particularly equity) capital markets for SME financial products.

Likewise, PECC (2003) recommends the promotion of a flexible environment for a venture capital market specific to SMEs. And, drawing on the very successful experience of Bank Rakya Indonesia in developing its own approach to the provision of uniquely tailored lending programs to SMEs, it also recommends that financial institutions be encouraged to tailor credit to SMEs and greater emphasis placed on training programs to help bank staff better understand the special requirements of SMEs.

Lack of access to technology

It is generally accepted that smaller firms are disadvantaged relative to large firms in terms of access to technology. Access to technology and making improvements to current technology are not ends in themselves, but a means to achieving dynamic efficiency and innovativeness. This issue is discussed in the following subsection.

Dynamic Efficiency and the Promotion of Innovation

The market failure rationale for government intervention in markets discussed above is based on the notion of departures from static efficiency. In the kind of world envisaged by static efficiency arguments, the implicit assumption is that the technology of production is stable and that companies will compete on the basis of price and quality. However, a relatively recent occurrence has been the increasing focus on the importance of dynamic efficiency as an objective of policy (American Bar Association, 2002; Clarke and Evenett, 2003). A survey of competition policy regimes by Industry Canada (1995) found that "around the world, competition policy is increasingly recognised as a vital element of the framework for a dynamic market economy."

Dynamic efficiency is concerned with technological innovations enhancing welfare, and refers to "the use of resources so as to make timely changes to technology and products in response to changes in consumer tastes and productive opportunities" (Bureau of Industry Economics, 1996). As Audretsch et al. (2001) argue, "In a dynamic economy competition in product and process innovations may have a more significant effect on welfare, at least in the long run, than does any likely variation in price." UNCTAD (1998) is less equivocal, asserting that "[d]ynamic efficiency is probably the most important beneficial effect of competition." The conceptual underpinnings linking competition to dynamic efficiency or innovation are provided by Porter (1990), who argues that "healthy competition" is essential to delivering ongoing innovations in products, processes and methods, which in turn are critical to a country's prosperity.
SME Development Programs: A Critical Review

The available research on the relative innovativeness of small versus large firms has been inconclusive despite extensive research into this issue since the 1950s. Policies intended to encourage R&D activities in all firms regardless of their size, through grants and subsidies, therefore seem appropriate in this context. Indeed, the evidence would seem to suggest that it is technological opportunities, rather than firm size, that explain firm innovativeness (see, for example, Scherer, 1970; Shrieves, 1978; Cohen and Levinthal, 1989; and Geroski, 1990). However, it is generally accepted that smaller firms, because of their relatively low levels of employment of technical specialists, are disadvantaged relative to large firms in a number of areas, including establishing communication with external sources of scientific and technological expertise and knowledge. From the viewpoint of their management, there are opportunity costs in seeking out appropriate external sources of technical and other advice (Rothwell, 1991).

Conclusions

The review in this paper suggests that many of the arguments put forward for subsidising SME activities (as distinct from some activities of firms regardless of size) are not economically justified. As Hallberg (2000) argued, SME assistance programs are often motivated more by social or political considerations than by economic ones. Nonetheless, it is widely acknowledged that SMEs suffer from disadvantage relative to large firms, principally in the areas of access to information and technology. Careful formulation of policy is therefore necessary to ensure that any SME assistance programs deemed appropriate do not conflict with other areas of public policy.

Notes

1 Hall (2002) reports the “latest available data” as at the time of his study.
2 Hall (2002) reports the “latest available data” as at the time of his study.
3 See, for example, Harvie (2004).
4 See the discussion under “number of competitors” below.
5 See Belli (1997) for a good discussion of the role of government in relation to the market.
6 See Rothwell (1991, Table 4) for a summary of the advantages and disadvantages of small versus large firms in innovation.
7 See also Gans and Quiggin (2003).
References


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CHARLES HARVIE & BOON-CHYE LEE, Department of Economics, Centre for SME Research and Development, University of Wollongong, NSW, Australia 2522. Email: charles_harvie@uow.edu.au boon@uow.edu.au