

# **Small and Medium Enterprises (SMEs) in mature and developing economies The cases of the European Union and Iran**

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## **Abstract**

Studies show that in both mature and developing economies, SMEs assume a crucial role in national and regional industrial development. By creating jobs and generating wealth, SMEs play their part in a broad spectrum of policies from poverty reduction and privatisation processes to helping vulnerable groups such as women and youth. Similarly SMEs have a positive impact on democratisation and the consolidation of civil society by participating in the economy, politics, and national affairs.

In mature economies, the advantages demonstrated by SMEs as growth engines were fully understood by policy-makers. Over the past few decades, in expanding free market economies, they have endeavoured to gradually abolish obstacles to the development of SMEs. Despite the fact that even in developed countries some issues in relation with the development of SMEs remain, statistics show that over the last few decades gigantic steps have been taken to enhance the foundations of entrepreneurship and the growth of SMEs.

In comparison, in developing countries (in particular those with a preponderant public sector) many obstacles, such as regulation, scarcity of financial resources for commercial investment and most importantly lack of overall incentive policies, have significantly slowed the rate of SME creation and development. In this regard, an analysis of the situation of SMEs in developing countries, particularly an understanding of the obstacles faced in their incubation, as well as a review of the experience of mature economies, can bring about constructive conclusions for the creation of mechanisms that would accelerate the expansion of SMEs in developing countries.

This article will firstly focus on the role of SMEs in development and secondly on their situation in developed and developing countries. In this endeavour, the European Union and Iran have been chosen as case studies. Based on an understanding of the obstacles to SME growth and some successful experiences, recommendations regarding the removal of these obstacles will be formulated.

## **Introduction**

SMEs are at the core of today's world economy. The first three quarters of the 20<sup>th</sup> century witnessed the third wave of industrialisation and development marked by the rise of mass production.. However, during the last quarter of the century, a new motto emerged to represent development and progress: "small is beautiful".

The concluding decade of the twentieth century brought about an increase in new technologies, which in turn revolutionised industrial production and the delivery of services. A new phase of development was initiated, positioning organisations of small and medium size at the centre of attention of policy-makers in mature economies. Researchers and graduates of Western universities founded small and specialised companies, which became the pioneers of technology development, launching major R&D programmes. What would have been difficult to achieve in the gigantic and intricate structures of large corporations became possible in the laboratories of SMEs, with fewer resources, but cutting-edge technology and know-how. The experience of SMEs in various countries demonstrates that their expansion can be one of the major pillars of sustainable development. They can provide fertile ground for the mobilisation of resources aimed at economic, social, and cultural development and their expansion can result in multi-dimensional economic transformation. Nowadays, SMEs make up 90% of the world's total number of businesses and 90% of innovations take place in this segment. This

indicates the significance of SMEs as regards growth, job creation and the export sector in a wide array of developed and developing countries.

For instance, the proportion of SMEs as a percentage of the total number of businesses in South Korea, Taiwan, Canada and Germany is respectively 99.5%, 98%, 95% and 99.3% and the share of SMEs in these countries' total workforce is respectively 78.5%, 78%, 62% and 70%.

Essentially, SMEs – more than larger corporations – are well suited to the conditions of developing economies as they operate within a local environment and with its specific resources.

Some of the advantages of SMEs in this regard can be summarised as follow:

- SMEs have higher profit margins than large corporations
- As SMEs are more dependent on local suppliers than large corporations, their indirect impact on job creation is more significant
- The managerial structure of SMEs being more flexible than large corporations, they are in a better position to adapt themselves to innovation and a changing environment
- SMEs are a more suitable environment to attract and benefit from highly creative researchers and developers
- The establishment of an SME requires a lower initial investment and can be achieved with a small number of highly skilled people
- SMEs can assume a constructive role in poverty-reduction and in helping the most vulnerable layers of society, such as youth or women
- Experience shows that the expansion of SMEs nurtures democracy and civil society by encouraging the participation of the private sector in economic, political and social activities
- SMEs can assume a crucial role in attracting the surplus of workforce that is deprived from employment in large corporations
- SMEs are adequate tools for privatisation since they combine better market knowledge with a fast decision-making process
- SMEs benefit disproportionately from more prospects for growth and have stronger potential in domestic and international markets

### **Wide array of SMEs**

SMEs boast a wide array of activities and skills. They can embrace such diverse activities as hand-craft or software development. The account of their achievements in different areas is rather diverse and depends on the considered countries' level of economic development in addition to social circumstances. In order to account for SMEs, various criteria can be taken into consideration, such as market capitalisation, assets, sales and production capacity but the most common criterion is still the number of employees. A small enterprise employs between 5 and 10 people according to some standards and between 5 and 100 people according to other standards. The maximum number of employees for a medium enterprise is commonly anywhere between 100 and 250. In summary, one can argue that SMEs constitute a wide array of companies with less than 250 employees. It should indeed be added that the standards for the assessment of a company as SME depend on the size of a country's economy and can differ. For that reason, in order to differentiate SMEs from other businesses, the level of technological sophistication is considered as a better criterion than the number of employees.

In Iran, according to the available statistics, more than 90% of the total number of businesses in the country is constituted by SMEs, which in turn employ 50% of the workforce. According to the last reports of the European Observatory, in the European Union – 20 million SMEs are active and employ a workforce of about 122 million people – representing 99.8% of the total number of businesses .

### **SMEs in developed and developing countries**

In this paper, developed countries refers to industrialised nations that have relied on liberal economics to create the conditions for the growth and expansion of industry; namely countries such as Australia,

the USA, Canada, the UK or Japan. On the other hand, among developing countries, those are of interest whose economies are still largely run by the state or are now in transition from a state-run economy to a liberal economy. From among these countries, which make up the bulk of the Middle East, this paper focuses on Iran, Egypt and the Central Asian states.

One of the major obstacles to the creation and expansion of SMEs in these countries are legal limitations. In one of its reports, the World Bank reviewed the obstacles to economic activity in more than 130 countries. These reports show that a flexible and light regulatory framework in developing countries creates an optimal situation for the growth of SMEs. In the same report, a close relationship between the straightforwardness of launching an economic activity on one hand and the existence of reliable and consolidated regulation on the other is substantiated. The conclusion of the report is that complicated and difficult regulations slow economic growth and the expansion of SMEs. SMEs in developing countries are confronted with such obstacles, whereas one of the elements for quickening the pace of the creation and growth of SMEs in the developed world is the existence of simple and sensible regulation.

Legal registration formalities that are needed for an SME to obtain the necessary authorisations to start its activity and the amount of time needed to expedite them are absolutely crucial. Figure 1 compares the simplicity and the speed of setting up a business in some developed and developing economies:

|  | <b>Winners</b>   | <b>Losers</b>         |
|--|------------------|-----------------------|
| <b>number of steps and formalities</b> | Australia (2)    | Chad (19)             |
| <b>time (days)</b>                     | Australia (2)    | Congo (215)           |
| <b>cost (USD)</b>                      | New-Zealand (28) | Saudi Arabia (10'814) |

**Figure 1, formalities to set up a business**

Figure 2 shows the amount of time necessary for an SME to start its activity in various countries. Nowadays, some developing countries, fully aware of the capabilities of SMEs for the creation of jobs and the expansion of opportunities for poverty-stricken populations, have launched major economic reform programmes. For instance, in 2002 in Pakistan, all fiscal and tax-related data-bases were electronically linked to each other and registration formalities for businesses were packaged, reducing the number of days necessary to set up a business from 53 to 22.

| <b>fastest countries</b> | <b>number of days</b> | <b>slowest countries</b> | <b>number of days</b> |
|--------------------------|-----------------------|--------------------------|-----------------------|
| Australia                | 2                     | Venezuela                | 119                   |
| Canada                   | 3                     | Zimbabwe                 | 122                   |
| Denmark                  | 4                     | Angola                   | 146                   |
| USA                      | 4                     | Brazil                   | 152                   |
| Singapore                | 8                     | Indonesia                | 168                   |

**Figure 2, amount of time necessary to start activity**

The high cost of setting up a business is another obstacle for the creation and growth of SMEs in non-developed or developing countries. Hernando de Soto demonstrates in his book *The Other Path* that the high cost for the set up of a business in Peru deprives poverty-stricken populations from economic opportunities. For instance, his research team investigated all the formalities and steps for the set up of a one-person sewing/cloth production business in Lima. Their conclusion was that they needed 289 days and USD 1'231 before the business activity is legally recognized. The cost equals three years of this activity's commercial income. The danger of such a situation is that "*when regulation exclusively benefits those that have political and economic power, those that are deprived from such power have no way out but illegality and the black market*".

In addition to the aforementioned obstacles to create and expand SMEs in some developing countries, the bankruptcy rate of existing SMEs can be another discouraging statistic. Reports point out at the following causes for the bankruptcy of SMEs:

- Young founders' lack of knowledge and experience. According to many studies, the lack of a sound and encompassing educational system in these countries can be identified as the main cause for this. As a matter of fact, before attempting at launching an SME, entrepreneurs have little opportunity to get managerial experience and do not have access to public teaching focusing on management sciences
- Absence of adequate economic environment, due to the state's monopoly of economic activity
- Poor market research and sales techniques. In fact, the exclusivity of the state economy and the absence of the necessary incentives within state-run companies to investigate and expand targeted markets causes deficiencies in the creation of these very techniques
- Absence of strong and sound civil unions and associations, which would nurture SMEs. This issue arises from the social and political conditions in those countries
- Lack of adequate consulting services, in particular international consulting

As mentioned before, developed countries, by providing a free space for the growth and the expansion of industries, and by abolishing many of the aforementioned obstacles have created a far more appropriate ground for the growth of SMEs. If we look into countries such as Australia, the USA, Canada, the UK and Japan and consider their economy's size, social and regional conditions, policies and incentive measures aimed at SMEs, it becomes clear that the common starting point of their endeavours at encouraging SME development was the establishment of a central organisation responsible for the policies that deal with SMEs and entrepreneurs. In fact in all of these countries at least one government agency assumes such crucial responsibilities. These agencies deal with the essential matters that pertain to SMEs and the relevant policies are devised with their input. The chief measures that were adopted in these countries were in the following areas:

- **Loans and grants.** One of the most evident measures to help SMEs is in relation to their access to capital, for the reason that by and large, SMEs are run and managed by people with limited financial means. They therefore tend to use modern and more cost-effective technology. Ease in the granting of loans without security are among the special measures to support the financial capacity building of SMEs.
- **Technology.** In the countries under study, the agencies dealing with entrepreneurs' affairs encourage the use of advanced technologies and rely on various means to achieve these goals, for instance the granting of loans for the purchase of high-tech equipment
- **Consulting services.** In the countries under study, the agencies dealing with entrepreneurs' affairs provide consultancy services in the areas of management, finance, commercial activities, market research and sometimes even the production of business-plans. The cost of these services is assumed by the state
- **Relationship between businesses.** The establishment and promotion of ties between the businesses of a given market can be considered as one of the most fundamental pillars of development. Sound economic policies take this important matter into serious consideration and in some cases the creation of ties between SMEs on the one hand and large corporations on the other is one of the most crucial responsibilities of these agencies
- **Fostering R&D capabilities.** In order to support technological innovation and promote information, efforts have been made to build ties between SMEs on one hand and scientific and technical centres on the other. These ties take place in the context of research, education, and industrial development
- **Simplification of business set-up.** Market fluctuation and related issues naturally cause some bankruptcies among SMEs. Therefore, the authorities of the countries under study, inspired by liberal economic principles such as the removal of obstacles to market access, have tried to simplify over-zealous regulation for the establishment of businesses in order to minimize the bankruptcy rate

- **Education.** Entrepreneurship education is a policy which directly and positively affects the quality and quantity of SMEs in a given market. Therefore, in many of the countries under study, governments have launched teaching programmes in high-schools which incubate entrepreneurship talents

It is with such measures that developed countries have achieved various socio-economic goals, such as an increase in exports or the development of underprivileged areas.

### **Situation of SMEs within EU member-states**

There are various kinds of SMEs with different structures in the EU. Currently, 25 countries with significantly different levels of economic development are members of the EU.

*“In the EU, [the SMEs segment] represents 99.8% of all businesses.[On average, there are 52 enterprises per 1000 inhabitants.They employ66% of all labour (in the Mediterranean countries of the EU even up to 80%) and are creating more jobs than large enterprises as these enterprises are striving for higher productivity through the utilization of less labour. The SMEs’ share of exports on average is 11%, with countries as Luxembourg, Sweden, Finland and Ireland reaching as high as 40, 34, 26 and 25%, respectively. In terms of direct and indirect taxes and social contributions, they provide 44% of the Gross Domestic Production in the EU. The share of “value added” of SMEs in the EU economy is approximately 70% and the share of gross operating profit as high as 77%, whereas the large enterprising sector is scoring 30% and 23% respectively”* (source: UNIDO).

Of the total number of SMEs involved in the non-primary sectors, 25% are active in industrial activities (manufacturing and construction), 28% in trade and 46% in services.

EU member-states, fully aware of the impact of SMEs on socio-economic development, have over the course of the past several decades launched comprehensive programmes to support them. Currently, EU member-states help SMEs in different ways; these are for instance grant issuance, loans and in some cases guarantees. The size and the quality of these tools vary from one member-state to another, depending on national conditions. EU programmes are harmonised and their implementation is the responsibility of the individual member-state. Generally speaking, EU support of SMEs is comprised of three vehiclesL:

- Direct financial support. This kind of support is granted in specific fields. SMEs can obtain up to 50% of a project’s financing from the EU. These specific fields include for instance renewable energy, transportation energy, education, health and security
- Creation of special funds, whose objective is to close the development gap between regions and increase social harmony within the EU
- Financial tools. In these programmes, there is no direct help provided to SMEs. However financial assistance is granted through intermediaries such as banks and funds. The EU, with these programmes, provides the SMEs with facilitated access to loans, credit letters, aid, risk consultancy and insurance for high risk projects. These facilitations and grants are channelled through the European Investment Fund (EIF) and the European Investment Bank (EIB)

Besides these EU programmes, each member-state carries out its own programmes according to its individual socio-economic situation and priorities.

### **Overview of SMEs’ situation in Iran**

According to statistics published by UNIDO, 98.4% of the total number of businesses in Iran are micro-enterprises – with between 1 and 9 employees – whereas small enterprises – with between 10 and 49 employees – constitute only 1,4% of the total. These figures show an obvious and marked disparity between the large number of micro enterprises and those of small and medium size. The absence of an adequate number of medium enterprises – which with large corporations constitute only 0.2% of the total number of businesses in the country – has a negative effect on Iran’s export potential. From an international trade perspective, medium enterprises typically carry out a large proportion of a country’s total exports, since they benefit from technical expertise, production capacities, market

research and have access to financial resources needed for participating in trade at an international level.

Launching a business in Iran is a demanding endeavour and many businesses, which are registered and operate in the country, never reach the operational phase due to bureaucratic formalities and lack of access to financial resources, in particular difficulties in obtaining loans.

Investigations into the causes of Iran's under-developed SME segment show that until recently the state's policies were geared towards supporting large corporations. Indeed, policy-makers were looking at SMEs as secondary businesses, whose participation in the economy was limited to the creation of jobs for semi-qualified personnel. Additionally, academic circles are characterised by a lack of interest in the study of SMEs and related issues. These factors hinder the creation of a fertile environment for the development of SMEs. In Iran there is no harmonisation in the very definition of SMEs and different ministries, organisations and businesses have their own methodology, description, classification and definition of SMEs.

A comparative analysis focused on incentives, facilitation and support for SMEs in developed and developing countries, point to the following obstacles faced by Iranian SMEs:

- The granting of subsidies and governmental assistance to state-run companies, which creates substantial competitive disadvantages.
- The absence of commercial and specialised banks able to grant loans to SMEs
- The absence of market research services and consequently the lack of access to national and international distribution channels
- Major issues in the production of guarantees to obtain loans
- Significant delays in needed financial leverage push SMEs towards non-official and costlier channels than official banks, in order to secure their financial resources
- Broadly speaking a poor business environment for SMEs
- Lack of financial and technical information about SMEs to guide potential investors
- SMEs must refer to numerous governmental bodies for their day-to-day operations, but they lack the leverage to negotiate with these counterparts
- Non-differentiation between SMEs and large corporations in the country's tax regulation

By taking these issues into consideration, UNIDO recommended measures that should be adopted in order to create optimal conditions for the development of SMEs in Iran. The most important of these recommendations are:

- Reforming regulation and streamlining business set-up processes
- Tax reform
- Creation of funds guaranteeing loans and securing primary investments
- Sustaining newly launched businesses that have not yet started to generate profit
- Improvement and development of education and human resources as tools aiming at enhancing competition
- Utilisation of up to date technology and management methods
- Provision of support to both industrial and labour networks
- Encouraging larger corporations to support SMEs

## **Conclusion and recommendations**

1. SMEs, more than larger corporations, are well suited to the conditions of developing economies as they operate within a local environment and with its specific conditions. Therefore, by studying the impact of the issues faced by SMEs on their economies and the utilisation of mature economies' experiences in this field, developing countries should devise local solutions in order to identify and remove the obstacles faced by SMEs. One should bear in mind that the expansion of these businesses positively and constructively impacts democratisation processes and the consolidation of civil society and social justice.

2. One of the main components of the inadequate growth of SMEs in developing countries is the lack of a national will and the absence of an effective organisation dealing with SME issues. The establishment of an organisation to act as a framework and catalyst for the expansion of the private sector and the institution of a governmental committee aiming at harmonising policies and promoting SMEs are recommended measures to be taken
3. The study of the EU's experience in the development of SMEs can be highly constructive, because *“much analysis is done as regards SME development in each of the member-states, which includes also the less economically developed [economies]; these could be studied as part of the greater EU, or as individual cases when comparing with developing countries realities; b. [...] it might be helpful for developing countries officials, researchers and developers to follow SME developments of [the EU's new member-states], so as to learn from experiences in getting their SME sector at a higher performance level.”*
4. In a developing country such as Iran, the necessary incentives for supporting the growth of SMEs already exist. Although oil revenue is the main engine of the economy, in economic and social development plans much emphasis is put upon the role of SMEs. According to numerous studies, the strengths and weaknesses of the SME sector should be identified and all the main actors dealing with this segment – be they ministries, banks or organisation dealing with development issues – should be harmonised rather than implementing differentiated and sometimes contradictory policies affecting SMEs. Concretely, this harmonisation can materialise in the creation of a platform bringing together relevant ministers and ultimately the establishment of an independent body to promote the development of SMEs.

*Special thanks to Elham Aghajanian, Julian Webb  
and Reza Zia-Ebrahimi*

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