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SMES AND ECONOMIC RESILIENCE BUILDING

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Abstract

This paper discusses the role of private sector development in the economic resilience building of small states. The private sector is generally more exposed and more responsive to market dynamics, thereby contributing to the flexibility of the economy. However, instances of market failure may be more prevalent in small economies, especially if there is a proliferation of monopolies and oligopolies. This calls for appropriate polices to encourage competition and efficiency, within the context of promoting a business environment that is congenial to small and medium sized enterprises which are the main drivers of economic growth in small states. The paper considers the Doing Business index published by the World Bank and hypothesises that small states which have overcome their vulnerability through the establishment of policies aimed at enhancing economic resilience also register positive performance in the doing business index.

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Introduction

The economic vulnerability of small states is well documented (Briguglio, 1992, 1995; and Atkins et al., 2000). The 'economic vulnerability' of small states, especially if insular, stems from their inherent and permanent features which renders them exposed to economic forces beyond their control. These include their high dependence on international trade which makes small states susceptible to exogenous economic conditions. Another characteristic of small states is their dependence on a narrow range of exports and on strategic imports. The small size of the market and a quest to reap economies of scale also limits possibilities for diversification. These inherent characteristics tend to result in higher per unit costs thereby eroding the external competitiveness of small states.

Developing the Private Sector as a Means of Building Economic Resilience 29 The recent wave of globalisation has brought on a new set of economic challenges including a faster than anticipated preference erosion for exports (World Bank and Commonwealth Secretariat, 2006) as well as greater exposure to economic shocks. The latter is mainly due to the fact that globalisation tends to magnify the frequency, magnitude and propagation of economic shocks. Unless backed by appropriate policies, such challenges will translate into enhanced risk. On the other hand, with adequate policies, small states can transform these challenges into opportunities.

The manifestation of the inherent economic vulnerability of small states can be observed by the wide variability in output. According to Easterly and Kraay (2000), part of the greater GDP volatility is due to the enhanced volatility in terms of trade shocks, although Cordina (2008) also points out that output volatility in small states may be exacerbated by internal endogenous macroeconomic dynamics which are not conducive to aggregate demand stabilisation. While such fluctuations are unwelcome, it is often argued that the benefits that can accrue from a higher degree of openness outweigh any of the disadvantages related to greater output volatility

Indeed, in spite of these inherent characteristics, a number of small states have achieved high GDP per capita. This observation has led to what has been coined as the 'Singapore Paradox' (Briguglio, 2003), referring to the fact that in spite of economic vulnerability, Singapore has managed to register a high GDP per capita. Briguglio (2003, 2004) explains this paradox in terms of the appropriate economic policies which have been adopted by Singapore and other small states with a high GDP per capita. Cordina (2008) further argues that small states as a group are characterised by relatively high deviations in per capita GDP from a cross-sectional perspective, which may in turn be explained by the quality of economic, social and political governance.

Briguglio et al., (2006) identify four main determinants of economic resilience namely, macroeconomic stability, governance, social development and microeconomic market efficiency. This paper focuses on the latter variable whereby microeconomic market efficiency is understood to incorporate the extent to which markets can adjust in an efficient and effective manner when exposed to exogenous shocks.

This paper is based on the premise that the extent to which small states respond to such shocks, be they positive or negative, strongly depends on the efficient operation of the price mechanism and on the flexibility of the goods and services, capital and labour markets. This paper argues that the degree of efficiency and flexibility is more pronounced in the private sector as opposed to the public sector as the former tends to be more exposed to market competition where survival requires quick and cost effective responses to market dynamics.

However, this paper also recognises that markets in small states are often too thin and lack institutional capacity (Downes, 2006) to the extent that market failure is more likely to be pronounced in small states. As a result, government must play an important role in supporting the market as well as creating an environment which is conducive towards its efficient operation, focusing on the need to support and encourage the development of the private sector through the promotion of small and medium sized enterprises (SMEs). It is however to be noted within this context that, as Cordina (2006) points out, the specific characteristics of small states may result in a greater prevalence of government failure, defined as a situation where government intervention results in net welfare losses. This thus emphasises the need for such intervention to be properly formulated and implemented within the context of a sound governance structure.

The paper also considers the Doing Business index published by the World Bank, and hypothesises that small states which have overcome their vulnerability, through the establishment of policies aimed at enhancing economic resilience, also register positive performance in the doing business index. Furthermore, countries with high GDP per capita, which to an extent is a manifestation of resilience, also register strong performance in the Doing Business index.

The paper is structured as follows. Section 2 reviews the literature on private sector development and economic resilience, noting the supporting role that government needs to play to encourage the development of the private sector. Section 3 contributes to the discussion on the role of the private sector in the development of small states by analysing the performance of small states in the Doing Business index compiled by the World Bank. Section 4 elaborates on the observations derived therefrom by discussing the specific role played by SMEs in the development of the Developing the Private Sector as a Means of Building Economic Resilience 31 private sector with special reference to the context of small states. Section 5 concludes the study.

Private Sector Development and Economic Resilience

Competitiveness is defined as the ability of an economy to achieve success in international markets under free and fair market conditions while increasing the living standards of its population over the medium term (OECD, 2001). It is argued that such competitiveness can be effectively nurtured through a market-based approach. In the case of small states, appropriate policies to foster competitiveness and private sector development could actually determine the extent to which their inherent openness to trade translates into a strength or weakness.

Briguglio et al., (2006) define economic resilience as a country's ability (a) to recover quickly from a shock, (b) to withstand the effect of the shock and (c) to avoid the shock altogether. One of the pillars upon which resilience depends is microeconomic market efficiency, entailing the efficiency with which resources are allocated and the flexibility to reallocate resources in the wake of exogenous shocks.[2]

Economic theory indicates that the extent to which the price mechanism can operate efficiently and effectively depends on the degree of competitive forces and thus the number of buyers and sellers in the market as well as the absence of externalities in the market. If the above conditions hold, the price awarded by the market would reflect the productive and allocative efficiency in production and consumption.

Lewis (2004) explains that the key to increasing productivity and efficiency in an economy is through intense, fair competition which tends to prevail in an environment where private sector initiatives are encouraged. Loayza and Soto (2003) also indicate that the prerequisites for the proper functioning of markets include private participation and the existence of competition among private agents.

Indeed the private sector, as opposed to the public sector, is generally more exposed and therefore responsive to market realities and is thus better-equipped to absorb, respond and recover from shocks. In addition, the private sector builds up entrepreneurial skills whilst the public sector is often encumbered by inefficiency and under-employment. It is within this framework that the role of the private sector plays a crucial role in building the economic resilience of small states.

Market Imperfections and Market Failures

It must however also be duly recognized that in the absence of conditions which render a market efficient and effective, a market can also fail. This situation tends to prevail even more so in small states compared to their larger counterparts as domestic markets in these economies are typically too small and too thin to operate in an efficient and effective manner (Downes, 2006).

Moreover, given the small size of the domestic market and the need to achieve a certain minimum efficient scale of operations for the export market, there are typically only a small number of operators which dominate the market resulting in monopolistic and oligopolistic market situations (Lee, 2007). A corollary of this is the fact that firms would be operating under conditions of increasing returns to scale, with marginal costs of production being below the average costs due to high fixed costs relative to the size of the market. This would prevent the market price from efficiently reflecting the marginal costs of production, and promote monopolistic pricing. In the case of imports, the low inter-

[2] Cordina (2004a) presents a conceptual application of the extent to which shocks faced by small states result in asymmetric effects. Typically the effects of negative shocks outweigh positive ones due to the diminishing marginal productivity. Consequently, a possible interpretation of micro-economic efficiency would be the extent to which an economy can avoid the onset of diminishing marginal productivity and foster productive conditions that are more conducive to promote endogenous growth

industry linkages and the limited possibility for import substitution also tends to result in monopolistic import channels.

Another characteristic of markets in small states is that they are typically protected by natural barriers to entry due to the minimal likelihood of success in setting new business where the market is already saturated by a limited number of players. Indeed, when this situation occurs, policy intervention is required to minimise the welfare loss associated with market failure. In the case of monopolistic and oligopolistic market Developing the Private Sector as a Means of Building Economic Resilience 33 structures, the enforcement of competition law could be instrumental in reducing the chances of abuse from dominant positions, but even here, small states face a number of constraints (Briguglio and Buttigieg, 2004).

Government's Supporting Role

The existence of market failure does not reduce the importance of the private sector nor the key role that it plays in nurturing economic resilience. Rather, it implies added importance to policy intervention which is required to minimise the welfare loss associated with such failure.

Indeed the Joint Commonwealth and World Bank report (Briguglio et al., 2006b) duly recognises that while small states face huge competitive challenges, for most small economies, investment in small and medium sized enterprises particularly in the export sector offers the best chance of rapidly creating jobs, increasing national income and widening the tax base.

The business environment in which firms operate is an important driver for the development of the private sector. The opportunities and incentives that firms have to invest, create jobs and to grow depends on the prevailing business environment. In turn, the environment depends on the costs and ease of doing business, and the risks associated with doing that business, factors which governments can influence.

Governments of small states have an additional role of designing and implementing policies of deregulation, privatisation, and liberalisation in a manner which promotes competitiveness. A flexible labour market is crucial in this regard as it adds to the overall market flexibility and provides the cornerstone required to achieve high employment levels. In addition government plays an important role in ensuring economic and political stability especially since the private sector requires certainty, predictability and confidence in the economy. Without these key requirements the private sector, be it domestic or foreign owned, is unlikely to flourish or succeed.

In fact, the government's role in fostering a favourable overall investment climate not only supports domestic capital accumulation but also attracts foreign direct investment, considered as a powerful means of enhancing competition and the growth potential of small states. For one thing, FDI facilitates the international transfer of know-how, thus fostering the competitiveness of the host country directly. At the same time, FDI can help

to improve the productivity of local companies by stimulating imitation of new technologies and is usually also an important driver of innovation.

Government also influences risks through policy predictability as well as through contract enforcement. This requires the strengthening and enforcing of intellectual and other property rights, contract law, bankruptcy procedures and antitrust regulations to foster private sector development. The role of the government in providing the physical infrastructure in small states is also of major importance in promoting private sector investment and initiative, given that such amenities as electricity, water and telecommunications are often natural monopolies.

Government Failure

It is however also important to note that while such policy intervention is required to spur the private sector, government intervention beyond an optimal level, may actually hinder the development of the private sector. Cordina (2006) argues that policy intervention may also be fraught with failure. Indeed, government intervention may result in unpredictable changes in economic conditions and in costly mistakes (Datta-Chaudhuri, 1990). This risk is especially high in small economies where the government sector is relatively large (Medina Cas and Ota, 2008) and any single intervention is bound to have widespread effects. There may also be mistakes in policy formulation, problems in policy implementation and high costs of policy intervention whereby such problems tend to be magnified in small vulnerable economies.

Private Sector Development and the Cost of Doing Business

An inappropriate regulatory framework exacerbates the problems associated with market imperfections and market failures. The challenges range from complicated and excessive regulatory controls, burdensome procedures, irregularities in the market structure and fragmented logistics services. Such inefficiencies raise the cost of production, increase the risk of market loss and in effect constraint external competitiveness.

Developing the Private Sector as a Means of Building Economic Resilience 35 Recent analytical work has led to a broad understanding among policymakers and development practitioners that microeconomic reforms aimed at strengthening property rights, promoting competition, and reducing the costs of doing business are critical in creating a sound investment climate which allows the private sector to prosper and thus contribute towards economic growth (World Bank 2004a, 2004b, 2005). Also recognised is the fact that these changes need to be credible and sustained for private firms to respond by increasing investment and production. Clear and consistent rules and regulations are critical to investors. As a result, policy makers in small states must recognise that for the private sector to develop and for SMEs to flourish, there is a strong need for policies to be geared towards the establishment of an institutional environment which reduces the costs of doing business and there is also the need for effective governance to support such policies (Spence et. al, 2008).

Towards this end, it is interesting to assess the cost of doing business in small states to determine the extent to which regulatory frameworks are conducive towards developing the private sector. The World Bank publishes, on an annual basis, a database on the costs of doing business by considering the following variables[2].

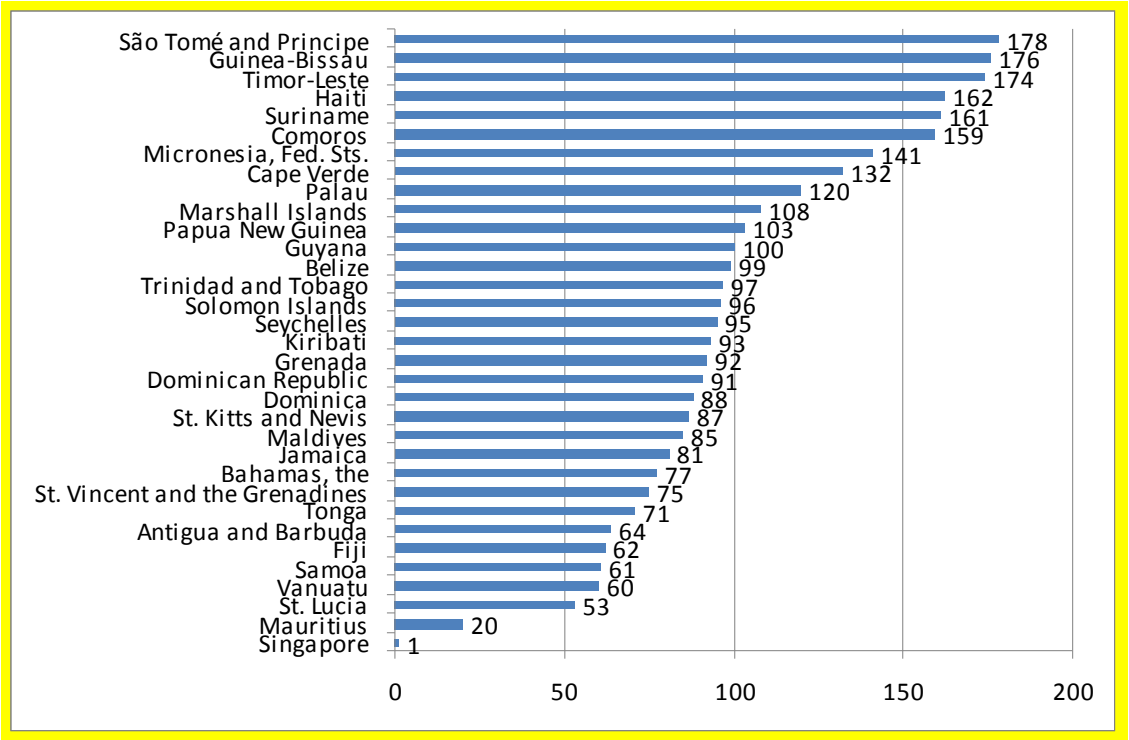
- Starting a Business: identifies the bureaucratic and legal hurdles an entrepreneur must overcome to incorporate and register a new firm;
- Dealing with Licenses: tracks the procedures, time and costs to build a warehouse, including obtaining necessary license and permits, completing required notifications and inspections, and obtaining utility connections;
- Employing Workers: measures the flexibility of labour regulations including hiring and firing decisions;
- Registering Property: examines the steps, time, and cost involved in registering a property, assuming a standardised case of an entrepreneur who wants to purchase land which is already registered and free of title dispute;
- Getting Credit: examines credit information registries and the effectiveness of collateral and bankruptcy laws in facilitating lending;
- Protecting Investors: measures the strength of minority shareholder protections against misuse of corporate assets by directors for their personal gain;
- Paying Taxes: addresses the taxes and mandatory contributions that a medium size company must pay to withhold in a given year as well as measures of administrative burden in paying taxes;
- Trading Across Borders: determines the procedural requirements for exporting and importing a standardise cargo of goods;
- Enforcing Contracts: looks at the efficiency of contract enforcement by following the evolution of a sale of goods dispute and tracking the time, cost and number of procedures involved from the moment the plaintiff files the lawsuit until actual payment;
- Closing a Business: identifies weaknesses in existing bankruptcy law and the main procedural and administrative bottlenecks in the bankruptcy process.

A snapshot of the performance of small states is presented by the World Bank in its publication titled *Doing Business 2011: Small States*. Economies are ranked on their ease of doing business, from 1 to 183 with first place referring to the country with the least cost of doing business. In general, the overall performance of small states is positive, with fifteen out of the thirty-three small states considered in the study registering an overall ranking lower than the mid rank of 92 as can be seen from Figure 1. Such performance outlines the fact that in order for small countries to overcome their inherent economic vulnerability they must focus on building economic resilience including the establishment of an environment which is conducive towards the development of the private sector. Vella (2007) further accentuates such a relationship by correlating population with the Doing Business index indicating that on average small states tend to perform better than larger countries.

Indeed, in general, small states tend to perform well with dealing with construction permits, protecting investors, trading across borders, paying taxes and starting a business.

On the other hand, small states fare poorly in registering property, getting credit, enforcing contracts and closing a business.

Figure 1
Ease of Doing Business



Source: World Bank: Doing Business 2011

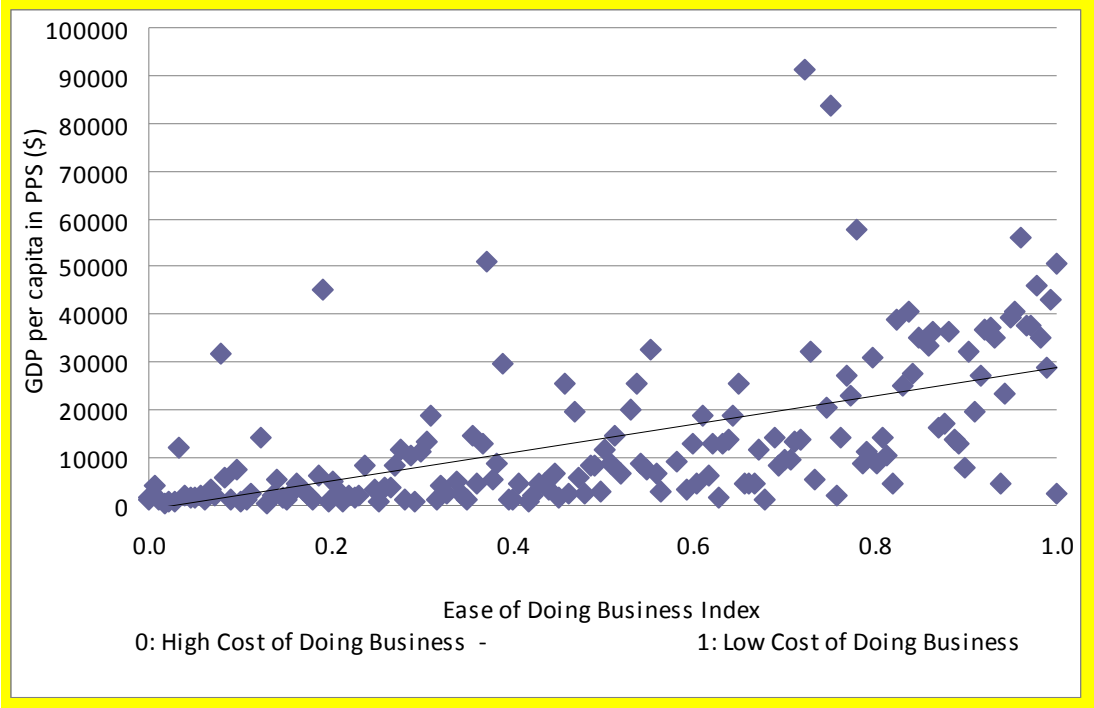
It is interesting to note that Singapore ranks as the country, among the 183 countries in the index, with the least amount of bureaucratic procedures and burden on businesses. Existing regulation has strengthened property rights and encouraged trade. There is adequate regulation which protects investors thereby encouraging investment and development and Singapore also provides easy start up and closure requirements to encourage the development of SMEs. Moreover Singapore also has low rigidities in the labour market allowing for flexibility to counteract and respond to shocks.

It is thus no surprise that Singapore also ranks as the most resilient economy in the resilience index calculated by Briguglio et al.,(2006).[3] Furthermore it is also not surprising that there is a positive correlation between the Doing Business index and the microeconomic market efficiency sub-index of the resilience index as established by Xerri (2008).

[3] The two indices do not cover the same set of countries

A further relationship is outlined in Figure 2 which depicts the relationship between GDP per capita and the Doing Business index. As can be seen from the Figure there is a positive correlation between the two variables implying that in general countries with low costs of doing business register high GDP per capita in PPS.

Figure 2
Ease of Doing Business and GDP Per Capita



SMEs as the Backbone of the Economy

It is important to recognise that the private sector in small states is composed of small and medium sized enterprises as well as microenterprises employing only a few workers.[4] These firms play a vital role in economic development as they are the primary sources of employment creation and economic growth (Tambunan, 2006).

SMEs in small states tend to face a double disadvantage due to the fact that size limitations are often magnified in a small country context, where the inherent economic fundamentals are such that they amplify the problems faced by small firms (Cordina, 2004b). Small enterprises are associated with a number of disadvantages vis-à-vis larger enterprises because of high fixed costs in relation to activity, limited capacity in reaping economies of scale and difficulties in negotiating with financial institutions and the national governments.

[4] See http://rru.worldbank.org/Documents/other/MSMEdatabase/msme_database.htm

However, small sized firms have a number of advantages which may offset scale disadvantages, including a high degree of motivation and commitment to the business, the ability to exploit market niches which require small production runs and the ready support by family members.

The role of government in this regard is to try to provide an enabling environment to help small firms minimize their disadvantages, notably fragmentation and maximize the advantages, most importantly entrepreneurship. It is also important to note that small firms benefit to a greater extent from business friendly regulations, as outlined in the previous section, compared to larger firms (USAid, 2008) thus placing greater emphasis on the need to create a framework that is conducive to business development within small states characterised by the prevalence of SMEs.

Towards this end, it is important to highlight the Small Business Act (SBA) for Europe launched by the EU Commission in 2008.[5] The SBA outlines a comprehensive policy framework for the EU and Member States through the establishment of 10 guiding principles aimed at providing a framework to meet the challenges offered through globalisation and increasing competitive pressures. The principles, listed hereunder, focus on the establishment of policy which is geared for the specific needs and challenges faced by SMEs including:

- Creation an environment in which entrepreneurs and family businesses can thrive and entrepreneurship is rewarded
- Ensuring that honest entrepreneurs who have faced bankruptcy quickly get a second chance
- Designing rules according to the 'Think Small First; Principle
- Making public administration responsive to SMEs needs
- Adapting public policy tool to SME needs: facilitate SMEs' participation in public procurement and better use State Aid possibilities for SMEs
- Facilitating SMEs' access to finance and develop a legal and business environment supportive to timely payments in commercial transactions
- Assisting SMEs to benefit more from the opportunities offered by the Single Market
- Promoting the upgrading of skills in SMEs and all forms of innovation
- Enabling SMEs to turn environmental challenges into opportunities
- Encouraging and supporting SMEs to benefit from the growth of markets

The EU has placed significant emphasis on these principles monitoring the progress in the implementation of these principles across each of the Member States. Indeed the EU is determined to continue to give priority to SMEs and to take into account their specific characteristics in its proposals and programmes.[6]

[5] COM (2008) 394
[6] SBA review: What has been done and what is to be done for Europe's SMEs?

Conclusion

The inherent economic vulnerability of small states stems from the fact that small states, particularly island states, are highly dependent on trade and therefore exposed to exogenous shocks over which they can exert little or no control. The recent wave of globalisation has given rise to a new set of challenges. The extent to which these challenges translate into enhanced economic risk or opportunities depends on the economic resilience of small states.

One of the essential foundations of economic resilience rests on the efficient and effective operation of the market and the degree of flexibility awarded by the market Typically, the greater the extent of competition driven by the private sector, the greater the operational efficiency of the price mechanism and flexibility in reallocating resources when exposed to exogenous shocks.

In fact it can be argued that the private sector builds entrepreneurial skills which allow it to be more exposed and responsive to market realities than the public sector.

In small states the private sector is essentially made up of micro enterprises which are burdened with costly bureaucratic regulatory procedures and with difficulties in finding funding opportunities.

Consequently governments in small states must play a complementary role and provide a level of regulation conducive to the development of the private sector as well as develop adequate competition law in markets which are dominated by a few players. Government driven policy must also be channelled towards developing effective governance, an adequate infrastructure and an educated labour force all conducive towards developing the private sector of an economy.

This necessity has become even more so pronounced as the economic forces channelled through globalisation have become more frequent. The magnitude of external shocks has increased such that the economic survival of small states strongly depends on their ability to build economic resilience. As a result a suitably equipped private sector, able to respond to market realities, is considered essential.

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