

## The role of Small and Medium Scale Enterprise in local economic development (LED)

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### Key words

Small and Medium Scale Enterprise, Local Economic Development

### Abstract

*This article explores importance of SMEs in a given economy. It will also show us the reason why SMEs should be given full concentration and also to provide for the existing SMEs and encouraging more to start up.*

*The contribution of the Small and Medium Enterprises (SMEs) to the Local Economic Development (LED) of a nation is well recognized. In developing countries, the contribution of SMEs towards employment generation is significant because they:*

- *Nurture entrepreneurship.*
- *Since small businesses employs the citizens of the country, it helps to reduce risks (reduce crime rates).*
- *Support the building up of systemic productive capacities and the creation of resilient economic systems, through linkages between small and large enterprises.*
- *Tend to use more labour intensive production processes than large enterprises, boosting employment and leading to more equitable income distribution*
- *Provide livelihood opportunities through simple, value adding processing activities in agriculturally based economies;*

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### Introduction

Generally this sector is the largest contributor to employment in most countries. This is especially relevant for new job creation. The SME sector is a major contributor to technical innovation and new product developments (Ou, 2006; Office for national statistics, 2009; Ergas& Orr, 2007; Organisation for Economic Co-operation and Development, 2005; National Development and Reform Commission, 2007).

To sum up, it has been argued that both entrepreneurship and innovation are linked to economic growth and industrial renewal. But it is not entirely evident exactly how. Often the relationships between growth, entrepreneurship and innovation, tend to be indirect rather than direct. The combination of entrepreneurship and innovation results in innovative entrepreneurship: new firms based on new (inventive) ideas, and sometimes, but not always, research-based. Such firms often have relatively high growth potential and may become gazelles companies (Åsa Lindholm Dahlstrand and Lois Stevenson 2007). Unfortunately, the research on and knowledge about innovative entrepreneurship is limited (Åsa Lindholm Dahlstrand and Lois Stevenson 2007).

The establishment and expansion of new firms is responsible for creating a high share of net new jobs (OCDE 2014). Gazelles and high-expectation entrepreneurial firms are often found among innovative and technology-based new businesses, but for them to play a key role in economic growth, it is also essential that there is a significant supply. That is, encouraging general entrepreneurial activities is not only likely to result in increased entrepreneurship, but also in a higher number of innovative high-growth firms. Many European countries need to be encouraged to increase their entrepreneurial activities.

SMEs have a propensity to employ more labour-intensive production processes than large enterprises (Olawale and Garwe 2010). Consequently, they contribute significantly to the provision of productive employment opportunities, the generation of income and, eventually, the reduction of poverty (OCDE 2014)

### Definition of SME.

Small and medium enterprises are considered those enterprises which have fewer than 250 employees. In distinguishing between small and medium sized enterprises, the small enterprise is defined as an enterprise, which has fewer than 50 employees. These businesses are often referred to as SME's and are traditionally associated with owner operators (Meredith 2001, ATO 2004, Schaper & Volery 2004). SARS does not have one single description for small business; instead there are several definitions utilised for different purposes: For Amnesty purposes, a small business is any business with a turnover of up to R10m; For Income Tax purposes (Section 12E), a Small Business Corporation (SBC) is defined as a business having a turnover of less than R14m, over and above other qualifying criteria. (The forum South Africa, accessed Sept 2012) For Capital Gains Tax, a Small and medium Enterprise (SME) is described as a business having total net assets of under R5m.

It is therefore proposed that SARS restricts itself to the definition as used for SBC regime purposes i.e. a small business is a business that has a turnover of no more than R14 million. The National Small Business Office (NSBO) therefore operates within the ambit and interests of businesses in South Africa with a turnover of no more than R14m per annum. (The forum South Africa, accessed Sept 2012).

Table 1. Schedule of size standards for the definition of SMEs in South Africa.

Type of firm	Employees	Turnover	Balance sheet
Small	1-49	Maximum R13m	Maximum R5m
Medium	51-200	Maximum R51m	Maximum R19m

Source: Government Gazette of the Republic of South Africa (2003), & Olawale and Garwe, 2010.

### Characteristics of SME'S.

Apart from the number of employees, there are other key factors that characterise the SMEs and these are related to management and the nature of operations. The SMEs may be managed by their owners who are often assisted by family members (Okello-Obura and Matovu, 2009). In this regard, the decision-making system is quite flexible, informal and dependent on the personal drive of one or more of the executives. By their very nature of operation, the SMEs have a narrow range of products/services and a relatively simple and unsophisticated management structure with a narrow tolerance range of risk. Individual SMEs experience difficulties in achieving economies of scale in the purchase of inputs and are often unable to take advantage of market opportunities that require large production quantities, homogenous standards and regular supply. Above all, SMEs are confronted with situations where decisions are made haphazardly and not based on accurate business information (Okello-Obura and Matovu 2009, (Gronum, Verreynne et al. 2012).

### The Importance of SME'S to the Economy.

The notion of SME and entrepreneurship development was introduced into the growth and development landscape as early as the late 1940's with the introduction of targeted policies (grants, subsidized credits, special tax treatment, etc.) and the establishment of small business or SME support. (Istanbul 2004, (Chimucheka 2013). Quoting Vermeulen, 2011, in his paper he delivered Importance of SME sector – or why ARC exists, he agreed with World Bank, that SMEs contribute the following to the Economy:

1. SMEs are the engine of growth;
2. SMEs are essential for a competitive and efficient market;
3. SMEs are critical for poverty reduction; and
4. SMEs play a particularly important role in developing countries.

In a 2010 paper<sup>2</sup> of world bank on the role of SME job creation in the South African economy, Kongolo notes that SMEs (defined as businesses employing 1 - 499 people) account for over 76% of the total employment in the economy, and of the net new jobs created between 2004 and 2007, they created 53% of these. In short, any sector creating 53% of the new jobs in our economy needs to be nurtured. Remember, this is arguably the 'highest risk' component of entrepreneurship (few SMEs have the luxury of corporate budgets or government largesse - if things do not work out, the shareholders and employees have very little safety buffer). If better policies and institutional support can encourage more entrepreneurs to launch their SMEs, imagine what this could do for job creation in SA?

On the second point, SMEs in SA play a massively important role. Take telecoms, for example. Many of the innovative products, new delivery models and general innovations are often driven by the SME sector. It would seem that SMEs are better placed to take advantage of the deregulating sector, and are nimbler and hungrier than their larger corporate peers. This is great news for the general public, as competitiveness increases, and ultimately, the economy is driven to a more efficient and productive space.

The third point, that of poverty reduction as a result of SME activity requires some more exploring. SMEs are often located in geographical areas outside of the typical large urban centres. This may be for lifestyle reasons, or simply because that is where the opportunity for business exists. Whatever the reason, the point is that economic activity outside of the major metropolitan areas leads to job creation, and the good old 'multiplier effect', much beloved by economists, kicks in, helping reduce the poverty of rural areas. Not every SME is in a non-metro area, of course, but both non-metro and metro area SMEs assist with poverty reduction through employment, training and softer social benefits such as CSI. Vermeulen 2011.

According to Rwigema and Karungu (1999), SMEs are dominant in numbers in most economies. In First World countries like the United States of America and the United Kingdom, small enterprises play an important role in the economy, accounting for an estimated one third of industrial employment and a lower percentage of output. In Third World countries where SMEs dominate economically active enterprises, the SMEs prosperity is considered far more important than in First World countries (Rwigema and Karungu, 1999).

The activities of SME enterprises in Africa (Rogerson, 2001a), is of vital importance for the promotion of economic growth, job creation and the mitigation of poverty. However, research conducted on SMEs in Africa by Mead and Liedholm (1998) confirmed that on average, there are more SME closures than expansions, with approximately only 1% of micro enterprises growing from five or less employees to ten or more. It has long been debated that SMEs are pivotal to employment creation and economic growth, particularly in countries such as South Africa that has a high unemployment rate, estimated at up to 40% (Friedrich, 2004; Watson, 2004), cited by (Smit and Watkins 2012).

The vital role the SME sector plays in the South African economy in addressing sustainable development, was highlighted by the 2003 Human Development Report (UNDP, 2003) for South Africa (Rogerson, 2004).

In South Africa, it is estimated that 90% of all formal businesses are small, medium or micro enterprises (Rwigema and Karungu, 1999). The SME sector is one of the largest contributors to the South African economy. The SME is not only seen as an employment creator, but this sector also acts as an absorbent of retrenched people coming from the private and public sector (Ntsika, 2001).

Although the SME sector is responsible for 75% of new jobs, largely due to the emergence of new micro enterprise formations, it compares poorly to Asian countries where SME employment contribution is estimated at 80% (Friedrich, 2004; Watson and Godfrey, 1999). The South African government has identified the SME sector as the means to achieve accelerated economic growth. However, this objective was not achieved partly due to the high failure rate of 80% of enterprises (Watson, 2004; Van Niekerk, 2005) in the SME sector, also cited by (Smit and Watkins 2012).

### **Challenges facing SME's despite their contribution to the Economy.**

According to Fatoki and Garwe 2010, there are external factors and internal factors affecting SME's.

External factors like:

1. Financial Constraint
2. Management

Internal Factors like:

1. Economic Factors
2. Market
3. Infrastructure

Below are the major problems been faced by SMEs within the internal and external environment:

Rank	Perceived obstacle
1.	Lack of access to finance
2.	Lack of collateral
3.	Insufficient owners equity contribution
4.	Crime
5.	Insufficient government support
6.	High interest rate
7.	Inadequate demand
8.	Inadequate market research
9.	Location of the business
10.	High competition
11.	Bad credit record
12.	High production costs
13.	Lack of information technology
14.	High transport costs
15.	High taxes and other tariffs
16.	Recession in the economy
17.	Lack of experience relevant to the venture
18.	Founder not familiar with market/industry
19.	Lack of networking
20.	Lack of business skills
21.	Shortage of skilled labour
22.	Costs of registration and licenses
23.	High inflation rate
24.	High foreign exchange rate
25.	Poor electricity supply
26.	Lack of training
27.	Corruption
28.	Poor roads
29.	Poor water supply
30.	Poor telecommunication

Source: Fatoki and Garwe 2010

### Conclusion and Recommendation

Despite the fact that SMEs contribute immensely to the development of a countries economy, they still have large challenges. If these challenges can be tackled with the relevant needs to meet them, surely the economy will get better. As we discussed above that SMEs contribute a large percentage of GDP to its economy, special interests should be given to them so as to make them perform well and affect the economy positively. SMEs contribution to employment reduces poverty etc makes an economy to grow well. It reduces crime rate, since it has provided for those that are unemployed.

As recommendation, I found out from the literature review that large SMEs still fail due to not having a follow up by bank or government that has provided fund for them. It is advised that the government or bank that is giving out loans to the SMEs must also stand by them in checking their books of account and following up with them. By doing this the banks, government will know when the SMEs are in good standing or they are not. Once it is known that they still need some help, government and banks will come to their aid before they collapse. There must be a fed back or report back to where they got their funding from. More business links that can help small businesses should be established. Such business links should be able to subsidize the cost of training and development, together with any costs incurred which enhance the performance of the small business. More organisations that act as mother companies like Business Support Centre (BSC) can be established.

From the current study, the researcher gathers that not all small businesses are au fait with suitable management of funds. Some companies mismanage the company funds, spending it on personal needs. There must be an understanding of how to allocate business funds. The likes of BSC and SEDA as business support organisations are able to assist in this regard (the researcher has few articles coming up this year that looked into this properly, e.g. Ph.D thesis on strategy and innovation, articles on strategy and innovation, internal factors affecting SMEs, external factors affecting SMEs, etc). Collaboration is another way in which small businesses can work together to gain a better result or a competitive advantage over rivals of small businesses. Collaboration brings about synergy in business, which encourages businesses to perform better as they collaborate to achieve their goals. Forming a business hub can also be of advantage here.

The following recommendation also applies based on Fatoki and Garwe 2010 and also findings from the authors' Ph.D thesis. These recommendations will strengthen the small businesses in their day to day operations.

1. Government support agencies that can help new SMEs with finance and training such as SEDA should be rigorously marketed to create awareness.
2. Concessional loans for SMEs should have low interest rates in order to ease the loan burden on the emerging ventures.
3. New SMEs should be able to produce business plans that forecast cash flow requirements, have an operational plan and demonstrate viability and sustainability in order to secure debt finance.
4. Transport and communication facilities as well as reliable power must be provided in rural and urban areas.
5. There is also need to choose the product or service that appeals to customers in order to fully satisfy customer needs.
6. It is important to include technology in the school curricula as well as adult education programmes to ensure that the wider population becomes more familiar with technology.
7. Good customer care and efficient service are the hallmark of customer retention.
8. Tax incentives need to be put in place to favour new venture creation and development.
9. Inflation targeting and interest rates reviews should consider the new SMEs.

10. Pricing decisions have to be considered carefully in order to beat completion as well as achieve lucrative profit margins.
11. Thorough market research is needed to ensure that there is adequate demand for the products or services being offered by emerging SMEs.
12. Strategic planning / innovation to determine the nature of competition and how to position the business is needed.
13. Choice of the business location needs to be considered carefully in order to minimize distribution costs, meet demand and beat competition.
14. Entrepreneurial trainers and consultants must themselves be well-trained and/or experienced in the specific area of expertise that they offer, for example Management Staff, Accounting, HR, Production, Marketing or logistics.
15. Provide up-to-date training programmes that focus on the needs of entrepreneurs rather than out-dated programmes that cater predominantly for General Managers.
16. Crime and corruption in both the public sector and the business community need to be dealt with decisively.
17. Business owners should not base the recruitment selection on their family alone. They should employ experienced and qualified people. And in the case of interns, they should also employ the qualified ones.

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