5 December 2018 | Geneva

UNECE

Promoting innovative, high-growth firms

Investment, enterprise, and development commission 10th session

Item 5:
Science, technology, and innovation for development

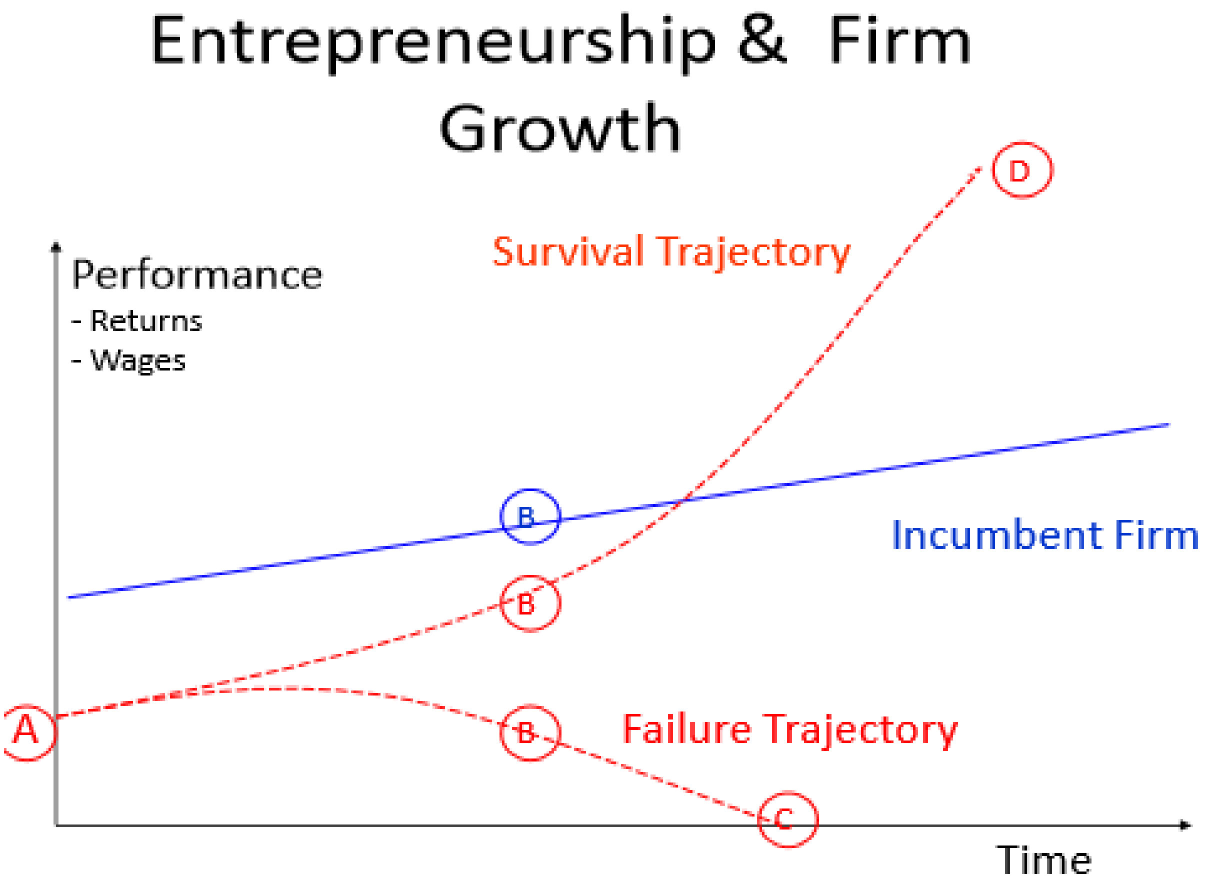
The paradox: If SMEs are so important, why can we not see this clearly in the data?

- SMEs are considerably less productive than large enterprises – and even than the economy overall. Their share in employment is much larger than their share of output
- SMEs are considerably less innovative
- SMEs are considerably less likely to engage in exports
- SMEs invest little capital
- Almost all SMEs are very small – and remain so
- The job creation myth: young companies account for only 1% of employment

The answer: a small sub-group of SMEs stand for most innovation, growth, and productivity gains

- 4% of start-ups create 50% of all new jobs in France – but on average, firm productivity increases with firm age; the average start-up makes worse use of resources than existing firms – and entrepreneurship declines as countries grow richer
- World Economic Forum panel study: the top 1% of all companies by revenue growth contributes 44% of total sector revenue and almost half of job growth
- Shane (2009) and other leading scholars say that this, rather than SMEs or start-ups as a whole, should be the focus of targeted support policies.

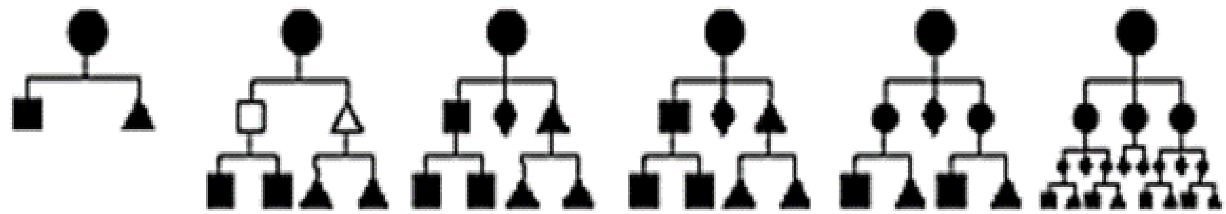
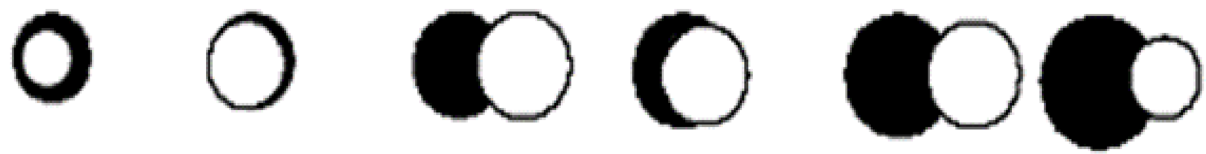
So let us take a closer look at this sub-group, starting with the sporadic nature of growth.



This reflects five stylised development stages.

EXHIBIT 3

Characteristics of Small Business at Each Stage of Development

	Stage I	Stage II	Stage III-D	Stage III-G	Stage IV	Stage V
	Existence	Survival	Success-Disengagement	Success-Growth	Take-off	Resource Maturity
Management style	Direct supervision	Supervised supervision	Functional	Functional	Divisional	Line and staff
Organization						
Extent of formal systems	Minimal to nonexistent	Minimal	Basic	Developing	Maturing	Extensive
Major strategy	Existence	Survival	Maintaining profitable status quo	Get resources for growth	Growth	Return on investment
Business and owner*						

*Smaller circle represents owner. Larger circle represents business.

HGEs differ, on average, from the general SME population in many different ways…

- Life-cycle variations strongly determine success of HGEs.
- HGEs excel in using technology well, but rarely engage in frontier innovation themselves.
- HGEs understand their markets and customers, able to pinpoint unmet potential demand.
- High-growth entrepreneurs are driven by opportunity rather than necessity…
- …and sport high education levels, strong networks, and often savings to invest.
- Access to finance is often not the leading constraint.
- Strong importance of location: growth opportunities draw on concentration, clustering, and knowledge spill-overs.

Risks and regulatory barriers rank among leading constraints for HGEs.

Constraints	Explanation
Dealing with high risks	Dealing with the inherent riskiness of new, potentially high-growth ventures can be especially costly in developing and emerging markets. As a result, many projects will not take place at all, to the detriment of sustainable economic development overall.
Regulatory barriers	While good business regulation is important overall, labour market restrictiveness and other areas have particularly strong bearing on enterprise dynamism.
Access to skilled labour	HGEs often engage in new activities, which often means that there will not be sufficient supply of adequately qualified human resources.
SME incentives not efficient	Many SME support instruments may not fit the specific needs of HGEs. Fiscal incentives, for instance, play at most a peripheral role in entrepreneurial decision-making, as they only apply after the project reaches breakeven and turns a profit.

UNECE

ASEAN‘s fastest growing companies come from all over the economy, but share excellence in listening to their customers, using technology well, and keeping close tabs on quality and branding

CADD CENTRE Skills Driven. Job Led | 30 YEARS OF SKILLING THE WORLD

ROLLING ARRAYS

G8 Education ltd

MITIGATE Compliance & Risk Management Ltd.

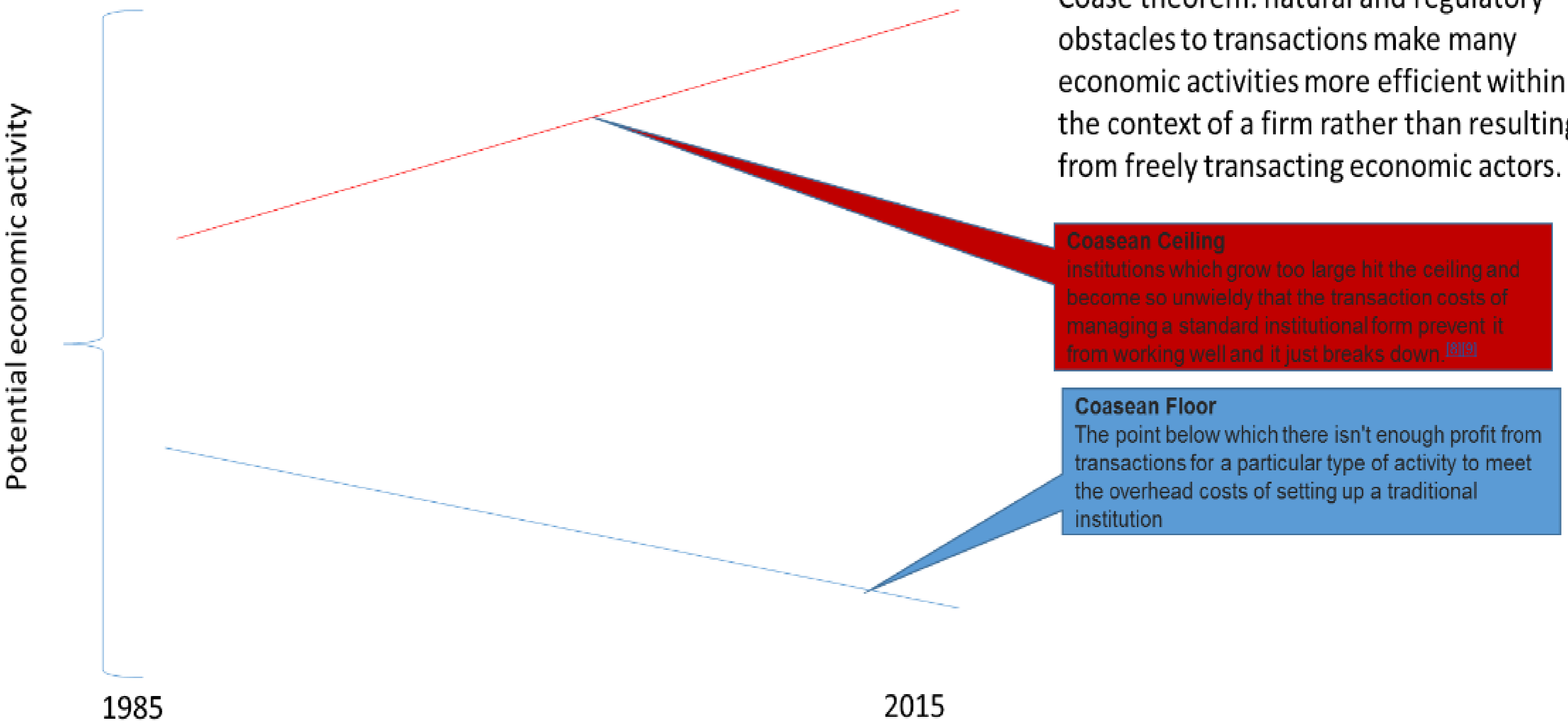
So what is the rationale for supporting IHGEs? First, we need to understand what is important for growth– at least in the long-term

- Countries grow in two ways:
  - by shifting resources (capital, labour) from less productive (agriculture, petty trade) to more productive (manufacturing, BPOs) activities
  - And by finding more efficient ways to do things within those sectors (ERP, automating production steps)
- The speed of this “structural transformation“ explains much of what distinguishes countries that sustain growth over the long term and those that do not
- The most salient factor behind this speed is learning, or accumulating productive capacities (as indicated by, for instance, product space and EXPY). At the middle-income stage, countries with a diversified production structure, reflecting a wide pool of such capacities, are the most likely to continue growing
- The leading drivers behind such learning are entrepreneurs and companies that experiment with new business ideas – ideas that, if successful, are likely to result in high-growth
- A strong focus on promoting learning, constrained by market signals (such as export competitiveness), underpinned the extraordinary success of industrial and innovation policy in East Asia (vs. Ecuador and Mexico)

UNECE

The theory: rapidly expanding opportunities…

Coase theorem: natural and regulatory obstacles to transactions make many economic activities more efficient within the context of a firm rather than resulting from freely transacting economic actors.



The problem is that this experimentation with new business ideas is risky

– so risky, in fact, that entrepreneurs may decide not to do them. This is where public support can make the difference.

Reasons for inordinate risk: market failures	What this means for entrepreneurs
Cost of self-discovery: exploring the cost structure, or commercial viability, of a new business idea, incurs substantial costs	If the venture fails, the entrepreneur bears the full cost. If it succeeds, it will only capture part of the benefit as others decide to copy the business idea
Co-ordination externalities: many business ideas require a range of elements to be in place to be successful, from suppliers over infrastructure to clear rules and regulations	If the entrepreneur is not able to ensure that all those elements are in place, the venture will likely fail
Market creation: the lack of an established market with predictable prices	The entrepreneur has to shoulder the costs and risks of creating a new market altogether
Network externalities: A product or service is useful only if enough supply and demand is active at the same time (cf. Uber and Go-Jek)	The entrepreneur will succeed only if he or she is able to single-handedly assemble a critical mass of supply and demand at the same time

For public support to work in such circumstances, an in-depth understanding of HGEs is essential.

… including their characteristics, needs, and constraints. Starting, of course, with a definition

- Typical definitions include growth in revenues or employment over three years, compared to the economy overall or the sector.
- Fundamental dilemma: a company that grows fast has already showed that it is working. So how can we get to them before they grow and help them overcome barriers that might stop them in their tracks?

Source	Definition
Eurostat-OECD manual on business demography statistics, 2008	High-growth enterprises are enterprises with average annualised growth in the number employees greater than 20% per year, over a three-year period, and with ten or more employees at the beginning of the observation period.
European Union; EU regulation No. 439/2014	All enterprises with at least 10 employees in the beginning of their growth and having average annualised growth in number of employees greater than 10% per annum, over a three-year period.
Industry Canada	SMEs: Less than 500 employees and less than $50 mn average sales volume HGSMEs: Revenue growth of more than 50% cumulated over three years

This has far-reaching policy implications…

Type	SME policies	Entrepreneurship	HGE policies
Target of policy	Existing SMEs, including micro-enterprises and one-person companies	Potential entrepreneurs and startups	SMEs with the potential and ambition to grow fast
Rationale	Sustain jobs, reduce poverty, support underdeveloped regions	Encourage creative destruction and structural transformation	Encourage structural transformation, job creation, and productivity growth
Objective	Creating a level playing-field and ensure SME survival or mitigate the social consequences of structural change	More start-ups in the economy	More high-growth firms in the economy
Nature of support	Financial incentives; regulatory simplification	Trainings, match-making, and facilities for incubation	Relational support; policy advocacy to remove constraints
Eligibility	All or most SMEs; sometimes limited to women or underrepresented groups	All entrepreneurs; sometimes limited to women or ICT sector	Limited eligibility, decided on a case by case basis with criteria strongly correlated with subsequent high growth
Examples: A2F	Credit guarantees; direct soft loans	Subsidies for seed funding	Matching HGEs with sources of finance; enabling environment and limited direct investment into risk finance
Examples: building capacities	Generic trainings on business planning, accounting, HR management, and process automation.	Entrepreneurship trainings; mentoring mechanisms	Targeted trainings and interventions, depending on the business life cycle and subject to strict performance requirements
Examples: Business climate	Comprehensive view of business climate reform, often with emphasis on starting a business and other aspects covered in the World Bank Doing Business report	Less of an emphasis; at times focus on business startup regulations	Very targeted to specific constraints that, as a result of careful analysis and consultation, appear to hold potential high-growth ventures back
Limitations and risks	Deadweight losses and displacement effects; may slow down efficient resource reallocation by keeping less productive enterprises running.	Most startups fail or stagnate; even venture capitalists reckon that 90% of investments will not perform.	Predicting high-growth is difficult. Effective targeted support can be costly, and the effects hard to measure. Risk of creating entrenched privileges.
Institutions	Standard SME agencies, with divisions for business climate reform, BDS, and access to finance.	Separate agencies, mostly with a specific purpose, such as incubation.	Autonomous agencies operating with a key account logic, with officials getting to know entrepreneurs and their activities and accompanying them throughout the life cycle.
Processes	Standard processes, with long-term and yearly work plans and indicators such as number of SMEs supported.	Ibid	Focus on key account logic. Need for continuous internal and external monitoring and evaluation, with decisive performance criteria that, if not reached, lead to discontinuation of support.

…with many typical approaches failing to support HGEs effectively.

Typical public policy	Needs of high-growth entrepreneurs
Subsidies or tax breaks for firm research and development	HGEs in developing and emerging economies are not especially prone to investing in research and development; they tend to adapt existing technology to the country and customers. Their value lies in discovering and signalling what works in the economy and listening to and often interacting with customers; the case of Go-Jek Indonesia illustrates this.
Emphasis on entrepreneurial finance	While essential in some cases, most HGEs in developing and emerging countries prefer to retail full ownership, resorting, where necessary, to traditional debt funding.
Focus on high-tech sectors	While many HGEs bring in ICT enabled automation and distribution, most of them operate in “traditional” economic sectors – pure ICT firms, such as software developers, make up a small minority at best.
Focus on exporting	Such a focus would miss valuable opportunities like GoJek. Traditional export facilitation measures misses that HGEs internationalise through many different channels apart from simple goods exports: joint ventures, FDI, acquisitions, and supply chain partnerships. In addition, most HGE-driven export growth comes from services, which is subject to different dynamics and constraints compared to goods exports.
Focus on start-ups and young firms	Most instances of high SME growth come from the existing SME population, resulting from growth triggers such as MBOs, MBIs, acquisitions, market opportunities, or regulatory changes.
Focus on organic growth	Growth through acquisitions, mergers, supply chain virtualisation, or joint ventures are often a much more efficient way to deal with a sudden boom in demand by consumers or clients.
Focus on transactional support	In many surveys, high-growth entrepreneurs stress the importance of relational forms of support: mentoring, strategic guidance, and organisational development. By far the highest success rates are clocked up by business angel networks, which combine investment with engagement from an experienced entrepreneur with a wide network and a personal and financial stake in the venture.

So what can countries do to adapt existing or design new policies that meet these needs?

- *Adapt policies to the institutional environment*: take a close look at what is there and what can be done using those capacities, and what is needed in addition
- *Ensure additionality*: support should build and encourage, rather than distort or even replace, the private sector and markets
- *Ensure neutrality and transparency*: use clear criteria, quantifiable objectives, and avoid targeting based on sector, location, size if not clearly linked to what policies should achieve
- *Ensure policy complementarity*: The success of HGEs will be strongly linked to other policies and dynamics

Overall policy implications

- HGE support policies to combat market failures make sense;
- Focus on sustainable growth and social return (spill-over effects);
- Manage the co-existence of general and HGE-specific SME and other private sector development instruments;
- Comprehensive approach needed, across sectors and functions;
- Avoid focusing on specific industries;
- Create the right framework conditions;
- Enhance coaching opportunities and networks;
- Improve growth finance, especially venture capital;
- Improve internationalisation opportunities.