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Defining SMEs:
A Less Imperfect Way of Defining Small and Medium Enterprises in Developing Countries

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Summary:

Within the community whose work it is to promote economic growth in developing countries, the role of small and medium enterprises ("SMEs") remains a topic of debate. This debate has been badly served by faulty definitions. As career practitioners in SME finance, we review in this paper how SMEs are defined for developing countries, how such definitions are used, and why this matters. We argue the following:

1. The inadequacies of current conventions in defining SMEs and the inconsistencies among official SME definitions can lead to serious distortions in the allocation of donor spending for private sector development.
2. The volume of turnover of a business is in general a more appropriate measure of its relative size than either of the more conventional measurements by number of employees or value of assets, when adjusted as described in the text.
3. The use of any single definition of SMEs for multiple countries in diverse stages of economic development leads to additional distortions.

In the analysis, we describe some of the key qualitative characteristics of SMEs, beyond simple numerical tests, which support the rationale for tax-dollar funded promotion of SMEs. In order to provide the sort of clarity currently lacking in SME policy, however, we propose for consideration a new quantitative *formula* for defining SMEs that blends the principles summarized above. Given that the economic contribution of SMEs depends critically on initial success in their home markets, we believe the size parameters of SMEs should be scaled relative to their home base.

To this end, the proposed formula is based not only the revenues of a company, but also takes into account the country-specific economic context in which the SME operates. By this formula, for example, an SME in Ghana would be defined as having annual turnover of between $23,700 and $2,370,000. [Editor's note: For the purposes of this paper, the use of the dollar sign refers to the U.S. dollar.] In Thailand, however, whose Gross National Income (GNI) per capita is five times that of Ghana, SMEs would be those companies with revenues ranging from $84,400 to $8,440,000. In the following pages, we explain the rationale and mechanics for deriving such ranges and juxtapose them to the almost inexplicable arbitrariness of SME definitions most commonly used now.

We believe this proposed change in the classification of SMEs can lead to powerful changes in policy recommendations. For example, its application would imply that the largest and most prosperous food distribution company in Malawi would not be the recipient of publically funded assistance, whereas a company in Mexico with the same turnover would and should be eligible, due its disadvantages in competing with large Mexican firms in its sector.

Introduction:

While it should be intuitively evident that SMEs are of special importance to private sector growth, there is considerable disagreement within development policy circles as to why, or even whether, this is so. Claims that SMEs are more efficient at creating quality jobs, are more innovative, or grow faster than larger firms have been questioned on the basis of large regression analyses or on the basis of examining company registrations and corporate failures. Arguments that the overall business environment in any given country is of greater importance than the development of the SME sector have apparently caused some in development to question whether taxpayer or foundation moneys should be spent on SME initiatives. The result is that the relative priority of SMEs, and therefore SME-related policy, in development is currently unclear.

A major contributing factor towards this lack of clarity is that few of these studies have used an informed definition of the "SMEs". Within the current debate over SMEs we suggest that there are four questions of fundamental significance that should encourage the development community to discuss and determine what the definition of SMEs *should* be. Once there is a clearer focus on the definition, then the appropriate policy towards SMEs in developing markets will also become clearer. The four key questions are:

1. Where do large firms come from?
2. How does a country best diversify its economy?
3. Which group of businesses, by size and degree of development, have the greatest incentive to insist on policy reforms and accountable, transparent government?
4. What, in its essence, is an SME?

This paper will briefly address each of these questions but will focus primarily on the fourth, as the resolution of this question is needed in order to resolve the others.

The Current Backdrop

For the past quarter century the widespread use of the term "SME" in the determination of economic development policy has implied first, that the segment of businesses occupying the space between microenterprises and large firms presents opportunities and challenges that are distinctly different from those of the other two groups. The claim that "SMEs are the backbone of the economy" has become virtual boilerplate for papers, presentations, and popular articles on private sector development. Almost invariably, however, this claim has been made in the absence of any rigorous data to support it and often without an effort to understand what an SME *is*.

As companion formulation to the "backbone" claim, one often sees the equally unuseful statement that "there appears to be no universally accepted definition of SMEs."

While both of these general claims are true, the passive acceptance of them has done more harm than good for the cause of private sector development in developing countries. The fuzziness with which development organizations and governments have defined what SMEs *do* and what SMEs *are* has undermined the very concept of "SME" – both as a discrete segment of the private sector and as a specific concern of economic development strategies.

A Dartboard of Definitions:

Imagine, for example, a discussion of SMEs among officials of the multilateral development institutions, each thinking within the context of the official definition of his or her own institution, as represented below by the maximum size criteria for SMEs.

Table 1: SME Definitions Used by Multilateral Institutions

Institution	Maximum # of Employees	Max. Revenues or Turnover ($)	Maximum Assets ($)
World Bank	300	15,000,000	15,000,000
MIF – IADB	100	3,000,000	(none)
African Development Bank	50	(none)	(none)
Asian Development Bank	No official definition. Uses only definitions of individual national governments.		
UNDP	200	(none)	(none)

Characteristic of the disparities among these definitions is the substantial difference between how the World Bank and the Multilateral Investment Fund (MIF) of the Inter-American Development Bank (IADB), let alone the African Development Bank (AfDB), define an SME. As Table I shows, the World Bank's definition includes businesses three times larger by employees and five times larger by turnover or assets than the largest SME under the MIF definition. At the same time, the average gross national income per capita (PC-GNI) of the developing member countries of the World Bank Group is significantly *less* than the average PC-GNI for the countries of Latin America and the Caribbean served by the MIF. Whatever explains this disproportionality between the two definitions, it is unlikely to be a scientific distinction. Nor are explanations for these substantial differences articulated by these institutions. Note further that none of these institutions set a *minimum* definition for SMEs, which in our view gravely compromises any conclusion that can be made.

Indeed, it has unfortunately become popular to adopt the acronym "MSME" (micro, small, and medium enterprise). We have learned in our experience with SME entrepreneurs that whether their firm is classified as a "small" or "medium" in size, most entrepreneurs have in mind a future in which they have sales equivalent to hundreds of thousands or even millions of U.S. dollars − and in which their businesses are not "micro" by anyone's imagination. This ambition with respect to the magnitude of their businesses is within neither the imagination nor the foreseeable capacity of any but the rarest of

microentrepreneurs, and certainly such an insufficient number of them as to preclude the expectation of any natural continuum from micro to SME.[1]

Consider also, within the same context, the official definitions of SME used by national governments. The following geographically and economically diverse group of countries is listed first by each country's rank in PC-GNI and then by their rank as to the maximum employment of an SME according to the national government.

Table 2. Official National Definitions of SMEs

Country by PC-GNI	Maximum # Employees
Norway	100
Switzerland	250
Australia	200
Brazil	100
Belarus	250
Thailand	200
Peru	200
Moldova	250
Morocco	200
Egypt	50
Nicaragua	100
Pakistan	50
Vietnam	300
Bangladesh	100
Ghana	100
Tanzania	20
Malawi	50

Country by SME Size	Maximum # Employees
Vietnam	300
Belarus	250
Moldova	250
Switzerland	250
Australia	200
Morocco	200
Peru	200
Thailand	200
Bangladesh	100
Brazil	100
Ghana	100
Nicaragua	100
Norway	100
Egypt	50
Malawi	50
Pakistan	50
Tanzania	20

Logically, these rankings should at least *tend* to be similar.[2] One could assume that the wealthier the economy, as defined perhaps by per capita income, the larger the size of any business considered to be small or medium relative to other businesses in the country. Yet the largest Vietnamese SMEs are, officially, three times the size of the largest Norwegian SMEs. What is officially an SME in Egypt may not exceed half the size of the upper limit in Ghana, despite the fact that Egypt's PC-GNI is roughly three times as large.

[1] In this regard, we have a particularly telling anecdote to offer: In 1998 we were doing the advance work for an SME risk capital fund in Bolivia to invest the range of $100,000 to $750,000 and as part of that visit, met with the CEO of BancoSol. BancoSol would finish 1998 with a spectacular 28.9 percent return on equity to its shareholders, making it one of the most profitable banks in Latin America and one of the most successful micro-lending institutions in the world. Yet we learned from the CEO that perhaps only one or two of its 200,000 borrowers had grown its enterprises to the point of being able to productively absorb financing of as much as $100,000, the minimum for our nascent fund. In our view, this shows that the supposed continuum from microenterprise to SME seems to be largely mythical.

Some of the strange "results" from the analysis of the impact of SMEs on their economies or net job creation now becomes somewhat clearer. If an economist or policymaker were to analyze the impact on net job creation of SMEs in Ghana, for example, he or she would have the choice of several "official" SME definitions, in which any of the employment maximums of 50 (AfDB), 100 (GoG), 200 (UNDP), and 300 (World Bank) might be used, and *in which no minimum modifier of any sort is used at all*.

The UNDP and World Bank definitions would include the manufacturing subsidiaries of both Nestle and Unilever[3] in Ghana, clearly not the intended objects of development inter-ventions. The World Bank definition would include the majority of Ghana's top 100 manufacturers. All would include microenterprises, to the extent data exist for these enterprises. It is thus evident why various policy papers are substantially out of sync with each other.[4]

"Complicating the Dialogue"

In the table below we simply show the upper employee cutoffs used in cross-country definitions as they compare with the official definitions used for Bolivia and Cameroon by their governments:

Country	PC-GNI	Govt. Cutoff	Upper Employee Cutoff			
			World Bank	UNDP	IADB	AfDB
Bolivia	1,010	50	300	200	100	50
Cameroon	1,010	200				

Given the similarity of the two countries, one can imagine representatives of these development organizations meeting to compare SME strategies with policymakers from the governments of the two countries. What is hard to imagine, however, is that the participants in this discussion could all possibly be talking about the same thing, given that:

(1) the World Bank definition would include companies in the top 50 firms of either country;

(2) AfDB's maximum for medium enterprises would not even include medium enterprises at the World Bank;

(3) IADB's definition includes companies twice the size of those included in both AfDB's and the Bolivian government's definition; and

(4) Cameroon's official government definition includes companies four times the size, by employee count, of the largest identically labeled "SMEs" in Bolivia, despite each country's having a per capita GNI of $1,010.

This is what we mean by "complicating the dialogue."

Evidently, we are far from an international consensus on what constitutes an SME. In the following pages we provide examples of how these disparities among SME definitions complicate the SME dialogue and open doors to misdirection of donor resources. In proposing an alternative approach, we do not imagine that any formula for defining SMEs will be perfect. Rather, we believe that what is urgently needed is something *less imperfect* than the current mosaic of SME definitions in common use. At least, we would hope ultimately to precipitate new thinking on the subject among policymakers and the donor community.

[3] Company rankings by number of employees reflect Dunn and Bradstreet marketing data as of February 2007 and include all manufacturing activities within the 20-39 series of SIC codes published by NAICS

[4] The term "enterprise development," subsuming businesses of all sizes into a single category, has come into use under the increasingly popular assumption that what is good for one is good for all. For example, in 2005, the former "Committee of Donor Agencies for Small Enterprise Development" became the "Donor Committee for Enterprise Development."[4] We expect that searching for a cogent analysis of the impact of any given policy on the inhabitants of this "big tent of MSMEs" will surely lead to meaningless conclusions.

What's at Stake?

At one level, the issue of SME definitions comes down to eligibility for special support. National governments, multilateral and bilateral development institutions, and NGOs support SME development with a varied menu of interventions, including billions of dollars in special credit lines and loan guarantees, firm level business development services and technical assistance, and fiscal incentives, such as tax holidays for early-stage companies. The presumed intention of SME policy is to provide this assistance to enterprises that need them most and are able to use assistance in order to help grow further under adverse conditions, for the good of that particular economy/society.

The Four Questions:

At a more profound level, however, the issue of SME definitions is directly related to our fundamental understanding of private sector development. We mentioned at the beginning of this paper that there are four questions that we feel are essential to assessing the role of SMEs. The first, *where large businesses come from*, is particularly significant at present. In most typical developing countries, natural resource extraction, privatization of state industries, and subsidiary operations of multinational corporations have in the past given rise to large firms that were born as large firms. Yet, such sources of large enterprises will clearly not generate anywhere near the number of *additional* new private firms as in the past.

Accordingly, the development of large companies will need to rely more than ever on a modified version of the trajectories followed by Microsoft, Apple, Ford Motor Company, Federal Express, Mattel Toys, Kellogg, and Westinghouse, all of which began small. With the exception, then, of privatized state-owned enterprises or natural resource monopolies, large, successful firms will arise from growing SMEs. Stated differently for policymakers, the more useful the support that growth-oriented SMEs receive, the more likely large firms will evolve from them. The key policy question then becomes whether we can differentiate at all as to which companies in the universe of MSMEs are likely to grow and which are not.

The second question asks *how do countries diversify their economies*. The importance of this question is self-evident. Single commodity exporting countries have long been victims of booms and busts, leaving little behind but unused buildings and roads that are soon washed out or overgrown. To provide sustainable opportunities for its citizens, an economy needs a diversified base that will serve consumers while fostering local comparative advantages, creating jobs and sustaining the global economy. Although it is not the task of this paper to further demonstrate the importance of such diversification, we note an increasing literature which examines and concludes that SMEs play a central role in poverty reduction as "connectors" of local economic activity.[5]

[5] Three useful studies in this regard are: the collection of essays, "Transforming the Developing Landscape: The Role of the Private Sector" edited by Lael Brainard. Brookings Institution, 2006, http://www.brook.edu/press/books/transformingthedevelopmentlandscape.htm; "From Poverty to Prosperity: Understanding the Impact of Investing in Small and Medium Enterprises," a data survey and case study analysis published by

The third question asks *which group of businesses, by size and degree of development, has the greatest incentive to insist on policy reforms and accountable, transparent government.* Predictably, it is those businesses that cannot impose their prices or conditions on others. In other words, businesses without significant market power have the most urgent incentive to push for level playing fields and to insist on accountability and transparency from government. Large enterprises, which often benefit from or even depend upon special privileges, will often have the incentives and the means to stifle competition and reform. Microenterprises are unlikely to show much interest in reform, being typically able to survive in the shadows away from the direct effects of oligarchs and government toll-takers. But SMEs in this context are by definition *not* the largest enterprises in any given economy. This insight brings us back to the formula for defining SMEs introduced in this paper.

Improving the Quality of SME Policy:

As we hope the preceding discussion makes clear, ,what is really at stake in considering what constitutes an SME is the quality of future discussions and formulations of SME policy, particular if we are at the point of a significant debate over the role of SMEs in developing economies. Which businesses, we should ask, are most likely to grow, reduce poverty, promote economic stability and, ultimately, undergird political stability? We believe these constitute the *relevant* SMEs, and these in turn are the SMEs that should be supported.

Toward a More Relevant Definition of SMEs

We hope the discussion so far has helped the reader to understand that the current multiplicity of SME definitions makes SME policy analysis, and therefore SME policy, virtually random. This leads us to ask, however, is it possible to use only one definition of SME? Is it possible to usefully translate the functionally important attributes of *relevant* SMEs into more conventional data, such as number of employees or turnover rates?

It seems clear that SMEs are more meaningfully defined by their functional and behavioral attributes than by Procrustean quantifications of employees, assets, and turnover. These functional characteristics are important to monitor, as they often define the very reasons for which taxpayer money is used to support SME development. However, given the impracticability of quantifying such attributes for large numbers of companies, a reasonable proxy for them must be found among the three conventional measurements. Before

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Small Enterprise Assistance Funds (SEAF), October 2007; and a report presented by David Rusnok of the German development bank, DEG at the March, 2004 IFI Working Group Meeting in Tunis, "Financing SMEs and Evaluation of their Development Effects with DEG's Corporate Policy Project Rating." These latter two efforts provide evidence that SMEs provide significant developmental effects in the areas of technology and know-how transfer, stewardship of the environment, and above and particularly in comparison with large firms, employee training leading to wage acceleration.

presenting our version of that process, however, we should review what we see as the less easily quantifiable characteristics of SMEs for which we believe a workable proxy is needed.

After nearly two decades of investing in SMEs on four continents, we find that SMEs, as distinct from microenterprises, are in general:

- formal, that is to say, registered with government ministries or other registration bodies;
- obligated to pay taxes and social security charges, as they are generally too large or visible in the community to avoid paying such governmental charges;
- able to allow their employees to take sick leave and vacations while receiving compensation;
- able and generally willing to provide formal skills training for their employees and providing such training for a substantial percentage of such employees;
- able to finance accounts receivables;
- able to invest in capital with a payback of longer than 12 months; and,
- able and inclined to voluntarily organize or contribute to local community projects or to make some charitable contributions.

There may be some microenterprises to which one or even a few of these attributes apply. However, taken together, the foregoing characterize SMEs and not micro-enterprises.

Similarly, there are organizational and behavioral attributes which some SMEs share with large firms. Nonetheless, as compared to large firms, SMEs are:

- less likely to have significant personal contacts within high levels of government and the financial sector, and therefore less able to negotiate special fiscal incentives or influence government benefits ("corporate welfare" or "sweetheart deals");
- therefore less likely to be involved with government corruption;
- more often managed by their owners, more centralized in their management, with substantially weaker delegation and departmentalization;
- more focused on short-term needs and medium-term survival than on long-term profitability or market share;
- less able, and less inclined, to prepare and follow business plans;
- less technologically sophisticated and slower to take advantage of available and affordable technology;
- more flexible and able to adapt quickly to changes in the economic and regulatory environment;
- more often only able to hire (and therefore compelled to train) unskilled workers who generally will not meet the hiring criteria of large firms;
- more likely to be deeply rooted and active in one community; and,

- more dependent upon personal relationships between management and workers and between management and customers.

In Search of a Common Proxy

What measurement of business size is most likely to describe businesses having the attributes listed above as well as the many other SME attributes on which people most familiar with SMEs would agree? What proxy is most likely to exclude businesses which are either too large and mature or too small and informal to be characterized this way?

Following, we explain what we see as the principal inadequacies of using employment as the standard size determinant. We then dismiss fairly quickly the use of asset size in SME definitions before describing why we believe that turnover provides a far more accurate measurement to serve as a proxy for the many more poignant attributes of SMEs. Finally, before presenting our proposed definitions, we defend our recommendation to merge "small" and "medium" into a single category.

Definition by Employment:

Defining SMEs by number of employees suggests, incorrectly, that the larger an enterprise is, the more employees it will have, and that to grow it must take on more employees. This latter notion would certainly not be welcome among Wall Street analysts of public companies and should be no more welcome among proponents of SME development. Cross-country studies and multi-country policies that use numbers of employees to define SMEs run the risk of classifying businesses by their inefficiency or their lack of value-addition.

In many developing countries, labor regulations and social security laws impose what amount to penalties for hiring full-time employees. Employee-related taxes are often so high as to constitute an undisguised form of income tax. This encourages the common practice of hiring nominally part-time labor, "consultants," or "students" who do the work of otherwise full-time employees but on whom their employers are required to pay neither employee taxes nor social security taxes.[6] These workers often outnumber full-time workers and are generally not reflected in the government statistics on which economists and policymakers often base their work.[7]

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[6] The problem of "true counts" is inevitable in certain sectors and industries, particularly agribusiness, where work is legitimately out-sourced or seasonal. For example, when independent farmers sell 100 percent of their production to a food processing business that supplies all their agricultural inputs and owns the land on which they grow, are these farmers not part of the direct employment generation accomplished by the business? Should they not be counted as employees, despite their disqualification under official guidelines? Similar undercounting occurs in companies such as retail chains and certain types of franchise operations where sales staff have the technical status of consultants or contractors, despite their functional status as a single company's sales force.

[7] A core obstacle to SME development are the high initial costs of formalization. It can be argued that countries that overvalue the development of the informal sector run the risk of an "informality trap," where successful

The practice of minimizing the full-time workers' share in the total man-hours of a company's labor also has the effect of permitting a company whose actual, but unstated, number of full-time employees would make it too large to be eligible for SME support under employment-based definition, if those employees were included in the count. Alternatively, in countries with plentiful low-skilled labor available, a rigid cut-off could penalize enterprises utilizing more labor as an appropriate substitute for more expensive capital or technology.

Definition by Assets

It is surprising to us that the asset criterion for defining business size is still used at all, but in fact it remains an element of the definitions used by a number of development institutions. The deficiencies of this method would seem to be so obvious that there is little need to dwell on them any further than to provide a partial list of imperfections:

- SMEs rarely have a precise estimate of the value of their fixed assets and generally minimize them in environments where substantial asset taxes are imposed.
- Governments are inconsistent with regard to what they count as assets when defining business size. Many use fixed assets and land while others use only fixed assets, thereby complicating cross-country comparisons.
- Where there is inflation, local currency values for various fixed assets are likely to be understating the "true value" of the assets, as a regular restatement of such assets is generally not required.
- As outsourcing-based SMEs become more prevalent and important in developing countries, the asset base of an increasing share of growth-oriented companies will be defined by rapidly depreciating personal computers and mainframe-terminal networks. In these situations, the value of fixed assets can decline even as revenues and employment increase.
- Just as employment-based definitions tend not to recognize labor efficiency, asset-based definitions tend not to recognize capital efficiency.

Definition by Turnover

If you ask any entrepreneur (assuming you are not a tax inspector) how big his or her business is, the response is *not* likely to be, "I'm up to 100 employees now," or "My net asset value is up to half a million." Rather, you are more likely hear, "We had 2 million in sales last year." If you are trying to sell a developing country business that has recently graduated from SME to large, you will surely not promote it on the basis of how many people it employs. Rather, as investment professionals who have actually sold such businesses will

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entrepreneurs will forego scale in return for "savings" on charges which they would otherwise have to pay, and which the informal businesses do *not* pay.

tell you, you will pitch it first on the basis of its growth in sales and market share, and only later, in more detailed negotiations, will the focus turn to EBITDA multiples and net asset values. In the world of developing country SMEs, where employment figures and profits are often seriously blurred by tax considerations, one might say that sales are the measure of all things. A definition based on turnover would seem to be both realistically measurable and meaningful.

Of the three conventional measurements, measurement of business size by turnover also most closely reflects functional and behavioral attributes. Although it is wise to consider the SME entrepreneurs' points of view here, we base our thinking on three more mechanical advantages to turnover-based definitions:

1. Indexation to the US Dollar:

Revenues in any country can be converted to dollars and the U.S. dollar, for better or worse, is still probably the most recognizable unit of measurement. It is clear, however, that the dollar value of a particular enterprise's turnover may place it higher or lower in the business size spectrum in one country than in another. The dollar's purchasing power will vary as well. However, when two or more parties talk about dollar value in sales, they are talking about exactly the same thing. By contrast, what constitutes an employee varies considerably from instance to instance and what is meant by an asset, never mind the value of that asset, varies considerably among governments and among institutions. Measurement in US dollars sales is thus universal and convenient.

2. *Cross-Industry Consistency:*

A firm with $1 million in turnover is a $1 million business in any sector. A firm whose business is performing genetic analysis of pharmaceutical tests will probably be a more sophisticated firm than a stone cutting business with identical sales volume. Yet, while differences are likely to exist at this level of revenue, the odds are that the two companies will share a number of the organizational attributes mentioned above as typical of SMEs, such as a substantial amount of employees, a base of recurring revenues, and formal recognition by government authorities, as well as probably a relative over-centralization of management, weakness in planning, and a lack of well-placed connections within the financial and public sectors.

The profit margins of the two businesses will probably differ considerably as well. Margins vary from industry to industry, arguably making a $1 million business in one sector a more significant business than a $1 million business in another.[8] Nonetheless, profit margins vary far less among SMEs in the same sorts of industry sectors than do labor requirements. The vast majority of going concerns producing $1 million in turnover in any given sector will fall within a 5 percent to 25 percent gross profit margins. By contrast, among companies with identical employment, say companies employing 100 persons, or having similar stated asset values, revenues can easily vary by orders of magnitude more.

[8] As an example, a distribution business or retail store with a turnover of USD 1 million is likely to be far less significant than a software company with the same amount of sales.

An additional, related benefit of the turnover-based approach in cross-industry definitions is that it allows us to un-tether from the manufacturing sector as the dominant standard and the default proxy for all industries. Among the many distorting influences of employee-based and asset-based measures of business size is that both these measures serve to maintain the impression that manufacturing is most typical of the SME sector in developing countries. This assumption is patently not true, as it excludes agriculture, the largest sector in many low-income countries, as well as the rapidly expanding service industries.

Instead, it seems that data is simply more readily available for the manufacturing sector.[9] As in the case of revenue figures, data for agricultural and service businesses will be harder to come by than for manufacturing. Nonetheless, the claim of inconvenience does not immunize us from misleading assumptions or results. No matter how we seek to control for biases mathematically, if we use misleading definitions for our variables, we will ultimately be misled. If we measure something which does not reflect the typical SME, we should not be surprised if what we find as a result of analysis does not have relevance for the typical SME either.

Determining eligibility by referring to the level of turnover should not pose a serious obstacle to SME policy. Asking for, and receiving, revenue figures from an SME applicant, whether it be for a loan under an SME credit line or a business development service under a technical assistance program, should be *de rigueur.*[10] Banks, of course, require and scrutinize financial statements before making a business loan and, only the most superficial of business services and technical assistance would not require an understanding of a business's sales in order to be effective. Turnover information may not always be accurate, but the magnitude of turnover is generally either available or relatively easy to extrapolate. And as we have seen, gaining information as to employment or assets is fraught with at least as many problems.

De Jure Merger of "Small" and "Medium"

We obviously see substantial differences in the needs and functionality of SMEs when compared with both microenterprises and large firms. In our experience, however, we see much less, if any, such differences between small and medium companies. It is perplexing that while many governments and development institutions define "small" and "medium" separately, only rarely does this distinction then carry forward into issues of eligibility and scholarly assessments of the SME sector. If small businesses are provided the same benefits as medium businesses and studies of SMEs make no distinction between the two, we see little reason to continue to use such distinctions. Indeed, it is surprising that the

[9] In fairness to this issue, Beck et al. (op.cit.) concedes that the authors would have preferred not to have been dependent on figures for the manufacturing sector alone, but that such information for agriculture and services was insufficiently available. However, it is our view that searching for the answer in the wrong place is not a justification for making conclusions on such a basis.

[10] SEAF has made more than 270 investments in SMEs in more than 25 countries, and has analyzed roughly 50 times as many candidate SMEs. Obtaining accurate turnover figures from these applicants has generally not been difficult. Obtaining accurate taxable income figures, by contrast, has been painful.

distinction has not atrophied from disuse. Where it is used, however, it needlessly undermines recognition of the essential attribute of SMEs: dynamic growth. We therefore think it is time to make the *de facto* merger of "small and medium" a *de jure* recognition of "SME"[11] as a single size group, or "developmental asset class."

If there is a purpose to the practice of separating small from medium it is a cosmetic device to make SME definitions seem less broad by dividing them into two narrower groups. The better way to make SME definitions seem less broad would be to actually make them less broad. The best way to do this is by slicing off from either end the enterprises which, in the context of where they operate, ought to be considered microenterprises or large firms.

Defining SMEs by Formula:

The differences in the stage of private sector development among various countries and even regions within countries are significant, making the use of one absolute number of turnover, or any other firm size measure misleading. Recalling our key questions at the outset of this article and the characteristics listed above (page 8), what functionally constitutes an SME in Norway differs greatly from what constitutes an SME in Ethiopia and we need to adjust the turnover-related definition for an SME accordingly. We propose an adjustment to be made according to a formula, by that we mean a single algorithm which will scale turnover figures such that *nominal* cutoffs will vary according to the degree of economic development of the countries to which they apply. Nonetheless, applying this formula retains the virtue of applying a single method for determining those cutoffs consistently across all countries. The distinction we are making is between *nominal* comparability and *proportional* comparability, closely analogous to adjusting absolute GNI to GNI adjusted by purchasing power parity.

We have stated our case for using turnover as the defining measurement of firm size. What turnover figures alone do not ensure, however, is consistency in the definition of businesses by *relative* size within their own environments, an aspect of firm size measurement which seems rather naïve to ignore. For example, a meat processor with $1 million in turnover in Haiti is, within its environment, a much larger company than a $1 million meat processor in Poland. The relative difficulty of achieving $1 million in sales in Haiti is simply not comparable with that of achieving $1 million in sales in today's Poland. The $1 million meat processor in Haiti is likely to be one of the largest meat processors in Haiti, enjoying advantages, contacts, even "privileges" attendant to its position as an industry leader. By contrast, the Polish company with equivalent sales would rank as a far smaller business among Polish meat processors and by contrast with the Haitian company more likely to suffer from the disadvantages, lack of contacts, and vulnerabilities attendant to its small size.

[11] There are those who, quite reasonably, call for elimination of the term SME and replacement of it with "small business." We note, however, that most of the people recommending this change are from the U.S., where the term SME is not regularly used, and where "small business" imparts a particular flavor of industriousness, and is viewed favorably by policymakers and somewhat protected. Elsewhere, SME would seem to be well ensconced and difficult to unwire.

Were eligibility for assistance and other SME development policy based on nominal size alone, regardless of the unit of measurement used, then one of the largest companies in a particular industry in Haiti would be treated identically to one of the smaller companies in that industry in Poland.

This problem occurs as well with what Beck sees as a virtue of using an absolute number of, say, 250 employees as the cutoff for SMEs in 54 of the 76 countries it studies:

> "SME250 is the share of the SME sector in the total labor force in manufacturing when a level of [up to] 250 employees is taken as the cutoff for the definition of an SME. This variable provides us with a consistent measure of firm size distribution across counties."[12]

We agree that using "SME250" is a consistent measure at an absolute level. However, to say that firm size is consistent is quite different from saying that such consistency is *relevant*. Indeed, what relevance to economic development strategies is a comparison of the largest firm in a sector in Haiti with a relatively small Polish company in the same sector, particularly when in doing so, we ignore the differences in *functional attributes* between the two.

By analogous situation presents itself when we try to compare economic welfare across countries using GNI and GNI/PPP. Both GNI and GNI/PPP can be used consistently, but their appropriateness will vary according to use. GNI is an effective way of comparing the size of a country's economy with that of another country. GNI/PPP, however, has become the standard for comparing standards of living and "income gaps." This is because GNI/PPP recognizes that a unit of currency is simply a proxy for purchasing power and it is purchasing power *itself* that determines standards of living rather than absolute numbers of dollars. In this context, GNI/PPP best reflects the functional attributes, or meaning, of a given absolute amount of income to the citizens of each respective country; GNI simply reflects how much money there is the national income. Both are consistent numbers, but GNI/PPP is far more *relevant* to measuring levels of wealth and poverty within a country, given that the meaning of a dollar in one country will often vary considerably from the meaning of a dollar in another. By contrast, the SME250 measure, or even a simple turnover number, does not adjust for productivity or relative labor costs, or in any other way differentiate between what can be very different contexts.

A firm with 250 employees in Belarus, Burundi, Ecuador, Kyrgyzstan, or Vietnam is going to be a much larger company by percentile rank in its own country, having far greater market power, influence, and ability to grow without special assistance, than it would be in Austria, Finland, Japan, Mexico, or the United States. The failure to distinguish firm size across countries from relative firm size within a country is our central complaint with the multi-country SME definitions in widest use today. It is also the problem we address with our recommendation to further qualify the turnover-based methodology by adjusting it to the

[12] Beck, p. 11.

economy in question. For the purposes of consistency and relevance, we would impose a formula on measurements of firm size, just as GNI/PPP imposes a formula on GNI.

An Alternative Formula for Defining SMEs

As we hope to have made a clear case for, any satisfactory definition of an SME should have the following three elements:

1. Replacement of a single *nominal* maximum cutoff (e.g., maximum 250 employees) in defining SMEs for *all countries*, with a simple *formula* which adjusts a single, accessible concept to provide a *relevant* definition of SMEs, taking the context of *each individual country* into account.
2. Adoption of annual *turnover* as the single best measurement of business size.
3. Designation of *"SME" as a single size category* within a defined range, thereby dispensing with the meaningless segregation between "small" and "medium," and the establishing of minimum as well as maximum criteria, excluding microenterprises from the SME group.

Conceding that no definition can be perfect and that any definition must be subject to both exceptions and further qualifications, we propose the following for consideration:

Proposed Formula for Defining SMEs

An SME is a formal enterprise with annual turnover, in U.S. dollar terms, of between 10 and 1000 times the *mean* per capita gross national income, at *purchasing power parity,* of the country in which it operates.

The Reasoning Behind our Variables and Constants:

By introducing a formula into the definition, other variables (such as population, sectoral distribution of economic activity, and even Gini coefficients[13]) could have been chosen for their relevance to comparative firm size. However, for the purpose of provoking a reconsideration of current definitions, we prefer a formula using simple and easily available data.

At first glance, the use of 10 and 1000 multiples of turnover for the lower and upper cutoffs may seems arbitrary, though they could hardly be more arbitrary than setting cutoffs

[13] On a cursory examination, this measure of disparity in income distribution appears to show some correlation with the distribution of enterprises among micro, SME, and large enterprises, with greater disparity tending to shrink the SME segment. As such, this apparent correlation may provide an interesting subject for further study. However, we feel that it cannot be wisely introduced into the SME definition without the benefit of appropriate protocols and regression analysis. For the sake of simplicity, our preference remains to use variables which are already easily available and regularly updated.

globally at 250 employees or 100 employees or $10 million in assets or $15 million in turnover as do conventional definitions. However, this broad range introduces both a critical *lower* boundary and the equally essential attribute of dynamic growth to the definition of SME as a developmental asset class. To our knowledge, none of the conventional employment or asset-related parameters has ever been justified by research. Rather, they seem to have been derived in relation to other such arbitrary cutoffs. Our use of 10 and 1000, by contrast, is more inductive than deductive: the results they produce simply argue in their favor for those who truly understand the nature of SMEs.

By "dynamic growth" we mean that SMEs are able to grow from quite small to an economically significant size. By contrast, as we underscored above in the anecdote about BancoSol's clients, microenterprises rarely grow out of their category and in most developing market economies large firms have, in the past, typically begun as large firms. SMEs typically start out larger than microenterprises, requiring larger initial investment (say, $100,000 as opposed to $500 or $5,000) and frequently have the capacity to grow "out of the garage" into great multiples of their initial size.

Development professionals would be quite excited by a microenterprise with the potential to grow to $100,000 in turnover in three years. By contrast, SME financiers would be unlikely to even consider financing an SME which could not convincingly project sales of at least $500,000 within three years. Rather, SME investors typically look for companies which can grow from, say $100,000 in sales to $10 million within five years. At the same time, one should question whether or not SME financiers should call themselves such if they are looking to finance companies with *current* turnover of $10 million. The fundamental purpose of SME interventions and, therefore the definitions which direct their resources, should be to facilitate dynamic growth from small to large. The range of 10 times to 1000 times GNI-PPP reflects this defining function of SMEs within developing economies.

We use of per capita GNI because, along with GDP, it is simply the best known and most universally applicable measurement of the disparities among sizes of economies proportional to population size. Again, it is these disparities that we believe must be captured in any legitimate cross-country definition of SMEs. Furthermore, GNI data, both via the Atlas and PPP method, are published annually with updates by the World Bank, in rankings by country as well as by country income group, and are thus easily accessible.

Table 3 below, "Proposed SME Definitions," shows the definitions produced by our formula for the 14 low- and middle-income countries profiled in Table 1 above. Table 3 provides PC/GNI/PPP for each country and then the "Range by Country" which results when we multiply PC/GNI/PPP by our constants of 10 and 1000.[14]

[14] .We have intentionally omitted ranges for the three high-income countries which were used in Table 1 for comparison. Indeed, we find no purpose in insisting that a formula for defining SMEs for aid-recipient countries be appropriate for high-income countries.

Table 3. Proposed SME Definitions

Country	Country PC/GNI	PC/GNI at PPP	Turnover Range for SMEs *Lower Cutoff*		*Upper Cutoff*
Brazil	3,460	8,230	82,300	-	8,230,000
Belarus	2,760	7,890	78,900	-	7,890,000
Thailand	2,750	8,440	84,400	-	8,440,000
Peru	2,610	5,830	58,300	-	5,830,000
Moldova	2,501	2,150	21,500	-	2,150,000
Morocco	1,730	4,360	43,600	-	4,360,000
Egypt	1,250	4,410	44,100	-	4,410,000
Nicaragua	910	3,650	36,500	-	3,650,000
Pakistan	690	2,350	23,500	-	2,350,000
Vietnam	620	3,010	30,100	-	3,010,000
Bangladesh	470	2,090	20,900	-	2,090,000
Ghana	450	2,370	23,700	-	2,370,000
Tanzania	340	730	7,300	-	730,000
Malawi	160	650	6,500	-	650,000

Advantages:

The principal advantage we see in the proposed formula is, of course, that the local context is taken into account. It replaces the one-size-fits-all limitations of a single, nominal definition applied across diverse economies, while keeping a consistent *approach* across all countries. The formula provides for a separate definition for every country, adjusted consistently to the per capita size of its economy while, by using a broad turnover range, encompasses both minimums and maximum.

The other principal advantage of country-specific definitions is that they allow us to use PPP in a meaningful way, adjusting for the significant differences in exchange rates and purchasing power parities among countries. We have often wondered why the World Bank and other development institutions do not typically use PPP in determining, for example, loan size limits for SME credit lines, given the simplicity with which PPP can be introduced. We use PC/GNI/PPP for the same reason for which PC/GNI/PPP exists: Although a dollar is a dollar, it is, for most practical purposes, less money where it buys only a loaf of bread than where it buys a loaf and a half. PPP simply allows us an additional adjustment in favor of consistency with local economic circumstances.

It would be reasonable to ask why we would want to introduce the scaling of SME definitions to local economic conditions just as SMEs are being widely seen as potentially significant players in the global marketplace. Part of the answer to this lies in the often underappreciated importance of production and services for domestic markets. Anyone wandering the aisles of a large supermarket in Sub-Saharan Africa will see that 90 percent or more of goods on the shelf are imported while local products often collect dust on their ill-fitting tops, skewed labels, and inferior shelf-space. Even those SMEs with real export promise need first to establish success in their home markets, due both to relatively lower

transport costs, and to reduced vulnerability due to currency and potential trade restrictions.[15] And these SMEs will often need special assistance in finance, management, and technical areas along the way. Our purpose being to match SME definitions with the realities of SMEs' home markets, we propose a formula which reflects domestic context in preference to a perhaps more homogeneous global marketplace.

Disadvantages:

The most obvious disadvantage to the adoption of the formula we propose, or any similar formula which might improve upon ours while accomplishing similar objectives, is that it will require changes in policies, agreements and a multitude of other documents. This is an understandable obstacle to reconsideration of current practice, but not an adequate one. All improvement requires change.

Table 4, "Comparison of Proposed Definitions with Global Definitions," first juxtaposes, for the countries used in Tables 1 and 5 above, the definitions produced by our alternative formula and those used by the World Bank. We use the World Bank definition, not so much because we believe it to be in greater need of reconsideration than others, but rather because it provides a range of turnover for SMEs with which we can compare the range produced by our formula. We then compare the cutoffs from our figures to those of the World Bank. To establish a turnover range for the World Bank definitions, we use the range implicit in the UNDP's employment definition if it were proportionally consistent with the ratio of employees to turnover used by the World Bank. That is to say that the UNDP's 200 employee cutoff is two-thirds that of the World Bank's 300 and, therefore, its turnover cutoff would be two-thirds that of the World Bank.)

[15] The authors were involved with an SME fund in Bolivia of which the vast majority of enterprises were involved with exports—primarily to the United States and Argentina--when, in short order, the rapid devaluation of the Argentine peso, the import restrictions imposed in the aftermath of 9/11, and the radical changes in treatment of suppliers to Home Depot all coincided to damage the financial health of a diversified group of exporting SMEs, each of which had an all too limited domestic "footprint." In our view, far too much attention has been paid by donor institutions to pushing SME sectors into exports before they have realized even a fraction of their potential in their domestic economies. Similarly, the focus of economic development strategies has over-emphasized foreign direct investment (FDI) at the expense of more meaningful promotion of domestic investment. This view needs to be challenged or pursued by policymakers, given its significance for the generation of additional large firms in underdeveloped sectors.

Table 4 - Comparison of Proposed Definitions with Current Global Definitions

Country	Proposed Range			World Bank Range[16]			UNDP Range		
	lower		*upper*	*lower*		*upper*	*lower*		*upper*
Brazil	82,300	-	8,230,000	100,000	-	15,000,000	67,000	-	10,000,000
Belarus	78,900	-	7,890,000	100,000	-	15,000,000	67,000	-	10,000,000
Thailand	84,400	-	8,440,000	100,000	-	15,000,000	67,000	-	10,000,000
Peru	58,300	-	5,830,000	100,000	-	15,000,000	67,000	-	10,000,000
Moldova	21,500	-	2,150,000	100,000	-	15,000,000	67,000	-	10,000,000
Morocco	43,600	-	4,360,000	100,000	-	15,000,000	67,000	-	10,000,000
Egypt	44,100	-	4,410,000	100,000	-	15,000,000	67,000	-	10,000,000
Nicaragua	36,500	-	3,650,000	100,000	-	15,000,000	67,000	-	10,000,000
Pakistan	23,500	-	2,350,000	100,000	-	15,000,000	67,000	-	10,000,000
Vietnam	30,100	-	3,010,000	100,000	-	15,000,000	67,000	-	10,000,000
Bangladesh	20,900	-	2,090,000	100,000	-	15,000,000	67,000	-	10,000,000
Ghana	23,700	-	2,370,000	100,000	-	15,000,000	67,000	-	10,000,000
Tanzania	7,300	-	730,000	100,000	-	15,000,000	67,000	-	10,000,000
Malawi	6,500	-	650,000	100,000	-	15,000,000	67,000	-	10,000,000

Table 5, "Comparison of Proposed Definitions with Regional Definitions" compares cutoffs by turnover for our alternative formula with those of the MIF/IADB and the AfDB when turnover is derived on the same basis as for UNDP.

Table 5 - Comparison of Proposed Definitions with Regional Definitions

Country	Proposed Range			IADB/MIF Range			AfDB Range		
	lower		upper	lower		upper	lower		upper
Brazil	82,300	-	8,230,000	33,000	-	5,000,000			
Peru	58,300	-	5,830,000	33,000	-	5,000,000			
Nicaragua	36,500	-	3,650,000	33,000	-	5,000,000			
Ghana	23,700	-	2,370,000				16,700	-	2,5000,000
Tanzania	7,300	-	730,000				16,700	-	2,5000,000
Malawi	6,500	-	650,000				16,700	-	2,5000,000

Application:

[16] The World Bank's definitions are expressed as "up to" maximum limits rather than as ranges with upper and lower boundaries. We are assuming that if "micro" is "up to" 10 employees, for example, then 10 employees is the implicit approximate minimum for "small" enterprises, and so forth.

To demonstrate the significance of our approach, let us look at an application of SME definitions to a specific area of SME policy as it relates to one of the four questions we posed near the beginning of this paper. Specifically, let us see how our attempt at answering the fourth question; namely—*what is an SME?*—applies to the first question—*where are large businesses most likely to come from in the future of less developed economies*?

To promote the growth of a greater percentage of the universe of SMEs into new large firms in any given country, SME development policy will need, above all, to focus on mechanisms to improve SME access to long-term finance. There is little disagreement on this. Here the application of an appropriate SME size range to SME policy is crucial, particularly in the case of small companies undergoing significant expansion in their early years. Twenty years of working with SMEs has made it clear to us that it is through SME expansions that significant growth in revenues, wages paid, taxes paid, import substitution, and exports is most effectively achieved, often within 12 to 24 months from the beginning of the expansion. Therefore, we believe that any SME policy seeking to accelerate growth in the SME sector will need to specifically target expansion financing. In this light, we take the example of the World Bank Group definition in its application to long-term SME finance and compare it with the application of definitions resulting from or formula.

The World Bank Group and most of the multilateral and bilateral development institutions have invested in risk capital or venture capital funds for the specific purpose of providing access to cashflow-based finance for "SMEs." Unfortunately, most often these investments have been made in the absence of any application of a consistent or scaled SME definition within the policies governing them. For example, the IFC and Norfund of the Norwegian Government[17] have invested in one particularly well-known "SME" financing vehicle, the Aureos East Africa Fund (AEAF).[18] Among Aureos's investments is a $4 million investment in Tanzania which, combined with $4 million from Barclays Bank enabled Shelys Pharmaceuticals of Tanzania to complete a takeover of Beta Healthcare in neighboring Kenya. For decades, Beta Healthcare was principally owned by the family of former president Jomo Kenyatta, and neither company would be considered an SME in its home market. At the time of the AEAF investment, Shelys Phamaceuticals had fewer than 300 full-time employees, arguably meeting the World Bank upper limit for SMEs, and less

[17] See the May, 2007 announcement of IFC's Investment in Aureos Capital Limited, entitled "IFC and Aureos Launch New Initiative to Promote SME Sustainability" (http://www.csrwire.com/News/8435.html). Norfund, which states on its Web site, "Our job is to support small- and medium-sized enterprises (SMEs) which otherwise find it hard to attract capital," and refers to Aureos as "a global manager of SME private equity funds in emerging markets" in its announcement of its investment in the Aureos Southern Africa Fund (http://www.norfund.no/
index.php?option=com_content&task=view&id=81&Itemid=83).

[18] In citing the Aureos example, we could be reasonably accused of a bias or conflict of interest, given that Small Enterprise Assistance Funds (SEAF), of which we have both served as CEO, could be said to compete with Aureos in raising fund capital. Nor do we say that Aureos has not been rational in its investment choices, given the SME specifications. We use this example nonetheless, given that the difference in investment size between the SEAF funds and the Aureos funds has now become so significant that vey few investors consider them to be direct competitors and given the particularly dramatic differences between financing at the level of the Aureos Funds and at the level of SME credit lines such as the one in Zimbabwe described above. We also use this example because it represents an area of SME policy with which we are particularly familiar and where we have seen first-hand the results of errant definitions of SMEs.

than the World Bank limit of $15 million in annual sales. But it was the largest pharmaceutical company in Tanzania.

Another example: in its completion report for its 2001 Enterprise Development Project (EDP) in Zimbabwe, long before hyperinflation seized the country, the World Bank described the project as "reflecting one of the few cases in Africa where a line of credit effectively reached the SME target group." The report also noted that "the average loan size was about $25,000."[19] EDP credit was one of the few such lines to be limited not only according to the size of its loans, but also according to the size of its borrowers. To be eligible for financing, a company could have no more than 100 employees, only one-third the number permitted by the World Bank Group's official definition. Some 500 enterprises were financed under the project, which limited individual loans to $150,000. At the time, Zimbabwe's GNI/PPP was nearly three times that of Tanzania where AEAF's limit was $4 million.

Whatever policy perspective limited EDP's financings to $150,000 maximum and produced an $25,000 average loan ignored not only the World Bank's own SME definition, but more importantly ignored the typical financing needs of the kinds of growth-oriented SMEs *which are not currently but could eventually become* large companies. It also, at least, suggests that the $25,000 borrowers were probably either start-ups, which have a high failure rate in all countries, or small companies in the turnover range of well below $100,000. In other words, in 2003, when the EDP credit line was in effect, a Zimbabwean business with $500,000 in turnover generally had a greater chance of becoming a large, mature business than one with turnover of $50,000. Given that it would be atypical for a business with $500,000 in turnover to undergo a significant expansion into new markets with a loan of $150,000 or less, and considerably less likely with a loan of $25,000, the EDP credit line probably reached few, if any, SME expansion situations that led to new large businesses.

This is not to deny that many SME credit lines and loan guarantee programs through local banks also provide $25,000 to $75,000 loans to larger SMEs with revenues already well over $1 million. However, this kind of financing is generally allocated for additional working capital, minor plant improvements, or short-term trade credits. Such loans, while useful, rarely bring about the kind of change in a small business which launches it on the trajectory toward becoming a significantly larger one.

In short, a credit line with a limit of $150,000 and an average loan of $25,000 is likely to finance either companies too small to become large businesses or larger businesses in amounts too small to finance significant expansions.

[19] World Bank, Implementation Completion Report No. 25661, March 23, 2003. http://www.wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2003/05/17/000094946_03050704063882/Rendered/INDEX/multi0page.txt

Based on our experience and on evidence from other SME financing programs with which we are familiar,[20] the early expansion financing needs of SMEs with sales in the range of $200,000 to $2,000,000, pre-investment, typically require investment in an amount equivalent to 50 percent - 100 percent of their pre-investment sales. That is to say that an SME in a developing country with $500,000 in annual turnover will typically need around $375,000 to implement a major expansion and a company with $2 million in sales will typically need roughly $1.5 million.

Given our estimate that the required investment for typical SME expansions is equal, on average, to approximately 75 percent of pre-investment sales, then Table 6 below gives us an idea of the differences among the ranges of expansion financing which SME policies would dictate using different SME size parameters. Table 6 first compares the range of required financing implied by the the official World Bank Group definition for SMEs with that implied by the formula proposed herein for Tanzania and Zimbabwe,[21] using our 75 percent ratio of financing to pre-investment sales. It then compares the SME size definition implicit, on this basis, in the financing range used by AEAF in Tanzania and that prescribed by EDP in Zimbabwe. The table then provided the mid-point in each size range as a rough indication of the typical turnover and investment amounts implied in each definition. As a point of comparison, it also provides such ranges and mid-points for Argentina, one of the World Bank Group's most prosperous client countries.

Table 6 - Comparisons of SME Definitions and Investment Ranges

Source of Definition	Country PC/GNI/PPP	Definition Range by Turnover Min.	Max.	Mid-Point		Implied Investment Range Min.	Max.	Mid-Point
World Bank Group		100,000	15,000,000	7,550,000		75,000	11,250,000	5,625,000
Proposed Formula Tanzania (2005)	730	7,300	730,000	368,700		5,480	547,500	276,500
Proposed Formula Zimbabwe (2003)	2,180	21,800	2,180,000	1,100,900		16,350	1,635,000	825,700
Proposed Formula Argentina[22]	15,390	150,390	15,390,000	7,703.000		11,800	11,855,000	5,778,000
Source of Definition	Country PC/GNI/PPP	Stated Investment Range Min.	Max.	Mid-Point		Implied Definition by Turnover Min.	Max.	Mid-Point

[20] Based on the SME portfolio of Small Enterprise Assistance Funds, various feasibility studies for SME funds performed by Tom Gibson for other organizations, and reviews of portfolios under a number of SME credit lines.

[21] For Zimbabwe, we have used the GNI/PPP for 2003, the terminal year of EDP. Sadly, GNI/PPP for Zimbabwe today is likely to be at the bottom of the ranking. In terms of its economy, it is presently an entirely different country.

[22] 2005 figure as calculated by the Population Reference Bureau (http://www.prb.org/Countries/Argentina.aspx)

AEAF Tanzania	730	500,000	4,000,000	2,250,000		666,700	6,667,000	3,667,000
EDP Zimbabwe	2,180	(not known)	150,000	25,000 (avg. loan)		(not known)	200,000	20,000 (based on avg. loan)

What does all this mean for SME policy, particularly if one accepts our view that expansion financing is the key financing requisite for growth in the SME sector?

1) *The World Bank Group definition is inconsistent with World Bank Group financing policies.*

The typical turnover of an SME, if we use the midpoint of World Bank Group's definition by turnover range, would be $7,550,000. Anywhere in Sub-Saharan Africa (outside South Africa) and in much of Latin America and Asia, a company with $7.5 million in annual sales would be considered, at least, a medium- to large-sized, fairly mature firm with little need of special programs using taxpayer funding. Expansion financing at 75 percent of the turnover of such a company would exceed $5.5 million, too large for AEAF in Tanzania and 40 times too large for EDP in Zimbabwe.

2) The World Bank Group definition of SMEs, if applied, invites a financing policy which, in most developing countries, precludes expansion financing for businesses of the average size implied by the definition's mid-point.

A typical SME credit line, maximum loans of which generally range from $100,000, to $500,000, might offer a business with turnover at the World Bank Group mid-point of $7,550,000 a loan of, say, $250,000 for additional working capital or plant improvements. But, again, even a loan at the maximum amount of $500,000 is unlikely to be the cornerstone of any significant expansion for a company with over $7 million in turnover. The typical SME capable of becoming a large firm, having obtained at start-up a loan of perhaps $25,000 to $50,000, will generally need expansion financing of 10 or15 times that amount to entertain the possibility of becoming a large company. Therefore, the Zimbabwe SME credit line was unable to target the kinds of companies with the potential to expand the number and sector diversity of large businesses in the country.

3) The World Bank Group's definition permits investments in low-income countries in amounts so large as to dramatically diminish the amount of money available for expansion financing of what would locally be considered growth-oriented SMEs.

Aureos's $4 million investment in the acquisition of one established company by another in East Africa could have financed 10 SMEs needing an average of $400,000, or 16 at an average of $250,000, or even four at an average of $1 million. Even at the $2,250,000 mid-point of Aureos's stated investment range for AEAF, $500,000 to $4,000,000, six to eight investments could have

been made in the $250,000 to $500,000 range. While we do not suggest that the Aureos investment was not beneficial to both Tanzania and Kenya, a question must exist as to whether public taxpayer funds were used most effectively in this case for accomplishing SME growth and development in Tanzania.

Again, our argument is not that Aureos and EDP are not useful economic development in these countries. Rather, we argue that they have not targeted the very SMEs which are most efficient to promote. This answers not only to our first question, where do large firms come from, but also the second and third questions, namely, which companies are most capable of significantly diversifying these private sectors and which are most capable and most incentivized to persistently press for free-market and democratic reforms. The $4 million invested by IFC in AEAF and the approximately $40 million invested by the World Bank in EDP were assumed to have been spent on what has come to be referred to as the "missing middle." We would expect that the missing middle is no less likely to be missing in these countries as a result of these two programs, and that a policy that was more focused on the size of expanding SMEs would have achieved a more significant result. Some $44 million which, with better SME policy, guided by a better SME definition and a better understanding of the implications of those definitions, might have gone to 100 or more businesses with greater potential to enlarge and diversify the economy.

Now, let's look at the application of our proposed formula to financing growth-oriented SMEs. In doing so, however, we would underscore the following:

We do not suggest that our definitions should be used strictly for all SME interventions within any given country. Rather, we recommend they be used as a "flexible" guide or starting point in determining the most appropriate definition of SMEs to be applied to any given program or project. We also recommend that our definitions be adjusted to something equivalent to PC/GNI/PPP in sub-national regions, particularly in large countries such as Brazil where there are sizeable economic disparities among regions of the country. It may well be that our indicated target range should be larger or smaller depending upon specific issues in any given case. However, we believe that any such analysis should START with our analysis, as at least a benchmark to ensure that all parties are speaking addressing functionally described "SMEs."

That stated, let us examine the definitions resulting from the formula for Tanzania and Argentina. With PC/GNI/PPP of $15,390, our definition for SMEs in Argentina would be about $150,000 to $15,000,000 in turnover. The mid-point in this range would be $7,700,000, roughly the same as the mid-point turnover for an SME under the World Bank Group's present definitions. Therefore, we would say that the World Bank definition is appropriate to Argentina and that any project targeting SME expansions in Argentina would be correct to provide for financing in the range of $3.5 million to $7.5 million. At the same time, for Tanzania, with a PC/GNI/PPP of $703, we would recommend targeting SME expansion financing of up to $550,000.

Financing at the lower end of our SME definition for Tanzania, with a minimum turnover of just $5,500, would most likely be accomplished through credit lines targeting start-ups of companies which are both capable of and focused on significant growth or mezzanine investments. Distinguishing between start-up SMEs and microenterprises with financing in the $5,000 to $50,000 range is not nearly as difficult as it might seem. In our view, any business, in any country, whose entrepreneur-owner does not have at least a plan to exceed sales of $100,000 annually in its first three years is a microenterprise, not an SME. This distinction is surprisingly easy to determine through a very brief conversation with the entrepreneur.

To better understand the reasoning behind scaling SME investment size to the size of the economy in which the investment is made, one need only compare Tanzania and Argentina. Tanzania's total GDP of $14 billion is less than one-fifteenth that of Argentina's $214 billion. It follows that the total market for virtually any good or service in Argentina will be at least a magnitude larger than in Tanzania. To capture a significant portion of a particular market in Argentina will take a far larger business than needed to take that same market share in Tanzania. Logically, therefore, the amount of expansion financing required for the Argentine business will be far larger than the expansion financing needed by the Tanzanian business. Indeed, to take equal market shares in the same product or service may require for the Argentine company something in the neighborhood of a $6 million investment—near the mid-point for SME financing we suggest in Table 6—while the Tanzanian company requires only $300,000, again as we suggest in Table 6.

To say that the size of SMEs in Argentina and Tanzania are one and the same is simply illogical. To implement policy that provides for the same range of financing for Argentine SMEs as for Tanzanian SMEs amounts to the same the absence of logic *applied*.

Summation:

We hope that in the foregoing article we have persuaded readers of, at least, the following principal conclusions, more or less in this order:

1. The degree of diversity and conflict among official SME definitions is currently so great that it borders upon, or surpasses, irresponsibility not to reconsider how they are derived and applied.
2. Multi-country definitions of SMEs cannot legitimately be said to be consistent among countries if they do not take into consideration the differing levels of poverty among such countries and the differing levels of relative competition among private enterprises.
3. Official national definitions vary too greatly in proportion to national economies for responsible use by international organizations.
4. In order to avoid further distortions in the generation of SME policy and the resulting misapplication of funds, the major multilateral development institutions should take steps, as a group, to introduce some coherence of

rationale among their SME definitions and encourage the same for individual national governments.

5. Microenterprises and SMEs are distinctly different, do not naturally elide in an unbroken continuum, and cannot be usefully discussed together.

6. Definition by turnover has multiple advantages over definitions by either employment or assets, given that it is the most consistent across sectors.

In the many discussions and debates over what SMEs do and what should be done for them, too much is at stake to go forward without knowing who they are. With this paper, we hope to have provided a useful benchmark for these discussions.

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