

## Why a more accurate EU definition of SMEs matters!

Federico Infelise and Diego Valiante

*As part of the European Union's commitment to deliver greater access to finance for small- and medium-sized enterprises (SMEs), EU policy-makers will have to deal with a fragmented market landscape and responses by individual member states to address failures. On the basis of some early evidence, this Commentary calls for a rethinking on the part of the EU of its definition of an SME, which currently does not take into account the internal market dimension. A more accurate definition, reflecting the internal market and the stages of evolution of a firm and its financing needs, would allow better benchmarking and a comparison of policy responses that often claim to address market failures in SME finance.*

After the financial crisis, supporting access to finance for small- and medium-sized enterprises (SMEs) has become the new mantra in the policy debate on how to restore growth in the European Union. SMEs are often synonymous with entrepreneurial dynamism, which can drive growth and innovation. But the picture is clearly far more complex. It is indeed paramount to ensure that SMEs can access proper financing mechanisms, but it remains highly unclear how this set of small and medium firms is actually defined. SMEs are often treated as a self-defined homogenous set of enterprises that is claimed to be in need of external financial support to improve their access to finance. A subdivision into clusters of size cannot give an indication of growth, but it provides a tool to devise policy solutions that can be effective by understanding the diverse financing needs that companies might have at various stages of their life. But the question is how these clusters are defined for policy-making purposes in the European Union. Lacking a sound definition may thus impede a proper measurement of the effectiveness of policy proposals.

The need for a more rigorous approach to the definition of SMEs for policy purposes has been at the top of the European Commission's agenda for at least

a decade. The Commission only harmonised its policy actions around a formal definition in 2005, after the revision of an earlier definition set in 1996. According to the latest statistics from Eurostat, 99.8% of the enterprises in the EU qualify as an SME, as defined today. Therefore, it should not come as a surprise to learn that most of the proposals aimed at SMEs are in fact targeting such a wide range of firms, each with different funding needs and with a very diverse impact on the economy, are often ineffective or remain in abeyance for months before being buried by other policy priorities. The European Commission, as requested by a 2003 recommendation,<sup>1</sup> distinguishes between micro, small, and medium enterprises as shown in the table below.

Table 1. The EU's classification of SMEs

Enterprise category	Annual workers/unit	Annual turnover	Annual balance sheet total
Medium	<250	< €50 million	< €43 million
Small	<50	< €10 million	< €10 million
Micro	<10	< €2 million	< €2 million

Source: European Commission.

<sup>1</sup> EU recommendation 2003/361.

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This definition includes a vast range of firms and individuals classified as an ‘enterprise’. This would include corner shops, small-sized professionals, up to companies with a scale that is around €50 million turnover. Compared to the definition of 1996, this version has higher thresholds of turnover (from €40 to €50 million) and balance sheet size (from €27 to €43 million). The most important innovation, however, has been the introduction of the sub-category of *micro-enterprises*, which was not included in the previous definition.

### Some general statistics on SMEs

The European Commission, following-up the commitments taken under the Small Business Act for Europe (SBA) of 2008, has been collecting some general statistics about the above-mentioned categories of firms, plus a set of remaining larger companies. According to these statistics, SMEs account for 99.8% of all enterprises, 67.4% of employees and 58% of value creation in the European Union.

Table 2. Features of EU-27 enterprises by size class, 2011

	Micro	Small	Medium	SMEs	Large	Total
Number of enterprises	19,143,521	1,357,533	226,573	<b>20,727,627</b>	43,654	<b>20,771,281</b>
% total	92.2%	6.5%	1.1%	<b>99.8%</b>	0.2%	<b>100%</b>
Number of employees	38,395,819	26,771,287	22,310,205	<b>87,477,311</b>	42,318,854	<b>129,796,165</b>
% total	29.6%	20.6%	17.2%	<b>67.4%</b>	32.6%	<b>100%</b>
Gross value added (€ mil)	1,307,360	1,143,935	1,136,243	<b>3,587,540</b>	2,591,731	<b>6,179,271</b>
% total	21.2%	18.5%	18.4%	<b>58.1%</b>	41.9%	<b>100%</b>

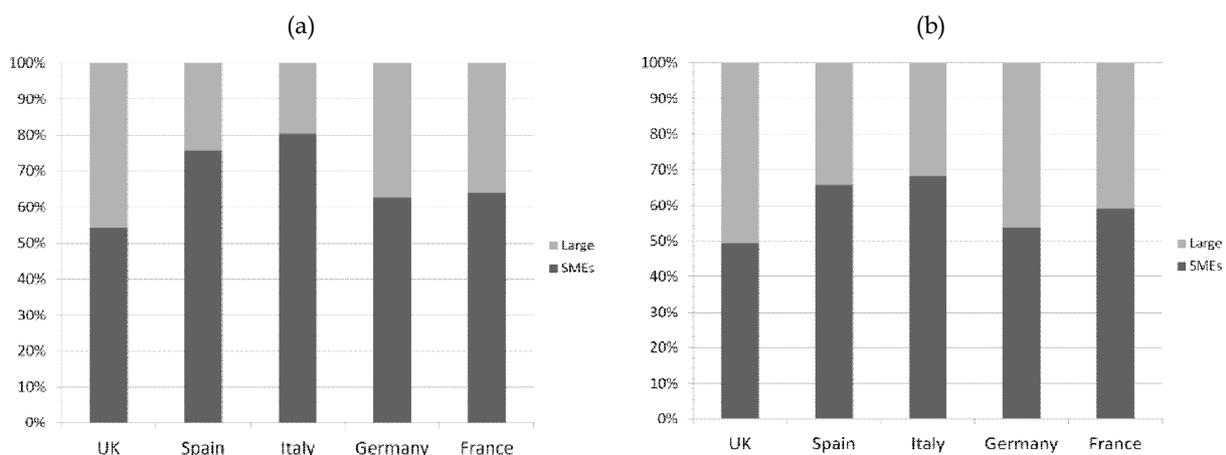
Notes: The figures are estimates for 2011, based on 2005-09 data from the Structural Business Statistics Database (Eurostat). The estimates have been produced by Cambridge Econometrics. The data cover the ‘business economy’, which includes industry, construction, trade, and services (NACE Rev. 2 Sections B to J, L, M and N). The data do not cover enterprises in agriculture, forestry, fishing or the largely non-market services sectors such as education and health.

Source: Authors’ compilation based on SBA Factsheet 2012.

Let us now take a closer look at the numbers in the five biggest EU economies and the impact that each of these three categories of SMEs (micro, small and medium) have on these economies. While SMEs are

worth more than 60% of the value and almost 80% of employment in Italy and Spain, they are less important (but still respectively around 50% and 60%) in Germany and the UK.

Figure 1. Employment (a) and value added (b) by country, 2011 (% of total)



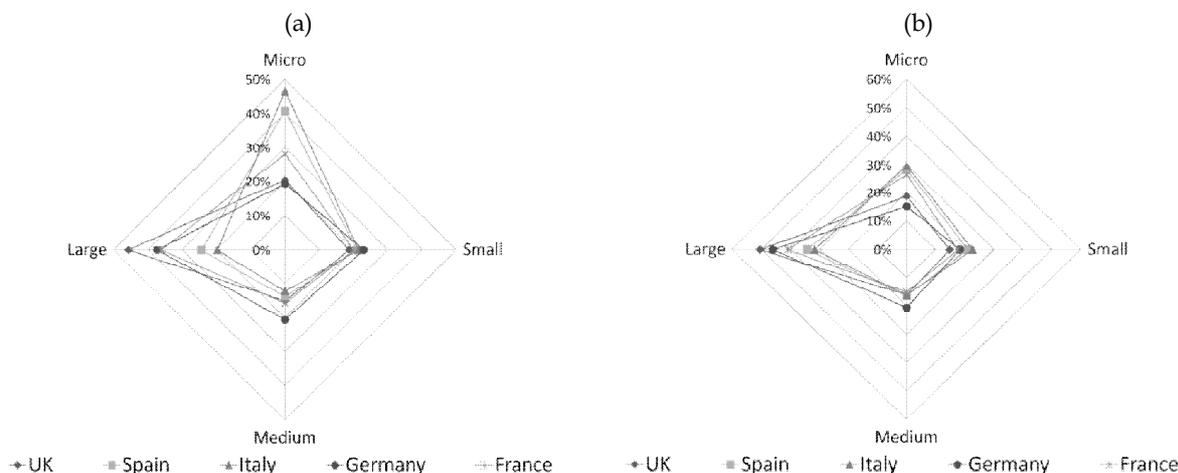
Note: Value added at factor cost is the gross income from operating activities after adjusting for operating subsidies and indirect taxes, as calculated by Eurostat. Eurostat defines the ‘Value added’ at factor cost as the gross income from operating activities after adjusting for operating subsidies and indirect taxes. It can be calculated as the total sum of items to be added (+) or subtracted (-): turnover (+), capitalized production (+), other operating income (+), increases (+) or decreases (-) of stocks, purchases of goods and services (-), other taxes on products which are linked to turnover but not deductible (-), duties and taxes linked to production (-).

Source: Authors’ elaboration based on data from Eurostat.

By breaking down the numbers by category of firm (see Figure 2), micro firms appears a very important driver of employment in Spain and Italy, but much less so in term of value creation. Large firms, instead, are key drivers both in employment and value added, in particular for countries like Germany and the UK.

France has a more balanced position in relation to the impact of micro and large firms. Small and medium firms appear to have a similar impact for all five countries (low standard deviation), which points at an early sign of a more homogeneous set of firms vis-à-vis their impact on the economy.

Figure 2. Employment and value added by category of firm, 2011 (% of total)



Source: Authors' elaboration based on data from Eurostat.

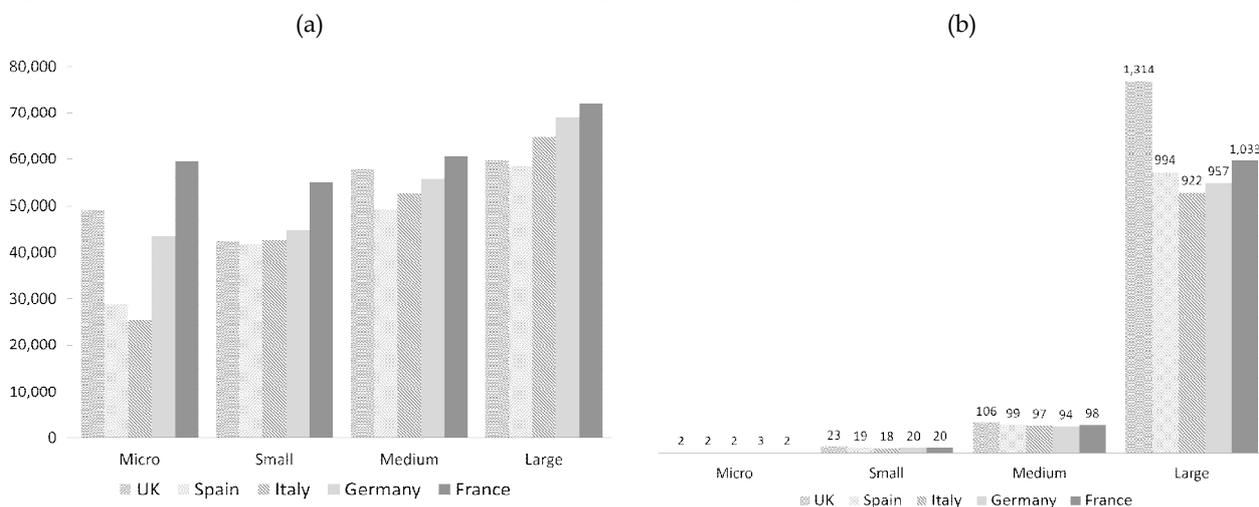
As a result, while the definition of small and medium firms seems well-balanced, due to their cross-country homogeneous impact, the 'micro' category is skewing the SME sample for its wide coverage of economic activities that have a highly diversified nature. The 'large' category, instead, even if it is not included in the SME sample, exhibits as well a broad impact on the economy and therefore needs additional analysis.

In relation to the 'micro' category, indeed, there are two important elements to be considered (see Figure 3):

- average number of employees and
- value added per employee

First, the average number of employees is very small (around 2 employees per firm), which points at the typical nature of these firms as corner shops or small independent professionals. These entities are mainly financed by the private equity of the owner (with his/her own real guarantees) and are mostly closed to external financing, mainly limited to current account overdrafts or credit card loans from banks. Corporate and individual income taxation may have a very important impact on these entities, as they are mainly driven by the equity of the owner. Secondly, except for France and partially the UK, the 'micro' category has a very limited impact in terms of value creation (for employees), especially in those countries where they are more diffused (Spain and Italy; see Figure 3).

Figure 3. Value added per employee (a) and average number of employees (b) by category of firm, 2011



Source: Authors' elaboration based on data from Eurostat.

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Finally, the ‘large’ category exhibits a big jump in terms of the average number of employees, compared to medium-sized firms. By also skewing the sample in terms of total value-added creation (Figure 2), it may raise the question whether this category should be further refined and split to capture a more intermediate set of firms that can be considered SMEs.

### A new EU definition for SMEs?

As a result of this brief comparative analysis, it is indeed very difficult to develop an effective EU policy for a set of firms that encompasses 99.8% of the EU enterprises. As shown, the sample is skewed by the inclusion of micro firms that are too small to be effectively captured by EU policies, and have a limited impact in relative terms on the EU economy. EU policies targeting SMEs require more focus in their scope and thus need to be revised and shaped around two general principles:

- Identifying and including those enterprises that contribute the most to the economy in terms of growth and employment (measured in relative terms); and
- Targeting those firms in which an EU intervention is justifiable (subsidiarity) and effective (available tools).

From the early evidence shown above, the inclusion of micro firms in the sample is a significant distortion to the sample and adds a lot of uncertainty to EU policies. In practice, the policy tools that the European Union can actually offer micro firms is limited and not necessarily the same as those needed for firms that can be classified as ‘small and medium’ enterprises. Most notably, the competence of the EU in taxation is very limited and the room for action in improving financing conditions on overdrafts or credit card loans with EU policies is constrained by the small size and the fragmentation of such transactions.

Furthermore, the European Union treats as large companies those firms with a turnover above €50 million, which are not yet ready for direct access to capital markets and are seriously penalised by the current credit crunch. A rule of thumb in capital markets argues that the ideal size for firms to be listed or to raise debt in capital markets is around €500 million at least. This leaves a significant space for firms between €50 and €500 million that are treated by policy-makers as ‘large’ stand-alone companies, but in reality they rely more heavily on bank funding than any other category of company (with limited or no real guarantees from the owners due to their larger size) and are hit by the credit crunch and increasing administrative burdens due to financial reforms.

This additional breakdown makes even more sense if we take into account that these firms are ‘currently’ considered large companies from a European single market perspective, which might be misleading in relation to the size of competitors in their category. It may be indeed the case that, for some small countries, large companies at national level would be classified as SMEs. But this would be a beneficial incentive for these firms to consider scaling up their business at EU level and consider internationalisation. This would ultimately contribute to a healthy competition in the single market.

As a result, and subject to more in-depth analysis, the definition of SMEs could be amended as follows:

- Removing the ‘micro’ category of firms
- Adapting the ‘employees’ requirement and
- Adding a new category of ‘M+’ firms.

Firstly, removing the ‘micro’ category would eliminate the distortion that these firms create for the definition of EU policies for SMEs.<sup>2</sup> Secondly, as the average number of employees per category of firm shows in the five biggest EU economies, the employee requirement may need an update. Assuming a deviation from the mean equal to 50% on average for ‘small’ firms, following Figure 3 (b), the requirements could be revised as follows:

- Between 10 and 30 employees for ‘small’ firms,
- Between 30 and 150 employees for ‘medium’ firms and
- Between 150 and 500 employees for ‘M+’ firms.

This also implies the creation of a new category of SME (the so called ‘M+’), whose cap in the number of employees is calculated by applying the 50% deviation from the average (around 1,000 employees) for the ‘large’ companies in the five biggest EU economies, thereby using 500 employees as a cap for M+ companies.

A revised definition would make more homogeneous the set of companies that can be considered SMEs with strong potential for value creation and growth in the European Union. Studies and surveys, which are lacking data today, would need to gather more micro data on the capital structure of these categories of firms that have the actual potential to deliver growth and innovation.

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<sup>2</sup> This category of enterprises would, of course, continue to deserve attention from EU policy-makers, but in a different context, which might involve greater harmonisation of taxation policies in the EU.