# EU SME POLICY: ON THE EDGE OF GOVERNANCE

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The EU's economy is a small- and medium-sized enterprise (SME) economy: 99 percent, or 23 million, of Europe's enterprises are SMEs and they provide over 100 million jobs dominating many growth sectors of the EU economy. In a comparative context the statistical importance of SMEs to the EU's economy is even more evident. The average number of employees by size in non-primary, private enterprises in the EU and USA is very similar: micro companies employ 3 people in the EU and 1 in the USA, small companies 19 in the EU and 20 in the USA, medium 98 and 94 and large companies 1,052 in the EU and 1,119 in the USA. But there is a stark difference between the USA and the EU in terms of the share of total employment by company size (see Table 1).

Almost twice as many people are likely to be employed in a very small company in Europe as in the USA so that the experience of work in the EU is far more likely to be in a small- and medium-sized company than a large corporation. Despite the many publications that have focused on the various institutional foundations of national capitalisms in Europe, it is the SME sector, not the "national champions", that do most of the work. The problem that any SME policy maker has to address is that it is very hard to find out what SMEs want. While larger companies have processes and hierarchies that help them to define and represent clear preferences, the preferences of SMEs are mediated heavily by the channels that represent their interests (Dannreuther 1999). After discussing some of the problems of SME definition we shall examine what has driven EU SME policy over different stages, how easy it is for the EU Commission to get it wrong, and how some SME issues are always likely to be beyond the scope of the EU.

**Table 1**

**Employment by enterprise size**

| | SME in % | | | | Large in % |
|---|---|---|---|---|---|
| | Micro | Small | Medium | Total | |
| USA (2000) | 22 | 15 | 12 | 49 | 51 |
| Japan (2001) | na | na | na | 67 | 33 |
| Europe-19 (2003) | 39 | 17 | 13 | 70 | 30 |

na = not available.

Source: "SMEs in Europe 2003" *Observatory of European SMEs* 2003, No. 7, p. 33.

## The enigma of the SME

The SME sector is extremely diverse because, by definition, contingent factors outweigh standardised ones. This is a serious obstacle to policy formation. It is the character of the entrepreneur, the sector they are working in and the general condition of the economy that influences the prosperity of an SME. It has therefore become something of a truism that the SME sector is so heterogeneous that little of universal value can be said of it (Torrès and Julien 2005). SMEs tend to be defined as a sector according to environmental characteristics, such as their national traditions, corporate status, number of employees etc. (e.g. Bagnasco and Sabel 1995). Historical assumptions and institutional persistence often inform these categories. Some states have long traditions of support through statutory chambers (Crossick and Haupt 1995), while others have provided little support for SMEs until relatively recently. British governments, for example, did not recognise their small business sector existed until 1972. Academic research has often distorted the picture and many myths have been attached to SMEs, such as their employment generation potential and intrinsic innovativeness. One current assumption of SME policy is that an enterprise economy needs a high number of small firm births that slightly exceeds a high number of deaths. This "churn" effect provides a clear rationale for the dynamism of an SME sector. But while there has been a lot of research into new

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firm formation, the social and economic costs of SME deaths has been hardly explored.

From the mid-1980s, research has focused more on the social institutions and cultural traits that influence SME behaviour (Piore and Sabel 1986; Best 1990). The idea of "social capital" grew from this research and has become a central topic in the discussion of competitiveness in development and management literatures. This came closer to the real experiences of self employment, but often at the expense of intellectual rigour. The problem of knowing what SMEs want remains and while this is so, SME policies tend to be attached to broader policy agendas or institutional priorities.

## Defining SMEs

For the last twenty years the EU has had to negotiate with national governments and a variety of sectoral concerns over its role in SME policy often with competing notions of what an SME is (Dannreuther 1999; 2007). The EU currently defines SMEs as those companies with fewer than 250 employees which are independent from larger companies, with an annual turnover of less than €50 million and an annual balance sheet total not exceeding €43 million (European Commission 2003). But while agreement over this definition has allowed a large body of statistical data to be collected on the SME sector, the definition has also changed three times in fifteen years in response to changes in state aids policy.

The Commission has observed that "the question of the appropriate definition of SMEs is meaningful only in the context of a specific measure for which it is considered necessary to separate one category of enterprises from others for reasons of their "size". The criteria adopted for making this distinction necessarily depend on the aim pursued" (European Commission 1992, 2). The contextual significance of SME definitions has rendered the comparative analysis of SMEs and their policies difficult. In its wide ranging compendium of SME policies the OECD observed that "the empirical basis for informed policy making in the area of SMEs and entrepreneurship is rather poor", blaming a "poor underlying statistical base" and a "notoriously limited cross-country comparability" that made "the analysis of economic forces or policies over time more complicated" (OECD 2004, 217). This diversity of data sources is reflected in the breadth of approaches to small firms in economic theory (You 1995) and explanations for their reassertion in the late 1980s (Sengenberger et al. 1990). Methodologically coherent evaluations of SME policies have been done (Storey 1990; Wren and Storey 2002) but the conflict between scientific excellence and practical policy solutions has been an obstacle in the engagement of researchers with SME policy (Curran and Storey 2002).

The politics of SME policy are vital to understanding its significance. Traditions surrounding small firms policies predate the modern capitalism of the twentieth century (Shonfeld 1965). On the 1st April 1792, for example, shortly after the French Revolution, the introduction of the *patente* or trade licence heralded the freedom of self establishment in France (Crossick and Haupt 1995, 30). Much of what distinguishes regulated capitalism of the "European" economic model from the "Anglo American" one has its origins in the histories of these corporations and guilds. In the late nineteenth and early twentieth century vigorous debates were held over how the small retailers and petit bourgeoisie were to be governed. The resolution of this "social question" has defined Europe's political landscape ever since. Key to these issues, however, was the ability of political actors to define the interests of the petit bourgeoisie according to agendas that fit their own interests. Just as the middle classes were acknowledged as a core but inevitably ill defined constituency, so too the SME sector has managed to maintain its importance in part though its enigmatic status. SME policy is rarely solely about SMEs.

## The three phases of EU SME policy

It is no coincidence that the EU's SME policy began immediately after the first direct elections to the European Parliament. After 20 years of managing an internal market of large national economies, the Commission had paid only passing interest to the SME sector. The first phase of SME policy was introduced through a year long consultation in the European Year of the SME (EYSME) in 1982 that explicitly engaged with interests beyond the Brussels village. The Commission's 1986 SME Action Programme organised these many debates into two categories of policy: (1) vertical measures, designed to address a particular market failing, and (2) horizontal measures to improve the business environment. These distinctions remain today with the Commission launching an Action Programme for Administrative Simplification in 2007 (European Commission 2007a). As well as introducing an important distinction for SME policy, the focus on the business environment complemented the free market rhetoric of the single market programme and privatisation agenda that was sweeping member states at that time. Although member states guarded their control over SME policy closely, enterprise, free markets and a renewed Europe were inextricably linked.

In 1990, however, a conference in Avignon asserted an important distinction between enterprise and SMEs. SMEs and craft sector companies experienced many aspects of their business life, such as access to finance, training, administrative obligations, differently to larger companies. The second stage of SME policy embraced these differences, and many others, to develop a policy of promoting SMEs through more targeted interventions using, among other instruments, the new Community Initiatives. This strategy focused on increasing competitiveness through improving the capacity of SMEs to, for example, innovate or engage in new research. SME policy was increasingly concerned with improving the coordination of existing measures in the 1994 Integrated Programme. It was also concerned with linking SME policy to broader objectives in the EU. The Competitiveness White Paper emphasised the role SMEs played in innovation (European Commission 1993), while the European Employment Strategy promoted entrepreneurship and self employment as a key measure for addressing unemployment in the EU (European Council 1997).

The final phase can be seen as the centralising of SME policy within the continual reform agenda of the Lisbon process. Immediately after the European Council launched the Lisbon process as the EU's response to globalisation in 2000, the Heads of Government agreed the SME Charter in Santa Feira. This specified a range of policy commitments for member states to respond to, such as entrepreneurship and education and decreasing start-up times, and was designed to promote the sharing of good practice between member states (European Commission 2007b). The promotion of entrepreneurship would be more actively carried out after a Green Paper on Entrepreneurship and there would be better communication with the Commission through an SME envoy.

While SMEs were of increasing interest on the international stage, with the OECD's Bologna declaration on SMEs signed the same year, the significance of Santa Feira was in the parallels that it made with SME policy more broadly. The Lisbon process incorporated a method of policy making (the open method of coordination) that was very similar to the EYSME in its transparency and breadth of engagement. The use of benchmarks that set agreed targets but maintained national control over implementation also paralleled SME policy. Finally there were a number of other horizontal measures that fitted the specific agenda of SMEs. These included better regulation, "active" labour market policies, and promoting innovation. Notably these all survived the critical Mid-Term Review of the Lisbon process conducted by Wim Kok, and the SME Charter was presented as an important success of the Lisbon process.

These three phases show how SME policy has gone from nothing to a core, even definitive, element of the EU's political economy (Dannreuther 2006). The fundamental nature of this relationship to the EU has become increasingly clear as social partners and civil society have become involved in policy implementation of the new Lisbon process and as cross party support for SME policy has become a consensus issue in so many areas of policy. One hundred years ago this was exactly the engagement that nation states were having with their petit bourgeois sectors in the social question. Perhaps ex-Commission President Jacques Delors, who was on the European Parliament committee that proposed the EYSME, was aware of this when he wrote a piece with the title "De la question sociale en France a l'Europe" (Delors 2001).

## SMEs, the knowledge based economy and the Service Directive

The knowledge-based economy (KBE) epitomises the progressive view of an SME economy. High-skilled flexible workers add value through services such as advertising, high-technology products, design and marketing to enable the EU to compete against the low manufacturing wage economies of the South. It has received significant support as a concept and in tangible policy. Significant investment has been made through the EU's Framework Programmes to improve the quality of knowledge available. The dissemination of this knowledge to SMEs has been actively promoted by encouraging their direct participation or through other incentives, such as encouraging spin-off companies from universities through state aids exemptions. One third of the Commission's new "Competitiveness and Innovation Framework Programme" (CIP) is dedicated to an "Entrepreneurship and Innovation Programme" (EIP) designed to improve the environment for SME innovation. Between 2007 and 2013 a sum of €2.17 billion will provide better access to finance for SMEs through venture capital and loan guarantees, a network of regional innovation support services as well as promoting the idea of entrepreneurship and innovation through policy and publicity (European Commission 2007c).

Much of the success of the KBE has been seen in the growth of the EU's service sector economy. In 2003 business services added 26.5 percent of value to non-financial services, employed 26.2 percent of the non-financial services workforce and generated €703 billion in value added (EUROSTAT 2006). An OECD report suggested that the "… services sector is by far the largest sector of economic activity in the euro area. In 2003 it accounted for 58 percent of business sector value added, 68 percent of total employment and two-thirds of total output" (Vogt 2005, 1). In addition to specific interventions in finance and innovation, the EU also sought to improve the regulatory environment for the sector. A key aspect of the Lisbon process, and the UK Presidency, was therefore to maximise this through an internal market in services. The Netherlands Bureau for Economic Analysis (CPB) quantified the effect of a single market in services suggesting that it would lead to increased investment in commercial services "in the range of 30 percent to 60 percent and the stock of foreign direct investment could [sic] increase by 20 percent to 35 percent" (CPB 2005, 1).

The Service Directive was fairly typical in its origins. The Commission's proposal linked it to SMEs through Article 47 (2) EC that provided for the right of establishment which it applied to services using Article 55. In addition to this strong legal basis, the Internal Market Commissioner Frits Bolkestein presented a report on the service sector in 2002 that revealed legal barriers to the establishment of service providers, and to the promotion, distribution, sale and after sale of services (European Commission 2002). It argued that this reflected a mistrust and protectionism between the member states and had a detrimental impact on the European economy, making victims of small firms and consumers and undermining the credibility of the internal market by encouraging black market behaviour.

As a framing directive the proposal did not deal with all issues but focused on those important to promoting the end goal of an internal market in services. An important part of the directive is what it does not address through derogations and codes of conduct for self-regulation. This was a technique that had been developed and used broadly for the completion of the single market. It also introduced a principle which, like the principle of mutual recognition, would facilitate the extension of a market in services with minimal regulation. The "Country of Origin Principle" allowed firms to trade in services in another state as long as they complied with the regulatory obligations of their home economy. It was specifically intended to "achieve the objective of guaranteeing the free movement of services whilst allowing the various national regimes to co-exist with all their distinctive characteristics" (European Commission 2004, 18).

The political response to the proposal was immediate, broad and hostile. Belgian Socialist Ministers Rudy Demotte (social affairs) and Frank Vandenbroucke (employment) both challenged the directive supporting protests that attracted between 50,000 to 70,000 people in June 2004 in Belgium, only three months after the initial proposal. Carlos Polenus, vice-president of the BBTK, the Belgian employees' union, highlighted how the Directive went to the heart of long standing domestic social compromises: "Polish employees can be sent by a Czech temporary agency to a Belgian small or medium-sized enterprise that works for a large firm. That temporary agency can hire people in any EU member state and put them to work. In Belgium, it will not be required to pay the Belgian minimum wage. The Belgian temporary employment sector works on the basis of the principle of equal pay: temporary employees receive the same wages as permanent employees in the companies where they work temporarily. Bolkestein has not incorporated this rule into his text" (De Standaard 2004).

The Directive had failed not only to propose a workable plan but had not engaged sufficiently with the interests of civil society that it would affect most directly. Opposition came from all over Europe, unifying left and right in their opposition. This was most noticeable in France where the Bolkestein Directive was presented as an example of the free market liberalism that was undermining French tradition. It played a central role in the No vote campaign that rejected the EU Constitution: "The Directive symbolised further unemployment, less social protection for French workers and a threat to France's social model. Thus "Polish plumbers" and others in the enlarged EU who might take over or undercut "French jobs" at home and abroad featured prominently in the No campaign, which focused strongly on the defence of public sector services in France" (Hainsworth 2006, 103–104).

While French and British politicians lost credibility, the European Parliament orchestrated a review and new set of proposals that would eventually save the directive. The Country of Origin Principle was replaced with a "Freedom to Provide Services". Services of a general interest were only included if member states chose them to be, and workers' rights took precedence over the Directive. Regulating the knowledge economy would require far more political sensitivity to domestic political concerns than the single market mechanisms traditionally employed by the Commission. Because of their heterogeneity, service sector SMEs would also not fall behind the leadership of their governments. Only the European Parliament was able to effectively engage the breadth of opinion needed to formulate a workable solution.

**National versus EU level governance**

As with many areas of EU policy, the pendulum has swung between European and national competences in SME policy. It is perhaps interesting to see how specific areas of policy have been retained at the national level and in what form they have been affected by the European level.

Tax policy has historically incited a passionate response from the SME sector (Crossick and Haupt 1995). The Federation of Small Businesses, the UK's largest SME representative group, was set up in response to a letter complaining about value added tax that was introduced as a condition of UK accession to the EEC. Member states have, therefore, been shy about harmonising tax regimes and have defended unanimity in tax policy making, despite the potential and real effect they could have on company performance. The EU tended to restrict its actions to areas where individual Member States could not provide an effective solution such as providing cross-national comparisons and identifying harmful taxation. The Commission also introduced a pilot project on "Home State Taxation" that would allow SMEs engaged in cross-border trading to calculate taxable profits in all countries according to the tax rules in their home country. This would reduce compliance costs for the firm and allow taxable income to be apportioned between the countries (European Commission 2005a). However, it did not receive member state support. Tax incentives to invest in SMEs are also often defended because they are often extremely helpful as a vehicle for other means. Various schemes in the UK have enabled investors to benefit as the current controversy over private equity investment schemes demonstrates.

Industrial policy has long been an area allied with the discretion and patronage of member states and one that has often benefited SMEs. As a potential distortion to competition, state aids have been closely regulated by the Commission. But SMEs have always benefited from *de minimis* exemptions, which is why the definition of an SME has changed so regularly over the years. Substantial resources have been directed to SMEs through industrial policies that have administered cheap or long-term credit, direct incentives and subsidies for employment and training and fixed capital investments. The linking of SMEs with vague notions of competitiveness (Krugman 1994) has only added to the range of interventions that they have benefited from. Combined with the poor economic growth of the single market programme, France and Germany have actively promoted more defensive industrial policies at the EU level (McGuire 2006). While the industrial policy at the EU level has developed sectoral dimension for seven sectors, its main focus has been to promote horizontal measures through policies familiar to SME policy. The policy fits within the Lisbon agenda to create better framework conditions for manufacturing industries and includes the New Legislative Simplification Program [2005 to 2008] (Commission 2005, 2). Industrial policy for SMEs will remain an area in which member state implementation prevails over EU level legislation.

## Conclusion

The spectacular growth in interest in policy for EU SMEs is explicable by the linking of the policy to broader agendas. Initially benefiting from the ideological interest in enterprise in the 1980s, SME policy became increasingly pragmatic as it was linked to other policy agendas and is now central to the Lisbon reform process. Some areas of policy do appear to be beyond the EU due to the sensitive nature of the political compromise or the inability of the EU to offer sufficient incentives to compensate for change. In the case of the Service Directive, the Commission also demonstrated that it was capable of making hugely inappropriate political judgements about the needs of its SMEs and service sector.

At a superficial level, SME policy appears to be a mess of measures that have been tagged onto other more strategically coherent agendas. But this denies both the significance and the importance of the EU's attempts to engage with its SME population. All states find this a difficult relationship to manage as the heterogeneity of the sector imposes uncertainty. Now that SMEs are at the centre of the EU's reform process there is every chance that it may engage more directly with its citizens and propose more modest and realistic policies.

SME policy is interesting because it describes the boundary between the state and the economy and in order to claim its legitimacy as political actor, the EU has to address this boundary. But this is also a risky political endeavour and more sparks will fly as the EU encroaches onto such a sensitive area of national economic policy.

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