The Contributions Of Small and Medium Enterprises (SME's) On Malaysian Economic Growth: A Sectoral Analysis

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Abstract. Small and medium enterprises (SMEs) including microenterprises have played an important role in fostering growth, employment and income, and have been integral to Malaysia's economic transformation process. The Malaysia government is targeting for SMEs to contribute at least 40% to the economic growth in 2016. It is crucial that the government must precisely know which sector in its economy contributes the most, which have the potential to generate greater future growth and which sectors are weak and need supports to survive in the competitive economy. Hence, this study examines the contribution of SMEs industry towards Malaysian economic growth. For this study we employ a range of statistical tools based on and trend analysis of the contribution of SMEs towards Gross Domestic Product. The sample data is SMEs by sectors for the period of 2005 – 2016. In this study we found that SMEs are important to the Malaysian economies which comprise 99.2% of total business establishments, where SMEs contributed 32% of Gross Domestic Product (GDP).

Keywords: Small medium enterprise, economic growth, Gross Domestic Product.

1 Introduction

Small and medium enterprises (SMEs) including microenterprises have played an important role in fostering growth, employment and income, and have been integral to Malaysia's economic transformation process. SMEs also considered to be the backbone of industrial development in the country and played an important role in fostering growth, employment and income in the past. As in other countries, SMEs in Malaysia are a very heterogeneous group. They involve in activities ranging from petty traders, grocery store operators, medium-sized contract manufacturers supplying parts and components to multinational corporations and, professional services such as software firms or medical researchers selling their services to overseas markets. SMEs are important to the Malaysian economies which comprise 99.2% of total business establishments, and SMEs contribute 32% of Gross Domestic Product (GDP), 59% of employment and 19% of total exports. For the current structure of Malaysian SMEs, 89.2% are in the services sector, followed by manufacturing 5.3% and construction 4.3%. In term of size, microenterprises represent a majority 79% of SMEs. By location, most of the SMEs operate in the Klang Valley 34.5% (Selangor and Federal Territory), followed by Johor 10.8%, Perak 8.3% and Pulau Pinang 7.4%. (Economic Census 2016). The importance of entrepreneurship to the growth of the country's economy was evidenced by the sheer amount and variety of supporting mechanisms and policies that existed for entrepreneurs, including funding, physical

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infrastructure and business advisory services. Meeting the Vision 2020 of a high-income nation is a challenging task and a fresh approach is required to accelerate the growth of SMEs. The aim is to increase the contribution of SMEs to the economy. The SME Master plan will therefore be the 'game changer' in navigating the new development path for SMEs across all sectors until 2020. In the last few years, SMEs have witnessed a marked improvement in their performance. Real Gross Domestic Product (GDP) of SMEs has consistently outperformed that of the overall economy, expanding at an average annual growth rate of 6.8% versus 4.9% for the overall economic growth for the period 2005 – 2016. Through the lens of long-term development, Malaysia has been a success story, enjoying significant economic and social progress for several decades, thus facilitating a transition from a low-income to a middle-income nation. Today, in facing several uncertainties in the external conditions, achieving Vision 2020 to be a high-income nation has become even more challenging. This requires a 'game changer' or a new approach towards a fundamental shift in enhancing Malaysia's competitive advantage from low-cost to high-value of income. It is crucial that the government must precisely know which sector in its economy contributes the most, which have the potential to generate greater future growth and which sectors are weak and need supports to survive in the competitive economy. Hence, this study examines the contribution of SMEs industry towards Malaysian economic growth.

2 Literature Review

As for the authors/researchers knowledge, not many studies have been done in this area especially in the context of Malaysia. While most of the studies available are only conceptual, this leaves a genuine gap in empirical work. Saleh and Ndubisi (2006) have analyzed and discussed the development of Malaysian SMEs, their roles and various contributions to the national economy. The authors found that Malaysian SMEs are still struggling with domestic and global challenges in achieving economies of scale and competing internationally. The current situation suggests the important role of SMEs in the nation's economy and as a major source of economic contribution. Due to significant contribution of SMEs towards the development of the economy, in the report Economic Planning Unit (2006) discussed about the various agencies particularly that of government, have given a lot of importance on the development of SMEs. In order to strengthen the SMEs a number of programs and facilities are provided to enhance their performance and competitiveness. In this connection, the Malaysian government has persistently allocated resource for the development of SMEs. Malaysian government allocation for the development of SMEs has been increased from RM 1,561.6 million in the Eight Malaysia Plan to RM 2,160.2 million in the Ninth Malaysia Plan. Looking at the experience of Indonesia, its SMEs have been the main player in the domestic economic activities. The Indonesian SMEs are not only the largest provider of employment opportunities, but they are also the generator of primary or secondary sources of income for many households. Investigation of the relationship between the small and medium-sized enterprises (SMEs) sector and economic growth for annual panel data of Brazilian states for the period 1985-2004 was conducted by Cravo et al. (2010). They used panel data approach such as fixed effects

using least–square dummy variable (LSDV) estimator. They also state that the human capital embodied in SMEs may be more important for economic growth than the relative size of the SMEs sector. In another study, Tambunan (2011) examines on the recent developments of SMEs in Indonesia which focus on the role of SMEs; critical constraints; development of women entrepreneurs in SMEs; and innovation capability. The author reviews the key literature of SMEs in Indonesia and in some other Asian countries as a comparison. Following the study, he performs a descriptive analysis of the secondary data on SMEs in Indonesia. The results confirmed that SMEs have been the main player in domestic economics activities as they account for more than 99.9 percent of all firms and the industry employs 96.2 percent of the workforce in Indonesia. Second, key SMEs constraints include limited source of credits and lack of capital to explore their markets. The third constraint is related to women entrepreneurs which is relatively low and can be attributed to low level of education and cultural/religions constraints. Finally, the general SMEs innovation capability in Indonesia is low for several reasons. Galindo (2013) has analyzed the relationship between innovation and economic growth, following Schumpeter approach. In his study, the author states several hypotheses comprising three equations, for the case of ten developed countries. The findings state that innovation plays a central role in the economic growth process and the entrepreneur is the vehicle to introduce the new technologies to improve the firms' activities and to obtain higher profit. The author also suggests including in this process, other variables such as social climate and the role of institutions.

3 Methodology

Models by Solow (1956) and Mankiw et al. (1992) provide a theoretical framework for growth regressions. However, the most common approach to empirically modelling economic growth is an ad hoc regression that encompasses other factors that influence growth (Temple, 1999). In this approach, variables are selected based on previous results in the literature rather than on an explicit theoretical model. Regressions of this type are known as 'Barro regressions', after Barro's (1991) seminal work. The hypothesis of convergence in the growth literature, has been tested by using the following equation:

$$gr_{it} = a_i + b \ln y_{i,t-1} + \psi X_{it} + v_{it} \qquad (1)$$

where i denotes each individual economy, t denotes time, *g*r denotes the GDP per capita growth, ln is the initial GDP per capita, b is the convergence coefficient, and X is a vector of variables that control for differences across economies. This X vector encompasses the growth determinants suggested by the original Solow model as well as other growth determinants that come from outside the model. If the convergence coefficient is negative ($b < 0$) and $\psi \neq 0$, then the data is said to exhibit conditional convergence. Following the influential work of Mankiw et al. (1992) and Barro (1991), the growth literature based on Eq. 1 flourished and considered hundreds of policy and structural variables in the growth framework. Sala-i-Martin (2002) argues that an important contribution made by the growth literature that follows this tradition

is that it has exerted influence on other research areas of economics such as development, economic geography, macroeconomics, econometrics and industrial organisation. Recently, this influence was also extended to the importance of SMEs and entrepreneurship for economic growth (e.g. Beck et al., 2005; Mueller, 2007). For this research we employ a range of statistical tools based on trend analysis of the contribution of SME and sub-sectors towards GDP. The sample data is SMEs by sectors for the period of 2005 -2016.

4 Definition of SME in Malaysia

Small and medium enterprises (SMEs) have been reclassified as companies whose annual turnover is less than RM50 million with workers not exceeding 200 for the manufacturing sector, from the current definition of less than RM25 million in revenue and less than 150 workers, Bernama reported. Najib was announcing the new definition for SMEs, which is expected to see an increase in the number of such firms and will facilitate the country's transformation into a high income nation, after chairing a meeting of the 14th National SME Development Council, with the members comprising 16 ministries and agencies, including those from Sabah and Sarawak, at Bangunan Perdana Putra .He said the National SME Development Council approved the proposal to enhance the qualifying threshold for annual turnover and number of workers, for all SME sectors. Meanwhile, Najib said the council discussed the "breakout strategy" for micro enterprises, which will be streamlined further to provide incentives and encouragement to improve productivity in the sector.The new definition of SME was simplified as follows:

i) **Manufacturing:** Sales turnover not exceeding **RM50 million** OR full-time employees not exceeding **200 workers**

ii) **Services and other sectors:** Sales turnover not exceeding **RM20 million** OR full-time employees not exceeding **75 workers**

A business will be deemed as an SME if it meet**s** either one of the two specified criteria, namely sales turnover or full-time employees whichever is lower. Under the new definitions, micro enterprises are firms with annual sales of less than RM300, 000 or fewer than 5 workers.

4.1 Trend Analysis and Stylized Facts

Below here we present the trend analysis and stylized facts on the impact of the SMEs as a whole and its sectors on GDP. In Fig. 1, we provide the contribution of different sectors to the GDP. The numbers are based on the current prices.

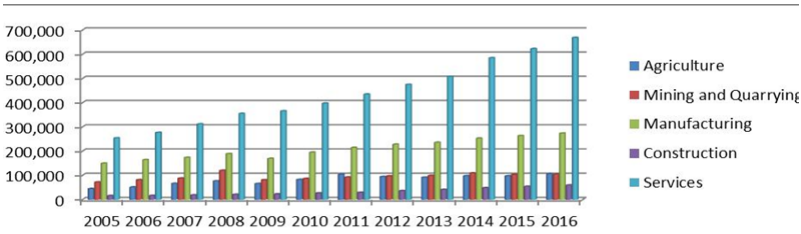


Fig. 1. Overall GDP by Kind of Economic Activity at Current Prices - RM Million.

As evident from the graph, the highest contribution comes from the service sector followed by manufacturing, and mining and quarrying. The least contribution comes from agriculture and the construction sectors. All the sectors have shown steady contribution over the years. The contribution of services sector has doubled from 2005 to 2016. Similarly, the contribution of agriculture and the construction sector has also doubled over the years. The contribution of agriculture, mining and quarrying and manufacturing dipped down in 2009 as compare to 2008 but since then it grew at a steady rate. Moreover, the contribution from agriculture went down again in 2012.

In Fig. 2, we provide the contribution/value added of SMEs to different sectors. The values added are based on the current prices. It is evident from the Table 3 that the highest contribution of SMEs is to the services and manufacturing sectors. The third biggest contributor from SMEs is towards the agriculture sector.

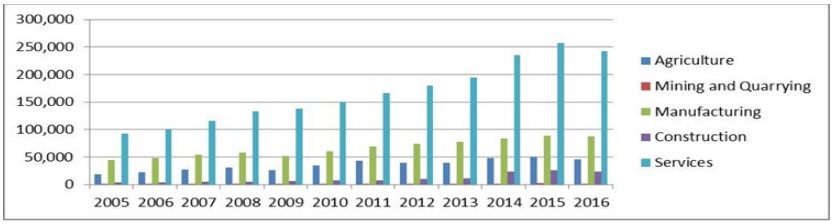


Fig. 2. Value Added of SMEs by Kind of Economic Activity at Current Prices - RM Million.

Regarding Fig. 3, the least contribution comes from mining and quarrying and the construction sector. Besides that, to the numbers based on current prices, the above table shows that the contribution of mining and quarrying and agriculture sector increase doubled up during 2013 until 2016. However, the numbers reported are based on the constant prices. It is evident from the table and the figure that the highest contribution comes from the services sector followed by manufacturing and agriculture sector.

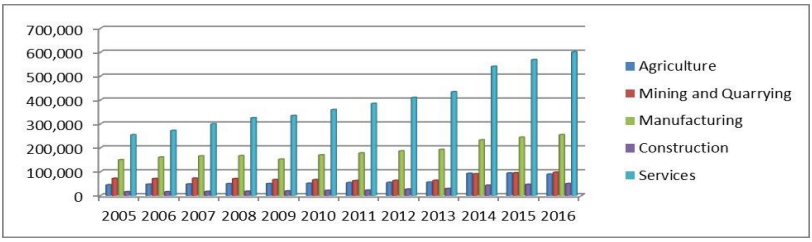
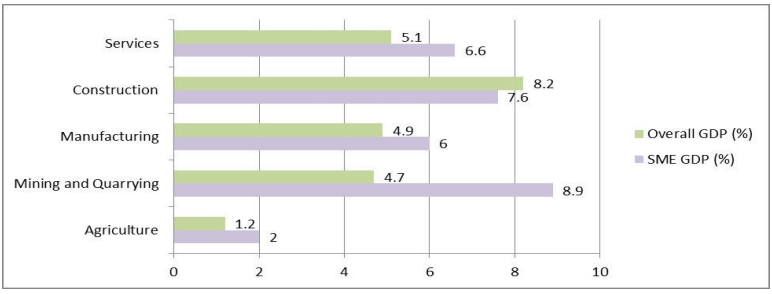


Fig. 3. Overall GDP by Kind of Economic Activity at Constant 2005 Prices - RM Million.

The least contribution of SMEs comes from agriculture and the construction sector. All the sectors have shown steady contribution over the years. The contribution of services sector has doubled from 2005 to 2016. Similarly, the contribution of agriculture and the construction sector has also doubled over the years. Fig. 4 shows the annual growth of SME GDP and overall GDP for year 2016 at price constant. All the sectors exceed the overall GDP except the construction sector which only achieved 7.6 per cent compare with the overall GDP 8.2 per cent in 2016. As a whole, SME value added has been contributing on average 25.7% of total GDP.



Source: Department of Statistics, Malaysia

Fig. 4. Annual Growth of SME GDP and Overall GDP for Year 2016 at constant 2010 prices.

Services sector has contributed to the maximum of 16.9% of total GDP and the minimum contribution has been 14%. Mining and quarrying sector's contribution has been the lowest. The maximum mining and quarrying sector has contributed towards GDP has been only 0.05% and the least contribution remained 0.04%. Construction has had the highest variation in terms of contribution towards GDP.

5 Conclusion and Implications

The role of small and medium enterprises is worldwide acknowledged for their unique contribution to the economic development. Both the developed countries and the ones in course of development realise that the SMEs and the entrepreneurs play a vital role in the industrial development of a country. So, there is no surprise that the political strategists have often thought that the SMEs can become the "seed" of economic revival. In this study we found that the SMEs are important to the Malaysia economies which comprise 99.2% of total business establishments, where SMEs contribute 32% of Gross Domestic Product (GDP). SMEs as a whole and all the SME sub-sectors have a high correlation with GDP which shows their significance. Services sector contributes as a biggest chunk of total SMEs and is growing with a fast pace. Mining and quarrying has been the smallest sector which might be due to high competition and intensive capital requirements which are necessary part of the sector. Services based SME sector basically includes tourism, education, medical services etc. which can be promoted to grow further.

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