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SMEs' contribution to the Maltese economy and future prospects

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Policy Note

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Abstract

In recent years Malta's economy has expanded rapidly, reflecting substantial structural changes such as a shift towards more export-oriented services. However this transformation left untouched a long-standing characteristic of the Maltese economy, namely its reliance on SMEs. While there has been a tendency to emphasise the contribution of large projects and new sectors, official statistics suggest that SMEs accounted for the lion's share of growth observed recently. This policy note, in fact, shows that SMEs in the business economy sector generated nearly two thirds of all growth in value added and half of the rise in employment. This is a healthy development as growing dependence on many SMEs is making the Maltese economy more diversified and therefore less susceptible to shocks. For this trend to continue, it is important that SMEs have good access to finance and skilled labour, and be sustained by an adequate infrastructure.

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Executive Summary

In recent years Malta's economy has expanded rapidly, reflecting substantial structural changes such as a shift towards more export-oriented services. There has been a tendency, particularly among the media, to emphasise the contribution of large projects and new sectors, such as remote gaming, and depict these as having been the main drivers of the recent economic expansion, in the process over-turning Malta's historic reliance on SMEs. If this were true, this could raise some questions on the resilience of Malta's growth model. Consequently, this policy note attempts to answer three questions:

- **How important are SMEs in the Maltese economy?**

Data on value added by size of firms are not published as frequently as data on value added by sector. This may be one of the reasons why there may have been a lot of focus on the growth of new sectors such as remote gaming. While the contribution of the latter has grown, official data suggests that the contribution of Maltese business economy SMEs was close to half of total value added, which is significantly higher than the proportion of total value added that is generated by SMEs in the EU (which is around two-fifths).

- **Has the contribution of SMEs risen over time?**

Official statistics suggest that SMEs accounted for the lion's share of growth observed recently in Malta. If one excludes Malta's non-business economy sector, growth in value added was still more than double the increase observed in the EU economy as a whole. This difference in growth was due to Maltese SMEs, as larger business economy firms grew at a slower pace than their counterparts in the EU. In fact, Maltese SMEs in the business economy sector generated nearly two thirds of all growth in value added and half of the rise in employment. This is a healthy development as growing dependence on many SMEs is making the Maltese economy less susceptible to idiosyncratic shocks.

- **What are the challenges facing Malta's SMEs and how can they be addressed?**

Surveys indicate that SMEs are more flexible and can be better agents for innovation than larger firms, with a greater proportion focused on introducing new processes and products. However, particularly in light of challenges brought about by their excellent performance in recent years, Maltese SMEs need to have better access to finance and skilled labour, and be sustained by an adequate infrastructure. It is very important that policymakers use the current strong economic situation to create these conditions so that Malta's long term rate of economic growth is boosted.

How important are SMEs in the Maltese economy?

Before describing the contribution of SMEs to the Maltese economy, it is important to discuss the data on which this policy note is based. The definition of small and medium-sized enterprises (SMEs) follows that adopted in Eurostat's Structural Business Statistics (SBS) database – which is solely based on the number of employees working with a firm.² Data on the number of enterprises are sourced from the National Statistics Office (NSO) business register which covers all economic sectors.³ On the other hand, SBS data on value added and employment are only available for the business economy sector.⁴ This sector excludes a considerable number of economic activities, such as agriculture and fisheries, public administration, education, health, social work, and arts, entertainment and recreation (including remote gaming). While data on the number of enterprises are available up to 2017, SBS data are only available up to 2015 for the EU as a whole and up to 2016 for Malta. The European Commission every year publishes an annual report on European SMEs, which includes estimates for 2016 and 2017 for Maltese SMEs, together with forecasts for 2018.⁵ That said, the data utilised in this report appear to be based on old vintages of SBS data and may under-represent the importance of Maltese SMEs. Thus the analysis in this policy note focuses only on official data.

Table 1 indicates that as at 2017 there were only 113 firms in Malta that employed more than 250 persons. SMEs constituted 99.9% of all firms, with the vast majority, 97.3%, being micro firms employing less than 10 persons. Small firms, employing between 10 and 49 workers, accounted for 2.2% of all enterprises, while 0.5% of all firms were medium-sized. The proportion of large firms is highest in the public administration, health and education

² In contrast, European Commission (2003) defines micro firms as those with less than 10 employees, a turnover below €2 million and a balance sheet of less than €2 million. The thresholds for small firms are the enterprise having less than 50 employees, turnover and balance sheet below €10 million; while for medium-sized firms the cut-off is 250 employees, €50 million turnover and €43 million balance sheet.

³ See

https://nso.gov.mt/en/News_Releases/View_by_Unit/Unit_B4/Business_Registers/Documents/2018/News2018_068.pdf

⁴ For more information see http://ec.europa.eu/eurostat/statistics-explained/index.php/Statistics_on_small_and_medium-sized_enterprises

⁵ See European Commission (2017).

sector, at 0.7%, followed by industry, at 0.3%. Industry also has the smallest share of micro firms, at 92.4% and the largest share of small firms, 5.9%. In terms of absolute number of firms, the bulk of SMEs are in trade, transport, hotels and catering, followed by professional and administrative services, and by financial and insurance services. Together these sectors account for nearly two-thirds of all SMEs in Malta.

Table 1

NUMBER OF FIRMS BY FIRM SIZE (2017)

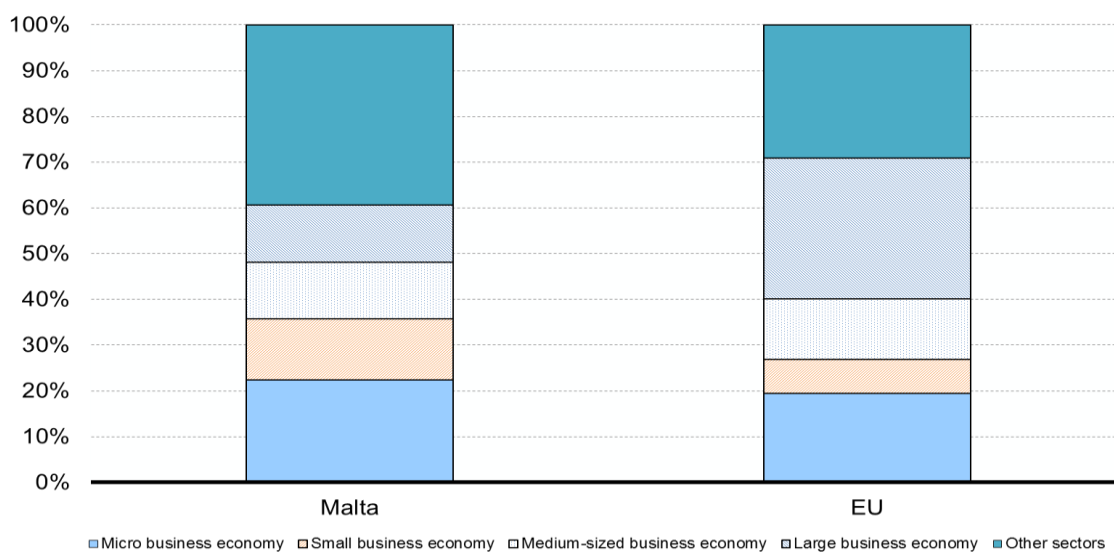
	Micro	Small	Medium	Large	Total
Total	100,614	2,240	491	113	103,458
Agriculture & fishing	3,242	8	3	0	3,253
Industry	3,912	248	58	14	4,232
Construction & real estate	12,155	157	28	6	12,346
Trade, transport, hotels & catering	26,287	932	162	19	27,400
Information & communication	4,166	113	24	5	4,308
Financial & insurance services	16,159	108	23	6	16,296
Professional & administrative services	20,434	363	75	23	20,895
Public administration, health & education	4,250	177	92	33	4,552
Entertainment & other services	10,009	134	26	7	10,176

Source: NSO.

Focusing on just limited liability companies, there were just under 51,500 such enterprises in 2017 in Malta. Of these 32,899 operated within the business economy sector, 99.8% of them being SMEs. This is the same proportion as that observed in the EU.

SBS data indicate that in 2016 the value added of the business economy sector in Malta totalled €5.5 billion. As can be seen in Chart 1, the Maltese business economy sector constitutes a much smaller relative share of value added than that in the EU. The non-business economy in the EU accounts for 29% of total value added, as against 39% in Malta. This mostly reflects the fact that Malta has a larger remote gaming sector and, to a lesser extent, financial sector than the EU. On the other hand, Malta's agriculture and public administration, education and health sectors are relatively smaller.

Chart 1
RELATIVE SIZE OF SELECTED ECONOMIC SECTORS
 (% of total value added - 2015)



Source: Author's calculations using Eurostat national accounts and SBS data.

Micro business economy firms in Malta generated 22% of overall value added in 2015, as against the 20% reported for EU micro business economy enterprises. The contribution of medium-sized business economy firms was also relatively similar, 12% in Malta and 13% in the EU. Conversely large business economy firms accounted for 31% of total value added in the EU, as against 13% in Malta; while the relative share of small business economy firms in Malta stood at 13% or nearly double the 7% share observed in the EU. Overall, the contribution of Maltese business economy SMEs was close to half of total value added, as against just two-fifths in the EU. Limiting the analysis to just the activity of the business economy sector, Maltese SMEs accounted for nearly 80% of value added, compared to 56% across the EU. It is not possible to determine the share of the Maltese economy's value added generated by SMEs in the non-business economy sector. However it is very likely to be considerable, as there are only 46 large firms out of a total 34,227 firms in this sector (a similar proportion to the share of the number of large firms in the business economy sector).

Table 2 shows value added by firm size and by economic sector for Malta. While data for the aggregates by size are readily available from Eurostat, for a significant number of cases of sectors by size (e.g. value added of construction and real estate small firms) the figures shown in the Table are author's estimates. The latter were based on either past available data for these types of firms adjusted in line with more recent information on other variables such as employment for that category, or else derived as residuals from available information on sub-aggregates.

Table 2**VALUE ADDED BY FIRM SIZE AND BY ECONOMIC SECTOR IN 2016 (€ millions)**

	Micro	Small	Medium	Large	Total
Total	1,900	1,393	1,066	1,153	5,512
Industry	145*	216*	190	361*	912*
Construction & real estate	334*	203*	68*	17*	622*
Wholesale & retail trade	445*	376	204	15*	1,040
Transport	79	111*	173*	231	594*
Accommodation and food services	80	75*	155	82*	392
Information & communication	197	135*	131	141*	604
Professional services	385	196*	78*	157*	816
Administrative support services	235	81	67	149	532

Source: Eurostat; author's estimates where indicated by *

Focusing solely on the value added of the business economy sector, micro enterprises account for 35% of this total, as against 25% for small firms and 20% each for medium and large firms. However this pattern differs by sub-sector. Construction and real estate are dominated by micro firms (that account for nearly 55% of value added in the sector), while large firms account for a negligible share. The latter can also be said of the wholesale and retail sector, though within this sector micro and small firms account for 43% and 36% respectively. In the accommodation and food services sector, medium-sized firms account for approximately 40% of value added (double the proportion observed in other sub-sectors); while in the transport sub-sector it is large firms that account for this share.

These breakdowns contrast with those found across the EU; where it is large firms and not micro firms that account for 40% of total value added, while the other categories account for roughly 20% each. Industry in the EU is dominated by large firms, with nearly 60% of all industrial value added, nearly double the relative proportion observed in Malta. Information and communication activity is also dominated by large firms in the EU; with the relative share there nearly triple that in Malta. SMEs account for a large share of the EU's construction sector, 82%, but still smaller than the 96% of activity observed in Malta; whereas wholesale and retail in the EU is more skewed towards larger firms, which account for more than a third of turnover in the sector.

Micro wholesale and retail firms account for the largest relative share in value added in Malta. They, in fact, generated €445 million in 2016, equivalent to 8% of the overall value added of the business economy sector or nearly a quarter of the value added of all Maltese micro firms. They were closely followed in importance by micro professional services firms, with about 7% of the overall value added of the business economy, and micro construction and real estate firms that accounted for about 6%. Large industrial firms contributed 6.5% of business economy value added, making them the third largest business economy sector in Malta. By contrast, in the EU the largest contribution to business economy value added was that of large industrial firms, which accounted for a fifth of overall value added. The second largest share was that of medium-sized industrial firms, closely followed by large wholesale and retail firms. Micro construction and real estate firms were the fourth largest contributor in the EU's business economy, while micro wholesale and retail were the sixth largest.

Table 3

EMPLOYMENT BY FIRM SIZE AND BY ECONOMIC SECTOR IN 2016

	Micro	Small	Medium	Large	Total
Total	45,922	33,881	31,841	30,962	142,606
Industry	4,307	5,902	5,671	8,900*	24,780
Construction & real estate	7,093*	2,162*	1,984	1,671	12,911
Wholesale & retail trade	16,548	10,044	6,519	1,242	34,353
Transport	2,113	2,248*	2,111*	5,374	11,846
Accommodation and food services	5,783*	4,880	6,303	2,290*	19,255
Information & communication	1,954*	2,086	2,516	2,004*	8,560
Professional services	5,701	4,032	2,464	1,669	13,867
Administrative support services	2,423	2,527	4,273	7,812	17,034

Source: Eurostat; author's estimates where indicated by *

The business economy sector in Malta accounts for close to 70% of total employment, as against 60% in the EU. Table 3 presents a sectoral breakdown of employment within Malta's business economy sector by firm size. Micro firms comprise a third of all employment in the business economy sector, while small and medium enterprises amount to about 24% each, with large firms employing 20% of all business economy workers. By contrast in the EU, large firms employ more than a third of the business economy workforce, while small and

medium firms between them comprise 37% of employees. The share of employment of micro firms in the EU, at 29%, is also lower than in Malta. Similarly to the picture observed for value added, employment in the Maltese construction and wholesale and retail sectors is dominated by micro firms. In the EU this dominance is less evident, but still strong. SMEs account for the lion's share of employment of most sub-sectors in Malta, with the exception of administrative support services and transportation where large firms account for over 45% of employment, while in industry large firms employ nearly 30% of the workforce. In the EU the dominance of large firms in these sectors is more accentuated, with for instance 34% of the industrial workforce employed in large firms. Interestingly while in the EU the accommodation and food services sector has 39% of its workforce in micro firms, in Malta this proportion is employed in medium sized firms. Another difference is in the employment distribution in the information and communication sectors, which in the EU is dominated by large firms while in Malta it is medium-sized firms that have the largest share of employment.

Micro wholesale and retail firms, who comprise the largest sectoral share of Malta's business economy value added, also account for the largest sectoral share of employment. However their share of employment, at nearly 12% of overall business economy employment, is much larger than their share of value added, at 8%. This contrasts with the second largest business economy category in terms of value added, i.e. micro firms operating in professional services. These firms account for 4% of overall business economy employment and 7% of its value added. On the other hand, large industrial firms (the third largest category) and micro construction firms (the fourth largest category) have similar relative shares in both value added and employment.

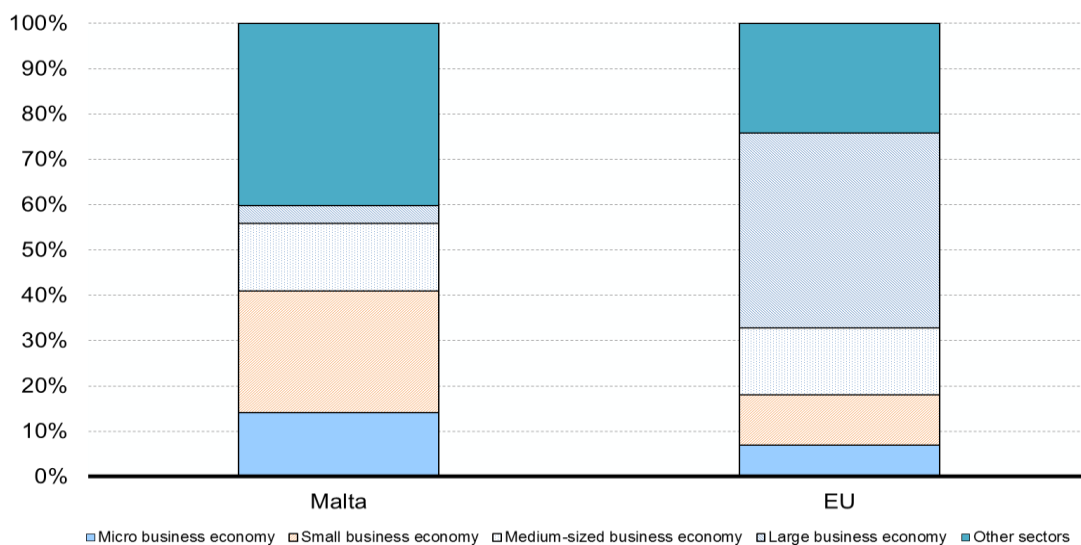
Unfortunately given that value added data are only available in nominal terms, it is not possible to make a reliable assessment of productivity by sector and by firm size. Nominal value added per employee ranges greatly, with the lowest values amongst Maltese SMEs being in the accommodation and food services sub-sector and the highest in information and communication, where nominal value added per employee is four times higher. In the EU one finds the same two sub-sectors with the lowest and the highest values, but in this case the nominal value added per employee of information and communication is only three times higher. Overall, the nominal value added per employee in Maltese SMEs stands at 88% of that in EU SMEs, while that amongst large firms stands at 59%. The main difference appears to be in the relatively low nominal value added per employee found in large Maltese construction and wholesale and retail firms. However as pointed out earlier looking at nominal measures of output can be misleading, as price levels and the nature of operations can differ very greatly.

Has the contribution of SMEs risen over time?

A substantial part of the high growth in value added that occurred in Malta was not due to the business economy sector (see Chart 2). In fact, other sectors accounted for about 40% of growth between 2011 and 2015 in the Maltese economy's gross value added, as against 24% in the EU. However nominal value added in the business economy in Malta grew by 47% during this period, whereas across the EU the pace of expansion amounted to just 13%. This difference arose mainly due to the rate of increase in value added across business economy SMEs in Malta, which during this period grew at six times the pace reported for business economy SMEs in the EU. By contrast, large business economy operators saw an increase of 10% in Malta, nearly half the growth observed in the EU.

Chart 2
SHARE OF GROWTH IN VALUE ADDED OF SELECTED ECONOMIC SECTORS

(Growth between 2011 and 2015)



Source: Author's calculations using Eurostat national accounts and SBS data.

Contrary to the general impression that the contribution of SMEs in the Maltese economy is declining and is being crowded out by sectors such as remote gaming, SBS data suggest that between 2010 and 2016, the contribution of business economy SMEs rose. Taken together, micro-, small- and medium-sized firms in the business economy sector increased their share in Malta's total gross value added from 40% in 2010 to 48% in 2016. By contrast in the EU, business economy SMEs saw their share of value added fall slightly from 41% in 2011 to 40% in 2015. This suggests that the exceptional performance of Maltese business economy SMEs underpinned the pronounced difference in growth rates between Malta and

the EU. If one excludes Malta's non-business economy sector, growth in value added was still more than double the increase observed in the EU economy as a whole. This difference in growth was due to Maltese SMEs, as larger business economy firms grew at a slower pace than their counterparts in the EU. Official data suggests that instead of becoming more concentrated, economic activity in Malta is spreading over a growing number of small firms.

For instance, SBS data suggest that between 2010 and 2016, micro-firms in professional services, information and communication and administrative support services increased their value added by €557 million, more than doubling their initial activity. Together these firms now employ approximately 10,000 persons, up by 25% since 2010. Although they account for one in twenty of all employees in Malta, they contributed one sixth of the growth in value added during this period. By contrast small-sized wholesale and retail firms, who also employ about one in twenty of all employees in Malta, saw an increase of €211 million during this period, implying a contribution of one-fourteenth of overall growth in value added.

Table 4

SME CONTRIBUTION BY SECTOR (% OF 2010-2016 ECONOMY WIDE GROWTH)

	Micro	Small	Medium
Business Economy	31	21	13
Industry	0*	1*	0*
Construction & real estate	3*	4*	1
Wholesale & retail trade	8*	7	3*
Transport	1	1*	3*
Accommodation and food services	1	1*	2
Information & communication	4	3*	2*
Professional services	8	3*	1*
Administrative support services	5	1*	1*

Source: Eurostat; author's estimates where indicated by *

Table 4 shows estimates of the growth in value added of SMEs by sector as a percentage of the overall growth in value added in the Maltese economy between 2010 and 2016. To provide some perspective, the remote gaming sector – the sector that tends to attract most

attention in the media as the driver of economic expansion – accounted for approximately 17% of overall growth in value added during this period. Table 4 indicates that SMEs in the business economy sector accounted for a much larger contribution, of close to two-thirds. The relative importance of micro firms in the business economy sector in generating value added has risen considerably over time, from 15.6% of all value added in 2010 to 21.1% in 2016. By contrast the share of the remote gaming sector rose approximately by 3.2 percentage points, from 8.3% to 11.5%. In absolute terms, remote gaming’s value added rose by €556 million, slightly less than the increase observed among micro-firms in professional services, information and communication and administrative support services.

Table 5

SME SHARE OF 2010-2016 ECONOMY WIDE GROWTH IN EMPLOYMENT

	Micro	Small	Medium
Business Economy	14	21	14
Industry	-1	0	-0
Construction & real estate	1*	0*	-0
Wholesale & retail trade	7	3*	4
Transport	-0	1*	1*
Accommodation and food services	3*	5	0
Information & communication	1*	3*	1*
Professional services	2	6*	3*
Administrative support services	1	2	4

Source: Eurostat; author’s estimates where indicated by *

Looking at employment growth during the same period, remote gaming accounted for 7% of the rise observed across the Maltese economy, which is only slightly higher than the share of small-sized professional services firms and the same as that of micro wholesale and retail firms(see Table 5). Taken together, business economy SMEs accounted for nearly half of the growth in employment between 2010 and 2016. Comparing Table 4 and Table 5, there is a noticeable difference between the contribution to growth in value added of micro firms and their relative share of employment growth. This reflects the fact that micro-firms in professional services, information and communication and administrative support services accounted for a significantly smaller rise in employment than their very substantial contribution to growth in value added.

What are the challenges facing Malta's SMEs and how can they be addressed?

The analysis presented in the previous section indicates that the very positive performance of SMEs underpinned Malta's rapid economic expansion. SMEs in Malta have been very successful, with turnover growth five times the EU average and their results contrast starkly with the decline in activity observed amongst SMEs in neighbouring countries such as Spain, Portugal, Cyprus, Greece and Italy. However success, particularly when the pace of growth was so high, widespread and (relatively) unanticipated, has brought about its own set of challenges. This emerges from a number of surveys that have been carried out amongst SMEs in recent years. In this policy note, we focus on the results presented in European Investment Bank (2017), which covers a survey carried out among nearly 180 SMEs operating in Malta and which can be compared with EU-wide results for SMEs (henceforth denoted as EIBIS 2017).

According to this survey 84% of Maltese SMEs are investing, as against 78% in the EU. Moreover a majority of about 15% of Maltese SMEs are planning to increase further their investment, compared to only 9% in the EU. The main investment priority for both EU and Maltese firms for the next three years are projects intended to develop or introduce new products, processes or services, but the relative importance for Maltese SMEs stands at 37%, vis-à-vis 26% among EU SMEs. The bulk of investment (around 45%) is expected to concern the acquisition of machinery and equipment. However, there are important differences in other investment priorities. While 8% of EU SMEs will be focusing on research and development, just 3% of Maltese firms have the same intention. On the other hand, relatively more Maltese firms (19% versus 15% of EU SMEs) will be investing in software and IT. Another significant difference relates to training of employees. For about 13% of EU SMEs this will be the main investment priority over the next three years. This is noticeably larger than the 8% reported for Maltese firms.

Nearly 75% of Maltese SMEs report they are operating at full capacity, as against 53% of EU firms. In fact, the results for Malta were the highest observed across countries included in EIBIS 2017. Operating at full capacity implies that firms need to invest more if they are to grow further and be able to fulfil future orders, while they are somewhat hard-placed to adjust for unanticipated changes in demand or customer requirements. Having no slack resources means that addressing unexpected events inevitably leads to higher costs – such

as having to sub-contract or else risk stretching further already over-stretched resources. The issue appears to be most pronounced within the services and construction sector.

EIBIS 2017 asked firms to indicate what they saw as the major long term barriers affecting their investment decisions. These ranged from demand conditions to energy costs to access to digital infrastructure. Across the EU, the main three concerns of firms were, in order of magnitude, availability of skilled staff, uncertainty about the future and labour market regulations. For Maltese SMEs the three largest major obstacles were skilled staff availability, uncertainty about the future and the availability of an adequate transport infrastructure. While the proportion of EU and Maltese SMEs worried about uncertainty was fairly similar, the degree of concern of EU firms about skilled staff availability was much lower than that amongst Maltese firms. 75% of the latter consider availability of staff with the right skills as a major obstacle, as against 44% of EU firms. Only 8% of Maltese SMEs do not see the labour supply as a barrier to investment, compared with nearly 28% of EU firms.

Maltese firms are increasingly relying on foreign staff. Undoubtedly while this is a quick way to address the current shortage of labour; there are indications that foreign staff has very high turnover rates. This poses issues for firms' growth prospects as it lowers the potential for productivity growth and skills transfer. It also implies that firms have to spend more resources on recruitment and basic training. While at present, buoyant economic conditions and the resulting plentiful internal funds allow such expenditure, it would be better if these funds were spent on training that leaves more long term benefits. One area that needs to be more actively considered is the retraining and continued use of older workers and recently retired persons. This could be a way to retain institutional knowledge and facilitate skills transfers. Moreover older age groups are becoming the fastest growing part of the Maltese workforce. To manage this transition, firms will need to become more flexible, offering more part-time and off-site working. Trying to accommodate the needs of employees is possibly a much better long term human resources strategy than continuing to rely too much on transient workers. To encourage SMEs to train and retrain staff, policymakers should seek ways to support the collective organisation of training and implement further schemes to share the costs of training across firms. The model used for the maternity leave fund could be extended to cover training costs, for instance.

Another challenge faced by Maltese SMEs is infrastructure. Only 29% of these firms do not view the existing transport infrastructure as an obstacle (compare to 59% of EU SMEs). By contrast 48% of Maltese SMEs, as against 58% of EU firms, have the same opinion regarding access to digital infrastructure. Double as many Maltese SMEs (40% vs 20%)

believe that public investment should prioritise transport infrastructure over the next three years, while four times as many (12% vs 3%) see public transportation as the key priority. By contrast, there is a less pronounced concern about public investment in professional training and higher education (13% vs 22% among Maltese and EU firms, respectively).

There is currently considerable fiscal space that could be used to finance infrastructural investment in Malta. Policymakers are committed to use the National Development and Social Fund partly for this purpose. Furthermore they can leverage EU funds, while the Malta Development Bank can tap into other EU initiatives and its own funds. However, the private sector needs to involve itself more in driving change in this area, particularly in light of spending limits faced by public institutions. Firms also can help reduce and address the infrastructure needs generated by fast economic growth. Rather than rely on public transport, more privately organised collective transport could be set up. More flexible starting times and use of teleworking could also help alleviate traffic congestion. It is also becoming increasingly important that economic activity in Malta does not remain so concentrated in few areas. This is leading not just to pressures on infrastructure but is also raising operating costs, possibly leading to losses in competitiveness.

Finally while at present the glut of internal funds appears to have lessened the appetite of Maltese SMEs for external finance (with the proportion of firms stating they were happy to rely just on internal finance doubling in just one year), it is vital to continue improving access to finance. While the latter is seen as just a minor barrier to investment at present, external finance remains very important for Maltese firms. EIBIS 2017, in fact, indicates that 82% of Maltese firms who used bank loans to finance investment in the past want to do this again in the next three years. By contrast, only 59% of EU SMEs gave the same indication. Maltese SMEs who were dissatisfied about access to external finance were mostly concerned about its cost and the collateral required.

The Malta Development Bank can play a key role in reducing lending costs and collateral requirements for SMEs through the provision of partial guarantees. The latter could also help local banks to engage with new and innovative firms. At the same time, while the local capital market needs to continue evolving, due care needs to be given to investor protection and financial education. In this light, it would be best if local banks remained the main provider of external finance for SMEs. Public authorities need to continue tackling barriers to access to finance (e.g. by continuing to expand the Central Credit Register, tap into EU and EIB funds, etc.). Reducing SMEs' reliance on internal funds is crucial to ensure investment continues when economic growth eventually slows down.

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