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# Challenges for Public Policy in Promoting Entrepreneurship in South Eastern Europe

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**Summary**

The economies of Central and Eastern Europe have an urgent need to boost entrepreneurial activity at all levels, but particularly in relation to small businesses. However, this is a significant challenge, as it must be done against a background of very scarce resources, poverty, an inefficient financial services sector, poor infrastructure and an undeveloped entrepreneurial culture. This paper addresses five dimensions of the policy challenges confronted by the governments in South Eastern Europe, namely institutional development, regulatory reform, simple taxation, access to finance and services for developing businesses and start-ups.

Enterprise development is rapidly increasing in policy importance in the South Eastern European (SEE) region. There is an urgent need to raise productivity and competitiveness and to tackle high levels of unemployment and poverty. In addition there is a high political imperative in all countries to achieve membership of the European Union as quickly as possible, which has brought enterprise development even higher up the policy agenda. By signing the European Charter for Small Businesses in

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June 2003, the SEE countries created a framework for their small enterprise activities to be monitored and assessed.

The term ‘small enterprises’ in this paper is used to cover micro, small and medium-sized enterprises (SMEs). The SEE region covers the following countries: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania and Serbia and Montenegro (excluding Kosovo). The paper draws heavily upon the most comprehensive recent sources of material: the OECD-EBRD’s Enterprise Policy Performance Assessments (2003a–2003j) and the EC’s Charter National Country Reports. These sources are supplemented with the author’s perspectives, based on extensive work in the region.

Although there are problems of definition and comparability in making sense of small business statistics from the SEE region (see OECD-EBRD, 2003a). SMEs make up 98.1 per cent of all enterprises in the SEE region, not dissimilar to the 99.8 per cent figure for the EU and its neighbouring advanced economies. However, there are only 13.7 SMEs per 1000 inhabitants in the SEE region compared with 52.8 in the EU-19 area. Small enterprises in the SEE region provide less than half (47 per cent) of total employment in the enterprise sector compared with 66 per cent for the EU-19 region. The very low density of SMEs in the SEE region indicates just how far the scope exists for public policy in making an impact on enterprise development.

## Institution Building

Despite the high degree of institutional variation in the region, most countries are looking to develop a three-tier institutional architecture involving a ministry, a SME agency and regional SME support offices. A key weakness, however, is the lack of financial muscle and human capital to do the job, particularly at the local level. As a rule, neither local authorities nor regional bodies are considered to be helpful by small businesses. The lack of resources means that, whilst most countries have approved SME development strategies and action plans, implementation has been poor. The majority of countries rely heavily on international donors and International Financial Institutions (IFIs) to fund the significant gap between intention and budgets, but there is often a lack of effective donor coordination, especially where the often extensive private sector development programmes are concerned.

Some of the most serious institutional challenges are self-imposed. There is a high degree of institutional turbulence. SME institutions are created for a few years, then transformed into something else or abolished altogether, only to be recreated a couple of years later, often without any evaluation or analysis underpinning the process. For example, Romania has gone through eight different models in the last 14 years. A related weakness is the high degree of staff turnover. Political change arising from elections and reshuffles often impacts directly on key civil servants and other public officials. This issue is not specific to the SME sector, but it undermines commitment and capacity building.

A further key challenge for these countries is to introduce effective mechanisms for dialogue and consultation between small business and government institutions. There have been some serious attempts to deal with this issue, such as in FYR Macedonia and Romania, but as a rule these initiatives tend to be ad hoc, under-funded and unrepresentative, thus contributing to the perception among small enterprises that Government does not take their interests sufficiently into consideration.

Whilst the broad institutional infrastructure required to support small enterprise development is already in place in the SEE region, there is a need for further good practice from EU member countries to be applied. In particular, technical assistance in implementing effective institutional cooperation and coordination is required. In addition, there is far too little performance monitoring of the ministries, agencies, and regional/local institutions dealing with SME policy.

## Business environment

All the evidence (see OECD-EBRD, 2003a–2003j) suggests that business entry remains exceedingly bureaucratic, complex and costly:

- the number of procedural steps to register a company ranges from 16 in Serbia to four in Montenegro. International experience suggests that this could be reduced to one procedure in 1 day;
- the number of days to register a company ranges from 74 in Bosnia/Herzegovina and four in Montenegro. Again, international experience suggests that this could be done in less than 1 day;
- the costs of registering companies varies from €11 in Montenegro to €746 in Croatia. It could be brought down to zero cost;
- online registration is non-existent;
- minimum paid-up capital ranges from a token €5 in Montenegro to €5000 in Serbia.

Most SEE countries are genuinely looking to create a more efficient process of business registration, creating so-called 'one stop shops', but so far only Romania has achieved this.

Municipalities affect the business environment in that they process licences (e.g. health and safety) and permits (e.g. construction activity). Among the most problematic barriers faced by entrepreneurs is public officials, who are frequently accused of inefficient and non-transparent practices, often extracting bribes and discouraging entrepreneurs from registering their activities, thus stimulating informal activity.

A further stumbling block in the business registration process is the role played by the courts, which are often under-resourced and in need of reform. Despite adding little to the process, courts cling tenaciously to this function since it generates income. Other barriers exist that inhibit investment by domestic and foreign entrepreneurs. Most countries in the region have invited the Foreign Investors Advisory Service (FIAS) to produce surveys and recommendations on how to improve the business environment. They have often established Business Simplification Working Groups and Action Plans, but there are many vested interests seeking to maintain the status quo. There has generally been little progress, except where donors and IFIs, especially the World Bank, have provided technical assistance, which is linked to conditional loans.

Finally, the informal economy is of major concern in the SEE region. Estimates suggest that its significance ranges from 29.1 per cent of GNP in Serbia and Montenegro to 45.1 per cent in Moldova and Macedonia (Schneider, 2002). An informal economy undermines state revenues and thus investment and public services, and results in unfair competition with formally registered firms. In general, initiatives to counteract the effects of the informal economy have had little impact.

### Tax System

One of the main problems is an overly complicated tax system, with a multiplicity of taxes, exceptions and regulations. In Bosnia and Herzegovina, for example, the Republika Srpska and the District of Brcko have their own tax administrations, rates and systems. Romania is not unusual in forcing companies to make 15 different tax payments. A constant complaint made by all enterprises is that the tax regime is constantly changing, placing significant compliance burdens on smaller firms in particular. An additional problem is the frequent requirement for taxes to be paid in advance or with inflexible deadlines, both of which imposed cash flow strains on small businesses.

The implementation and administration of Value Added Tax (VAT) also causes problems for entrepreneurs in the SEE region. All countries have introduced VAT except Serbia and Bosnia and Herzegovina. However, VAT avoidance is widespread, VAT thresholds vary widely around the region and, with registration being largely voluntary, enterprises are able to pass on the cost to the final consumer. The poor administration of the tax refund also often places severe cash flow strains on businesses.

### Access to Finance

Access to finance is a problem for small firms all over the world, but those in the SEE region suffer disproportionately, due to the poor level of the development of the financial services sector and higher risk aversion by commercial banks.

The mono-bank systems in the SEE region have been dismantled, but the depth of reform varies from country to country. Privatisation and foreign direct investment have led to a restructuring and the legal, supervisory and regulatory framework has improved dramatically. However, stronger capitalisation, improved banking practices, higher profitability and increasing competition have simultaneously increased risk aversion and thus affected the lending activity to small firms. When lending resumes in these countries, the beneficiaries tend to be households, blue chip companies and large, usually foreign-owned enterprises, rather than SMEs. The levels of banking intermediation remain low (36 per cent of GDP in the SEE region versus 135 per cent in the Euro area in 2002), partly due to economic downturn and the various banking crises that led to more stringent banking regulations and supervision to ensure more prudent lending.

Experience suggests that, given such a background, it is necessary to create dedicated channels for small enterprise lending through SME credit lines, micro finance banks, and micro credit by NGOs. Micro finance banks have been a major success, having spread to all SEE countries, except Montenegro and Croatia. A very large number of small loans to micro and small businesses have been made (see OECD-EBRD, 2003a) and loan arrears are very low, suggesting that it is perfectly possible to lend on a commercial basis to small enterprises in transition economies. The success of micro finance banks may now be having an impact on attitudes and practices of some of the commercial banks. Various SME credit lines exist and these are being complemented by the micro finance activities of NGOs, typically making finance available to non-bankable clients such as start-ups and rural communities.

In terms of other funding instruments, all SEE countries are looking to implement state credit guarantee schemes, but a lack of good practice has meant that the experience has been poor. Leasing is largely unknown in the region, but is beginning to have an impact in Bulgaria and Romania. Venture capital has really failed to take off, with the possible exception of Croatia, and mutual credit guarantee schemes are generally unknown.

A key issue blocking improvements in access to finance for entrepreneurs is the need for reform of the legal and regulatory environment. A combination of very high minimum capital requirements for firms and a lack of effective land registration translates into very high collateral requirements by banks, excluding most SME entrepreneurs.

## Advisory Services and Business Incubators

The SEE region has benefited from substantial inflows of funding from the international community for the establishment of service provision, such as business centres designed to assist start-ups and early growth enterprises. The result is that SEE countries have between 8 (Moldova) and 50+ such centres (Albania and Romania). In addition, private sector providers are beginning to deliver services such as bookkeeping, legal advice, consultancy and training. These tend to be concentrated in urban areas resulting in gaps in provision in the countryside.

A fundamental problem, however, is that small business clients often consider these services too expensive or insufficiently attuned to their needs. Firms use such services when they are free but avoid them when they are charged on a commercial basis. The domestic public sector does not have the resource to support such services. Consequently, once international subsidies run out, business centres either close down or try to refocus their services to firms able to pay commercial fees or to donors.

Business incubators are recognised in the SEE region as an effective means of providing new firms with premises, business infrastructure and support services, thus enhancing their chances of survival. Many countries have established them, mostly in the 1990s. However, many incubators have been unable to attain the levels of occupancy and activity to be viable and have closed down. The main reason for this is that incubators were often created as unemployment alleviation and poverty reduction measures, rather than focusing on entrepreneurs and enterprises with high growth potential and long-term prospects.

## Conclusions and Lessons

This paper has highlighted the main progress that has been made in the SEE countries to boost entrepreneurship in relation to small businesses. It shows that a significant amount of progress has been made. However, major challenges remain in unleashing the potential for generating wealth and employment, and reducing poverty. The policy emphasis has been, and remains, on learning from EU countries in terms of enterprise policy issues, given the stage of development of the SEE countries and the need to overcome five decades of the influence of a socialist economy.

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