Small and Medium Enterprises in Central and Eastern Europe

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Summary
Various obstacles have prevented the growth and modernisation of the SME sector in transition countries, although they did not inhibit the foundation of great numbers of traditional, mostly micro-enterprises fighting for survival. These obstacles require that proper policies are addressed to the SME sector, both involving the general context or SME specific issues. The situation varies greatly through countries due to pre-transition features and different transition strategies. Since countries differ also under other features, policies should be different. The role of the European Union is particularly important in both an indirect and a direct way, as provider of uncertainty reducing role and devices and as supplier of resources.

Keywords
Small and medium enterprises, Transition, Policies, European Union

1. Transition and SMEs

The small business sector was widely expected to play a crucial role during transition in Central and Eastern Europe (CEE). Indeed, many observers expected that it would boom once restriction to economic freedom were lifted and this would lead the transition to the market economy both directly, by creating large numbers of competitive small and medium sized enterprises (SMEs), and indirectly, by pushing large companies to adapt and restructure through competition. Barely anything like this happened since 1989 and the events since then have shown that these expectations were false, or premature, for a number of reasons.

The first reason is that SMEs existed in CEE well before transition. A certain number of small businesses survived through the Soviet-type period in private hands. Others were in state or co-operative ownership. Finally, and most importantly, the revival of the SME sector, usually in mixed ownership, was one important outcome of economic reforms, particularly in Central European countries and primarily in Hungary and Poland, but also in former Soviet Union (the so-called co-operatives of the late Eighties-early Nineties: at the beginning of 1990 the 250,500 co-operatives employed 5.5 million people with nearly 22 employees per firm). For instance, it was estimated that employment in the non-socialised sector in Poland (including the activities that were not directly included in the state and the co-operative sector and had a mixed character, measured in per cent of the socialist sector employment) amounted to 28.3 per cent in 1980 and 30.0 per cent in 1988. Corresponding figures for Hungary were even higher, respectively 33.4 per cent and 43.3 per cent.[1]

A second, and more important reason for disappointment of easy expectations has been that SMEs are not by themselves enough to foster economic growth and transformation during transition. If proper institutions and structures and if economic growth are not in place, SMEs hardly develop. Although their number can increase and even boom, their economic strength and role remain weak. [2]

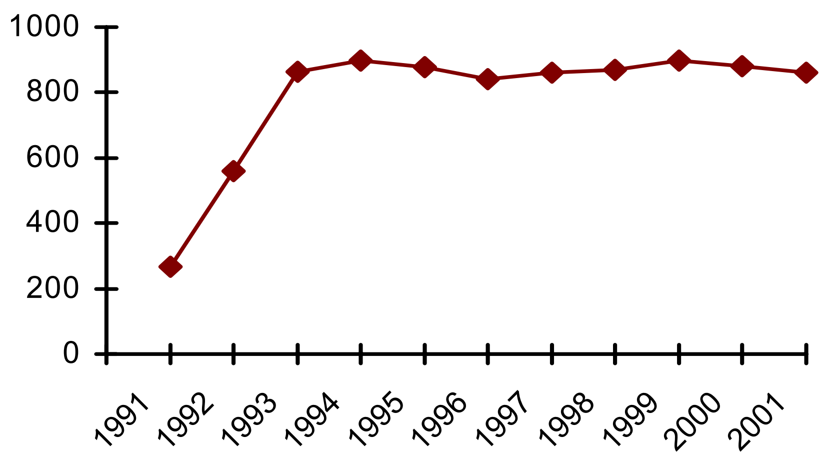
If one is convinced that a modern and thriving SME sector is fundamental for the success of transition as a process that leads to the transformation of the economic system of a country and to the modernisation of its economy, then it is necessary to understand what are the obstacles to this role of SMEs as a first step to remove them. As it turns out, obstacles to SMEs establishment, growth and modernisation vary largely through countries, as the nature and present role of SMEs do. Countries in transition are remarkably different also under this aspect.

In general, the problem is not necessarily that SMEs did not grow in numbers. True, in some cases, such as that of Russia (see Figure 1), there are too few SMEs compared to the size of the country and to the numbers existing in comparable market

[1] Bruno Dallago, 'The Non-Socialized Sector in Hungary: An Attempt at Estimation of its Importance', *Jahrbuch der Wirtschaft Osteuropas/Yearbook of East-European Economic*s, 1989, 13, 2: 67–92. Bruno Dallago, 'Hungary and Poland: The Non-Socialized Sector and Privatization', *Osteuropa-Wirtschaft*, 1991, 36, 2 (June): 130–53.

economies. However, in some other cases the problem has been labelled as "too many, too small". This label stresses that SMEs size is too small to make them viable in modern and competitive market economies. A corollary of the latter is that most small businesses are concentrated in the traditional consumers trade (including shuttle trade) and some traditional handicraft. Scarce examples of vertical integration with large firms exist, and barely any horizontal networks.

Figure 1. NUMBER OF SMALL ENTERPRISES IN RUSSIA, 1991-2001 (thousands)



Source: Goskomstat, *Small Entrepreneurship of Russia in 1995,* 1996, p. 13; *Small Entrepreneurship of Russia in 1998,* 1999, p. 14, Goskomstat (1996): 13; (1999): 14; (2001a,b). Reported from Vadim Radaev, 'The Development of Small Entrepreneurship in Russia', in Robert J. McIntyre and Bruno Dallago (eds.), *Small and Medium Enterprises in Transitional Economies*, Houndmills, Basingstoke and New York: Palgrave Macmillan, 2003, pp. 114-133, p. 117

This has been the dominant pattern for various years in even the most successful transition countries, such as Poland and Hungary. In general the situation could be described as "too few, too small", with the exception of post-Soviet republics among accession countries (see table 1 and table 2). Even more than size, what is more problematic is the relative technical and commercial backwardness of these enterprises in most transition countries.

[2] Robert J. McIntyre and Bruno Dallago (eds.), *Small and Medium Enterprises in Transitional Economies*, Houndmills, Basingstoke and New York: Palgrave Macmillan, 2003.

Table 1 – Average enterprise size, accession countries and Europe-19, 1995-1999

	1995	**1999**	**Change 1995-1999**
Bulgaria	9	8	-0
Cyprus	4	4	-0
Czech Republic	6	5	-2
Estonia	12	9	-2
Hungary	9	4	-5
Latvia	17	15	-2
Lithuania	11	11	-1
Malta	4	4	0
Poland	5	5	-o
Romania	3	6	2
Slovak Republic	8	8	-0
Slovenia	6	6	-0
Turkey	4	4	0
Total accession countries	***6***	***5***	***-1***
Europe-19	***6***	***6***	***-0***

Source: Estimated by EIM Business & Policy Research from various national and nternational sources. Reported in European Commission, *SMEs in Europe, including a first glance at EU candidate countries*, Observatory of European SMEs 2002 / No 2, p. 15

Table 2 – Structure of non-primary private enterprise, total accession countries and Europe-19, 1999

	SME				***LSE***	***Total***
	Micro	**Small**	**Medium-sized**	**Total**		
Total accession countries						
- Enterprises (1000)	5 540	205	45	5 795	10	5 805
- Total employment (1000)	11 760	4 430	4 890	21 075	8 210	29 290
Occupied persons/enterprise	2	21	107	4	837	5
-Size-class dominance*						micro
Europe-19						
- Enterprises (1000)	18 710	1 185	165	20 060	40	20 100
- Total employment (1000)	41 040	22 755	15 765	79 555	40 445	120 000
Occupied persons/enterprise	2	19	94	4	1 019	6
-Size-class dominance*						micro

* A country or sector of industry is said to be micro, small and medium-sized, or LSE dominated, if either micro, small and medium-sized (taken together), or large scale enterprises have the largest share in total employment.

Source: Estimated by EIM Business & Policy Research from various national and nternational sources. Reported in European Commission, *SMEs in Europe, including a first glance at EU candidate countries*, Observatory of European SMEs 2002 / No 2, p. 15

2. Obstacles to SMEs development

Recognising the obstacles to SMEs growth and modernisation is the first step on the way to consider policy intervention either to remove the obstacles in order to allow for spontaneous processes to unfold successfully, or to implement affirmative action when spontaneous processes are insufficient or unfavourable. Obstacles to SME growth and development are of three different kinds due to: a) the nature of transition; b) poverty and low income; and c) policy mistakes.

Transition has been like a journey into a sea badly known only on paper by means of an unknown ship. The journey has been badly known because – in spite of early pretensions of clear knowledge of the nature, means and goals a modern and competitive market economy – it was not known how to get there. Surprises and unforeseen facts and consequences have been more the rule than the exception. The ship itself has been unknown because the institutional setting of such a market economy and its implications were all but unknown to most economic actors since they had no previous experience.

In the case of SMEs all this has meant that institutions and infrastructure, including those necessary to SMEs, were missing or undeveloped. SMEs themselves – their owners and entrepreneurs in particular – missed the necessary experience and expertise to successfully operate in a competitive market economy. To these one should add that transition as it was implemented also meant liberalisation of foreign competition, often excessively abrupt for new SMEs to survive. Privatisation and other forms of wealth distribution offered plenty of opportunities for pursuing rent instead of profit, particularly in the form of accumulating ownership at low costs. Last but not least, the disruption of the state offered the possibility and opportunities for criminal organisations to get a strong hold over the economy.

The second obstacle to SMEs growth and development has been low income and spread poverty, both largely the outcome of rising inflation first and macroeconomic policies then. Low income and poverty depressed demand, thus spoiling the necessary condition for establishing new firms. To this one should add that inflation and stabilisation policies sometimes severe beyond the needs dramatically decreased the value of savings, thus wiping out the main basis for financing SME foundation.

Beyond damaging although partly needed policy choices, such as macroeconomic stabilisation, there were plain policy mistakes that hampered the foundation of SMEs. Main among these have been the inconsistency and instability of policies in general and those that have been most relevant for SMEs in particular. Regulation and taxation rules have been often highly unfavourable to SMEs – thus giving indirectly a boost to tax evasion and regulation avoidance as adaptation mechanisms – and changed frequently. Governments of different level (in particular, central and regional ones) in some countries adopted inconsistent and even predatory measures related to SMEs, with the partial exception of Central European countries. All this created uncertainty among owners and entrepreneurs.

Obstacles SMEs in transition apparently change during their life cycle. Credit is an important issue in point. While observers and scholars often quote the lack of credit as a major obstacle to SMEs foundation, this is not supported by closer observation and by SME owners and entrepreneurs. Indeed, alternative financial sources are available for founding SMEs. Own capital is in fact by far the most important source of starting capital, particularly for domestically owned firms, including the founder's own resources and those of relatives and friends or – in case of spin-offs – those of the mother firm. The importance of bank credit is generally marginal and that of loans from special support schemes is negligible in all countries. However, the lack of credit (including bank credit, trade credit, and leasing) becomes a major obstacle that prevents or slows down the growth and modernisation particularly of domestic firms.

Under these circumstances, then, one should ask why so many SMEs were established in various countries in the first years of transition. To be sure, one should ask first whether official figures are reliable or not. Indeed, many reasons to doubt the reliability of official figures exist, although inter-country differences are important also in this case. The political pressure to privatise fast and inexperience with the issue led statistical offices to fail inquiring whether registered SMEs were actually operating. Many firms were registered to obtain fiscal and credit benefits or to take advantage of the privatisation of large companies, since registration was submitted to no cost or control. SMEs that ceased to operate were not cancelled from registration. All this artificially enlarged the number of SMEs. When the production of the SME sector was obtained by generalising to the entire (registered) population the values obtained by respondents to sample surveys (disregarding non-respondents), an overestimation of SME production was obtained.

Statistical measurement aside, the experience obtained so far with SMEs in transition suggests that a diverging pattern of the SMEs nature and role is gaining ground. The large majority of SMEs are of very small size in nearly all countries[3] (although not in Russia), have traditional character, and are risk-averse. Indeed, their major concern is survival without major concern for competitiveness and growth. As a consequence, they invest neither in modernisation nor in growth and survive in traditional market niches, small scale trade being the most important case in point.

During the first decade of transition many of these SMEs could be correctly defined as proprietorships – as against entrepreneurship characterising the most dynamic SME segment – in the sense that they were mostly concerned with keeping the value of the assets than producing a profit and were nearly perfectly risk-averse. In some cases, "proprietorships" were the outcome of small-scale privatisation or were set up to take advantage of large scale privatisation even before the latter was implemented (in particular, by siphoning profit from large companies through transaction at favourable managed prices). In any case, this SME segment has played a particularly important role within the booming irregular (underground) economy (including tax evasion) in nearly all countries in transition.

However, there is a growing segment of SMEs, particularly in Central European countries, that have a definitely different character. They are dynamic in the sense that invest in growth and modernisation, are risk-inclined and pursue profit maximisation. Some of these are active in the international market and supply final consumers, but most are suppliers to transnational companies, particularly those which established some premises in the transition countries themselves. Another interesting feature of these SMEs is that they seldom make use of the irregular economy (including tax evasion) and state subsidies and increase employment through time.

Many of the successful SMEs are not really new. Indeed and in particular in the countries that reformed their economy prior to transition, they are often spin-offs of pre-existing state owned companies or co-operatives or, as said above, of transnational companies. In some cases they were established during the years preceding transition as the outcome of "experiments" with different kinds of organisations, usually in mixed ownership.

Apparently "good" (dynamic, modernising, competitive, successful) firms – both small, medium and large – tend to cluster together and pull economic revival and growth in transition countries, including foreign trade. On the other side, "losers"

[3] For instance, in Poland 71 per cent of SMEs had one employee or none in 1996. *Activities of Small Enterprises in 199*6, Warsaw: Central Statistical Office.

include firms of any size that may be isolated or co-operate and trade together, also by means of external open (e.g. state subsidies) or hidden (e.g. tax evasion) support. This dualism requires differentiated policy instruments and strategies.

Inter-country differences are very important, though. Hungary and Russia offer two clear cases in point.

3. Hungary and Russia

Comparisons between different countries are usually made difficult by statistical discrepancies. Hungary and Russia illustrate this point particularly clearly. Hungary has adopted the EU definition of SMEs, while Russia has not distinguished SMEs from large firms for various years and lately included large and medium firms in one size category and small firms in another one. The size definition has itself varied through time, which made difficult not only inter-country comparison, but also inter-temporal comparison in Russia herself. Even presently the size categories adopted in Russia are different from those used in most European countries, the upper limit for small enterprises in industry being 100 employees. [4]

The most striking feature resulting from the comparison is that the number of SMEs is roughly similar in the two countries, although Russia's population is nearly 15 times the Hungarian population. Clearly the possibility to set up a business are definitely higher in Hungary. However, and inevitably so, the average size of SMEs in Russia is a multiple of the average size of Hungarian SMEs: 7.6 employees as against 2.6 employees.[5]

The reasons for this difference can be found in both statistical registration and SMEs reality. Russian statistics do not register individual entrepreneurs, butthey are registered in Hungary.[6] As to SMEs reality, one should consider the diverse size of the two countries, the lower population density in Russia and the greater importance

[4] Vadim Radaev, 'The Development of Small Entrepreneurship in Russia', in Robert J. McIntyre and Bruno Dallago (eds.), *Small and Medium Enterprises in Transitional Economies*, Houndmills, Basingstoke and New York: Palgrave Macmillan, 2003, pp. 114-133.

[5] In fact, on 1 July 2001 there were 842,200 small enterprises in Russia having 6.4 million full-time employees, i.e. 7.6 employees on average. In Hungary there were 638,400 SMEs having 1,668 thousand employees at the end of 1996, i.e. 2.6 employees on average.

[6] Registration as 'individual entrepreneur without a legal entity' form simplifies the tax system and provides certain tax privileges. Since this category is not subject to statistical reporting, a large part of the SME sector was (and still is) concealed from official statistics. The number of individual entrepreneurs was estimated as 3.5–4 million in 2001, more than four times the number of small enterprises.

in the latter of natural resources and heavy industry. While the former features lead to lower importance of small-scale trade and consumers' services, the latter may explain the larger average size of Russian enterprises. To these factors one should add that the Russian environment, particularly the institutional context, is less favourable to SMEs than Hungarian one.

There are other striking differences among SMEs in the two countries. One has to do with policy content and consistency. In Hungary there was an early concern with SME specific policies – dating back to the reforms of the old system before transition started when new kinds of SMEs were liberalised. When transition started and although not always successful, SME policies and the relative funds have been decentralised. This approach strengthened the original geographical and industrial dualism: although a great part of the country and the economy were striving to survive, a relatively important part of the country and the economy started to grow forcefully and became intimately and successfully integrated in the world economy. Overall, policy instability – although is has usually been quoted as a very important obstacle to SMEs growth - has not been disruptive, with sufficient co-operation and clear division of labour among governments of different level, in spite of the serious fiscal crisis of municipalities. Although dualism has persisted, the outcome has been a substantial degree of integration within each segment, particularly so in the modern and richer segment.

In Russia the situation has been quite different and SMEs have remained typically separated from large firms. This has been due to different factors. One was certainly the rather negative experience with pre-transition so-called co-operatives. However, also policies are to be blamed. In particular, SMEs specific policies were missing for many years, although they were regularly promised and scheduled, and even now they are nearly irrelevant. Funds allocated to this purpose have been typically insignificant and policies have been typically centralised, with some exception in the case of particularly dynamic regional governments. The financial system, both private and public, and foreign resources – that accrued mostly in the natural resources sector - has been unable and unwilling to finance SMEs foundation and growth. More important, there has been no co-ordination among governments of different level: lack of co-ordination of goals and instruments, inconsistency and volatility of policies, and predatory actions by governments have been more the rule than the exception.

Tax evasion and other irregular practices have been of no great help, since in a demonetising economy not only the public sector was not providing services, but even the private sector was characterised by important (involuntary) interenterprise arrears. Overvalued rouble and the consumers' dispreference for Russian goods made the Russian SMEs situation very difficult and led them to fight for survival – or else base their activity on proprietorship in the form of rent-seeking in the privatisation process. This situation changed partially only following the 1998 financial crisis, when the massive currency depreciation introduced de facto an import substitution policy that favoured SMEs. However, there are no signs yet of a structural change in the SMEs situation and their number continues to stagnate at the level reached in 1993.

4. Policy strategies vs. spontaneous development

The discussion of Russia and Hungary, as much as previous considerations highlight the fact that spontaneous processes may be insufficient or counterproductive in the development of a healthy SME sector. This opens the important issue of what kind of policies may be necessary, what kind of strategies they should implement and when they should be used.

Strategies that can be devised in the case of SMEs in transition countries belong in four different types. There is no doubt that a serious effort should be done in supporting the survival of and job creation by traditional SMEs. These enterprises have and will have for time to come an important role in absorbing those employees that have been and will be expelled through restructuring of large companies. They are also important in supplying the poorer strata of population with traditional, cheap goods and services. However, these conservative policies do not support the transformation and modernisation of the economy. To this end other policy strategies are necessary. These include fostering a) the modernisation and competitiveness of individual SMEs (e.g. by stimulating and easing investment activity); b) SMEs vertical integration with both domestic and foreign companies; and c) horizontal integration among domestic or domestic and foreign SMEs.

Strategies require particular policies and policy instruments to be implemented. Their choice depends on the strategies that are pursued, but also on the particular features of the context where they are implemented, including the institutional context and the efficiency/efficacy of the individual instruments in the given situation. For instance, while the support of vertical integration with foreign companies appear to be an important and realistic strategy in countries such as Poland and Hungary, this kind of strategy would probably be inappropriate in the case of Russia.

In general, the more neutral policies are the better, when spontaneous processes need only a more favourable context to unfold their positive outcome. This perspective requires policies influencing the general context, including growth policies, macroeconomic stabilisation, policies fostering the development of financial markets and the flexibility of labour markets.

In the particular situation of transition countries, however, such general policies may be insufficient. If so, SME specific policies are necessary. For instance, it is well known that SMEs are hardly bankable, particularly so if financial markets are not fully developed. In fact, large banks must afford much higher transaction costs when dealing with SMEs than with large firms. The SME averse attitude of large banks is at the roots of the lack of modern SMEs. Market processes may fail solving this problem, because of informational problems that prevent venture capitalists to enter the market and because of transaction costs that hamper small banks. The experience of transition countries apparently shows that in these circumstances a parallel, informal capital market takes place to finance the establishment of SMEs. However, this market is unable to finance the development of SMEs.

This is a clear case for SME specific policies that should support the development of new agents, such as small, locally based banks specialised in lending to SMEs. Other cases include training programs, specialised advisors, technical support in international markets and tenders, and the like. In all these cases local governments are likely to play a dominant role, since SMEs conditions and needs vary, sometimes substantially, from place to place. Central policies are often too rigid to deal with this specificity. Another important reason for SME specific policies is the need to solve or attenuate the SMEs dualism mentioned above, in particular by fostering the modernisation of the disadvantaged SME segment. Clearly and particularly in this latter case, SME specific policies should be carefully co-ordinated with policies addressed to other branches and to large companies.

Finally, one should consider the issue whether the complex world of policies in the transition countries – that is more complex than in well established market economies – requires special organisations and structures. Special organisations and structures to deal with specific policies have the advantage of specialisation and specific knowledge and information gathering and elaboration. However, such organisations and structures would inevitably increase transaction costs and further segment the economy. This would increase costs and create special interests that would make policies biased and more rigid. Although there may be particular cases that may require special organisations and structures, in general it appears preferable to trust existing (general) organisations and structures with working out and implementing SME specific policies. Although specialisation could be weaker under these circumstances, chances are that better policy co-ordination, lower costs, and weaker special interests would overcompensate that disadvantage.

5. The discriminating role of EU

A new player has gained strength in the transition process in general, and SMEs development in particular. This is the European Union, which will shortly enclose part of the area through the membership of some of the transition countries. The EU is important for transition countries in two distinct ways: a) as a stabilising and co-ordinating factor and b) as a provider of financial resources.

As a stabilising and co-ordinating factor the role of the EU spreads to all transition countries, although at a varying extent. In spite of a certain degree of protectionism that is characteristic of EU, as of other large extra-European countries, transition countries gain from the possibility to trade with the large EU market at relatively low transaction costs. The influence of EU monetary and fiscal policy offers the other countries a more stable environment.

Various transition countries have already been accepted as new members and others are associated to the EU. Still others are hoping to become members in a not too distant future. For all these countries the EU influence is quite direct and includes the absorption of the *acquis communutaire*, the adaptation to conditionalities, technical advice, and political support. These contributions play an important role in strongly reducing institutional and policy uncertainty that is so typical of transition. The countries that are interested in becoming members of the EU know in advance what they have to do: how their institutional context should look, how their policies should be. Discussion, bargaining and conflict are at the margin and they never concern the core of the issues. Domestic adaptation and co-ordination are much easier in this way and less disrupting, as external adaptation and co-ordination are.

Transition uncertainty is strongly lessened as a consequence and the crucial problem of collective action in transition is largely solved at relatively low costs.

The role of the EU as a provider of financial resources is not less important and is intimately linked to what was just stressed. Indeed, the availability of the EU financial support has been and is an important factor in pushing many transition countries on the way to accession and membership. It is also an important factor in solving the complex problems of collective action in many cases: the availability of financial support for well defined purposes is often sufficient to induce transition countries to solve their problems in a EU compatible way. Choices on which to discuss and bargain are consequently restricted and working examples are ready and can be followed. Financial support itself, then, offers additional resources to implement the costly transition.

The EU plays an important uncertainty reducing role that extends to SMEs. The access to the EU market offers SMEs in CEE important opportunities to become parts of trans-European industrial and trade networks. In this SMEs play an important role that is quite useful also to EU firms. These can decrease costs by decentralising production. The gain for SMEs in CEE goes beyond the availability of new markets and includes know-how transfer, the acquisition of new technology, and greater specialisation. These gains come at a cost, though, including greater competition by firms of more developed economies and the well known risks for firms that enter the value chain of transnational companies (such as the specialisation in labour intensive processes and the possible dismantling of the home research basis).

These gains and costs materialised for SMEs in transition countries, although in a differentiated way for SMEs in different countries and also within the same country. Overall, it appears that SMEs - and the regions where these are based – that have been able to take advantage of stricter business relations with West European firms have gained more than what they lost. Although this has been the outcome also of important transfer of EU funds, much of the gain has been strictly economic in nature: the incentive from greater competition, learning through the interaction with economically more developed economies and firms, technology transfer, scale and scope economies, specialisation. However, this modern SME sector is still rather small even in the most successful CEE countries, i.e. those that are entering the EU in the first round and needs policy action to develop.

6. Conclusions

For some time after transition begun there was the illusory sense of spontaneous SME success as testified by imposing numbers. This was in part the outcome of statistical illusion and in part simply denoted subsistence activities and the pursue of rents. Truly modern SMEs were relatively few and mostly concentrated in those countries which already had a relatively substantial SME sector during the central planning period (Poland, Hungary, Slovenia, the new German states) or where small-scale privatisation was successful (Czech Republic and Slovak Republic).

The early success in numbers delayed or diverted attention from the policy issues that must be addressed before competitive markets can be expected to yield good results. These issues include proper market institutions and structures – such as a SME friendly financial sector – and also require an active role of governments in fostering the development of a SMEs friendly environment and also in supporting the modernisation of SMEs, at least until a critical mass of modern, competitive SMEs develops. In some countries even the full reestablishment of "law and order" appears a fundamental condition for SME development.

Finally and however important, the SME sector does not solve the fundamental problems of transition by itself. SMEs are important actors in solving those problems together with large firms, governments, the international actors, workers and consumers. The continuous transformation of these actors is important for the growth and modernisation of SMEs as much as the latter are important to allow for the transformation of the former. EU membership offers great opportunities in this sense to both future CEE members and present member countries.

Biographical sketch

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