Entrepreneurship and Small Business Development in Post-Socialist Economies

David Smallbone
and Friederike Welter

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This book examines entrepreneurship and small business in transition economies in Central and Eastern Europe and the former Soviet Union, showing how far small businesses have developed, and discusses how far ‘market reforms’ and a market mentality have been taken up by ordinary people in the real everyday economy. For each of the countries highlighted – Russia, Ukraine, Belarus, Poland and Estonia – the book reviews the progress of market reforms within the wider context of social and economic transformation, surveys the development of entrepreneurship and small firms so far, and assesses the role of government in the process, and the strengths and weaknesses of the small business sector.

Drawing on entrepreneurship theory and institutionalist approaches, this book conceptualises the distinctiveness of entrepreneurship in transition conditions and discusses the implications for entrepreneurship theory – as well as for policy. It critically assesses the nature and extent of entrepreneurship and small enterprise development in economies which, until 1990, operated under central planning.

In addition to its conceptual contribution, the book presents original empirical evidence (including survey material and previously unpublished case studies) from a number of large-scale research projects conducted by the authors in Central and Eastern Europe. Each chapter highlights different facets of small enterprise development and entrepreneurship, including employment relations, innovation and strategic behaviour, as well as government policies and their influence on entrepreneurship.

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1 Introduction

Aims of the book in context

Entrepreneurship and the development of small and medium enterprises is a key feature of market-based economies. This book is concerned with the nature and extent of entrepreneurship and small enterprise development in economies that were operating under the rules of central planning until less than 20 years ago. The second decade after the commencement of the process of market reform in these former socialist economies is an appropriate time to consider what has been achieved in terms of the development of entrepreneurship. A key question in this regard is the extent to which the forms of entrepreneurship that have occurred may be considered a distinct response to the specific external conditions that have existed. The answer has potentially important theoretical implications, in terms of the social embeddedness of entrepreneurship.

The book seeks to provide insight into the nature of the processes of entrepreneurship development in countries selected to represent economies at different stages of market reform. As well as providing empirically grounded analysis of the processes of entrepreneurship and small business development in specific countries, the authors also provide conceptualisation of the distinctiveness of entrepreneurship in transition conditions and the implications for entrepreneurship theory.

The decision to write this book was influenced by a desire to address what the authors perceived to be a gap in the existing literature. On the one hand, it can be argued that entrepreneurship in economies in transition has received less attention than is justified by the nature and extent of the changes that have occurred in former command economies; and on the other hand, by the fact that most existing books on the topic of entrepreneurship in transition economies consist either of edited collections of conference papers or are concerned with particular countries or regional groupings. At the same time, there was also a strong personal desire to attempt to synthesise some of the results emerging from more than a decade of working in the field, both individually, and together, on a variety of projects that have embraced a wide range of Central and East European countries and former Soviet republics.

The research approach

The research approach used in the book reflects the approach used in the individual projects, which provide the raw material for the book. Key characteristics include a strong empirical grounding; policy orientation; and an approach based on a high level of international collaboration. Detailed information about these projects, including participating international partners and funding bodies is provided in the Appendix. However, they include studies of: the development of SMEs in Poland, Hungary, the Czech and Slovak Republics (1993–1994); the survival and growth of SMEs in Poland and the Baltic States (1995–1996); internationalisation, inter-firm linkages and SME development in Poland, Bulgaria and the Baltic States (1997); the conditions for SME development in Poland in comparison with those in EU countries (1998–1999); the implications of Poland's accession to the EU on Polish SMEs (1999); identifying the support needs of small enterprises in Ukraine, Moldova and Belarus (1996–1998); the contribution of small firms to regional development in Ukraine, Belarus and Moldova (1997–1999); innovation in SMEs in Ukraine and Belarus (2000–2002); female entrepreneurship in Ukraine, Moldova and Uzbekistan (2001–2003); entrepreneurial strategies in high-trust and low-trust environments: Russia, Estonia, Germany, UK and Italy (2001–2003).

Not surprisingly perhaps, the trend in these projects was from general topics (e.g. factors influencing the survival and growth of manufacturing SMEs) to more specialised research issues (e.g. female entrepreneurship). Some involved an element of primary research in mature market economies, while others focused solely on transition countries, in which the role of western partners was mainly focused on research design, project management and co-ordination.

Although the number of empirical studies of entrepreneurship and small business development in transition countries has grown over the years (e.g. Aidis 2003, Bilsen and Mitina 1999, Clarke and Kabalina 2000, Gray and Whiston 1999, Kalantaridis and Labrianidis 2004), in the early 1990s such studies were thin on the ground. This was partly due to the difficulties of undertaking empirically based entrepreneurship and business research under transition conditions, but it also reflected certain characteristics of the research community in these countries, whose skills and orientation at the start of the transformation period had been shaped by the needs and priorities of the command economy. However, the emergence of new topics during the transformation period, including entrepreneurship, contributed to the emergence of a new scientific agenda, which included methodological and conceptual challenges for local scientists, who had little access to the resources needed to respond to them. This meant that empirical studies of entrepreneurship, undertaken by local researchers were few in the initial stages of the transition period.

At the same time, the collapse of the Berlin Wall, and the events associated with it, created new opportunities for East–West collaboration between scientists, facilitated by the emergence of new international funding opportunities, from the European Union in particular. Noteworthy amongst these were the Phare[1] (ACE[2]) and Tacis (ACE) programmes, targeted at economic researchers in Central and East European countries (CEECs) in the case of Phare; and former Soviet republics, in the case of Tacis.[3] There was also INTAS,[4] which was a funding programme for collaboration between scientists in the former Soviet Union and their western counterparts, which was open to a wide range of academic disciplines, until its closure in 2007. All three of these funding sources have been used by the authors for research contributing to this book, working in close association with Eastern partners.

Most of the research reported in subsequent chapters is the result of teamwork. One of the authors of this book has typically had overall responsibility for project management, research co-ordination and overall research design. However, in all cases local partners have been responsible for organising the collection and preliminary analysis of data in their respective countries and, in most projects, for the production of national reports also. The positive nature of the collaborations over the years is illustrated by the lasting nature of most of the partnerships, as the Appendix illustrates.

Lasting co-operation depends on mutual benefits accruing to the various partners, as well as to the presence of developmental aspects in the partnerships. The starting point in the case of the research collaborations, on which much of the content of this book is based, was a strong mutual interest in small business development in a transition context, combined with the complementarity that stemmed from the respective partners bringing different previous experience to the table. On the one hand, western partners were able to help Eastern colleagues to access what was a rapidly expanding base of scientific knowledge and practical research experience, in the field of entrepreneurship and small business. On the other hand, Eastern colleagues provided knowledge of local conditions, which was essential, both in shaping the research approach and also in contributing to the interpretation of research results. In addition, the lasting nature of these partnerships has meant that the relationship between partners has evolved over time, as Eastern colleagues have become more familiar with the international entrepreneurship literature and western partners have built up their knowledge of local conditions. This in itself demonstrates the extent of the learning experience for all participants, which in the case of the authors of this book, has been one of the most rewarding aspects of the work.

Although space does not permit a complete listing of all research collaborators who have contributed to this book in some way, there are certain people whose contribution must be acknowledged, because of the extent and lasting nature of their contribution. They include Professors Bogdan Piasecki and Anna Rogut, from the University of Lodz in Poland; Professor Kiril Todorov, from the University of National and World Economy in Sofia, Bulgaria; Dr Urve Venesaar, from Tallinn University of Technology, Estonia; Dr Nina Isakova, from the STEPS group, Ukrainian Academy of Sciences, Kiev; Dr Anton Slonimski, from the Economic Research Institute of the Ministry of Economy of the Republic of Belarus; Dr Elena Aculai, from the National Institute for Economy and

Information, Chisinau, Moldova; and Professor Alexander Chepurenko, from the Moscow Higher School of Economics, Russia.

It must also be stressed that all of the colleagues listed above are leaders of research teams, which have included some extremely able young researchers, who have diligently applied data-collection methods and contributed to data analysis. Without the various contributions of Eastern partners, the empirical data and analysis which underpin this book would not have been produced. Moreover, the collaborative nature of all the projects drawn upon in this book has contributed to the research reported being very enjoyable to undertake, as well as being a stimulating learning experience.

Another recurrent theme is policy orientation, which in turn reflects a focus of many of the projects on which the book is based. This partly mirrors the research interests of the authors, and the orientation of some of the funding regimes that were used to provide resources to undertake the research, but more fundamentally it reflects the policy vacuum that existed in many transition countries in the 1990s, with respect to the development of entrepreneurship and small business. At the same time, it was left to research teams to develop an appropriate strategy for achieving this, as part of their research proposals, although effective dissemination of findings to policy makers and practitioners, as well as to the scientific community, was expected. As a result, a key element in our research approach in most projects was to seek to engage policy makers and practitioners in the research process itself. It is felt that this type of approach is more likely to lead to research being relevant to, and influencing, policy, rather than an approach where the development of links with policy makers and practitioners are left until the research has been completed.

Policy workshops were typically organised at different stages in the development of the research projects. In the early stages, the aim was to inform policy makers of the objectives of the research; how it was to be conducted; to discuss with them how the research might contribute to meeting their needs; and to seek to involve them in the research as much as possible. At later stages of projects, policy workshops were arranged to disseminate research results and to discuss the potential implications of the findings for the development and implementation of policy. It must be emphasised that this was at a time (i.e. the mid-1990s) when the concept of evidence-based policy was much less familiar in EU countries than it is now and it also presented many challenges when applied in transition conditions pertaining at that time.

One of the challenges faced was that the potential contribution of entrepreneurship and SMEs to economic development was not well understood by policy makers. Moreover, the 'explosion' in the number of small firms that occurred in many transition economies at the start of the transformation period was often referred to by policy makers as evidence that entrepreneurship would develop without stimulus or intervention from government. More fundamentally perhaps, policy makers found it difficult to define the role of the state in the emerging market economies of the 1990s, tending to adopt either a minimalist position or asked for advice on the optimum number of small firms in a market economy. Another problem was that local researchers had little experience of the critical and evaluative approach to policy, which was a typical stance for academic researchers to adopt in western countries.

Not surprisingly perhaps, there was often a greater degree of success in establishing dialogue with practitioners, representatives of donor organisations and local policy makers, than with policy makers at a national level, although the specific experience varied between projects and between countries. Nevertheless, the experience overall was valuable for all parties, contributing to more practical policy oriented research and to building local research capacity, on the one hand, while also contributing to some policy makers becoming better informed about the needs of entrepreneurs on the other.

Methodological perspectives

All of the projects listed in the previous section were empirically based. Although the detailed methodologies employed varied between projects, most included a survey component. However, in the more recent projects, a survey approach was typically complemented by a programme of case studies, to enable more qualitative insights to be gained into the processes of entrepreneurship and small business development. Surveys typically involved 500–600 interviews, which were undertaken face to face, facilitated by cheap labour costs, although this latter aspect varied between countries, as well as over time. The initial reliance on survey-based approaches was also influenced by the dominant research paradigms at the time in the countries under study, as well as by the previous experience of participating researchers. However, as the research partnerships matured, more ambitious, qualitative methods were attempted, supported by training workshops in methods of data collection and analysis. In addition, this also reflected a changing attitude of both authors, who came to appreciate the deeper understanding of entrepreneurship in a transition context originating from qualitative approaches.

In the early years, training workshops had focused on Eastern research colleagues acquiring the skills to use software packages for quantitative data analysis, such as SPSS, but in latter years, the focus has increasingly been on aspects of qualitative data collection and analysis, which few Eastern colleagues had any previous experience of. As a result, methodological development has occurred over time, facilitated by a high degree of stability in the composition of research partnerships and a willingness on the part of Eastern research colleagues to learn new skills. The preferred empirical approach that has emerged typically involves duality, with the use of case studies combined with a survey approach. An example of a project using a dual methodology is the study of innovation in SMEs in Belarus and Ukraine, which provides empirical data, used in Chapters 5 and 6.

One of the challenges facing researchers seeking to undertake empirical research of small firms and entrepreneurs, concerns the availability and adequacy of business databases, from which samples of small firms to be contacted for interviews, may be extracted. Of course, the problem of inadequate databases from which samples can be identified is not unique to transition economies. However, a combination of inadequate official data, and a lack of commercially produced databases by firms such as Dun and Bradstreet, means that it has typically not been possible to start with a reliable sampling frame that includes contact details of small firms.

One specific problem concerns the tendency for business registers to include large numbers of firms that are no longer trading. Another common problem, in the early years of transition in particular, was a tendency for the activities registered to be inaccurate, making sector classifications unreliable. Although such issues have much improved in the new member states of the EU, such as Poland and Estonia, as the process of accession has encouraged greater attention to be paid to the quality of data on SMEs, in the mid-1990s there, as well as in the other former Soviet republics, researchers have typically needed to rely on snowball methods, with implications for the nature of generalisations that can be drawn from survey results.

Another aspect of the research approach with methodological implications is the international dimension. Undertaking international collaborative research presents some specific challenges, compared with work undertaken in a single national context. One of the key issues concerns the need for the harmonisation of the research process in each country, since this influences what it is that can be compared. This may be illustrated with reference to a specific example, namely one of the early projects entitled: 'The Survival, Growth and Support Needs of Manufacturing SMEs in Poland and the Baltic States 1994–96', funded under the EU's Phare (ACE) programme. The empirical evidence used in this project was drawn from surveys of SME owners and managers in Poland, Estonia, Latvia and Lithuania, involving a total of 600 in-depth face to face interviews (300 in Poland and 100 in each of the Baltic States). The SME interviews included a variety of questions relating to the characteristics and background of the entrepreneur; a descriptive profile of the business; the management of products, markets, production and labour; the financial and management resource base, and the experience of the firm with respect to external assistance from a variety of sources. To be included in the survey, firms had to be in one of four manufacturing sectors (food processing, clothing, metal products/engineering and wood products/furniture); independent and privately owned, indigenous firms; and trading for at least a year at the time of the survey.

As a result, the study focused on business development issues in established manufacturing SMEs, because of the potential contribution of this type of SME to economic development and the potential policy significance that stemmed from this. Of course, such firms were not typical of the bulk of the SMEs that existed in these economies at the time, in which retailing and low-order services were predominant. A common sampling design was used in the four countries that involved stratification by firm size and sector, in order to facilitate a direct comparison of the survey results between the four countries, based on a 'like-for-like' comparison.

This project provides an example of a research approach, based on a tightly harmonised methodology, designed to facilitate international comparison. Indeed, the process of harmonisation of sampling designs and survey instruments proved extremely important in facilitating an exchange of concepts between researchers through close collaboration in all aspects of the project. A common interview schedule was developed in English, translated into four languages and then back into English as an accuracy check. Although developing the harmonised interview schedule was often a lengthy and laborious process, it proved extremely useful in stimulating detailed discussion, when issues of operational definition frequently led to deeper conceptual issues being raised. Examples included how to operationally define ‘product portfolio’ or ‘product range’; as well as operationally defining apparently simple concepts, such as ‘full-time’ and ‘part-time’ employment, in a transition context. Such discussions were important because they contributed to greater understanding of the social contexts in specific transition environments between members of the research team, as well as to greater shared conceptual understanding and a sense of common purpose.

This project was co-ordinated from the UK, although the interviews were undertaken in each country by local partners. Workshops were held at the start and end of the project in an attempt to involve other academics, practitioners and policy makers. In addition, planning and harmonisation meetings were held between members of the project team at critical stages in the research: to design the interview schedule, to discuss the results of the pilot interviews, and also after the data collection was complete.

While a degree of harmonisation is essential in any international collaborative project, the model described above may be viewed as an extreme form of harmonisation, although appropriate given the objectives of this particular project, which focused on the characteristics and performance of firms in countries at different stages of transition. The approach used was also necessary in view of the limited empirical experience of some Eastern partners at the time and the fact that this was the first occasion that the research partners had worked together. At the same time, such close harmonisation does have some disadvantages, particularly when partners wish to analyse national samples separately to draw conclusions about SME development at the national level. This is because internationally harmonised, stratified samples may not be very representative of SMEs within individual national territories.

There are alternative and looser harmonisation models, which have been used in some projects. For example, survey instruments can be partly harmonised to provide consistently gathered core data, while also allowing for questions to be included that reflect national issues or variations. In addition, samples can be drawn to make them representative of enterprises within particular sectors in national territories, with comparison based on the results of national analyses, rather than direct comparison of national samples as described above. The choice really depends on the aims of the investigation, although the implications of the approach used for the type of analysis that can be undertaken should be made explicit in all cases.

The rest of the book

The rest of the book contains eight chapters, grouped into four main sections. Part I entitled 'Setting the scene', and contains two chapters. Chapter 2 seeks to place entrepreneurship into the context of the wider processes of transformation; and Chapter 3 to provide a conceptual basis for considering entrepreneurship under transition conditions. Part II, 'Entrepreneurship and small business development in former Soviet republics', includes chapters on Russia, Belarus and Ukraine. Part III, 'Entrepreneurship and small business development in Central and Eastern Europe', has chapters on Poland and Estonia. The final part is entitled 'The way forward', which focuses on drawing out conclusions with respect to both theory and also future policy development.

Although sharing many common processes, a combination of different starting points, differences in the nature and pace of market reforms (such as with respect to privatisation), and in the wider process of social and economic change during the transformation period, has resulted in considerable differences in the experience of entrepreneurship development in practice. This affects both the nature and the extent of the entrepreneurship and private sector development that has emerged in different countries, reflected in the number of private firms and the nature of their contribution to the transformation process. For this reason, the authors distinguish between two groups of countries: first, those where market reforms are fairly advanced, such as Poland and Estonia, which have now joined the EU; and second, countries where market reforms have been slow and/or only partially installed, such as the Russian Federation, Ukraine and Belarus. Although differences are identified between countries within each group, these are less than the differences in experience that can be observed between groups.

Each of the country-based chapters includes an overview of the development of entrepreneurship and small firms; an assessment of the role of government in the process; and a summary of the current state of the small business sector in the country, paying attention to its strengths and weaknesses. In addition, each chapter also includes a thematic section, based on unique empirical data drawn from a research project in which one or both the authors have been involved. For example, in the case of the Russian Federation, there is a particular focus on employment and labour market issues in Russian SMEs; in the chapter on Belarus, entrepreneurial behaviour and adaptation strategies in the face of institutional deficiencies are highlighted; in the case of Ukraine, innovation in SMEs; in Poland, the implications of EU Accession for the SME sector; and in Estonia, the role of institutional change in facilitating SME development. It is not suggested that these themes are exclusive to the countries to which they are applied, but rather that the latter are suitable vehicles to illustrate them.

Part I

Setting the scene

2 Entrepreneurship, SME development and the transformation process

Introduction

This chapter presents the context for entrepreneurship and SME development in post-socialist economies. After a short introduction, the chapter continues with a discussion of the processes involved in transforming a centrally planned into a market-based economy, which have implications for private sector development. Since the experience of the last 15 years or so has not been uniform across post-socialist economies, the second section summarises progress with market reforms in the former centrally planned economies of Central and Eastern Europe and the former Soviet Union, focusing on the five countries that feature later in the book. The third section concentrates specifically on the role of entrepreneurship in the process of transformation; the final section is concerned with the role of policy in relation to the development of entrepreneurship in a transition context.

Since the 1990s, the countries of Central and Eastern Europe and the former Soviet Union embarked on a transformation of their entire political and economic systems, the scale of which is unprecedented in recent history. The collapse of the Berlin Wall signalled a process that has changed the course of history in Europe, while at the same time presenting enormous challenges for the countries involved. The shift from central planning to market-based economies involved more than processes of economic change, which must be viewed as part of wider processes of democratisation and social change. Indeed, one of the distinctive characteristics of the transformation that has been occurring is the scope of the processes involved, comprising interrelated economic, social and political change processes. This in itself represents a major challenge for the entire societies, as free-market influences widen social and economic disparities and require new forms of governance to be established.

Although in widespread usage (including in this book), strictly speaking, the use of the term 'transition' implies a process of transformation towards a target state, namely that of a market economy, although experience suggests this may not necessarily be the goal in all former Soviet republics. For example, recent experience in Belarus (see Chapter 5) provides little evidence that, under the current leadership at least, a market economy is the ultimate goal, suggesting that use of the term ‘transition’, in this context, may be inappropriate. As a result, unqualified use of the term ‘transition’ can be misleading. Use of the term in this book refers to former centrally planned economies, where sufficient changes have been introduced to allow private businesses to exist, although market conditions may have only been partially installed. Our use of the term ‘transition’ is without any implication that the economy is necessarily on a path towards becoming a market-based economy.

The effective transformation of socialist societies also involves a process of political change, as one party states are replaced by multi-party democracies. Clearly, political and economic change is not independent of one another, since in the initial stages of transition in particular, the effectiveness of economic reforms is dependent on political commitment. At the same time, changing the ownership structure of the economy, effectively introducing economic liberalisation, and building and consolidating market institutions takes much longer than organising free elections and introducing new political parties into public life.

Processes of market reform

From an economic perspective, the transformation of a centrally planned into a market-based economy involves three main aspects: first, a shift in the dominant form of ownership from public to private; second, a liberalisation of markets and a removal of price controls; and third the creation of market institutions. The interrelationship between these three elements is also important in establishing the framework conditions for a market economy, because the effectiveness of one element will typically be affected by the nature and extent of progress with the other two.

A change in the dominant form of ownership, and resource allocation mechanisms, implies fundamental, systemic change, since it involves a change in the main criteria used to classify an economic system. Furthermore, the nature and extent of reforms with respect to each of the three aspects listed has important implications for the extent to which a private business sector is likely to develop. Imperfections and deficiencies with respect to any, or all, of these dimensions are likely to have implications for the forms of entrepreneurship that develop, as well as for their frequency of occurrence.

At the same time, it might be suggested that the nature of the relationship between the transformation of the economy and the development of entrepreneurship is a recursive one. Piasecki (1995) notes that at an early stage of transformation, the development of the SME sector that is positively promoted becomes one of the most effective instruments in the reorientation of social awareness, without which the emergence of the private sector and a market economy are impossible.

In other words, the emergence of a business-owning class is a key element in contributing to the social change that is integral to the wider transformation process, as well as being influenced by the opportunities to own one’s own business, which the process of market reform enables. For example, the Lithuanian government explicitly recognised the social implications of SME development by including the following as one of the stated aims of its initial programme for SME development: '*the development of a new category of businessman in society*' (Lithuanian Ministry of Economic Affairs 1994).

From public to private ownership

A shift from public to private ownership can be achieved through the privatisation of former state-owned enterprises, but also through the creation and development of new privately owned enterprises i.e. 'de novo' start-ups. As a result, one of the distinctive characteristics of economies in transition is that the privately owned business sector typically includes a mixture of businesses, with some created through processes of 'de novo' start-up, as well as some firms with their origins in privatised companies. However, the balance between these sources of privately owned enterprises is likely to change over time, as the effects of privatisation will tend to be more prominent in the initial stages of transformation, depending on the pace of privatisation. As a result, the vast majority of private enterprises in the more advanced 'transition' economies are likely to be the result of de novo start-ups. Estonia is a good example of this. By contrast, in countries that have been slower to transform, the proportion of businesses founded as a direct result of privatisation may be higher. A number of studies show that new private firms tend to perform better than privatised firms, making them the principal agent of growth in some transition countries (EBRD 2005: 85).

The privatisation of land and capital is a key element in the transition process, because establishing private property rights over the means of production holds the key to the ability of the supply side of the economy to respond to price liberalisation. Without this, the removal of price controls may stimulate the distribution of scarce goods, but not their production by private individuals and/or enterprises (Gros and Steinherr 2004). In a market-based system, private ownership of the factors of production is necessary in order to create a business environment to encourage investment. This operates directly through its effect on the confidence of investors in receiving longer-term returns on their investments, but also indirectly, since private property represents a potential source of collateral, which can be used by entrepreneurs to secure loans from banks and other financial institutions.

Property rights represent one of the fundamental defining elements of an organised society. In Western Europe, land ownership by individuals is an established concept, with the tradition extending historically to Central European countries, which means that the freedom to own, sell and buy land is typically well understood. In former Soviet countries, by contrast, the shift from feudalism through communism, to its ultimate collapse, has resulted in the lack of a recent tradition with respect to land ownership, other than by the state. Moreover, changing laws to make private ownership (e.g. of a business) legally possible is only the first step in the process of market reform, since guaranteeing equal treatment of private and state-owned companies under the law is also necessary. This emphasises the importance of effective implementation of the law, which in turn draws attention to the adequacy (or inadequacy) of institutional capacity to achieve this.

At the beginning of the transition period, all land, buildings and equipment were owned by the state. This means that the development of the private sector depended on the transfer of a large part of state-owned capital from the state into private hands. While the privatisation of land and capital is a crucial element in the transition process, experience in various transition economies shows that it is often not easy to implement. This particularly applies where privatisation involves large enterprises, which comprised the bulk of the manufacturing sector during the socialist period. This is partly because in large enterprises, the state and existing management lose effective control when the firm is privatised and a change of ownership is not necessarily associated with effective control being assumed by the new owners.

In comparison, so-called ‘small-scale privatisation’ (e.g. of shops, garages and restaurants) has typically been easier to implement because new owners can immediately assume effective control of an enterprise, which in many cases they had been running previously (Gros and Steinherr 2004). Other ways in which privatisation contributed to the development of entrepreneurship, particularly in the early years of the transition period, included the sale of assets (such as plant and equipment) by (former) state-owned companies that were either bankrupt or were downsizing. The purchase of such assets by potential entrepreneurs contributed to the process of new firm formation, particularly in more advanced transition economies, such as Poland and Estonia (Spicer *et al.* 2000, Smallbone *et al.* 1997a).

The role of privatisation in relation to SME development is influenced by the privatisation methods used, which in Estonia, for example, often involved denationalisation of former state-owned enterprises into new legal forms before their actual privatisation (Smallbone and Venesaar 1999). At this pre-privatisation stage, most of the large state-owned enterprises were divided into smaller units, which was one of the factors that created a basis for the subsequent development of SMEs. There is evidence from Estonia to suggest that where privatisation involved the creation of SMEs in this way, the pace of transformation was quicker than in the case of privatisations involving the establishment of large private firms, reflected in their stronger performance (Terk and Pihlak 1996). Such evidence suggests that in the initial stages of transformation, the development of the SME sector facilitated by ‘small-scale privatisation’ was a positive force in contributing a source of dynamism to the process of restructuring (OECD 1996).

By contrast, in larger firms, corporate governance remains a problem area in transition economies, particularly in the case of the privatisation of former state-owned enterprises (SOEs), where the methods of privatisation used resulted in a large number of shareholders. Additional problems associated with large-scale privatisation include the loss of employment that inevitably follows the transfer of ownership into private hands, although some of the more entrepreneurial individuals, who lose employment as a result, may start their own businesses; others may be employed in newly created private companies.

There can also be societal concerns about a small minority of the population benefiting at the expense of the majority by, for example, wild privatisation (see Chapter 3) and/or about foreign investors gaining control of what had hitherto been state assets. Lavigne (1995) refers to the ambiguous attitudes that developed in post-socialist economies concerning foreign direct investment, once transition began. On the one hand, governments created legislation to encourage foreign investors, while on the other they were often sensitive to public opinion, which tended to be particularly concerned over issues of land ownership.

Protection of property rights

The protection of property rights is an important part of establishing the framework conditions for private sector development, requiring legal underpinning in post-socialist countries. Protection of property rights includes freedom from bribery, extortion, racketeering and corruption, which are conditions still faced in countries such as Ukraine, Russia and Belarus. The elimination of corruption needs to be tackled at different levels. While the corruption of state power may attract the most attention, because of its higher profile, steps to eliminate petty bribery at a local level are also important. In this regard, special attention needs to be paid to the attitudes and practices of local officials towards groups, such as petty traders, craftsmen, shuttle merchants and owners of illegal taxis, which are an important part of contemporary entrepreneurial activity in many of the former Soviet republics. A toleration of 'double standards' at this level may be incompatible with raising the ethical code of business practice in post-socialist economies in the longer term.

One aspect of the protection of private property rights concerns the protection of intellectual property, which in mature market economies is one of the regulatory functions of the state. Effective protection of intellectual property rights (IPR) is necessary to ensure that entrepreneurs, who take risks and support the costs and effort involved in developing new products and services, can benefit from the rewards in terms of a financial return. In principle, this can be implemented by means of a patent system, offering protection to those enterprises that are set up on the basis of a new idea, as well as to existing firms, which use new ideas to maintain their competitiveness and growth. The failure to offer adequate protection for IPR can act as a disincentive to innovation, as well as to certain types of foreign investment. While some businesses can benefit from such protection, it is important that the procedures for acquiring it are not excessively burdensome for applicants and are effectively implemented.

One factor influencing the willingness of investors to invest capital, and of some entrepreneurs to set up new businesses, is the ease with which it is possible for them to realise their assets by selling their business, or their share in it, if and when they wish to do so. This also applies to the ease with which it is possible to change the legal form of a business, such as between a partnership and a limited company. Moreover, it is important for the survival of many enterprises (and thus for the jobs of employees) that the administrative requirements for transferring the ownership of businesses are simplified in the same way as the procedures for setting up of new companies, i.e. with few formalities, short deadlines and a single point of contact for entrepreneurs.

Liberalisation of markets

The liberalisation of markets is another fundamental element in the process of transforming a centrally planned economy into a market-based system. It is potentially important for the development of small businesses and entrepreneurship, because liberalisation involves an increase in market opportunities, as well as in the level of competition. Reform of the price structure is the cornerstone of the process of market reform, since, in a market-based system, prices must be determined by scarcity, rather than being arbitrarily fixed by bureaucrats. Price liberalisation involves the introduction of a mechanism for self-restoring market equilibrium, in response to changes in demand and supply.

The liberalisation of markets involves a liberalisation of factor markets, as well as markets for final products and services. This enables the allocation of factors of production to adjust to reflect the profitability of the supply of different goods and services, as a means of achieving greater production efficiency. At the same time, inelasticities in the supply of certain factors of production, such as labour, may lead to short-term mismatches between demand and supply in certain factor markets. The labour market is a good example of this, since, in a transition context, the responsiveness of the supply of labour to the skill needs of the emerging private sector is likely to depend on the pace of change of development and adaptation in training institutions, including through the development of new market-oriented training organisations. Since former centrally planned economies were typically highly concentrated on manufacturing industries, labour markets have often been slow to respond to the skills and training needs of an emerging private sector that is focused on service activities.

In theory, the effective introduction of price liberalisation depends on the freedom to trade, since this provides the mechanism for linking demand with supply, although initially this freedom may lead to some serious distortions. For example, as the old distribution system breaks down, a few well-connected individuals may be able to get rich quickly if they are able to use their position and influence to buy scarce goods at very low prices and sell them on at a price that generates excess profit. Although over time a new market-oriented distribution system may evolve, the ability of a minority of people to generate excess profits from what appears to be an unproductive entrepreneurial activity may cause popular resentment.

External trade liberalisation

Market reform also involves a degree of external trade liberalisation, to match domestic price liberalisation. Practical steps in this regard include abolishing state monopoly control over foreign trade; unifying the exchange rate, rather than having different rates for importers and exporters; eliminating quantitative restrictions on trade; and moving to unrestricted exchange rate convertibility for current account transactions.

As the case of Estonia in Chapter 8 demonstrates, an abolition of trade barriers and tariffs can lead to a growth of exports and an inflow of duty-free imports, which have been exploited by manufacturers for both domestic and foreign production. This has in turn contributed to an increase in competition in domestic markets and ultimately to accelerating the pace of economic restructuring. A liberal trade policy is also likely to encourage foreign investment, which in the Estonian case has been an important enabling factor contributing to the success of its economic reforms and structural transformation of the economy. At the same time, an open trade policy is only one piece of a larger policy jigsaw in Estonia, which includes rapid privatisation, the establishment of a relatively transparent business environment and the protection of property rights.

Foreign direct investment (FDI) is an integral part of an open, international economic system and a major potential catalyst for development (OECD 2002). The *potential* benefits of FDI for host economies include increasing the supply of capital; technology and knowledge transfer; and employment generation. It may also contribute to enterprise development within a host economy: directly through the establishment of foreign-owned private enterprises; but also indirectly, through linkages and spillover effects. The additional source of capital, which FDI represents for a host economy, is clearly potentially important in countries where financial constraints may act as a major barrier to private sector development. In a situation where the size and scope of existing local markets is limited, inward investment can also offer increased market opportunities for domestic SMEs through, for example, subcontract and other types of backward linkages.

In terms of technology and knowledge transfer, the flow of FDI into transition economies can potentially contribute to the upgrading of local suppliers through technical assistance, training and the transfer of knowledge. It may also contribute to increasing the rate of adoption of new technologies by local industries, as a result of processes of imitation and competition. In terms of employment, inward investors can generate new jobs directly, but they can also contribute to raising skill levels, because their skill requirements may be higher than those required by domestic firms.

At the same time, the actual benefits of FDI for host economies in practice often fall short of the potential benefits described above, for various reasons. These can include the sector and host-country contexts (OECD 2002), but also the strategy or rationale for investments on the part of foreign investors. One of the practical reasons why export-oriented FDI may have limited positive, or even negative, impacts on local private sector development is that local suppliers can often find it difficult to meet the quality standards required by inward-investing foreign firms. Such factors emphasise the important potential role for policy in ensuring that the opportunities for potential positive spillovers for local SMEs are maximised and fully exploited.

Creating market-oriented institutions

Perhaps the most difficult of all aspects of market reform is the creation of market institutions. This includes organisations, such as banks and other financial institutions, but also business and training support services, which are an important part of the business infrastructure in mature market economies. It also refers to state organisations, such as regulatory bodies, and other public agencies, including those arms of government (at the national, regional and local levels) whose actions may potentially impact on businesses.

In assessing progress with the development of market institutions in former centrally planned economies, it is important to consider institutional behaviour and actions, as well as simply their existence. This draws attention to the important role of the knowledge, skills, competencies and codes of conduct of their staff, which are the heart of institutional behaviour. As evidence presented in later chapters demonstrates, an inadequate institutional environment, in countries where market reforms have been slow or only partially installed, can play a major role in constraining small business development.

In many transition countries with slow reform progress, the *legal framework* is still the main barrier for the development of small business and entrepreneurship. Creating an adequate legal framework involves laws relating to property, bankruptcy, contracts, commercial activities and taxes, but it also involves developing an institutional framework with the capacity to effectively implement laws and regulations. Low public-sector salaries, combined with a lack of education and training opportunities for staff in enforcement institutions, often prevent the proper implementation of business laws and regulations. In addition, frequent changes in tax regulations and other commercial laws, which are characteristics of the early years of the reform period, require a constant adjustment of knowledge by small business managers, as well as by those in government administration.

All of this results in time-lags and a rather uncertain attitude, or even arbitrariness, on the part of public officials regarding law enforcement, that is not helped by a typical lack of specificity in the drafting of laws. Fundamentally, these institutional deficiencies often reflect a lack of political commitment to facilitate private enterprise development. Political considerations with respect to the enforcement of laws can aggravate the situation, resulting in the fostering of ‘old’ networks between former state-owned firms and government (Welter 1997). In some transition countries, these networks appear to be one of the major problems impeding the establishment of independent juridical institutions and the enforcement of the legal framework required for market-based economic development.

Another major barrier to small business development in transition countries where market reform has remained slow is the *financial infrastructure*, which may not have improved much in recent years, at least as far as supplying finance to private business is concerned. While stock exchanges developed quickly in the more advanced transition countries, in most former Soviet republics, national risk capital markets are virtually non-existent and the banking system is still highly inadequate (Zecchini 1997).

The extent of the challenge faced in transforming the financial infrastructure is illustrated by the fact that under central planning, banks were mere accounting agencies without an active role in the financial transactions of households or enterprises. As a consequence, in less advanced transition economies particularly, the majority of banks are not effective in the task of guiding savings towards capital investment in private enterprises, especially small businesses. The extension of credits to small businesses has also been hampered by the fact that newly created or privatised banks often faced liquidity constraints, resulting from insufficient equity capital provision, inherited liabilities from the central planning era and/or from massive repayment delays. At the same time, banks have typically followed a conservative strategy with respect to the financing of private enterprises, particularly small enterprises, which are viewed as high-risk clients.

As a consequence, most banks in countries such as Ukraine and Belarus, lack a willingness to finance small businesses, which is reinforced by a lack of expertise and know-how with what represents a new clientele and a shortage of collateral to provide security to support loan applications, on the side of the enterprises. In these circumstances, informal institutions and practices may compensate for some of the deficiencies in the formal market institutions, although not without implications for the types of strategies adopted by entrepreneurs to set up and develop businesses, as the evidence presented later in the chapter on Belarus demonstrates.

All of these factors can contribute to a negative attitude on the part of small businesses toward formal institutions, such as banks, but also government agencies and regulatory bodies, which was a common phenomenon in the early years of transition particularly. In such situations entrepreneurship remains restricted, the number of firms is small and their contribution to economic development in terms of jobs, innovation and external income generation rather limited. Frequent changes in the tax system, combined with high tax levels, unpredictable behaviour of state officials in applying tax regulations, and inadequate access to external capital encourage entrepreneurs to use evasion strategies in order to reduce profits and tax payments, with the underlying objective to preserve the capital base of their enterprises (see Chapter 5 on Belarus, for more detail). Since entrepreneurs perceive that the level of taxation is much higher than in mature market economies (Johnson and Kauffman 2001), this also contributes to the development of considerable informal activity, as entrepreneurs avoid paying taxes.

Weakly specified regulations, combined with inadequate law enforcement, encourage corruption not only when entrepreneurs seek to register a company, but also in their everyday business transactions. Such behaviour reflects inadequate formal institutions (such as commercial laws and courts) to regulate business activity as well as inconsistent and inadequate informal institutions to assist law enforcement. Both lead to mistrust on behalf of entrepreneurs, state officials and society more generally, thus resulting in a potentially vicious circle, which is difficult to break out of. As a result, while the specific priorities for the development of entrepreneurship vary between individual 'transition' countries, a key underlying theme is the importance of institutional development and capacity building, over which governments exert a key influence.

Variation in the pace of transformation

Not surprisingly perhaps, in the second decade after transformation began, there is considerable variation between countries in the extent to which a facilitating environment for the development of entrepreneurship has been created. As a result, it is inappropriate to refer to transition economies as if they are an undifferentiated, homogeneous group, any more than so-called market economies may be considered as a uniform group.

Variation in the nature and extent of transformation between countries was also affected by the varied starting point for the process in 1989/1990. At the outset of transformation, three broad groups of countries have been identified (Gros and Steinherr 2004). The first group includes only East Germany, which is a special case, because transformation there essentially involved an extension of West Germany's institutional framework to the East and a wider process of integration of East with West Germany. The second group comprises all other socialist economies outside the former Soviet Union, which were mainly small economies, where market-based systems had existed in the inter-war period. The third group comprises the so-called newly independent states (NIS), where the challenge facing policy makers was the greatest, because of the need to create a state and administrative system appropriate to the needs of a market economy.

Although starting points were different, and the strength of the political commitment to the process of market reform varied, the main elements of the reform programme were common. At the same time, detailed differences, for example, in the privatisation model used, had implications for SME development. This can be illustrated with reference to Lithuania, where it is reported that the use of a voucher system of privatisation resulted in some privatised manufacturing enterprises having a large number of owners, which contributed to their slow pace of restructuring (Smallbone *et al.* 1997a).

A key theme running throughout this book is the diversity of transition contexts that currently exist in CEECs and the NIS. Another theme is the importance of the institutional context on the nature and pace of entrepreneurship that develops. Both can be illustrated with reference to Table 2.1, which summarises the EBRD's so-called transition indicators for the five countries featuring in the book, namely Russia, Belarus, Ukraine, Poland and Estonia, in relation to some of the key aspects of market reform.

Table 2.1 Progress in transition in selected CEECs and NIS (based on EBRD indicators 2005)

	Russia	*Belarus*	*Ukraine*	*Poland*	*Estonia*
Pop. mid-2005 (m)	144.9	9.8	47.3	38.2	1.4
Private sector share of GDP	65%	25%	65%	75%	80%
Large-scale privatisation	3	1	3	3+	4
Small-scale privatisation	4	2+	4	4+	4+
Governance and enterprise restructuring	2+	1	2	4+	4–
Price liberalisation	4	3–	4	4+	4+
Trade and foreign exchange system	3+	2+	3+	4+	4+
Competition policy	2+	2	2+	3	3–
Banking reform and interest rate liberalisation	2+	2–	3–	4–	4
Infrastructure reform	3–	1+	2	3+	3+

Source: EBRD (2005: 4).

Note
The measurement scale used for the indicators ranges from 1 (little or no change from a rigid centrally planned economy) to 4+, which represents the standards of an industrialised market economy.

The EBRD has been tracking progress with market reforms in all 27 transition countries, since 1994. The classification system used in Table 2.1 is a stylised reflection of the judgement of the EBRD's Office of the Chief Economist. Progress is measured against the standards of a mature market economy, which is represented by a score of 4+ on the measurement scale, while a score of 1 indicates little or no change from the conditions associated with a centrally planned economy.

The indicators included in the Table are intended to cover four main elements of a market economy:

i *Markets and trade*, where reform is assessed in terms of the liberalisation of prices; liberalisation of trade and access to foreign exchange and the effectiveness of competition policy.
ii *Enterprise restructuring*, which includes indicators for both large-scale and small-scale privatisation. Small-scale privatisation refers to the transfer of small-scale state assets to private persons, mainly in the retail and service sectors, but also in road haulage. Large-scale privatisation refers to the privatisation of large state-owned assets. For large-scale privatisation, the scores also reflect the standards of corporate behaviour amongst privatised large companies. Governance and restructuring describes progress in cutting subsidies, introducing effective bankruptcy procedures and introducing sound corporate governance practices.
iii *Infrastructure*, which includes a composite assessment of reform in relation to five types of infrastructure (i.e. road, rail, etc.), covers issues such as commercialisation; the extent of the reform of tariffs; the quality of the regulatory framework and the involvement of the private sector.

iv *Financial institutions*, which includes reform and development of the banking sector and the extent to which banking and financial regulations have been raised and implemented to international standards.

In terms of the countries featuring in this book, Table 2.1 suggests that an overall distinction can be made between three groups of countries: first, Poland and Estonia, where at least three-quarters of GDP is contributed by the private sector and a minimum score of 3 is achieved on all of the selected indicators; second, Russia and Ukraine, where a significant majority of GDP is generated from private sector activity, although progress with market reforms is more patchy; and third, Belarus, where private sector development is restricted, with market reform having stalled, leaving the country with many features of a centrally planned economy. This suggests that although Poland and Estonia have made significant progress across the spectrum of different aspects of market reform, and are undoubtedly qualitatively different from the other three countries in this respect, Russia and Ukraine also appear qualitatively different from Belarus.

Certain differences can also be noted in the pace of reform over time, along the various dimensions of economic transformation. In this regard, a distinction can be made between the so-called ‘initial phase’, or period of liberalisation reforms (such as price and trade liberalisation and small-scale privatisation), which tended to take priority in the early stages of transformation; and ‘second phase’, or institution-building reforms (such as competition policy, enterprise restructuring and the development of financial institutions), which typically take longer to implement (EBRD 2003). The first type of reforms are easier to achieve because essentially, they require a reduction in state activity, while the second type are more difficult, because they focus on the development of market-based structures and institutions. Table 2.1 shows that initial phase reforms are well advanced in most countries, even in Russia and Ukraine, although Belarus is still a laggard in this respect.

In view of the fact that Poland and Estonia have both been members of the European Union since May 2004, it might seem surprising that reforms in some areas in these countries are not more advanced than they appear in Table 2.1. The process of accession to the EU involved candidate countries completing all 31 chapters of the ‘acquis communitaire’, which contains the principles, policies and laws on which the EU is based. Although countries in the first wave of new member states to join the EU (including Poland and Estonia) were able to meet the requirements of the ‘acquis communitaire’, they have not all been able to achieve top scores on the EBRD transition indicators. This is mainly because unlike the transition indicators, the 31 chapters of the ‘acquis communitaire’ are not concrete benchmarks, but rather the result of negotiations between individual accession countries and the EU, which means they are less clearcut. As a result, EU membership does not necessarily mean that the process of transition is complete.

Although preparations for EU membership involved a process of harmonisation with EU legislation, which started before 2004, the process was still ongoing at the time of Accession. For some countries, this involved being granted temporary postponement of certain aspects of the 'acquis communitaire', on the basis of agreed transitional arrangements. For example, in the area of Competition Policy, Poland (together with the Czech Republic, Hungary and the Slovak Republic), was given a period of eight years to phase out fiscal subsidies to sectors that include SMEs and also some large enterprises (e.g. in the steel industry) (EBRD 2003). As a result, the process of transition continued after EU membership.

Recognition that transformation is a process, which countries navigate at different rates, raises the question of the framework conditions that need to be in place for entrepreneurship to develop and become embedded in transition economies. According to the OECD (1998: 270), these framework conditions include:

> the initial administrative and legal reforms, which allows private enterprise to exist within the law; the establishment of private property rights; market based institutions; a commercial banking system; competition and business law and a code of business ethics. It also includes bankruptcy laws and procedures; simple procedures for licensing and regulation; a non-prohibitive and transparent tax regime and stable legislation and regulation.

Although the experience of countries, such as Belarus, where few of these framework conditions have been achieved, shows that entrepreneurship can exist despite these deficiencies, the number of private enterprises is typically small and their contribution to economic development limited. In other words, the absence of key framework conditions will undoubtedly hamper the development of productive entrepreneurship. At the same time, it is arguable as to whether their achievement of these framework conditions represents a sufficient condition for entrepreneurship to become established, because of the influence of the years under central planning on the attitudes towards entrepreneurship and the wider culture of enterprise in the population.

The need to recognise the variation in the pace of market reforms between countries, with implications for the development of entrepreneurship, has also been recognised by the UNECE (2003). According to their assessment, the development of entrepreneurship in countries in transition may be classified into three broad groups:

i *Countries making rapid progress*, which includes the eight new member states of the EU from Central and Eastern Europe (i.e. Poland, Hungary, Czech Republic, Slovakia, Latvia, Lithuania and Estonia, but also Croatia on the basis of its 'advanced enterprise development and state of the art government support approach' (OECD 1998: 6).

ii *Countries at an intermediate stage of transition*, which includes Bulgaria and Romania (both members of the EU since January 2007) and three of the NIS, namely the Russian Federation, Uzbekistan and Kyrgyzstan.

iii *Countries making slow progress*, which is a group characterised as having low government commitment to the development of SMEs. The group includes Albania, Bosnia, Herzegovina, Macedonia and the majority of the NIS.

Although lacking an explicit set of criteria, which means that one might quibble over the classification of individual countries, the UNECE typology emphasises the overall variation in the nature and pace of SME development, reflecting varying levels of progress and commitment to the process of market reform.

The need to distinguish between different groups of ‘transition’ economies rather than treating them as a homogeneous group may be supported with evidence drawn from the large-scale Business Environment and Enterprise Performance Survey (BEEPS) (EBRD 2005). This survey includes data from Central and Eastern Europe and the Baltic States (CEB), Southern and Eastern Europe (SEE), the NIS, as well as from selected mature market economies for benchmarking purposes. The results show that while significant differences exist between transition and mature market economies in most cases, transition countries themselves portray considerable variations between the three country groups on certain key variables. These include the so-called ‘bribe tax’ (i.e. the reported proportion of annual sales which is paid in unofficial payments), which is highest in the NIS, followed by SEE, CEB and mature market economies. The reverse order applies in the case of reported use of external finance, except that in this case enterprises in CEBs report similar results to those in mature market economies.

The roles of entrepreneurship and SMEs in the transformation process

Identifying the potential roles of SMEs in the process of economic and social transformation can be informed by the experience of mature market economies, as well as by theories of transition. However, the extent to which these roles are actually achieved in practice is likely to depend on the extent to which the framework conditions described earlier are in place; and the extent to which financial and human capital resources are available to provide a supply of entrepreneurs to create and respond to emerging business opportunities.

SMEs and job generation

One of the key potential roles of SMEs in a transition context is generating employment, thereby contributing to absorbing some of the labour released from large state-owned enterprises, as a result of economic restructuring. While in most transition economies, small firms have been one of the few sources of new jobs during the transition period, this has typically been insufficient to compensate for major job losses in large enterprises. Critics have also pointed to the lack of sustainability of some of the employment generated, because of the marginality of many of the businesses created (Scase 2003). However, the issue is not straightforward, partly because of possible differences between the sustainability of individual enterprises and the performance of the SME sector in the economy as a whole. For example, if job losses associated with high rates of non-survival of individual enterprises are less than jobs gains associated with high rates of new firm formation, then total employment will increase.

Self-employment and small business ownership may provide a means of 'self-help' support for former employees of SOEs, who have either lost their jobs through restructuring, or who have been forced to take leave. Rather than adding to the number of official unemployed, state-owned firms often offer so-called 'administrative leave' to some employees, which is usually unpaid and without redundancy compensation. Many of these workers on 'administrative leave' are employed, either part-time or as contract staff in small private enterprises, or enter self-employment or start businesses themselves, often operating at least partly in the informal sector.

In all economies, the small business sector is a heterogeneous mix of businesses with varied growth orientation and performance. In a mature market context, a minority of growth oriented firms create a majority of new jobs (Storey and Johnson 1987, Storey 1994) and many small firms are showing little dynamism in this respect (e.g. Gray 1998). Micro level research evidence from transition environments shows that once small firms have survived the first year or so (and high rates of non-survival amongst new firms is a phenomenon that is not confined to transition countries), they are capable of generating employment, although their ability to do so is affected by external conditions.

Results from the EBRD's Business Environment and Enterprise Performance Surveys, covering the period 1996–2005,[1] provides evidence of employment change in three groups of transition countries: CEB; SEE; and the NIS (EBRD 2005: 88–89). The surveys show that employment grew in firms across the region during the 2002–2005 period, but with significant variations in rates of growth between countries. In terms of ownership, new private firms showed particularly strong employment growth.

This can also be illustrated with reference to a study of manufacturing SME development in Poland and the Baltic States, undertaken in 1994–1995, and based on surveys of broadly matched samples of firms in the four countries (Smallbone *et al.* 1997a). The survey included indigenously owned private firms employing fewer than 100 and the employment change data referred specifically to the period between December 1993 and June 1995. The results showed considerable variation in the employment performance of SMEs between the four countries surveyed, reflecting differences in the pace of transformation. On the one hand, in Poland and Estonia there was a net increase in employment of 29 per cent and 21 per cent respectively during this 18-month period and the majority of surviving firms were able to increase employment. By contrast, in Latvia and Lithuania the pattern of employment growth was much more mixed and firms that were in existence throughout the 18 month study period actually experienced a net reduction in employment of 4.9 per cent and 6.0 per cent respectively.

The explanation is that external conditions in Latvia and Lithuania were slower to stabilise than in either Poland or Estonia. Although the number of private enterprises grew rapidly, the external environment presented many threats as well as opportunities for entrepreneurs. In addition, there were still some privatised firms in Latvia and Lithuania where the process of restructuring was not complete at this time, which had implications for employment change. These findings suggest that the contribution of SMEs to employment generation varies with external conditions, with implications for the role at different stages in the transformation process.

At the same time, one of the key findings of this study was that the firms making the biggest contribution to employment growth were those that were able to grow in terms of sales (at constant prices). Research in western countries has consistently shown the relationship between employment growth in SMEs and output growth; in other words, employment growth depends on firms being able to increase their sales (North *et al.* 1994; Storey *et al.* 1987). Despite the fact that in the study reported here, employment and turnover change data only refers to a one year period, nevertheless the results illustrate that growing firms (in terms of sales) show a considerably higher propensity to generate jobs than firms with stable or declining sales turnover (Table 2.2).

Table 2.2 shows that in all four countries, the rate of employment increase in growing firms was above that in stable and declining firms. In fact, in Latvia and Lithuania it was only firms that grew in real turnover in 1994 that actually increased employment overall. Certainly, the results summarised in Table 2.2 suggest that firms making the biggest contribution to employment generation in

Table 2.2 Employment change and sales growth performance of manufacturing SMEs in Poland and the Baltic States (December 1993–December 1994)

	Growing sales	*Stable sales*	*Declining sales*	*All firms*
Poland				
Net employment change	26.3%	4.9%	–3.4%	20.8%
No. of firms	191	39	40	270
Estonia				
Net employment change	9.7%	16.2%	2.3%	14.3%
No. of firms	37	9	21	67
Latvia				
Net employment change	35.6%	–27.5%	–12.7%	–4.4%
No. of firms	33	24	21	78
Lithuania				
Net employment change	16.1%	–16.0%	–6.1%	–4.8%
No. of firms	12	12	42	66

Source: Own survey (see Appendix, Project 2, pp. 236–237).

Note
Only firms that were in existence in December 1993 and for which both sales and employment data are available for December 1993 and December 1994 are included in the Table.

1994 in all four countries were those that were performing the most strongly in terms of sales trends. Referring specifically to firms that were in existence throughout the study period, growing firms accounted for 99 per cent of the total net increase in employment in the Polish sample (from 71 per cent of firms) and 79 per cent in Estonia (from 55 per cent of firms). However, in Latvia and Lithuania, the increase in employment in the minority of growing firms was insufficient to compensate for the net decrease in jobs in firms that were unable to increase real turnover during the period.

Further empirical evidence at the micro level is provided from a survey of 394 small firms in Bulgaria, undertaken in 1993 (Bartlett and Rangelova 1997). Although the sampling frame included firms with up to 50 employees, the vast majority of surveyed firms were very small enterprises with fewer than ten employees. The study showed that more than half the firms surveyed (59 per cent) reported taking on new employees in the six months prior to the interviews, and two-thirds claimed to be planning to expand employment during the subsequent year. While recognising the inability of the small, private enterprise sector to compensate for rising unemployment in Bulgaria at the time, associated with a contraction of jobs in state-owned firms, the authors emphasised the dynamic contribution of small private firms to the development of the Bulgarian economy and its important role in employment generation. This is a theme which is developed in more detail in Chapter 4 on Russia.

SMEs and the wider processes of economic restructuring

A productive SME sector can also contribute to the development of a more diversified economic structure, as an economy moves away from central planning. This includes sectoral restructuring, since one of the characteristics of the economic structures that evolved during the socialist period was an emphasis on manufacturing (particularly heavy industry) at the expense of other sectors. The initial explosion of small enterprise activity in service sectors contributed to widening the portfolio of services available to consumers, as well as contributing to a changing balance of activities on the supply side of the economy.

Additionally, within the manufacturing sector itself, the development of SMEs can contribute to an adjustment from highly concentrated structures based on mass-production methods to more flexible production systems. During the socialist period, manufacturing in the former Soviet republics was integrated into a technological chain and locked into markets in the former Soviet Union, which resulted in a high level of military-orientated production at the expense of consumer goods. As a consequence, there was a need to radically restructure the manufacturing base in order to develop a more flexible system of production, which is responsive to changes in consumer demands and the forces of market competition.

Clearly within such a context, the *potential* role of SMEs is considerable because of their inherent flexibility, although to fulfil such a role in practice almost certainly requires more than a ‘laissez-faire’ response on the part of government. In the mid-1990s, the external environment for business development in transition economies was a fairly hostile one in terms of enterprise development. A combination of a loss of traditional markets, the effects of recession on demand conditions in the domestic market, together with the effects of trade liberalisation on the level of foreign competition, was exacerbated by the competitive disadvantages associated with the underdeveloped state of the producer services sector. Moreover, structural change is not a painless process, since it inevitably involves a closure of some activities on the one hand and the creation of new activities on the other, as the extent of the change required goes beyond the capability of many individual enterprises.

Another way in which SMEs can contribute to economic development is through their complementary linkages with other businesses, such as via supplier and customer relationships. In a mature market context, it has been estimated that up to two-thirds of small firms rely on some kind of supply role to other firms for their livelihood (e.g. Rainnie 1989). By acting as suppliers to larger companies, SMEs contribute to the external competitiveness of these firms, which together comprise economic systems or networks. In this context, many small firms act as specialist suppliers to large companies of parts, subassemblies, components or (increasingly) services, which are often produced at a lower cost than large companies can achieve in-house, thereby contributing to enhanced price competitiveness.

In this respect, small firms provide an important part of the infrastructure on which the competitiveness of a market economy depends. However, in order to fulfil this function SMEs typically need to achieve very demanding quality standards to meet the requirements of large-firm customers. More fundamentally perhaps, this type of supply role depends on there being a potentially competitive large-firm sector to engage with small-firm suppliers, which in the case of most transition economies does not exist, apart from those countries where foreign investment has made a significant contribution. This is an important point to emphasise, because the weakness of the large-firm sector has undoubtedly had knock on effects on the business opportunities presented to entrepreneurs, with implications for small business development.

In some parts of Europe, SMEs play a leading role in economic structures through various forms of inter-firm co-operation. In regions, such as Emilia Romagna, for example, regional competitiveness is based on the interdependence between SMEs, rather than simply on the strategies and actions of individual firms, or a dependence on larger firms. While it may be argued that the social conditions within which such integrated production systems develop are highly specific, the potential advantages of co-operation between SMEs in terms of external economies of scale, make such regions of considerable policy interest, including to some of the economies emerging from transition. Croatia is a good example of this (NCC 2004), although it has been suggested that the concept of 'clusters' is being utilised without any real understanding of its nature, operationalisation or linkage with enabling and constraining factors (Redzepagic and Stubbs 2006).

SMEs and innovation

Another economic role of SMEs in mature market economies is as a source of innovation, although there has been considerable debate in the literature about the relative contribution of firms of different sizes in this regard. For example, based on an analysis of the size distribution of innovating firms in the UK between 1945 and 1984, Pavitt *et al.* (1987) concluded that small firms are more likely to introduce new innovations than larger firms, because they have less commitment to existing practices and products than larger enterprises. Acs and Audretsch (1990) provided further empirical support for the disproportionate contribution of SMEs to innovation, based on US data. On the other hand, evidence from the second Community Innovation Survey (CIS) in the UK suggested that across all sectors SMEs made fewer innovations (in terms of introducing technologically new or improved products or processes) between 1994 and 1996 than large enterprises. Moreover, the gap is wider when only 'novel' or 'radical' innovations are considered (Craggs and Jones 1998).

Part of the reason for such discrepancies is that different studies use different definitions of what constitutes innovation, as well as different databases to examine it. Perhaps the point to stress is that when viewed across all sectors and types of innovation, there is no optimal firm size from the point of view of innovation (e.g. Tether *et al.* 1997). It is also important to recognise the heterogeneity that exists within the SME sector, in all economies. On the one hand, there are many conservatively managed traditional SMEs, operating in niches that are relatively untouched by technological change, where innovation is not an issue for their owners/managers. On the other hand, there is a minority of highly innovative SMEs, whose knowledge base may make them potential world leaders in a specific field.

When applied to a transition context, the innovative role of SMEs takes on some distinctive dimensions. Under socialism, national innovation systems focused on the needs of large state-owned enterprises, with their innovative effort orientated towards the needs of the military industrial complex. Much of the innovative activity was undertaken in state operated research institutes, in which innovation was legally defined during the socialist period in narrow technological terms. Essentially, an innovation system includes a production structure and an institutional structure, as well as the relationship between these two. The system collapse that occurred after 1990, included both elements of the innovation system, leaving a vacuum as far as the emerging private sector was concerned in most transition economies.

While some SMEs in transition environments have contributed innovations, as the later chapter on Ukraine demonstrates, much of this is best characterised as incremental innovation, taking the form of introducing new products and services to domestic markets, rather than being fundamentally innovative in an international sense. In itself, this is not necessarily a weakness, because it shows that SMEs are performing a function as change agents within these transforming economies. Moreover, in mature market economies, much of the innovation that takes place in SMEs involves entrepreneurs finding new or better ways of competing, which emphasises the commercialisation of ideas and methods, rather than more radical innovations.

The difference is that in transition conditions, innovative activity in SMEs has been hampered by the inadequately developed innovation systems described above, because of the importance of external inputs to the innovation process in SMEs, within the context of a so-called interactive model of innovation. In a transition environment, such processes are hampered by the underdeveloped nature of public and quasi-public institutions to support innovation (such as science parks, innovation centres and universities, at least in terms of commercial orientation), although this is changing, particularly in some of the new member states of the EU. At the same time, it is also a function of the underdeveloped nature of the market in a transition context, compared with mature market economies, where the most consistently reported external linkages supporting innovation in SMEs are with customers and suppliers (e.g. Smallbone *et al.* 2003). In this regard, it can be seen that the innovative capability of SMEs in a transition environment is highly interdependent with other system developments. As in other respects, there is no doubt that some SMEs are contributing to the innovative performance of emerging market or transition economies, but the extent to which they are able to achieve this is contingent on other external developments.

Public policy and the development of entrepreneurship

Undoubtedly, the potential role of entrepreneurship and SME development in contributing to the wider process of social and economic restructuring is considerable, although the extent to which this has been achieved so far has been limited by other aspects of the change that has occurred. Part of the problem is that because the development of SMEs has been one of the few sources of dynamism in the transformation process, too much has been expected of it. In this regard, it is difficult to disagree with McIntyre's (2003: 5) statement that: 'one conclusion emerging from the decade-long experience is that the small enterprise sector is not in itself enough to create successful economic growth', although the explanation may stem from the naivety of assumptions that small firms alone can achieve this. As the experience of mature market economies demonstrates, many SMEs need large firms, as a source of inputs and/or as potential customers. Hence, in any environment, policy debates that are characterised in terms of the contribution of small versus large enterprises, if presented as competing alternatives, appear naïve and misunderstanding the nature of the changes that have occurred in mature market economies in recent decades.

At the same time, while important questions for policy makers, such issues are only part of the story of what has occurred in the former socialist countries. As the evidence presented in this volume shows, the SME development that has occurred during the last two decades, in countries where private business activity was previously illegal, constitutes achievement for individuals and enterprises, which cannot be dismissed as insignificant. Hence the approach adopted in this book is to seek to identify the strengths and limitations of what has been achieved so far, based on systematically gathered empirical evidence, while emphasising how more of the potential contribution of entrepreneurship to ongoing transformation and development could be mobilised in the future.

The extent to which the potential contribution of SMEs to the process of economic transformation is actually fulfilled in practice is undoubtedly influenced by the policy stance taken by the state. This is because government is one of the key influences on the external environment in which businesses develop in any economy, acting as an enabling and/or a constraining force, particularly in relation to institutional change and development.

While emphasising that setting up and developing businesses results from the creativity, drive and commitment of individuals rather than as a result of actions taken by government, the conditions that enable and/or constrain the process of entrepreneurship are affected by the wider social, economic, political and institutional context, over which the state has a major influence. In this respect, it is important to stress the variety of ways that government can affect the nature and pace of SME development, rather than narrowly focusing on direct support measures and programmes. One reason why this is important is because any benefits accruing from the latter may be more than outweighed by the negative effects of other government policies and actions and those of state institutions. This applies in mature market-based economies as well as those at various stages of transition, although the transition context typically adds further dimensions to such issues.

Adopting a broad view of the role of government policy as an influence on the nature and extent of entrepreneurship, the authors have previously identified five main types of policy through which government influences entrepreneurship (Smallbone and Welter 2001b):

i *Through the influence of government on the macro-economic environment in which business is conducted.* Although macro-economic policy is not normally highly sensitive to the effects on smaller businesses, SME managers in mature market economies frequently see matters such as the level of aggregate demand, interest rates and taxation as key factors influencing the development of their businesses, and typically more important than government measures which are aimed specifically at small firms.

  In the early years of transition, in all former socialist economies, the macro-economic development was recessionary and inflationary, although in a few countries (e.g. Poland) inflation was rapidly brought under control. Nevertheless, in most transition countries, high inflation in the early years discouraged potential entrepreneurs from investing in projects that depended on long term returns on capital invested, encouraging them instead to engage in trading and speculative activity that offered rapid returns (Lageman *et al.* 1994, Smallbone *et al.* 1997b). In addition, a combination of stabilisation programmes and the disruptive effects of the sudden demise of the planned economy caused GDP to fall rapidly, contributing to weak demand conditions for entrepreneurship. At the same time, it must be recognised that in practice the ability of governments in transition economies to independently create a stable macro-economic environment has been limited, with international organisations exerting a key influence.

ii *Through the impact of government legislation and regulations, which may have a differential impact on firms of different sizes.* This refers to the fact that policies, which are wholly neutral in intention, may be far from neutral in their effects, because of the different circumstances of large and small firms (Bolton Committee 1971). Two broad types of cost which government places on business may be identified: first those direct costs which fall on firms such as the costs of employers' social security/insurance contributions; and second, the compliance costs of meeting particular legislative requirements (Bannock and Peacock 1989).

Compliance costs result from the time needed to understand the legal requirements of legislation, to deal with the necessary paperwork and to train and pay staff to carry out any additional tasks that result. It is argued that these costs fall disproportionately on smaller firms because of their more limited internal resources compared with larger firms. This can be particularly problematic when legislation is changing quickly, and/or is overly complex. This has often applied in transition countries, where such factors can add to the operating costs of firms, because of the need to employ specialists such as tax advisers or consultants to assist with business registration and deal with reporting requirements and regulatory issues (Smallbone *et al.* 2001a). While Gibb (2000) is right to stress the importance of the process by which laws are interpreted by agents rather than simply focusing on the creation and clarification of appropriate laws, the two issues are interrelated. Imprecise laws or regulations that are difficult to implement can leave too much scope for interpretation and the use of discretion by local officials, which can in turn contribute to corruption.

Another regulatory issue that is particularly relevant in a transition context is the tax regime. This includes the overall level of the tax burden, which it has been suggested encourages entrepreneurs to move into the informal sector or shadow economy (Arendarski *et al.* 1994). While a growth in the latter may be viewed as a policy problem to be reduced through stronger policing and controls, the informal economy may also be viewed more positively as a potential source of entrepreneurship for a wide variety of activities. In the early years of transition in particular, the level of taxation imposed on small privately owned firms often appear high by western standards, since employers were often expected to pay 30 per cent of wage costs in social insurance payments, in addition to enterprise income tax. It is hardly surprising that in such circumstances many small firms trades were operating at least partly in the informal economy.

At the same time, the taxation system itself can be a source of unnecessary compliance costs where, for example, frequent changes in tax rules and regulations mean that time and resources need to be allocated within businesses to enable entrepreneurs to keep up to date with what the firm's tax liabilities are, ensuring that the business operates within the law. While frequent changes in legislation affecting private business activity (e.g. tax laws) might be expected in the early years of transition, as the system initially adapts to recognise the existence of private business, the ongoing tinkering with the tax system that occurred in some countries, suggests that the negative effects on entrepreneurship have been ignored by policy makers and legislators.

iii *Through direct support measures and programmes that are designed to assist small firms in overcoming size-related disadvantages*. This is perhaps the most obvious way that state policy can influence SME development. The main rationale for this type of intervention in a transition context is based on the view that while small units of organisation offer some potential economic advantages and can contribute to the process of economic development; their ability to achieve their potential contribution may be impaired by certain size-related disadvantages. Arguments based on 'market failure' are less applicable in contexts where markets for small firms, such as for finance, advice/consultancy and business training, are still underdeveloped and market building is necessary.

iv *Through its influence on the development of those institutions that are a necessary part of a market economy, such as banks and other financial intermediaries; business courts; training the business services organisations.* The dynamic growth of entrepreneurship that occurred in many post-socialist economies after 1990 generated considerable demand for institutional change, which in turn affected the nature and extent of private sector development. Three main elements of institutional change can be identified: first, a legal infrastructure appropriate to market conditions; second, the creation of a legal framework to facilitate the development of entrepreneurship; third, the creation of commodity, capital and labour markets. The absence of appropriate legal and institutional frameworks in the early years of transition, and which still exist in some former Soviet republics, created opportunities for so-called nomenclatura business activity to exploit the institutional deficiencies that existed, and protected by the political power of those individuals involved (see Chapter 3 for a detailed discussion).

Although not the most immediate priority at the start of the transition process, another aspect of institutional change is the creation of an effective business services infrastructure conducive to supporting the creation and development of new and small enterprises. While few would argue these days that it is the role of government to deliver business services directly to firms, the state has an important potential influence over the type of support infrastructure that develops. Whatever system is devised to suit the needs of particular national or regional environments, the aim should be to avoid a proliferation and fragmentation of agencies which can cause confusion in the minds of SME managers about who to approach for what types of assistance. This is a particular danger in situations where funding organisations make resources available on a project basis with little regard to the integration of programmes at the local level, which is a common phenomenon in Central and East European countries, particularly where international donor organisations are involved.

v *Through its influence on the value placed on enterprise and entrepreneurship within the wider society.* Clearly, this is a longer-term influence of government policy and is affected by many factors, including the characteristics of the education system (at all levels). This involves both the curriculum and methods of teaching since the pedagogy or the process of learning may be at least as important as the actual content (Gibb 1993). However, the value that society places on entrepreneurship is also influenced by the stance that government takes with respect to encouraging people to start and develop their own businesses and through the behaviour of politicians and government officials in their dealings with entrepreneurs (Mugler 2000).

In many ways, this is the most fundamental and important role for government, which is largely underdeveloped in most of the former Soviet republics. For example, in the Russian Federation, the absence of a recent tradition of private business ownership, combined with a lack of self-governing (business) organisations and a poor public perception of the contribution of small business to social and economic change, means that the state must take a lead in modifying the institutional conditions and in establishing the ground rules on which business is conducted. This is essential if entrepreneurship is to flourish and fulfil its potential contribution to social and economic development.

While each of these policy areas are applicable in mature market as well as in transition economies, the key underlying factor in a transition context is the extent of the commitment of government to market reforms, together with the ability to implement them. In this context, the role of good governance and market-oriented institutions becomes an essential feature of the reform process, if the development of productive entrepreneurship is to be encouraged and sustained, enabling the SME sector to achieve more of its potential contribution to the process of social and economic transformation. This can be illustrated with reference to a commonly recognised issue in countries where SME policy has sometimes been declarative in nature, leaving an 'implementation gap' between the stated policy and the practice. There can be various reasons for this, but a lack of clarity with respect to *responsibilities*, a lack of *accountability* for actions, combined with procedures that are less than *transparent* can all contribute. All are elements of good governance in terms of the practices that encourage productive entrepreneurship and the establishment and development of SMEs.

Public policy and governance can influence most of the contextual factors that affect both the demand for, and supply of, entrepreneurs. On the demand side, this includes average income levels and other factors influencing the level of aggregate demand; on the supply side, it includes factors such as the orientation of the public education system and curriculum content. The term 'governance' is a versatile one, referring to the exercise of power in both a corporate and a state context. However, its use here focuses on the latter interpretation, embracing actions by executive bodies, assemblies (such as national parliaments) and judicial bodies. In this sense, governance has been defined as 'conscious collective action extending beyond government deploying, for example, the capacities of businesses, community groups and academic institutions' (Hart 2003: 8). Governance is concerned with the rules, procedures and practices affecting how power is exercised. These issues are central to the democratic process, because they influence the legitimacy and effectiveness of institutions, which can have major impact on entrepreneurship development.

One of the basic roles of government in a market-based system is to create an environment in which private sector business can flourish and thereby make an effective contribution to generating employment and economic development. At the same time, the state also has an important regulatory function to ensure that business operates within certain rules that seek to balance the need to encourage and promote enterprise with a need to protect wider social interests and the public good. Establishing an appropriate balance has been the subject of considerable debate in mature market economies. However, in a transition context, establishing an appropriate balance is doubly difficult because of the lack of any tradition of the state as a regulator of business activity.

In this context, it is important to stress that regulation covers the full range of legal instruments and decisions through which governments establish conditions on the behaviour of citizens or enterprises (OECD 1994). Regulations that are overly burdensome, complex or impractical may reduce business competitiveness by contributing to higher administrative and compliance costs, as well as to a diminution of the rule of law when non-compliance becomes rife. As a result, minimising the regulatory burden on business to the level that is necessary for the protection of the public good is a key element in government policy designed to encourage entrepreneurship and private sector investment.

In this regard, the foundation of the rule of law is based on a mutual respect for the legitimacy of regulation by both government and citizens. Rather than viewing regulations as tools by which government directs its citizens, they need to be viewed as a means of limiting the power of the state by closely defining it. Such a view is based on a democratic principle of 'co-operation' between government and its citizens, rather than an 'authoritarian' style of regulation, which transition economies have experienced in the past.

It should be also noted that regulations are part of a wider regulatory system that includes processes and institutions through which regulations are developed, enforced and adjudicated. Apart from the regulations themselves, the regulatory system includes processes of public consultation, communication and updating, thereby emphasising the wider governance issues. Although the issue of regulatory burdens can affect the development of all businesses, it can be a particular barrier during the start-up period, when entrepreneurs face many other demands on their time, in a context where time and money resources can be particularly scarce. All this can affect transaction costs, which in turn have implications for business competitiveness.

It can be argued that an entrepreneurial society is one where legal, administrative and institutional processes and procedures facilitate ease of exit for entrepreneurs, as well as ease of entry. From an economic perspective, ease of entry and exit can influence the mobility of factors of production between less and more productive uses, thereby influencing the degree of flexibility and adaptive capacity of an economy. However, it may also contribute to the development of an 'enterprise culture' through influencing the extent to which exiting from a business venture is necessarily considered to represent failure.

In considering the roles of public policy in relation to the development of entrepreneurship and small businesses, it is necessary to consider the roles of regional and local authorities, as well as of national governments. The development of entrepreneurship in most transition economies typically varies considerably between regions and localities, as indeed it does in most mature market economies (Reynolds *et al.* 1994). This emphasises the importance of the promotion of and institutional support for, entrepreneurship at the local and regional levels. This, in turn, raises questions concerning the respective responsibilities of authorities at different levels; the co-ordination of state and regional support programmes; the establishment of appropriate lines of demarcation of responsibility; and the need to take steps to avoid unnecessary layers of bureaucracy and duplication of effort. There may also be issues concerning institutional capacity at the regional and local levels, which may be dependent on a wider process of institutional reform.

The role of international organisations

Finally, one cannot assess the role of public policy in relation to the development of entrepreneurship and SME in transition countries without considering the role of international organisations, which have influenced the environment for private sector development in various ways. Indeed, at one level, transition policies used in CEECs were mainly drawn up by international agencies, such as the World Bank and the International Monetary Fund, western governments and the consultants contracted to assist with policy formulation and implementation. According to Bateman (2000b), the approach may be characterised as a 'market fundamentalist' model, which he unfavourably contrasts with a 'local developmental state model' that is claimed to have formed the basis of SME-based development success in Japan, Italy, the former West Germany, Taiwan (since the 1950s) and China (since the 1980s).

One of the most visible forms of international support for SME development, especially in CEECs, was the Business Support Centres (BSCs), modelled on initiatives such as the UK's local enterprise agencies and the Small Business Development Centres (SBDCs) in the USA. Although the precise form and details varied between funders, these agencies were meant to provide business information and business advice to start-ups and established SMEs. Since reducing unemployment was a major aim of such initiatives, many were located in regions of high unemployment. They were also expected to take on a promotional role for SME development at a local level.

Unfortunately, the impact of such initiatives on SME development has been lessened by design flaws that according to some (e.g. Bateman 2000a) may be explained in terms of the ideology that inspired them, although inappropriate policy transfer from mature market contexts is another variant. One of the fundamental weaknesses concerned an over-emphasis on financial sustainability, which led to agencies prioritising the development of services that could generate fee income, such as consultancy for medium and large companies, rather than for new and small firms, which have much less ability to pay. Indeed, in a transition context, there is often a lack of effective demand for consultancy services, certainly as far as SMEs are concerned, suggesting that in such conditions market failure has a demand as well as a supply-side dimension to it. In practice, the lack of financial sustainability of BSCs is evidenced by the fact that many that were set up with donor support in the 1990s have ceased operating and most of those that have survived have been transformed into commercial organisations.

Moreover, while it is important for business support agencies to tune their services to the needs of clients and potential clients, where public funding is involved, a wider definition of public good or welfare gain is also expected. Specifically, this means paying attention to the development needs of local economies, which are likely to go beyond those of existing firms, implying a long- as well as a short-term perspective. In practical terms, this may involve prioritised support for new start-ups in activities that may help to improve the performance of the local economy in the longer term, by contributing, for example, to changing the economic structure.

Concluding remarks

In examining the context for entrepreneurship in transition economies, this chapter has demonstrated the enormity of the challenge facing countries with a recent heritage of operating under the rules of a socialist command economy, while also highlighting some of the differences between them. This mainly reflects variations in the degree of commitment of governments to market reforms, but also differences in the starting points for transformation and in the nature of the processes used during the transformation period.

The result is a series of very specific environments for entrepreneurship and SME development, which present many challenges for entrepreneurs and for policy makers. It also presents a challenge for the theories and concepts used by academics to analyse entrepreneurship, which is the focus of the following chapter.

3 Entrepreneurship in transition economies

A conceptual review

Perspectives on entrepreneurship

This chapter sets out to review and analyse entrepreneurship in transition economies from a conceptual perspective, concentrating on whether current entrepreneurship theories can adequately embrace forms and patterns of entrepreneurship found during the transition period. While the previous chapter has focused on the macro context for entrepreneurship, we now turn to behavioural aspects of entrepreneurship at the micro level. In considering elements and concepts of entrepreneurship in a transition context, it may be helpful to briefly clarify some definitional issues, including what is meant by entrepreneurship. Entrepreneurship involves both inputs and outputs. Gartner (1988, 1995) emphasises a process view, where entrepreneurship is understood simultaneously as behaviour (i.e. actions that entrepreneurs take) and outcome (e.g. new organisations). Inputs involve entrepreneurial skills and qualities, with participation in the competitive process as the main output. A firm is a vehicle for transforming the personal qualities and ambitions of entrepreneurs into actions and outputs. Context may be viewed as a third dimension of entrepreneurship, since the specific internal organisational and external operating contexts provide the framework within which the input and output dimensions can take place (de Wit and Meyer 1998).

Entrepreneurship is also a multidimensional concept, which can be analysed at different levels. First, entrepreneurship is concerned with individuals in terms of their roles, traits and actions, integral to which are their learning abilities and behaviours (Pedler *et al.* 1998). The second dimension is at the firm level and the third at the aggregate level of industrial sectors, regions and nations. A consideration of the role and characteristics of entrepreneurship in a transition context involves linking the individual level to the aggregate level, as the context for entrepreneurship is a distinctive one, with a stronger influence on entrepreneurial behaviour than in mature market economies. At the same time, in any context, entrepreneurial activities need to be analysed as a reciprocal process between an individual entrepreneur/firm and the external environment, which involves interaction and mutual influences between the two (Berger and Luckmann 1967).

In the following sections, the terms entrepreneurial action and entrepreneurial behaviour are used to describe and analyse what happens with regard to entrepreneurial activity in a transition context. Use of the term entrepreneur is sometimes connected to individuals who legally own a firm, but we broaden this to include individuals operating as self-employed, whether or not a legal entity is involved. It was Mises, who pointed out more than 50 years ago that entrepreneurship was related to a function, which is 'inherent in every action and burdens every actor' (Mises 1998 [1949]: 252–253). Although one could debate whether or not all actions may necessarily be considered entrepreneurial, the underlying reasoning that entrepreneurship may be considered as human action itself, and not just the result of human action, is part of the concept of entrepreneurship that is applied in this book, while recognising that entrepreneurship also refers to outcomes. At the same time, the rapidly changing nature of external conditions in a transition context means that to fully capture entrepreneurship in such conditions, it is necessary to observe how individuals behave and not solely focus on what the outcomes of their actions are (van de Ven and Engleman 2004).

Much entrepreneurship research has tried to define what entrepreneurship is, mainly in relation to characteristics of entrepreneurs or their role in economic development (Hebert and Link 1988). This is explicit in early definitions of economists, such as the one used by Cantillon who emphasises the risk taking function of entrepreneurs; or that used by Say and Marshall, who emphasised the management role of entrepreneurs; and Schmoller and Coase, who considered entrepreneurs to be the persons who organise and co-ordinate factors of production (Welter 1996). Schumpeter, on the other hand, focused on the role of entrepreneurs as innovators or pioneers carrying out new combinations (for an overview on Schumpeter's work, see Reisman 2004). In the 1950s and 1960s, entrepreneurship research picked up the entrepreneurial dimension, focusing on personality characteristics of entrepreneurs. A common issue of most definitions of entrepreneurship is their focus on an individual perspective, while the role and influence of the overall environment is relatively neglected. For example, Aidis, who explicitly discusses entrepreneurship in a transition context, introduces the topic as an essentially behavioural characteristic of a person (2003: 47), although she goes on to emphasise the importance of institutional influences on individual behaviour. In particular, distinctions between so-called proprietorship and entrepreneurship, and opportunity- and necessity-based entrepreneurship, which will be explained below, relate behaviour to the goals and motives of individuals, which are rather abstracted from their social context. Implicitly, this view draws on the psychological traits approach in mainstream entrepreneurship theory, which has been widely criticised for its restrictive focus on entrepreneurship as an individual phenomenon (e.g. Gartner 1988).

While it can be argued that an approach to analysing entrepreneurship, which narrowly focuses on the traits of individual actors, does not capture the reality in any context, this particularly applies in transition economies, where characteristics of the external environment, and the pace of change within it, play a major role in influencing both the extent of entrepreneurship and the forms that it takes. In this context, Davidsson (2003) introduces notions of entrepreneurship as a societal phenomenon, which draws attention to outcomes of entrepreneurial behaviour, as well as to entrepreneurship as a scholarly domain, which aims at understanding what entrepreneurship is about. In terms of the societal dimension, a transition environment is characterised by uncertainty and changing conditions, which, as explained in the previous chapter, differ across countries and stages of the transition process.

All this might result in entrepreneurs both seeing and exploiting opportunities in different ways, compared with how they may be seen and exploited in a mature market context, and the results (i.e. forms of entrepreneurship) might also differ (Baker *et al.* 2005). As far as the scholarly domain of entrepreneurship research is concerned, there is a need to consider whether, and how far, existing theories can be stretched to embrace forms of entrepreneurship occurring in a transition context. Entrepreneurship needs to be analysed and understood in its social context, which is a theme that is explicitly discussed in a subsequent section, where the institutional embeddedness of entrepreneurship during the transition period is emphasised. Gartner draws attention to the fact that observers 'have a tendency to underestimate the influence of external factors and overestimate the influence of internal or personal factors when making judgements about the behaviour of other individuals' (Gartner 1995: 70). While this may apply in most contexts, it is particularly pertinent in transition conditions where uncertainty is high and the pace of change rapid.

These issues will be explored throughout the chapter. The following section discusses concepts of entrepreneurship and their applicability, as well as possible distinctive elements of entrepreneurship in a transition context.

Key influences on entrepreneurship in transition conditions

Entrepreneurship development in post-socialist societies began from a variety of starting points in different countries, since the experience of former Soviet republics, for example, varied from that of CEECs. Although there was a common legacy of central planning, differences can be identified in terms of the types of business activity that were tolerated under socialism, as well as in the timing of the reform process. An important question here is whether (any) previous experiences may act as antecedent influences, as identified by Cooper (1981) and to what extent institutional legacies have had an impact on entrepreneurship during transition. Both issues might have potential implications for the balance between productive and unproductive entrepreneurship, which is an important distinction with respect to the role of entrepreneurship in the wider society (Baumol 1990).

Entrepreneurship in the socialist period

Some researchers are highly critical of the potential of a Soviet-type system to produce productive entrepreneurship at all (e.g. Dallago 1997). Implicitly, this refers to the concept of the homo sovieticus,[1] depicting someone who is characterised by a lack of initiative, low propensity to take risks and a weak responsibility for his/her actions, all of which are the antithesis of an ideal-type entrepreneur. However, there are problems with this kind of concept. One is that it implicitly excuses unproductive forms of entrepreneurship, understanding them first of all as a result of a Soviet mentality and mental inertia. Although path-dependent attitudes and learned behaviour have often proved problematic during transition, some individuals were also quick to grab opportunities which presented themselves when transition started, thus demonstrating the remarkable potential of individuals to adapt to changing conditions. As a result, in assessing the potential of entrepreneurial behaviour under socialism, one needs to be more discriminating in terms of the different kinds of experience gained within the socialist system, which could result in a variety of forms of both productive and unproductive entrepreneurship (Grancelli 1992, Glinkina 1992, Rehn and Taalas 2004, Sauka and Welter 2007), without assuming, ex ante, a generally negative impact of socialist values and norms.

Different forms of private entrepreneurship co-existed beside state ownership and entrepreneurship within state enterprises, which leads Rehn and Taalas (2004: 243) to refer to the complexity of Soviet entrepreneurship, observable in former Soviet republics. Conceptually, researchers distinguish between a formal economy, on the one hand, which included state enterprises and legalised private enterprises, and the grey economy, on the other, which itself consisted of what has been termed the second and the illegal economies (cf. Dallago 1990). The second economy included any form of unlicensed but tolerated entrepreneurial activities, while the illegal economy contained quasi-criminal activities within state enterprises (e.g. activities based on bribes and/or theft of resources) and criminal private activities. The boundaries of the grey economy frequently changed following political trends of liberalising and restricting private ownership and entrepreneurship (Welter 1996).

Elements of *legalised private entrepreneurship*, such as craft enterprises or private small retail shops, were common in Central European countries, although not in the former Soviet republics (e.g. Lageman *et al.* 1994, Welter 2003). For example, the Hungarian government allowed the creation of joint ventures in 1973, and in the late 1970s it liberalised retail trade by renting shops to private entrepreneurs (Bod 1989). During the 1980s legal private entrepreneurship gained momentum in Hungary, when economic reforms increased the upper limit for the number of employees allowed in small firms as well as introducing new forms of private ownership. This included the 100 per cent private business partnership (GMK), which consisted of no more than 30 members and 30 employees; and the so-called business work partnerships (VGMK), in which, from 1982 onwards, state employees could rent machinery or space from their employer to collectively produce their own products and services. However, neither initiative fostered the emergence of a sustainable private sector, producing instead working brigades (i.e. semi-independent departments within a state firm) for performing overtime work within state enterprises (Laky 1989).

In former Soviet republics, and also in Czechoslovakia during the socialist period, all forms of private entrepreneurship were illegal. Entrepreneurial behaviour was mainly restricted to illegal activities such as moonlighting, the unofficial use of state machinery for private aims and tolerated theft at the working place (Dallago 1990, Los 1992, Taigner 1987, Schulus 1993). However, a more productive form of entrepreneurial behaviour was expressed by the 'tolkachi', i.e. state-enterprise employees, who were responsible for securing external resources in order to meet planning targets (Kerblay 1977). Often, unaccounted for production in state firms was used to barter for resources, or for goods and services that were in popular demand (Kordonskii 1995), although this kind of behaviour was actually illegal. Such forms of entrepreneurial behaviour within state-owned enterprises may be viewed as a necessary response to the constant shortage of materials that was endemic during the Soviet period.

In addition, Rehn and Taalas (2004) have emphasised how entrepreneurship flourished in the daily lives of individuals during the Soviet period, as people struggled to cope with material shortages. In pointing out the importance of interpreting entrepreneurship in its specific social context, Rehn and Taalas raise definitional issues concerning the nature of entrepreneurship, which they interpret as a search for opportunities and beneficial outcomes in economic interactions (ibid.: 246). According to their understanding, this made most citizens of the USSR entrepreneurs through necessity, although perhaps entrepreneurial behaviour is a more appropriate description for individuals that needed to be to some extent entrepreneurial if they were to survive.

One element which connected all kinds of entrepreneurial activities in Soviet times was *blat*,[2] which Ledeneva (1998) describes as a multilateral system of exchanging favours, thus supplementing and complementing the deficiencies of the planned economy. *Blat* is visible in state firms in the activities of the tolkachi, but it also played a large role in the private, daily lives of individuals, facilitating access to products and services that were in short supply through a complex system, where simultaneous exchanges of a range of favours and counter-favours took place. *Blat* does not need immediate and bilateral reciprocity between *blat*-giver and *blat*-taker, but is rather based on building up an extended network of favours that one can draw on, which in this respect resembles the Chinese concept of *guanxi*. Rehn and Taalas (2004) suggested that *blat* introduced flexibility into a rigid system, thus assisting individuals to cope with, and/or overcome, some of the shortcomings of a planned economy. *Blat* resembles the weak ties within a network, although, contrary to the general understanding of the properties of a personal network, *blat* provides access to favours at public expense (Ledeneva 1998: 37).

Distinctive forms of entrepreneurship under transition conditions

When considering entrepreneurship in transition countries, a recurrent question concerns the potential of entrepreneurial activities during the socialist period to breed capitalism (Kornai 1992). Even though the transformation process changed the rules for entrepreneurs, some forms of entrepreneurship and entrepreneurial activities survived from the Soviet period, contributing a distinctive experience of entrepreneurship into transition. For example, entrepreneurial activities within state organisations fostered the development of the so-called nomenclatura businesses during the transition period (Smallbone and Welter 2001a), based mainly on the links and connections established by these nomenclatura entrepreneurs during the socialist period. For example, in Russia, both government officials and party members were quick to appropriate assets within their reach, e.g. through unofficially privatising enterprises, in order to keep their influence and income in a post-Soviet environment (Aslund 1997, Satter 2003, Service 2002). This often led to negative types of entrepreneurial behaviour, in the sense of Baumol's destructive entrepreneurship. While this form of entrepreneurship need not necessarily have a destructive impact on an economy, it contributes to a negative image of entrepreneurship in those cases where enterprises were used for individual rent-seeking purposes, such as where a business is dismantled immediately after purchase to realise personal profits.

Nomenclatura entrepreneurs frequently originate from the Soviet 'Komsomol' economy, where business organisations were established within the youth organisation (Gustafson 1999, Kryshtanavoskaya and White 1996). Alternatively, they are sons or daughters of parents who were members of the socialist political nomenclatura that had used their connections to set up new businesses. This was a common occurrence in former Soviet countries, but also in Central European states (Dallago 1997, Tibor 1994). Nomenclatura entrepreneurship took place all over Central and Eastern Europe, although some governments were quicker in changing regulations to prevent this phenomenon developing further, than others.

Another avenue for nomenclatura entrepreneurship, besides party membership and family connections, was wild or unofficial privatisation, for example the spontaneous privatisation that occurred in Hungary in 1988/1989 (Frydman *et al.* 1998). As soon as the Hungarian government introduced new laws allowing state enterprises to be converted into corporate legal forms, many directors stripped their state-owned companies of assets in order to start their own business. At the same time, it must be stressed that the sale of assets of former state-owned firms was a common phenomenon in the early years of transition and was not always related to the emergence of nomenclatura business. The latter tended to apply in those cases where red directors used their political power for rent-seeking purposes, for example, to protect a market niche they entered with their private business. Moreover, the importance of nomenclatura entrepreneurship varies across countries, as well as over time, as outlined in the previous chapter.

Another type of entrepreneurship inherited from the Soviet period in some CEECs was the craft and retail trade enterprises that had been allowed to operate during the period of the planned economy and which continued to exist during the transition period, mainly contributing to family income. Most of the owners of these enterprises were elderly when transition started (for Hungary cf. Tibor

1994) and often experienced difficulties in adjusting to the requirements of a market economy, because during the socialist period, they had acted on sellers' markets. In some CEECs, this included the so-called craft enterprises that were legally tolerated during the Soviet period (see Chapter 7 on Poland, below). However, neither entrepreneurs who had been able to operate legally during the socialist period, nor those coming from the second economy accounted for a large share of newly founded enterprises during the transition period (Dallago 1997). At the same time, they represent a distinctive feature of the trajectory of small business development in transition economies.

In countries such as Poland and Hungary, which had a strong pre-war tradition of private entrepreneurship, some of the people entering entrepreneurship during the transition period came from former entrepreneurial families. For Central European countries, various studies have estimated that the offspring of pre-socialist entrepreneurs accounted for between 25 per cent and 40 per cent of all private entrepreneurship during the early years of transition (Lageman 1995: 114). In Hungary, pre-war entrepreneurs and their offspring had often either been (partly) self-employed in the second economy, or they had occupied leading positions in state enterprises during the socialist period (Szelenyi 1988). This appears to confirm a thesis modelled on Max Weber's research, stating that cultural entrepreneurial traditions could be transported via high-level professional positions, where individuals essentially parked their entrepreneurial skills. Although they were able to practise them to some extent in such positions, by being able to engage in autonomous decision making, such decisions involved limited risk taking (ibid.).

Drivers for entering entrepreneurship

Richard Scase (1997, 2003) has questioned the nature and extent of the contribution of entrepreneurship to economic transformation in former centrally planned economies. In doing so, he distinguishes between entrepreneurship and proprietorship, based on 'contrasting psychologies of business founders; their attitudes towards trading; and their orientation towards capital accumulation' (Scase 2003: 67). According to Scase, entrepreneurship refers to a person's commitment to capital accumulation and business growth, whereas proprietorship describes the ownership of property and other assets, which may be used for trading purposes to realise profits, but which are not utilised for longer-term purposes of capital accumulation. Any surpluses generated by proprietors are likely to be consumed rather than reinvested for business purposes.

In the pursuit of capital accumulation and long-term growth, an entrepreneur may forgo personal consumption and may actively seek out market opportunities, which involves taking risks and coping with uncertainty. In the case of proprietorship, the motives of individuals are quite different, since surpluses are not reinvested in the business for future long-term capital accumulation but rather consumed and used to sustain living standards. According to Scase, in the transitional economies of Russia and Central Europe, proprietorship rather than entrepreneurship best describes the majority of small business activity. His assessment is that while small businesses may be numerically significant, particularly in sectors such as services and retailing, offering employment and providing income for those involved, the proprietors who own and run most of these firms are incapable of constituting an indigenous force for economic development.

Although Scase focuses on transition economies, his distinction between entrepreneurs and proprietors is not specific to a transition context. A lack of commitment to long-term capital accumulation, with an emphasis on consuming any surplus rather than reinvesting it in the business (i.e. proprietors, according to Scase), is a common feature of many small-firm owners in mature market economies. Indeed, it is one of the reasons why typically only a minority of small businesses grow to any great extent. Perhaps the issue needs to be viewed as part of a wider discussion about the role of entrepreneurship and small business in economic development, rather than as a specifically transition issue. In this context, the importance of Schumpeterian-type entrepreneurs to economic development in any economy cannot be overstated, because it is the creation of newness, such as in terms of products, processes, types of organisation or some combination of these, that entrepreneurs contribute most to economic development. At the same time, as Wennekers and Thurik (1999) note, in practice, few business owners are either pure Schumpeterians or pure shopkeepers, and individuals can change their orientation over time, as a result of their own learning and/or substantial environmental change.

As discussed in Chapter 2, the rapidly changing nature of external conditions in transition environments means that the characteristics and contribution of small business activity may change over time, as well as in different national contexts (Smallbone and Welter 2001a). In this context, the so-called proprietorship, which Scase emphasises, may be a more common condition in the early stages of transition, or in countries where market reforms have not been properly installed, but becoming relatively less important in countries where external conditions are more stable. Moreover, as Scase himself recognises, the emergence of a stratum of small traders in transition economies must be seen as part of a social transformation contributing to wider consumer choice and the emergence of a middle class, as well as an economic agent.

Scase's approach is related to an earlier concept developed by Bögenhold (1987), who distinguished between entrepreneurship motivated by economic needs and entrepreneurship which is driven by a desire for self-realisation. In empirical studies, this is often tested by surveying pull and push motivations, where pull factors (such as an identified market opportunity) may be associated with more active and enterprising individuals and push factors (such as the lack of employment opportunities) referring to so-called reluctant entrepreneurship. For pull entrepreneurs, market opportunities or the wish to work independently are the main drivers in setting up a new venture, while push entrepreneurship could result from depressed market conditions, i.e. entrepreneurship is due to a lack of opportunities.

At the micro level, various studies have analysed the motives for people going into business, although the topic of start-up motivation is difficult to operationalise and typically studied retrospectively, which can lead to positive hindsight biases. Some studies have demonstrated differences in the types of motivation between employed and unemployed business founders, with push factors playing a more important role for unemployed founders and pull factors for employed ones (Hinz and Jungbauer-Gans 1999). Not surprisingly, (expected) job loss was one of the most commonly reported motives for unemployed founders to start their enterprise, while employed founders emphasised personal independence.

More recently, the GEM consortium have distinguished between opportunity and necessity entrepreneurship, based on the reasons given by entrepreneurs for starting a new business. Since 2001, the GEM researchers have asked respondents to indicate whether they started and grew their business in order to 'take advantage of a business opportunity' (opportunity entrepreneurship) or 'because you have no better choices for work' (necessity entrepreneurship) (Reynolds *et al.* 2002: 12). Similar to researchers that have identified push and pull motivations, GEM authors view opportunity-based entrepreneurship as reflecting a voluntary career choice, while necessity-based entrepreneurship is a decision based on other options either not being available, and/or judged to be unsatisfactory. Empirical results suggest that necessity-based entrepreneurship occurs more often in developing countries, concluding that this assessment uncovered a dynamic dimension inside entrepreneurial activity (Reynolds *et al.* 2001: 4). Moreover, there are fundamental differences across educational levels with opportunity entrepreneurs typically being better educated compared with their necessity-driven counterparts (ibid.: 16). The 2003 GEM report shows necessity-based entrepreneurship to vary significantly between countries, with high levels of necessity entrepreneurship being associated with countries where the framework conditions for entrepreneurship were assessed by experts to be disadvantageous for entrepreneurship development (Reynolds *et al.* 2002: 25). This leads the authors to view so-called necessity entrepreneurship as a negative factor as far as national growth and development are concerned.

However, empirical results presented throughout this book, as well as in other studies, challenge the appropriateness of such a crude dichotomy to describe entrepreneurship in a transition context. Although intuitively attractive, such categories may at best oversimplify, but at worst distort the reality of business behaviour, particularly in circumstances where the external environment is changing rapidly; and where entrepreneurs appear to have considerable human capital and adaptive capacity. In terms of human capital, the propensity of entrepreneurs, in early-stage transition conditions, to be highly educated is a consistent theme emerging from the transition literature (e.g. Drnovsek and Glas 2006, Matusiak 2002, Smallbone and Welter 2001a, Wasilczuk 2000). This is partly explained by the specificities of external conditions that can lead to even well-educated people being presented with limited opportunities for satisfying and sufficiently rewarding employment, encouraging them to consider the entrepreneurship option. The human capital possessed by these individuals means that they are well equipped to identify and exploit opportunities as they emerge over time, even if the reasons for becoming an entrepreneur in the first place can reasonably be described as necessity-based.

The limitations of such a crude dichotomy are also reinforced by the learning experience of individuals, which can contribute to changes in their motivation and behaviour with respect to entrepreneurship over time. In this context, evidence from transition economies shows that entrepreneurs typically have a wide range of business motivations (e.g. Ageev *et al.* 1995, Smallbone *et al.* 1999c, Welter *et al.* 2003), which often reflect a mixture of so-called opportunity and necessity drivers, as well as demonstrating that motives change over time as transition proceeds (e.g. Mroczek 1997). Stewart *et al.* (2003), for example, found that the entrepreneurial dispositions of Russian and American entrepreneurs varied according to culture and the initial business goals, drawing attention to the embeddedness of entrepreneurship in the current political and economic context, as is inherent in Davidsson's notion of entrepreneurship as a societal phenomenon (Davidsson 2003).

Even in those post-socialist countries where institutional and other external conditions for private entrepreneurship are inadequate, entrepreneurs set up businesses for a variety of reasons, including pull as well as push factors. The aims and orientation of entrepreneurs can also change over time, as new opportunities are presented and/or because of the development of their own entrepreneurial capacity. As a result, it may be misleading to use simple distinctions between opportunity- and necessity-driven entrepreneurs in order to discuss entrepreneurship and its wider implications to economic development.

Entrepreneurship from an individual perspective

After having reviewed the antecedents, starting points and drivers for entrepreneurship in transition countries, subsequent sections will develop a conceptual perspective, in order to bring out the distinctiveness of the transition context. This section begins with a review of entrepreneurship from an individual perspective, understanding it as a process influenced by opportunity recognition and the availability of resources, both of which affect the behavioural patterns of entrepreneurs.

Opportunity recognition

A popular contemporary stream of research, which analyses entrepreneurship from an individual perspective, refers to opportunity recognition, which approaches entrepreneurship by looking at the individual understanding and actions behind venture creation, as well as factors influencing this.[3] The merit of the concept of opportunity recognition lies in its emphasis on the processes underlying entrepreneurship and venture creation, while most of the earlier research analysing entrepreneurship from an individual perspective has focused on explaining its occurrence as a function of the individuals involved (Eckhardt and Shane 2003).

Although only recently gaining prominence in entrepreneurship research (e.g. Davidsson 2003, Eckhardt and Shane 2003, Gartner *et al.* 2003, Hills and Shrader 1998, Sarasvathy *et al.* 2003, Shane 2003, Shane and Venkataraman 2001), the concept of opportunity recognition is not new. Back in the 1920s, Knight drew attention to risk and opportunity conceptions of entrepreneurs, while Schumpeter emphasised the dynamic entrepreneur as a person who recognises new market possibilities. In particular, economists of the Austrian School have extensively researched the process of entrepreneurial discovery. As Kirzner (1979) argues, entrepreneurship is connected to the alertness that an individual displays towards opportunities, which exists independent of the entrepreneur him/herself, while their recognition and discovery is also influenced by beliefs of the entrepreneur. Interestingly, the concept of entrepreneurial alertness, which is defined as 'scanning the horizon, as it were, ready to make discoveries' (Kirzner 1997b: 72) has a lot in common with the concept of strategic awareness, which emphasises the emergent nature of strategic behaviour in new and small firms (Gibb and Scott 1985).

Consideration of the process of discovering and exploiting opportunities raises the question of the factors influencing the process. Psychological and behavioural research has identified a number of personal traits for entrepreneurs, which drive entrepreneurial behaviour, such as the need for achievement (e.g. McClelland 1961), locus of control, risk orientation and independence (e.g. Brandstätter 1997, Scherer *et al.* 1991). Similar research has been undertaken in transition economies. For example, Utsch *et al.* (1999) compared personality characteristics of East German entrepreneurs and managers, confirming the existence of significant differences between entrepreneurs and managers with regard to autonomy, innovativeness, achievement orientation and what they characterised as competitive aggressiveness. In Poland, Wasilczuk (2000) found that growth-oriented entrepreneurs reported a higher level of risk taking propensity, and persistence, compared with low-growth-oriented entrepreneurs, suggesting a link between entrepreneurial characteristics and business performance. However, results are not conclusive with regard to the precise influence of personality characteristics on entrepreneurial behaviour (Gartner 1988), nor with regard to the nature of the causal links. In addition, the question remains as to whether such traits are inherent in the personality of individuals or culturally dependent (e.g. Mitchell *et al.* 2000, 2002b) and thus learned and acquired (Filion 1997). This leads Mitchell *et al.* (2002a: 95) to conclude that 'efforts to isolate psychological or demographic characteristics that are common to all entrepreneurs, or are unique to entrepreneurs, have generally met with failure, due to weak, disconfirming, or non significant results'. Contrary to research on personality characteristics, the concept of opportunity recognition emphasises cognitive processes and cognitive properties of entrepreneurs, which influence the discovery and exploitation of a business idea.

In this context, Kirzner's understanding of opportunities as a result of entrepreneurial alertness, entrepreneurial beliefs and information asymmetries (Kirzner 1979, 1997a, 1997b) emphasises the cognitive properties of (potential) entrepreneurs, which have an impact on entry patterns into entrepreneurship, as well as subsequent development paths, thus indirectly influencing the extent and nature of entrepreneurship. Self-perceptions of entrepreneurs might restrict their possibility of recognising (the whole range of) business opportunities, thus constraining their ability to enter entrepreneurship, or possibly leading them to engage in less productive forms of entrepreneurial behaviour. This refers to self-imposed psychological barriers in those cases where entrepreneurs (wrongly) perceive that they may not have the possibilities and know-how to start or grow their own businesses. This has been shown to apply in the case of some entrepreneurs coming out of unemployment (e.g. Hinz and Jungbauer-Gans 1999), although the extent of the human capital involved is also likely to be an influence here.

There is also a substantial literature which shows that entrepreneurship can be driven by a wide variety of personal goals, which include non-pecuniary as well as monetary objectives (e.g. Cromie *et al.* 1999, Kotey and Meredith 1997, Kuratko *et al.* 1998, Routamaa and Vesalainen 1987). Moreover, as Gatewood *et al.* (1995: 373) have emphasised: 'How entrepreneurs think about themselves and their situation will influence their willingness to persist towards the achievement of their goal.' In other words, self-perception and ambitions will affect the willingness of entrepreneurs to choose from different possibilities in order to pursue an idea or grow a business, suggesting that the extent of opportunity recognition, and consequently entrepreneurship, is likely to be closely linked to personal goals.

A resource-based view

Previous research has identified a variety of factors influencing the nature and extent of entrepreneurship and SME development, which include the background and experience of entrepreneurs and external environmental characteristics at the sector, technological and regional levels. In this context, a resource-based perspective offers a means of integrating the variety of previous research results into a theoretical framework of influences on the propensity of potential entrepreneurs to create and develop businesses.

The resource-based view defines enterprises as a collection of productive resources (Penrose 1995: 24). Consequently, survival and success depends on the resource base of the respective enterprise. If such a view is applied to the start-up process, variations in business creation are a result of distinctive combinations of tangible physical resources, financial capital, and intangible resources, such as human and social capital as well as access to such resources. In this context, Brush (1998) indicated different resource conditions for new ventures than for established organisations, because the resource base of a start-up is still evolving.

Human capital expresses itself through factors, such as the (professional) education, work experience and previous management experience of the entrepreneur, which some previous research has suggested can positively influence entrepreneurship and business formation (e.g. Cooper and Dunkelberg 1986, Evans and Leighton 1990). In transition economies, education and professional experience has additional potential importance, since, initially at least; most entrepreneurs had no previous private business experience. In this regard, several studies have drawn attention to the high education level of entrepreneurs in transition countries compared with their western counterparts, which appears a consistent result over different time-spans, as well as in different countries. For example, in Hungary this is demonstrated by Kuczi and Vajda (1992) and Fogel (2001), while Smallbone *et al.* (1996b), Wasilczuk (2000) and Matusiak (2002) have shown this to be the case in Poland. Smallbone *et al.* (1999c), Welter *et al.* (2000) and Obydennova *et al.* (2000) have similar results for entrepreneurs in Ukraine, Belarus, Moldova and Russia respectively. Empirical evidence from Poland suggests that entrepreneurship became a more attractive option for educated people once the transition process began, than the forms of entrepreneurial activity that were tolerated under communism had been. For example, in a survey of 300 Polish manufacturing SMEs undertaken in 1995, in which 18 per cent had been established before the start of the process of administrative reform in 1981, firms set up after 1988 were significantly more likely to be graduate-led than older firms set up before 1981 (Smallbone *et al.* 1996a).

In terms of gender, Drnovsek and Glas (2006) and Glas and Petrin (1998) found a comparatively high level of education for Slovenian women entrepreneurs in relation to their western counterparts, as did Welter *et al.* (2003) for women entrepreneurs in Ukraine, Moldova and Uzbekistan and Wells *et al.* (2003) for women entrepreneurs in Russia. However, in making such comparisons between transition and western countries, it is also important to recognise the highly qualified nature of the population as a whole in some former Soviet republics, such as Ukraine, where approximately 90 per cent of the population have secondary or higher education. In addition, a combination of restructuring, recession and a contraction of the defence sector in the 1990s led to a reduced demand for highly qualified labour in some transition countries, which encouraged more people of this type to start their own businesses.

Relations between human capital and other resources are complex following evolutionary principles. In this regard, some authors (e.g. Kolvereid 1996) claim a more indirect influence on the propensity of individuals to engage in entrepreneurship, in terms of the influence of factors such as family background, demographic characteristics and previous self-employment experience through attitudes and subjective norms. Other authors (e.g. Aldrich 1999: 93–96, Robinson *et al.* 1991) emphasise the importance of human capital itself as a source of entrepreneurial knowledge. Moreover, a higher level of human capital might increase entrepreneurial awareness, for example, in encouraging entrepreneurs to be more outward-oriented in terms of looking for external help, as some research has suggested (Smallbone *et al.* 1996a).

Mobilisation of *financial resources* is often reported to be difficult for new and small ventures. Most start-ups are financed through some combination of own savings and credit from family and friends. Once again, there are additional dimensions in a transition environment, where a private banking system had to be built up from scratch, which restricted the access of entrepreneurs to external finances, particularly in the early stages of transition (see Chapter 2). A consequently low capital resource base, combined with a lack of access to external credit constrained business development. Aldrich and Auster (1986) referred to the liabilities of newness and smallness, drawing attention to the fact that new and micro-enterprises, in particular, experience difficulties in surviving and growing, which might be even more difficult in a fragile transition environment, where banks are typically unwilling to channel resources to new ventures. Moreover, the possibilities for self-financing, which are a common financial strategy used by small and new ventures all over the world, are limited in a context where average income levels are very low.

Social capital in the widest sense refers to the ability of entrepreneurs to draw on the resources required to start and/or run a business, by drawing on network contacts. Social network approaches emphasise the social embeddedness of economic actions (Granovetter 1985), which might be crucial in influencing potential entrepreneurs in their decision to attempt to start a business, as well as in their ability to realise this goal. In this context, network support can provide financial capital, information, potential employees, or access to clients that entrepreneurs are able to draw on to enter entrepreneurship. Network support can also include the emotional understanding, encouragement and support that family and friends are able to offer, which itself depends on societal values regarding entrepreneurship, thereby emphasising the importance of cultural norms. Research has shown social capital to be an important potential resource for starting and developing a business (e.g. Aldrich 1999, Dubini and Aldrich 1991, Brüderl and Preisendörfer 1998, Davidsson and Honig 2003), although results have not been conclusive with regard to the nature of network ties (Hoang and Antoncic 2003).

Networks and networking can gain particular importance in fragile environments, such as former Soviet republics, where the formal institutional framework for entrepreneurship does not function properly, or is yet to be installed. This is partly due to a lack of institutional trust and fragile informal institutions, as discussed above. For different transition economies, several authors have described how in such an environment, individuals use social contacts and individual networks dominated by mutual trust in order to pursue business (e.g. Copp and Ivy 2001, Kuznetsov *et al.* 2000, Manolova and Yan 2002, Peng 2000, Smallbone and Welter 2001a, Chepurenko 1994, 2000, Welter 2003, Welter and Smallbone 2003, Welter *et al.* 2007, Yan and Manolova 1998. Further examples are provided in Chapters 4 and 5 of this volume).

In summary, a resource-based perspective draws attention to the fact that individuals may enter entrepreneurship with different endowments of human, financial and social capital resources, although this also depends on the respective institutional framework. In a transition context, resource endowments of entrepreneurs are distinctive compared with their counterparts in mature market contexts, and the environments in which they are operating typically distorted, thereby contributing to resource constraints affecting aspiring and existing entrepreneurs.

Patterns of entrepreneurial behaviour in a transition context

This section considers the question of how entrepreneurs behave in fragile and uncertain institutional environments, paying particular attention to behavioural characteristics that may be considered a response to the specific external conditions pertaining. For example, it has been suggested that in environments where formal or regulatory institutions are weak or unstable, forms and patterns of unproductive or destructive entrepreneurship might be expected to occur (Baumol 1990). At first glance, one might expect similar responses from entrepreneurs in different country environments, as the cognitive principles of decision making and strategising are the same regardless of environment. However, ways of understanding are specific to particular cultures and time periods, depending on the 'particular social and economic arrangements prevailing in the culture at that time' (Burr 1995: 4). They reflect an individual's interpretation of their environment, which in turn is affected by an individual's background and experiences. This in turn may result in differences in entrepreneurial behaviour.

At the individual firm level, unproductive entrepreneurship might constrain the growth prospects of firms, such as in cases where the development of new markets is dependent on increased legal compliance and legitimacy, although the extent to which this applies depends on the extent to which entrepreneurs seek legitimacy. For the economy as a whole, unproductive entrepreneurship may restrict the contribution of entrepreneurship to economic development. For example, in early stage transition countries, where progress with market reforms has been limited (see Chapter 2 for an overview), forms of behaviour can frequently be observed that may be characterised as muddling through and rule avoiding, representing a learned response to a particular set of external environmental conditions. This is an example of a strategic response to a specific institutional context (Oliver 1991), which is investigated empirically in Chapter 5 on Belarus following the work of Peng (2000, 2003a) in a transition context.

Principally, entrepreneurs fall back on behaviour which they have previously used successfully, as long as they are facing familiar situations, for which closed loop learning can provide a basis for them to make an adequate response. However, faced with less predictable, or unknowable change situations, tried and tested routines may be inadequate. An example refers to the rapid series of changes in, and instability of, macro-economic and institutional conditions at the beginning of the transition process, when the cognitive biases inherent in decision-making processes could reinforce 'muddling through' and unstructured behaviour of entrepreneurs. The conflict theory of decision making explains this in terms of avoidance. In other words, once an entrepreneur has settled on a particular course of action, he/she will only change behaviour in cases where current actions lead to negative results, which are worse than the risk associated with taking an unknown course of action. If new actions and options are considered to be too risky and/or costly, entrepreneurs will not change their behaviour, hoping that the problem 'will eventually go away' (Lyles and Thomas 1988: 136). Although such behaviour may appear irrational, based on a standard set of economic man assumptions, it may be viewed as a rational reaction to the given institutional framework. In adverse, unfamiliar and fragile environments, entrepreneurs tend to keep a low profile, either avoiding adherence to official regulations whenever possible, or complying as far as they can, although compliance can be made difficult in environments with rapid institutional changes. As a result, environments with institutional gaps tend to favour a 'muddling-through' process (Barrett 1998), as the discussion of entrepreneurship in Belarusian conditions in Chapter 5 illustrates.

In this regard, the concept of *path dependency* can help to explain behaviour which '. . . may bear little resemblance to the legitimate courses of action stipulated by the formal rules' (Nee 1998: 86). While laws and official regulations may be easily modified and transformed, norms of behaviour and values appear to be more persistent, changing slowly (Williamson 2000). This influences entrepreneurial behaviour in those situations where a new regulatory frame is introduced and previous codes of conduct, as well as values guiding individual behaviour, no longer fit (Mummert 1995, 1999). As a consequence, conflicts between the legal frame and prevailing norms encourage individuals to recur to a familiar course of action. If successful, this tends to reinforce trusted and known codes of conduct, resulting at the individual level in an escalating commitment of entrepreneurs to viable, but not necessarily the best courses of actions (Whyte 1986). This in turn further constrains the required adaptation of norms and values, often resulting in vicious circles and low-level efficiency traps for entrepreneurial behaviour, which are a widespread phenomenon in transition economies, especially during the early phases of transition (Kuznetsov 1997, cf. Chapter 2, above). From an economic point of view, these lock-in effects (Arthur 1994), which are a result of path-dependent behaviour, can foster sub-optimal resource allocation, resulting in unproductive entrepreneurship as described by Baumol (1990). Thus, in a situation where individual behaviour no longer fits the prevailing business codes of conduct, this might lead entrepreneurs to over-conforming, in order to re-establish legitimacy in a new order; at the same time, it might also result in avoidance strategies.

The embeddedness of entrepreneurship in a transition context

New venture creation must be viewed as a process, which means that business aims and motivations operate at different levels, including deep-seated antecedent influences, as well as immediate triggers. All this is likely to be influenced by personal circumstances and individual opportunity recognition, as well as by a specific set of external conditions. This emphasises the importance of viewing entrepreneurship in its social context (Johannisson *et al.* 2002), which may be illustrated with reference to the motives reported by entrepreneurs for starting and running businesses. Factors such as independence, autonomy, and self-fulfilment must be interpreted in the context of the environment in which they are used. Although much of the research on entrepreneurship in transition economies has focused on entrepreneurs and their behaviours at an individual level, the specific characteristics of the external environment under transition make it a potentially more dominant influence on entrepreneurship than in a mature market context, where external conditions are typically more stable. In this context, an institutional approach is used below to explore the links between environment and entrepreneurship under transition conditions.

Entrepreneurship from an institutional perspective

With the exception of the eclectic approach to entrepreneurship (cf. Verheul *et al.* 2002) and population ecology approaches (Aldrich 1995, 1999), most entrepreneurship theories focus on micro level influences in order to explain new venture creation and the development of entrepreneurship, taking the institutional environment as given. However, there is considerable empirical evidence from transition economies, which shows the external environment to be one of the dominant features influencing the nature and pace of entrepreneurship (e.g. Peng and Heath 1996, Peng 2000, 2003b, Polishchuk 2001, Radaev 2001a, 2001b, Smallbone and Welter 2001a, 2001b, Welter and Smallbone 2003). Although it can be argued that, in *any* context, enterprise behaviour results from a dynamic interrelationship between internal (i.e. both organisational and personal characteristics) and external conditions, in situations where market conditions are only partially installed, the institutional context becomes a critical factor. Referring back to the previous chapter, where a continuum of market development was described, if entrepreneurship is viewed as an individual act, undertaken in specific social/institutional/environmental conditions, then the balance between individual and environmental factors in explaining entrepreneurial behaviour is likely to vary at different points along that continuum.

In this context, an institutional perspective can be used to explore differences in the embeddedness of entrepreneurship in post-socialist and market-economy environments and the influence on entrepreneurial processes. There is a growing body of literature which explicitly links entrepreneurship to the overall institutional frame (e.g. Acs and Karlsson 2002, Audretsch *et al.* 2002, Davis and Henrekson 1997, Henrekson and Johansson 1999, Karlsson and Acs 2002, Verheul *et al.* 2000, Wennekers *et al.* 2001, Wildeman *et al.* 1999). Related research mainly concentrates on the influence of the regulatory frame on entrepreneurship (for an overview, see Urbano and Veciana 2001), although few studies pay attention to informal institutions such as values, codes of conducts and norms (e.g. Mummert 1995, 1999). Even fewer are explicitly concerned with the influence of culture on entrepreneurship, comparing, for example, countries with different institutional profiles (e.g. Busenitz *et al.* 2000, Klandt and Brüning 2002, Wennekers *et al.* 2001), and/or linking Hofstedes' cultural dimensions to entrepreneurship (e.g. Audretsch *et al.* 2002), analysing single cultural factors such as post-materialism (e.g. Uhlaner *et al.* 2002), or researching the legacy of the Soviet mentality or contemporary patterns of entrepreneurial behaviour (Aidis 2002, 2003). Moreover, as Wright *et al.* (2005: 9) point out, little institutional theory related research has been done on start-ups in transition economies.

Institutional theory is a suitable theoretical framework for analysing the influence of the environment on patterns of entrepreneurial behaviour (Hoskisson *et al.* 2000), because it emphasises the influence of different aspects of the external political, economic and societal influences on individual behaviour. Institutionalism is not a new theoretical perspective, since it dates back to the late nineteenth and early twentieth centuries when American institutionalists such as Veblen, Mitchell and Commons, as well as the 'Historische Schule' (historical school) in Germany, represented by Schmoller, Sombart and others, set out to describe the role of institutional legal, political and social factors in the economy (Seifert and Priddat 1995). New institutional theory ranges from new institutionalism in sociology (Richter 1998, Scott 2001, Tolbert and Zucker 1996) and organisation theory (Walgenbach 1995), to new institutional economics (for an overview, see Richter and Furubotn 1996). In coining the phrase 'new institutional economics', Williamson emphasised the dynamic nature of the theoretical concept, describing it as 'a boiling cauldron of ideas' (Williamson 2000: 619). It includes concepts such as property rights theory, public choice considerations and transaction cost theory. It also includes North's recognition of informal as well as formal institutions, which emphasises cultural and societal influences on economic phenomena.

Types of institutions and their influence on individual behaviour

Institutions act as the incentive structure of a society, because they assist in reducing uncertainty and risk for individual behaviour, as well as the transaction costs connected with entrepreneurship (North 1990). Using North's terminology, formal institutions include the constitutional, legal and organisational frame for individual actions, while informal institutions embrace uncodified attitudes, which are embedded in a society, regulating individual behaviour. Other authors employ different terms to identify and describe institutions, although the meaning only varies marginally. For example, Raiser (1997) distinguishes between conventions (i.e. societal solutions to collective choice problems); social norms, which reflect one's desire to be accepted in society and where breaches are not without consequences, and self-enforcing moral norms or values. In this context, informal institutions reflect the collective, tacit interpretation of individual mental perceptions (Denzau and North 1994). Other authors differentiate formal and informal institutions according to their enforcement mechanisms, where formal institutions are enforced by the state, while informal institutions are enforced by private actors and psychic sanctioning mechanism respectively (e.g. Knight 1997). Alternatively, formal institutions have been identified as being accessible to all, while informal institutions may be restricted to specific groups (e.g. Eissrich 2001). Scott (2001: 52) identifies three pillars of institutions, which are enforced by different mechanisms. He distinguishes between regulative institutions, enforced by coercion; normative institutions, enforced by normative pressures; and cultural-cognitive institutions, which are enforced by mimetic mechanisms.

Nooteboom (2002: 34) defines institutions as ‘things that constrain, enable and guide behaviour’, consequently discussing a separation between so-called surface institutions, which would enable and constrain (in North’s terminology, the formal institutions), and deep structures, which would guide individual behaviour (reflecting informal institutions, in North’s concept). However, Nooteboom himself concludes that a clear separation is not viable, due to recursive links between formal and informal institutions in practice. It has been suggested that informal institutions such as cultural traditions, societal customs, or human rights mainly have spontaneous origins (Williamson 2000), i.e. they self-organise; while formal institutions arise out of human actions, with transition apparently providing an excellent showcase of this organic growth of informal institutions (Polishchuk 1997). However, as both informal and formal institutions are mutually dependent, they normally co-evolve. In this regard, informal institutions may arise out of intended human behaviour, while formal institutions might as well be a result of the cumulative effect of the unco-ordinated actions of individuals (Ben-Ner and Putterman 1998: 38).

This indicates a problem inherent in the institutional approach, namely the endogenous and recursive nature of both institutions and behaviour (Zafirovski 1999), which needs to be recognised when applying institutional theory to entrepreneurial behaviour and entrepreneurship. While informal institutions can develop as a result of spontaneous and intended individual actions, they can also partly result from formal institutions, which they in turn (can) modify. In this regard, they evolve as a culture-specific, collective and individual interpretation of formal rules. For example, while a specific legal framework normally contains explicit regulations for implementing laws, over time these regulations are complemented by an implicit understanding of their content, i.e. unwritten rules. In this sense, informal institutions may fill legal gaps, which may only become apparent when laws and regulations are applied to daily life.

In mature market economies, informal institutions may contribute to the effective implementation and enforcement of the formal framework. Although legal sanctions, such as penalties for unlawful behaviour, play an important role in implementing new rules of the game, such means are often not sufficient. While formal institutions, such as the legal framework, are normally enforced and enforceable by the state, this is always likely to be imperfect because of the opportunistic and only partly rational behaviour of human beings, who often pursue their own interests. In this regard, any society needs implicit mechanism to sanction new institutions, thereby emphasising the role of (institutional) trust as an important informal mechanism. Formal institutions will only operate successfully if individuals are able to establish a basic level of trust in the reliability of any exchanges, but also in any sanctions and penalties that may need to be imposed (Kahle 1998). Thus, the maintenance of such forms of trust may supplement formal institutions, acting as an enforcement mechanism. Trust assists in lowering the transaction costs of commercial actions, which do not have to be (fully) based on formal regulations (such as contracts) in those cases where the participants know each other either personally, or by name.

In this context, Williamson (1993) distinguishes between personal trust, which he limits to non-commercial relations; risk, which characterises commercial transactions; and institutional trust, which refers to the social, cultural, political and organisational embeddedness of economic transactions. In both personal and commercial relations, trust often has elements of risk calculation, which applies when the person who is trusting is convinced that this is a rational form of behaviour (e.g. least costly). In this context, trust is based on a calculated risk and not 'some sort of belief in the goodwill of the other'. (Seligman 1997: 43). Smallbone and Lyon (2002) point out that individuals use reputations as sources of information, assessing the extent to which sanctions, such as recourse to authority, or exclusion from future benefit, can be applied. However, in extending Williamson's understanding, one needs to take into account that trust can also involve variable degrees of goodwill, which is partly due to behavioural routines that facilitate decision making in view of limited individual information capabilities. Routinised behaviour contains an element of goodwill trust, if it is applied to new situations, where it may not be justified and could fail (Nooteboom 2002).

Personal trust may depend on the characteristics of a group, such as kinship or ethnicity, or some other social group with which an individual identifies. It can also occur in bilateral (business) relationships, often longstanding ones, where individuals have come to know and trust each other. In both cases, they know or assume that the partner/friend will not behave in a way that is detrimental to the relationship, even when there are no written or explicit rules set out. This means that these relationships also are governed by informal norms and rules. By contrast, institutional trust refers to the institutional environment, in terms of the formal organisations and their sanctioning mechanisms, as well as informal codes of conduct and values.

A high level of institutional trust is essential for an efficient market economy, in order that agents are able to enter into transactions with only limited information about the transaction partner's specific attributes (Raiser 1999). In other words, the scope of trust extends beyond the number of people that are known to an individual personally (Putnam 2000). In this regard, institutional trust allows for the use of anonymous sources in business relationships (such as new partners, or consultants for business assistance), because there are legal safeguards and sanctions that may be applied in cases where the relationship fails. However, building trust in institutions has been one of the major challenges for governments during the transition period and one where progress has been particularly slow.

Whereas personal trust can exist regardless of any formal institutions, institutional trust requires stability and predictability of the institutional context.

Formal institutions need to be legitimised through societal norms and values and they also need to be stable over time. In this regard, Williamson (1993: 476) draws attention to the fact that ‘transactions that are viable in an institutional environment providing strong safeguards may be non-viable in institutional environments that are weak.’ A consistent institutional framework therefore needs both personal and institutional trust. Where formal rules fail or are absent, and/or where particular social groups are excluded from mainstream society, informal institutions and trust-based relationships gain importance in not only supplementing, but also substituting for formal rules. It is only in situations where formal and informal institutions combine to form a coherent framework that formal regulations and the rule of law will shape individual behaviour, while in fragile settings with institutional conflicts, non-compliance with the formal rules becomes pervasive (Feige 1997: 32) and the rule of law is absent. These are key propositions underlying the potential application of the institutional approach to analysing entrepreneurial behaviour, particularly in transition conditions.

Institutions, entrepreneurship and the transition context

Institutions represent the formal and informal constraining and enabling forces, which shape the development of entrepreneurship. While informal institutions are the culturally accepted basis for legitimating entrepreneurship, formal institutions provide the regulatory frame (Wade-Benzoni *et al.* 2002). Examples of *formal institutions influencing entrepreneurship* include the legal framework, the regulatory framework and the financial system. Fundamental rules of a society, such as private property rights, can be a major influence on the existence of entrepreneurship while the legal frame determines the nature and extent to which productive entrepreneurship develops. The legal frame that is particularly relevant in this respect refers to laws relating to bankruptcy, contracts, commercial activities, taxes, but it also involves organisations with the capacity to implement them.

Laws might create new opportunity fields for entrepreneurship, as happened in the initial stages of market reform in transition economies with the simple introduction of property rights, which allowed private ownership to exist legally. On the other hand, a deficient legal infrastructure (including implementation gaps, a lack of judges, economic courts, cf. Chapter 2, above) could restrict entrepreneurship. This especially applies where an institutional void (Polishchuk 1997) allows for arbitrary discretionary actions by administrators, thus fostering rent-seeking, corruption and non-compliant or defiant behaviour of entrepreneurs. Other key relevant institutions include the financial system, which needed to be restructured from a mono-tier system into a market-oriented banking system, catering for the financial needs of private entrepreneurs.

Normative and cultural-cognitive elements of institutions reflect what North labels informal institutions. Normative elements are apparent at different levels: first, at the level of society, where norms and values shape attitudes towards entrepreneurship; second, at the sectoral level, where normative institutions are reflected in codes of conduct, as set down by business associations and professions; and third, at the level of communities, such as religious, kinship or ethnic groups. Normative elements contain the collective sense-making of a society, while cultural-cognitive elements refer to the individuals' understanding of meta values and rules, which is influenced by individual experiences and backgrounds. In terms of entrepreneurship, this refers back to the debate outlined earlier in the chapter, concerning the possible negative heritage of socialist experiences. With regard to entrepreneurship, informal institutions also influence patterns of opportunity recognition in a society.

With regard to informal institutions at the societal level, Busenitz *et al.* (2000) refer to a normative dimension, which measures the degree to which a society admires and values entrepreneurial activities. Empirical studies such as the GEM demonstrate that the image of entrepreneurship varies between countries, which may help to explain some of the variation in the extent of entrepreneurship internationally. In this context, cultural norms, which tolerate and foster entrepreneurial activities, affect the number of people with previous entrepreneurial experiences and thus the number of potential role models (Shane 2003). Cultural institutions can also influence the resources available for entrepreneurship, such as access to finance, since societies vary in the practice of saving for the future, compared with spending on consumption, i.e. living and spending to enjoy the moment (Morrison 1998: 9), which has implications for the amount of personal savings available for financing business start-ups. Moreover, cultural norms can also influence whether a society tolerates profit-making behaviour as one of the prerequisites for entrepreneurship development. For example, South Asian producer economies stress values such as economical behaviour or long-term orientation while European societies may be classified as consumer economies (Weber 1997).

The nature and extent of the development of entrepreneurship, and patterns of entrepreneurial behaviour, across different environments reflect particular settings of institutions and enforcement mechanisms (Scott 2001, Honig and Karlsson 2004). Formal institutions are enforced by coercive mechanisms, as set down in government rules, while informal institutions are enforced by normative and mimetic mechanisms. Normative mechanisms push entrepreneurs to follow codes of behaviour as set out by specific communities, such as industries, business associations, families or ethnic groups. They also assist in creating legitimacy, which is of particular importance for nascent entrepreneurs and entrepreneurs in unfamiliar environments, who face a high degree of liability of newness.

Mechanisms to ensure normative behaviour include formal regulations, such as certification or accreditation (Scott 2001), but, as stated above, informal institutions are also enforced by mechanisms such as trust. Normative pressures, as codified in informal institutions, regulate entrepreneurs' behaviour and restrict their options, thus often forcing entrepreneurs to comply with regulations, even when they have to employ illegal actions. One such example is the Russian tax system. When paying taxes, entrepreneurs face a bundle of unwritten rules, such as bargaining over the law; making friends with tax officials; observing the formalities (i.e. filling in fictitious statements); and knowing their limits, which applies to both taxpayers and inspectors (Busse 2002, Chepurenko 2002a). These institutions are partly founded on Soviet predispositions, where, for example, previously the individual bureaucrat was the ultimate decision making authority, rather than referring to a law or a written regulation (Busse 2002: 215). However, such normative behaviour is also a result of regulatory shortcomings and gaps in implementing the new institutional frame (cf. Chapter 2, above).

The entrepreneurial process in transition conditions

In this section, we discuss the entrepreneurial process in a transition context, looking at opportunities and institutional change. The underlying question is one asking whether there is distinctiveness to be taken into account when conceptualising entrepreneurship in transition conditions.

Opportunities in a transition context

As emphasised above, one of the contemporary themes in the mainstream entrepreneurship literature is concerned with the creation and identification of entrepreneurial opportunities, which raises the question of whether the entrepreneurial process differs in a transition environment, and if so, in what respects. Most recent models of the entrepreneurial process concentrate on opportunity recognition as an important element. For example, Beattie (1999) identifies two main models of the business creation process, differentiated by factors which influence the opportunity recognition process. The first incorporates individual characteristics and environmental influences, understanding venture creation as an interactive process, in which a person, his/her personality and interpretation of events influence any decision to start a business. The second model, of which Gibb's and Ritchie's approach (1982) is an example, accepts venture creation as an outcome of the situations encountered and the social embeddedness of the entrepreneurs. In this approach, (potential) entrepreneurs are also influenced and shaped through their transactions with specific social contexts and groups, thus acknowledging context influences on opportunity recognition.

Shane (2003) distinguishes between two types of opportunities, i.e. Schumpeterian and Kirznerian ones. Schumpeterian opportunities result from disequilibrating situations, which makes them rare and innovative, involving creative destruction and the creation of new combinations. Implicitly, Schumpeter's understanding of opportunities draws attention to environmental influences, which allows the construction of a link between an embeddedness perspective and an individual perspective of entrepreneurship. The institutional framework influences the existence of opportunities, as well as their recognition and possibilities for exploitation, which is explicitly recognised by Kirzner (1980) also. In this context, Shane (2003: 22–33) and Eckhardt and Shane (2003: 341–343) review empirical evidence for opportunity creation, which results from what Eckhardt and Shane (2003) have labelled exogenous shifts in information. Several studies confirm that changes in technology, political forces, regulation and macro-economic influences as well as social trends can be decisive influences on the existence and occurrence of new opportunities. All this particularly applies in the case of transition economies, which underwent fundamental changes when starting the process of transformation from central planning towards a market-based system (cf. also Chapter 2, above).

In comparison, Kirznerian opportunities are understood as being equilibrating, not requiring new information; less innovative; and more common than Schumpeterian opportunities; and having a limited potential for discovery (Shane and Venkataraman 2001, Shane 2003). While this appears to paint a rather negative picture of Kirzner's approach, as being anti-entrepreneurial, in the sense that entrepreneurship is commonly related to innovativeness and newness, one might question Shane's interpretation, that this type of opportunities does not require new information (Shane 2003: 21), because they result from individual sense making of existing information. This might be new for the respective entrepreneur, although not necessarily new for the markets in which he/she is operating, or plans to operate.

A similar caution applies to the general classification of Kirznerian opportunities as being equilibrating. In fact, this is qualified by Kirzner himself, in stating that Austrian theory deliberately and precisely claims a tendency towards equilibrium, thus merely encouraging this movement (Kirzner 1997b: 81), without necessarily reaching it. Entrepreneurs demonstrate alertness by noticing opportunities that arise from existing disequilibrium situations. 'The entrepreneurial role involves alertly noticing ("discovering") where these errors have occurred, and of moving to take advantage of such discoveries' (Kirzner 1999: 6). This refers to Kirzner's understanding of entrepreneurs as arbitrageurs, in moving towards a new equilibrium. In this context, opportunities might also result from mimicking behaviour such as entering markets, where excess profits are made by few existing firms. This understanding could also be applied to shortage situations, illustrated by experience drawn from socialist economies.

In a transition context, Kirzner-type opportunities are likely to be more apparent in later stages of transition, where markets have been developed and flows of information, ideas and knowledge from mature market economies represent an important source of innovation for enterprises. This is reflected in empirical surveys in more advanced transition countries, where entrepreneurs complain about growing competition as one of their pressing business problems (e.g. Smallbone *et al.* 1999c, Smallbone and Welter 2003), while in early stage transition countries it is a lack of resources needed to realise their business idea, together with a lack of institutional stability and unpredictability of institutional behaviour that is emphasised (e.g. Smallbone and Welter 2006, Welter *et al.* 2003).

At the beginning of the transition period, limited competition existed in many markets and market opportunities resulted from the shortages of certain goods, for which a latent demand existed. Such an environment was potentially a seedbed for the Schumpeterian type of opportunities for entrepreneurs, although a variety of institutional constraints typically restricted their ability to exploit these. In this context, a Schumpeterian perspective emphasises the embeddedness of opportunities in the formal institutional environment. This may best be illustrated with reference to the initial changes in the institutional framework, which fostered entrepreneurship, when legal and administrative reforms made it legally possible for privately owned businesses to compete with state-owned enterprises (see for example, Chapter 8 on Poland). However, in situations where a new formal framework is not (yet) properly implemented, loopholes for creative entrepreneurial activities may be created, although some of these may fall into the category of unproductive, or even destructive forms of entrepreneurship, as described by Baumol (1990).

While focusing on the effects of the institutional environment on the exploitation of opportunities, Shane (2003: 160) recognises, in principle at least, that the former may also influence the discovery of opportunities, although he is unable to give examples. One example of institutional deficiencies creating opportunities for entrepreneurship is the development of business service consultancies in Ukraine, which is described in Chapter 6 of this volume. The customers of these small consultancy firms look for firms to supply a full range of services to avoid the necessity of employing several specialist companies. This full service portfolio would include not just business advice, but also the acquisition of the necessary licences and permits needed to start and run an enterprise or, in some cases, to develop a new project. The consultancy firms that had developed to fill this niche were not grey sector enterprises, but some of the most innovative and successful services firms, which had responded positively to a market opportunity created by the specific institutional conditions pertaining in Ukraine at the time. While the specific nature of the opportunities may be transient, as the institutional environment for productive entrepreneurship improves, the behaviour demonstrated by these enterprises shows a high level of sensitivity and responsiveness to the needs of customers, which are themselves heavily influenced by institutional conditions.

While Schumpeter puts more emphasis on the objective side of opportunities and the related process of discovering and exploiting them, which he describes as a process of creative destruction, Kirzner (1997a: 51) implicitly understands this as an enacted phenomenon: 'Entrepreneurial discovery represents the alert becoming aware of what has been overlooked. (…) When the (…) human agent acts, he is determining what indeed he sees in the murky future.' In this context, Kirzner (1979, 1997b, 1999) also refers to spontaneous learning and 'surprise' as a fundamental basis for entrepreneurial discoveries, which allows for the inclusion of 'serendipity' and 'luck' as possible sources for entrepreneurial actions. Thus, a Kirznerian perspective draws attention to the interplay of ideas, beliefs and actions in defining and creating opportunities (Sarasvathy *et al.* 2003), defying a simplistic view. Opportunities do not only 'exist out there' (Davidsson 2003); they are also created. This does not imply that there is no objective reality regarding opportunities, since an objective opportunity in the Schumpeterian sense may also be considered to be subjective, in the sense that opportunities emerge as individuals make sense of information and their actions, thus retrospectively discovering and recognising opportunities (Gartner *et al.* 2003).[4]

As Gartner *et al.* (2003) argue, this so-called opportunity enactment perspective draws attention to the fact that environments are also influenced by the scope of individual actions, thus emphasising the recursive links which exist between individual perceptions and environments, both simultaneously creating opportunities. A similar point was made with respect to the institutional embeddedness perspective on entrepreneurship in the previous section. While formal institutions create opportunity fields for entrepreneurship, informal institutions influence the collective and individual perception of entrepreneurial opportunities, which results in differences in the opportunity recognition process across contexts, cultures and countries. In transition environments, this conception takes on particular importance, because the environment in which opportunities are created is qualitatively different compared to market economies and conditions can also change very quickly.

Institutional change and entrepreneurship

Clearly, in the context of uncertain and unstable contexts, institutional change is an important factor influencing the pace of development of entrepreneurship. Institutional change can positively influence entrepreneurship when it removes or lowers barriers to market entry and market exit, thus creating opportunity fields for entrepreneurs, such as by the introduction of private property rights at the beginning of the transformation process. However, institutional change itself is affected by the complex relations between formal and informal institutions, as path dependency not only result in distinctive patterns of entrepreneurial behaviour; it also constrains institutional change (Peng 2003b). Mummert (1999) explains this in terms of sanctions for deviant individual behaviour, although it also reflects a time-lag apparent in human actions and individual preferences for known patterns of behaviour. In this context, entrepreneurs frequently rely on forms of behaviour as described in Chapter 5, which assists them in coping with the constraints imposed by unstable and weakly structured institutional environments, but which may not fit the changed formal institutional frame. Therefore, in situations where formal and informal rules conflict, previous experiences and tacit knowledge are the main influences on entrepreneurial behaviour, while a change of informal institutions would require an environment conducive for entrepreneurial (re-)learning.

This suggests there may be potential benefit in combining a learning approach to entrepreneurial behaviour with an institutional perspective. In institutional terms, enterprise behaviour is mainly understood as a calculated reaction to inadequate formal and informal institutions, which at first glance leaves little scope to explain emergent complex behaviour. A similar criticism applies to changes in enterprise behaviour, which the institutional approach predominantly interprets as a mechanistic response to changes in the institutional environment. Although institution theory concedes a context-based rationality, individual decisions are based on a process of rational choice, in which entrepreneurs decide on the basis of cost-benefit calculations, albeit taking into account the institutional environment (Nee and Strang 1998). Thus, the decision-making process of institutional economics draws on modified neo-classical foundations of individual behaviour, in modelling individuals as bounded rational 'homo economicus'.

At the same time, institutional economics implicitly recognises seemingly irrational, emergent behaviour, as described specifically in Chapter 5, below. The assumption of context based rationality concedes that entrepreneurial behaviour could possibly be a result of unintentional (re)actions to institutional constraints (Nee and Strang 1998). Nevertheless, the cognitive basis of decision making processes in institutional economics remains blurred and unrefined. Denzau and North (1994) discuss the influence of individual cognitive processes on the evolution of informal institutions, which North himself (1990: 140) identified as one of the shortcomings of his concept: 'We need to know much more about culturally derived norms of behavior and how they interact with formal rules to get better answers to such issues.' At first glance, the foundation of informal institutions (i.e. the ideologies, according to North 1981), resemble mental concepts such as individual cognitive maps containing experience-based interpretations of the environment (Handlbauer 1997). However, institutional economics is mainly interested in explaining the origin and emergence of informal institutions through collective processes, thus reducing the role of ideologies to that of *shared* mental models of groups and societies.

Mummert (1995) draws attention to the paradox that institutional theory ascribes conflicting roles to ideologies. In institutional terms, ideologies simultaneously serve as the cognitive interpretation of the environment, which consists of informal and formal institutions, while they also form the internal basis of informal institutions, thereby determining the environment they interpret (Denzau and North 1994, North 1998). This implies that institutional economics is still unable to really explain how informal institutions co-evolve and which particular role individual cognitive processes play (Williamson 2000).

The comparative-static view of institutional economics can be supplemented by a cognitive-based individual perspective, drawing attention to the evolutionary processes that underpin human behaviour. In this context, North (2005, cf. also 1995) incorporates an enactment perspective, when he emphasises the intentionality of players enacting institutional change, concluding that their grip of the respective situation influences the development of the institutional environment. Behavioural change is based on learning, which is reflected in changing 'theories-in-use' (Schön 1975), the process of 'effectuation', as suggested by Sarasvathy (2001) and in North's 'learning by doing' (North 1990: 81).

Learning results from simultaneous, mutual feedback relations between reflection and action – reflection-with-action. It refers to changes of known and trusted patterns, i.e. theories-in-use, which individuals use to reflect on and interpret their environment, while espoused theories of action guide their decisions and actions (Schön 1975). Learning is generated if a fit between theories-in-use and espoused theories of action does not occur. In other words, the entrepreneur's interpretation of what to do leads to an action that is no longer wanted by the external environment, e.g. in cases where new regulations have made this particular action illegal. This should lead individuals or organisations to reflect on their actions and interpretations, resulting – at least theoretically – in new theories-in-use, although the inertia and myopia of individual behaviour needs to be taken into account (Levinthal and March 1993).

Both internal and external events can act as triggers for change in entrepreneurial behaviour, provided they exceed the stress tolerance threshold, above which the entrepreneur recognises an urgent need for behavioural change (Koch *et al.* 2000). This threshold depends on the entrepreneur's background and experiences and his/her business objectives, and may itself change over time in the light of an individual's experience. Triggers for more active entrepreneurial behaviour are to be found in situations where entrepreneurs can no longer rely on their proven strategic responses. For example, internal triggers include new business opportunities, tight liquidity positions; while external triggers include a drop in demand and fundamental economic and political system changes, such as reforms to initiate transition to a market economy. Thus, the entrepreneur may move from simple reactions to the challenges and pressures emanating from the external environment to a more complex behavioural pattern (Welter 2003). Such entrepreneurial behaviour that evolves from simple to complex patterns, indicates an emergent process of individual learning, which depends on the mixture of institutional factors, such as personal experiences and background (cultural-cognitive institutions); the socio-cultural and sectoral milieu (normative institutions); and regulative settings. However, individual learning is itself affected by the environment and/or access to resources, drawing attention again to the role of the environment.

Outlook

In summary, the key question, as far as this chapter is concerned, was the extent to which existing concepts and theories are appropriate bases for analysing entrepreneurship in transition conditions. The discussion shows that entrepreneurship in a transition context is not unique, as the essential principles of individual behaviour are similar regardless of the environment. However, where the process of entrepreneurship under transition conditions appears distinctive is with respect to the specific interplay between individual entrepreneur/firm behaviour and the external environment, which changes as the process of transition unfolds. These are issues which will be analysed empirically in the following chapters. More specific issues to be tackled empirically include how trust and changing institutional norms influence entrepreneurial behaviour, and how entrepreneurs behave in adverse environments and those where institutional change is often rapid and unpredictable.

Part II

Entrepreneurship and small business development in former Soviet republics

4 Employment in new and small firms

The example of the Russian Federation

Introduction

This chapter focuses on the Russian Federation, where the development of productive entrepreneurship across the country has been hampered by the slow pace of institutional change, particularly outside Moscow and St Petersburg, together with a variety of cultural factors. Following a review of the development of entrepreneurship in Russia over time, and the role of government policy, original research results are presented relating to employment and the use of labour in Russian SMEs.

Market reforms and the development of private entrepreneurship

By the end of the 1990s, the Russian economy had recovered from the earlier decline in GDP, which was reflected in negative growth rates of the real GDP in 1993 and 1994. From 1999, GDP grew to reaching a peak growth rate of 10 per cent in 2000, although subsequently declining after that, with a projected growth rate for 2005 of 6 per cent (EBRD 2005). From the standpoint of private sector development, there also appears to have been a shift during the transition period from an industry-based and heavily monopolised economy, with few opportunities for private small firms, towards a service-led economy, which is dominated by private firms and small-scale entrepreneurship. However, a closer look at different elements of the results of the reforms qualifies this optimistic picture, because of the negative aspects of some of the changes that have occurred. For example, the 'unofficial' privatisation, which preceded the official privatisation programmes, allowed government officials to take over their companies and reorganise them as private enterprises (Satter 2003). In addition, mass privatisation initially gave rise to considerable insider ownership. The mass privatisation programme, as carried out between 1992 and 1994, was based on a voucher method, where anyone could buy shares, although in practice, it favoured the involvement of company insiders. Company directors and persons in a position of influence used this to privatise their companies, but employees also used it to gain possession of enterprises.

A high level of insider privatisation, which is apparent in some of the evidence assembled in Box 4.2, has been confirmed in several studies (e.g. Blasi *et al.* 1997, Gustafson 1999). Estimates based on various empirical surveys set the share of insider ownership between 46 per cent and 60 per cent, with the majority of shares belonging to employees (Blasi *et al.* 1997, Sprenger 2002: 4). However, outsiders gained more shares after the mid-1990s. The privatisation strategy was a result of power held by the directors of SOEs, once the branch ministries lost their influence, during *perestroika*. Sprenger (2002) also assesses the large share of employee ownership as an instrument to prevent outsiders gaining control over the privatised enterprises. As a consequence, the high degree of worker ownership does not necessarily imply that workers had a significant influence on decision making within the enterprises. For example, a survey of 111 firms in the St Petersburg area showed that although workers controlled all work-related decisions, they were not in control of strategic decisions (Jones 1998). All this led Goldman (2003: 86) to characterise the outcome of Russia's privatisation programme as a 'plum pudding delight for the factory directors and insiders'. Moreover, since Putin became President, the Russian government has increasingly intervened in the economy, with a tendency to centralise decision making (EBRD 2005: 170).

Such trends reflects an attitude on the part of the state and society towards private business that is, at best, arbitrary. Although entrepreneurship is accepted as a legitimate activity by the population at large, it is still associated in the minds of many with criminal or at least anti-social behaviour. For example, in early 2000, more than two-thirds of the Russian population favoured stricter governmental controls of private entrepreneurship, while 46 per cent regarded the term 'entrepreneur' unsympathetically (Chepurenko 2001). On the other hand, a survey undertaken in 2002 in order to assess the entrepreneurial potential of Russian society showed 39 per cent and 35 per cent of respondents to have a positive attitude towards small and family entrepreneurship respectively (Chepurenko 2003, Chepurenko *et al.* 2002).

The development of entrepreneurship started relatively late in Russia. In contrast with countries such as Poland or Hungary, which tolerated private business during the socialist period and which experimented with enterprise reforms as early as the late 1960s, private entrepreneurship in Russia (as in all Soviet states) was restricted to illegal activities in the so-called second economy (see Chapter 3, above). In 1986, for example, there were only 97,000 registered private entrepreneurs; however, a huge illegal private sector existed, providing an estimated one-third of the total demand for consumer services (Aslund 1991). The adoption of the Law on Co-operatives in the former USSR in 1988 made it possible for non-state-owned enterprises, albeit co-operatively-owned ones, to legally exist (Nuti 1992, Knaak 1992), in an attempt to legalise 'unearned incomes'.

In this context, SME development initially made rapid progress in Russia (Table 4.1). Nearly 16,000 SMEs were newly established in 1988, 94 per cent of which were co-operative firms; with the number rising to nearly 30,000 by 1989 (Bukvald and Vilensky 1995: 45, cited in OECD 1998: 26) and 190,000 in 1992 (Chepurenko and Vilensky 1996). During the 1990s, the total number of SMEs and private entrepreneurs increased to reach a peak of in 1994 (Table 4.1),

Table 4.1 SME development in the Russian Federation (1991–2003)

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*
Number of SMEs (1,000)	268	560	865	896	877	841	861	868	890	879	843	882	891
Percentage share of all enterprises	84.9	92.0	69.5	46.1	39.0	33.8	31.6	29.9	28.9	26.3	*	29.2	24.3
No. of individual entrepreneurs (m)				No data available				3.5	3.8	4.2	4.5	4.7	4.8

Source: Aslund (1997), Astrakhan and Chepurenko (2003), Kihlgren (2002), OECD (2002), Russian SME Resource Centre (2002, 2003, 2004).

Notes
i Data is for end of year/beginning of next year respectively.
ii *No data for all enterprises available for 2001.

although after 1996, the pace of entrepreneurship development decreased. According to official statistics, in 2003, 891,000 small firms with up to 250 employees existed; together with 4,797,000 individual entrepreneurs (Russian SME Resource Centre 2004), although this is less than the total existing in 1999. Moreover, sole proprietorships mainly represent self-employment activities and are often created for tax reasons, which means that official data typically includes a high share of inactive entrepreneurs (Economics Unit 2002).

As in other transition economies, huge core–periphery differences in the distribution of SMEs can be observed in Russia (Russian SME Resource Centre 2000), although in most regions, less than 10 per cent of the active labour force works in small firms. Almost one-third of all small enterprises are concentrated in the Central region, which mainly comprises two major Russian cities, Moscow and St Petersburg. Greater Moscow accounts for nearly 25 per cent of all Russian small enterprises; St Petersburg for another 12 per cent. The emergence of this regional diversity at the beginning of the 1990s indicates a strong relationship between small business development and regional factors, such as the institutional and physical infrastructure, regional policies, as well as variations between regions in the nature and extent of market reforms (OECD 2002).

Box 4.1 Definitions of SME in Russia

During the 1990s, Russia changed its definition for SMEs twice. In 1991, the Decree of the Russian Federation Council of Ministers defined small enterprises based on the number of workers, including part time and contract workers, differentiated across sectors. In manufacturing industry, a small enterprise had up to 200 workers; in science and scientific services up to 100; in other production activities 50; and in retailing, catering and other non-production services up to 15 employees. The Law ‘On State Support of Small Enterprises in the Russian Federation’, issued in June 1995, modified these definitions. The upper limit in manufacturing and in science and scientific services was decreased to 100 and 60 employees respectively, but increased in trade and services. Small enterprises in retailing and consumer services can now have up to 30 employees; in catering and other non-production activities up to 50 employees.

Source: OECD (2001)

Although Goskomstat (the statistical office) provides statistical data on small firms, the statistics are not very reliable, tending to underestimate the size of the small enterprise sector, its development and contribution to the economy. This is partly due to the fact that the data rely on registered enterprises, excluding the shadow economy as well as secondary and self-employment, which play an important role in the small enterprise sector in Russia (Kihlgren 2002). Moreover, frequent changes in the statistical methodology make longitudinal comparisons difficult.

Reviewing the development of the private sector, Radaev (2001b) distinguishes a number of *stages of private enterprise development in Russia*. Rapid growth of the small firms sector occurred during the initial stage (1988–1991), fostered by spontaneous privatisation. Growth in the number of small firms slowed down during the second stage (1992–1994), despite ongoing economic liberalisation and small-scale privatisation. In the third stage, from 1995 to 1997, small enterprise development stagnated, although in this stage government policies and legislation started paying (more) attention to private small businesses. Stage four (1998–2000), which was an outcome of the financial crisis in 1998, was characterised by a shift in activities towards domestic goods, which was supported by the devaluation of the Russian currency, while small business support policies suffered from budget constraints during this period.

Overall, the financial crisis in Russia in 1998 had both positive and negative implications for small enterprises. Most firms, especially those engaged in trade activities, which include the partly illegal cross-border 'shuttle' trade, experienced a sharp drop in purchasing power, which was aggravated by customers' payment problems. On the other hand, the crisis created new opportunities for small businesses (OECD 2001), which managed to replace larger enterprises by entering formerly monopolised market niches. Small firms also benefited from decreasing costs, as interest rates for bank credits fell and many employees, who were reluctant to lose their jobs, agreed to accept wage cuts and payment delays. Finally, there is some evidence to suggest that the crisis led small business owners and managers, whose firms survived, to recognise the value of a more strategic approach to management in order to discover and to respond to new market opportunities.

This is best illustrated by looking at evidence from interviews with entrepreneurs. For example, Natasha, who owns a small travel agency specialising in business study tours, experienced a major loss of customers after the Russian crisis, as demand for her services depended on the economic situation of her customers. The Russian crisis in the summer of 1998 caused a majority of her customers to cancel their signed contracts for the coming autumn. Business was bad for approximately six months, although the firm had enough money to cover current expenses. The entrepreneur was stimulated to begin market research in order to place her business on a more sustainable basis: 'Before that I always talked about broadening our field and considering a policy for my firm, but I had no time until the crisis came'.

Several studies appear to confirm that the Russian small enterprise sector was quick to recover from the crisis in 1998, with some positive benefits (e.g. Chepurenko *et al.* 1998). The OECD reports that a survey of SMEs in St Petersburg, conducted by the Leontiev Centre in autumn 1991, found more favourable than negative responses with respect to changes in the business environment, since the crisis (OECD 2002: 92). However, the fifth stage in private sector development, from 2001 onwards, saw an end to the positive effects of the 1998 devaluation, although this was associated with a period of economic growth of the Russian economy as a whole.

Who are the Russian entrepreneurs?

The early stages of private sector development in Russia were accompanied by different '*waves' of entrepreneurs* (Astrakhan and Chepurenko 2001: 188–189, 2003). At the start of the process in 1987–1989, many of the entrepreneurs who owned and led co-operative firms had illegal incomes, often through contacts with criminals. High-level government clerks dominated the second wave of entrepreneurs in 1989–1990, whereas the third wave (1991–1992) contained mainly directors and managers of state-owned firms, who took the opportunity to privatise 'their' enterprises or to establish new businesses (Dallago 1997, Kusnezova 1999, Lageman 1995). Other sources of entrepreneurs during the transition period included the Soviet 'Komsomol economy', which had established a number of businesses within the youth organisation under socialism (Gustafson 1999); and the 'privatisation' examples set out in Box 4.2, where owners either had longstanding working relations with 'their' enterprise, or used insider knowledge from political positions to privatise an enterprise (Chepurenko 1998, 2000, Welter 1996, Malle 1996, Saizew 1994, Johnson *et al.* 1992, also see Chapter 3).

Box 4.2 Patterns of entrepreneurship in Russian SMEs

A family business: This small construction firm 'Domus' was set up in 1997. Its owner-manager is female, in her forties. Her husband, aged 45, works as a production manager in the company, appearing to have been the driving force in creating this business. Before transition started, he worked in a state-owned enterprise, initially as a locksmith and later as a foreman, responsible for plumbing. After *perestroika*, he switched to the private sector and worked in a private construction business, in order to accumulate knowledge and experience. With friends, he then set up a small firm, selling household appliances. When all partners decided to split and set up different businesses, he founded his construction firm.
Using contacts and privatising the workplace: The 'Magazin Rostovskii', selling foodstuffs, was privatised in the early 1990s. Its current owner was formerly a manager in the same store, taking an active role in the privatisation process. She persuaded the workers' collective to register as a limited partnership in 1991, which was the first step in gaining independence from the local trade department. When the privatisation campaign started in 1993, the owner had the idea to take an active role in privatising her workplace, which resulted in the workers' collective succeeding in buying enough vouchers to take over the store.

Another example is the 'Orbita-Servis' firm, which was established as a government company in 1967 to service and repair household electronic equipment. From the 1980s onwards, the firm operated 70 workshops. In 1992, it changed its structure to a joint-stock company. The current manager has been working in the firm since it was established, taking over its management in 1987 and consequently restructuring and privatising the firm. In the early 1990s, he realised that the firm was on the edge of bankruptcy, which led him to restructure the workshops into limited partnerships. Most of the workshops are still dependent on the main firm, as the manager privatised all of its property, subsequently leasing it out to the workshops.

Insider knowledge, former nomenclatura status and shady dealings appeared to have played a role in the creation of this small retail store in 1997, specialising in trading foodstuffs. Currently, the store is 100 per cent privately owned. Although when interviewed, the entrepreneur refused to give details of how the shop was transferred to private ownership, his employees explained this in terms of their employer's connections to the municipal authorities in Moscow, where the owner had previously been a deputy of the Moscow Municipal Duma [parliament].

Spin-offs and multiple jobholding: In 1996, employees of the Research Institute of Communications initiated this firm to modify and sell Russian-made radio equipment, especially mobile phones. The firm is co-owned, one of the owners being the Chief Designer of the Research Institute; another an enterprise manager. However, it appeared that the enterprise had been established initially to facilitate the marketing of a state firm's products.

Source: own study (see Appendix, Project 9, p. 241)

Finally, the fourth wave of private entrepreneurs (1992–1993) included those who benefited from small privatisation, as well as entrepreneurs who set up business as an alternative to unemployment and/or because they perceived market opportunities.

Government policies and SME support: the environment for SME development

While the formal requirements for private entrepreneurship to exist legally were quickly introduced in post-Soviet Russia, in practice, many of the institutions that are essential for the large-scale and sustainable development of private sector businesses are either non-existent, or inadequately focused on the needs of entrepreneurs. A consistent institutional environment involves developing organisations, such as private banks, economic courts, and a private legal profession with the capacity to implement laws, with major implications for staffing. Specialised organisations, together with effective enforcement mechanisms, are lacking for the most part, with a typical lack of adequate and effective personnel in government administration (Blankennagel 2000). The reasons are low public-sector salaries combined with a lack of education and training opportunities, which prevent their proper implementation. Privatised banks still typically follow a conservative strategy with respect to the financing of private enterprises, being more oriented towards their traditional clients, i.e. (former) state-owned enterprises (Stern 1997).

In addition, frequent changes in tax regulations and other commercial laws, which are characteristics of the early years of transition, have required a constant adjustment of knowledge by entrepreneurs as well as by those in government administration. For example, more than 30,000 bye-laws regulate labour and employment relations, often being contradictory and applying to state and private entrepreneurs alike, regardless of the size of enterprise. An example of regulations from different agencies contradicting each other is reported in Moscow, where the tax inspectorate prescribed electronic cash registers as obligatory for all market stalls, while the fire inspectors prohibited electricity on markets (Fruchtmann and Pleines 2001). All of this contributes to a rather uncertain attitude or even arbitrariness on the part of public officials regarding law enforcement that is not helped by a typical lack of specificity in the drafting of laws, causing unnecessary delays and costs for enterprises.

In terms of how entrepreneurs perceive their environment, one of their major complaints relates to the requirements of various state and municipal authorities, such as the tax inspectorate, the Department of the Interior, fire inspectors, the sanitary service, licensing board, customs officer and pension funds and architectural control, which in some cases is combined with a high frequency of visits. In Moscow, for example, small firms can be under the control of more than 50 bodies. In Voronezh, 33 inspection agencies are reported, all of which have the power to close down a business, or close its bank account (Polishchuk 2001). In the 1999 survey (Appendix, Project 9), inspectors and officers from the sanitary service made visits at least quarterly in more than one-fifth of surveyed enterprises, and monthly in 12 per cent. Almost one-quarter of surveyed firms (23 per cent of cases) experienced quarterly visits from tax inspectors, with another 12 per cent from the Department of the Interior. Such inspections are time-consuming for businesses, often leading to unauthorised payments and threats of business closure. One empirical study confirmed that nascent entrepreneurs who failed in realising their venture, named such visits, and a lack of personal connections within authorities, as the second and third most important barriers to starting their enterprise, following a lack of capital, which ranked first (Chepurenko 2002b).

Following a period of political indifference towards the development of small private firms in the early 1990s, there were a number of institutional developments and government initiatives in the mid- and late 1990s, which were designed to encourage the development of small business. These included simplified tax-reporting requirements, which were introduced at the federal level in 1998 and at regional level one year later; the establishment of a State Committee for SME Support and Development; and renewal of the fundamental legislation, which provided the legal basis for SME policy (OECD 2001). However, a failure to fund and implement these initiatives was combined with disputes between institutions concerning the extent of their powers and responsibilities.

For example, the Committee for the Support of Small Businesses and Entrepreneurship, which was created in 1994, was eliminated again in 1998, while its functions were transferred to the Ministry for Anti-Monopoly Policy and the Support of Entrepreneurship (MAP) (OECD 2002), which was itself dissolved in spring 2004. Moreover, almost all regions set up their own small business support committees, but regional and federal responsibilities are not clearly spelt out, reflecting a lack of co-ordination and institutionalisation of policy. The so-called 'implementation gap' is a familiar feature of government policy in transition economies (Smallbone and Welter 2001b) and this deeply influenced the effectiveness and coherence of Russian SME policies. On the whole, it has been suggested that, in retrospect, political support for SMEs in the Russian Federation has tended to be strongest during election campaigns, while fading soon after. This occurred in 1995–1996 and again in 1999–2000, preceding the Presidential and state Duma elections (OECD 2001).

In this context, a major factor affecting the development of SMEs in Russia has been the constraints on legitimate business development imposed by criminal activity. Many early stage transition countries have not yet developed, or at least implemented, adequate regulatory mechanisms to restrain criminal behaviour through both formal sanctions and social norms (Lotspeich 1995). Research has shown that 83 per cent of SME managers in Russia complained about coercion and threats, with a quarter frequently experiencing racketeering (OECD 1998); while Russian officials estimate that in 1994 between 70 per cent and 80 per cent of all private enterprises in major cities paid protection money to organised crime (Alexeev *et al.* 1995). Bribes to officials for business registration are another serious obstacle for SMEs. While public perception of growing economic crime might be skewed by a metropolitan (e.g. Moscow) bias, the phenomena could seriously impede the motives of entrepreneurs concerning the development of their businesses in terms of creating new jobs.

Although surveys have indicated that the overall criminal influence on small entrepreneurs has decreased since 2000, corrupt middle- and low-level bureaucrats appear to replace the organised crime. In this context, the shift in SME and entrepreneurship policies could help to alleviate some of these problems, provided it does not remain purely a paper exercise. Since 2000, the Russian government has aimed to foster entrepreneurship and small business through improving the overall climate for fair competition and investment. The main elements of this strategy include removing administrative barriers, reducing bureaucracy and deregulation (OECD 2002).

Patterns of employment in small Russian firms

Ever since the publication of the Birch Report (Birch 1979) which showed that between 1969 and 1976 small firms accounted for approximately 80 per cent of net employment growth in the US, the contribution of SMEs to employment generation has been a major focus of attention of policy makers at the local, regional and national levels. Although later empirical results were less dramatic than the earlier Birch findings, various studies in market economies, that include a variety of time-spans and both recessionary and non-recessionary conditions, reinforced the original message with respect to the disproportionate contribution of small enterprises to new job creation (e.g. Storey and Johnson 1987, Sengenberger *et al.* 1990, Lageman *et al.* 1999). While nowadays few observers would disagree that small firms are creating jobs at a faster rate than larger firms, the extent and nature of their contribution remain the subject of more debate.

In transition economies, there are some distinctive characteristics of the small firms sector, compared with their counterparts in mature market economies, which has implications for their job creation potential and the job quality. The vast majority of firms are very small enterprises employing only the owner him-/herself and family members. Self-employment also includes part-time activities, often representing an additional source of the household income of the 'owner'. Medium-sized enterprises on the other hand are mainly newly founded firms or privatised enterprises, the growth potential of which may be limited because of a considerable labour surplus. In larger countries such as the Russian Federation, there are also wide regional variations. Furthermore, in transition economies, a considerable part of the private enterprise sector, especially the smallest firms, is operating in the shadow economy, with many engaged in both formal and informal economic activities.

There is a considerable lack of precise information on employment patterns and employment behaviour of new and existing private enterprises in the Russian Federation, as in other transition economies. The inadequacies of official data sources contribute to a lack of knowledge concerning the extent to which private enterprises are actually contributing to employment growth in practice, although a study by the Russian Foundation 'Bureau of Economic Analysis' (2002) attempted to analyse the structure, dynamics and problems of the Russian labour market in more detail. For example, the Russian labour force survey, based on a household sample in all Russian regions, concentrates on employees. The enterprise reporting system of the statistical office neglects small enterprises and new firms. In this context, the following sections of this chapter analyse the extent to which Russian private small enterprises contribute to employment, as well as to changes in employment patterns, especially taking into account the effects of the Russian economic crisis of August 1998 (see Appendix, Project 9, p. 241).

Do Russian SMEs create (additional) jobs?

In transition economies, the absence of reliable statistical data makes it difficult to produce accurate estimates of the contribution made by SMEs to employment generation, although those data that are available suggest they are making a significant contribution (e.g. Smallbone *et al.* 1996b, Bartlett and Rangelova 1997). In 1991, according to a survey in which the authors of this book were involved, 1,154 surveyed firms in Russia employed a total of 25,599 employees, which averages 22 employees per firm. In interpreting this figure, one needs to take into account that in this particular study, larger SMEs were deliberately over-sampled in order to being able to study employment relations within firms of different sizes. As a consequence, the survey mean is higher compared to official statistics, which show the average number of employees in small enterprises amounting to ten persons per firm. Not surprisingly, average employment in existing firms is much higher (23 per firm) compared to new enterprises (12 per firm overall, with a range from 8.2 in Ekaterinburg to 44.5 in Voronezh).

There has been much debate in the West about the extent to which the increase in employment in small firms represents additional jobs for the economy, or simply a transfer of jobs from large to small firms. It is argued that large firm fragmentation and externalisation strategies have contributed to job growth at the expense of jobs in contracting organisations due to increased opportunities for small firms as subcontractors, franchisees or as suppliers of services which were previously provided in-house (Shutt and Whittington 1987). It would appear that the question of whether SMEs create additional employment, or whether employment in SMEs is in a sense transferred from larger firms as a result of the latter fragmenting their production and outsourcing, takes on an additional dimension in a transition context. This is because SMEs are assumed to have a particular role to play in the process of fragmentation and absorption of surplus labour, which is implicit in the privatisation of state-owned industries.

Evidence from the Russian Labour Flexibility Survey suggests that a notable job-to-job movement of labour from state and privatised enterprises into the private sector occurred until the mid-1990s, focusing particularly on sectors such as construction and trade, as well as in specific regions (Gimpelson and Lippoldt 1997). At the same time (official) figures for Russian SMEs showed a decline in total employment in the late 1990s (allegedly from 9 million in 1995 to 6 million in 1997), although this was partly due to changes in the statistical methods used in recording employment and also to changes in SME definitions (Institut strategicheskogo analiza 1997, Chepurenko 1998).

Such data cast some doubt on the long-term capacity of SMEs to absorb labour on a sustainable basis, although this must be seen in the context of the level and lack of stability in external environmental conditions, as well as in the context of a growing shadow economy. The latter accounts for a substantial proportion of the total employment in the SME sector, adding another distinctive dimension to the question of whether SMEs create additional jobs in transition economies. Comparisons between transition economies have shown that during the 1990s the shadow economy in most former Soviet republics was typically growing (Schneider 2002). The high numbers of workers on unpaid leave and those with part-time employment in Russia (as well as in several other NIS) suggests a high share of secondary employment (formally or informally), most of which is found in SMEs (Commander and Yemtsov 1994).

Temporary, unregistered (i.e. informal sector) employment in small private firms was initially one of the ways in which employees of state-owned enterprises survived when they were placed on ‘administrative leave’; another was to start an (unregistered) enterprise themselves. All transition economies initially had a highly distorted size distribution of enterprises, combined with considerable disguised unemployment in state enterprises, which was inherited from the Soviet period. The reaction to new market conditions, once transition commenced, was either to place labour on so-called 'administrative leave' (short-time work or unpaid leave) or to shed labour (Standing 1996). In this context, newly created small enterprises provide one of the few job opportunities for redundant workers. In fact, there is empirical evidence which suggests that a net reallocation of labour from large and medium-sized enterprises to smaller firms took place in the early 1990s in most transition economies (e.g. Jackman and Paun 1997), although this typically accounted for a minor part of the total labour turnover.

In such a context, temporary employment (often illegal) represented an alternative to redundancy for employees, which avoided the need for the enterprise owners to pay a compensation payment and for the employee to keep open, in theory at least, an entitlement to pension rights. One such indicator for multiple job-holding is self-employment, which in Russia increased by 62 per cent between 1992 and 1994 (Commander and Tolstopiatenko 1997). This suggests that while a significant share of employment in SMEs may not represent net additional employment for the economy, it has acted as a cushion for the labour shedding and hidden unemployment in the state sector.

Interestingly, in the large-scale survey of Russian SMEs, in which the authors were involved, the vast majority of firms reported using permanent employees, while less than one-third additionally made use of temporary employees (Table 4.2). Total permanent employment, which includes full-time and part-time employees, accounted for 21,977 of all employees in surveyed enterprises. Most employees are employed on a permanent full-time basis, with less than 4 per cent of surveyed enterprises relying exclusively on temporary employment. The distribution of core–periphery employment across surveyed firms is mainly determined by sector and size. Periphery employment, i.e. part-time permanent and temporary employment was more commonly reported in business-oriented services and larger firms; core (full-time permanent) employment in industry and trade and surprisingly in smaller firms with fewer than 50 employees.

Regional employment patterns

Evidence from previous research suggests that in Moscow and other large cities, 'de novo' start-ups are more dynamic firms than privatised enterprises, whereas in the provinces it is privatised or restructured former state enterprises that appear to play a more significant role (Starodubrovsky 1998), because start-up rates for de novo enterprises are typically lower. Moreover, there appear to be dynamic growth regions where the institutional infrastructure, regional administration and support infrastructure is better developed, contributing to a higher rate of development of SMEs (and thus employment growth) than in lagging regions (Gimpelson and Lippoldt 1997, OECD 1998, Chepurenko and Seregyi 1998).

Table 4.2 Employment patterns in existing[a] surveyed Russian enterprises by region (1999)

	No. of existing firms	*Permanent employment*		*Temporary employment*		*Total existing employment*	
		Full-time	*Part-time*		*Number*	*Mean per firm*	*% of total employees in region*
Regions with very favourable and favourable SME conditions							
Moscow	274	4,956	218	830	6,004	21.9	96.6
Omsk	73	1,750	139	179	2,068	28.3	98.1
Regions with mainly favourable SME conditions							
Moscow oblast	83	1,779	82	90	1,951	23.5	97.2
St Petersburg	186	2,810	220	651	3,681	19.8	97.1
Kazan	103	2,333	213	506	3,052	29.6	98.8
Voronezh	88	1,949	95	396	2,440	27.7	96.5
Ekaterinburg	123	1,978	291	443	2,708	22.0	97.3
Regions with satisfactory SME conditions							
Irkutsk	58	745	63	153	961	16.6	91.1
Krasnoyarsk	25	468	42	39	549	21.9	92.9
Regions with rather unfavourable SME conditions							
Arkchangelsk	72	1,025	101	239	1,365	18.9	95.2
Total employment in existing firms							
	1,085	19,793	1,464	3,526	24,779	22.8	96.8

Source: Own survey (see Appendix, Project 9, p. 241).

Note
a Only firms included, which were older than 12 months in June 1999.

Table 4.3 Employment patterns in new[a] surveyed Russian enterprises by region (1999)

	No. of new firms with employment	*Permanent employment*		*Temporary employment*		*Total new employment*	
		Full-time	*Part-time*		*Number*	*Mean per firm*	*% of total employees in region*
Regions with very favourable and favourable SME conditions							
Moscow	18	188	10	11	209	11.6	3.4
Omsk	3	39	0	0	39	13	1.9
Regions with mainly favourable SME conditions							
Moscow oblast	5	57	0	0	57	11.4	2.8
St Petersburg	11	78	13	18	109	9.9	2.9
Kazan	3	37	1	0	38	12.7	1.2
Voronezh	2	61	0	28	89	44.5	3.5
Ekaterinburg	9	59	9	6	74	8.2	2.7
Regions with satisfactory SME conditions							
Irkutsk	10	72	4	18	94	9.4	8.9
Krasnoyarsk	3	36	6	0	42	14	7.1
Regions with rather unfavourable SME conditions							
Arkchangelsk	6	45	5	19	69	11.5	4.8
Total employment in new firms	69	672	48	100	820	11.9	3.2

Source: Own survey (see Appendix, Project 9, p. 241).

Note
a Set up within 12 months prior to interview.

The structure of employment in firms of different ages is fairly consistent across the regions. Permanent employment, both full-time and part-time, played a major role in existing firms across survey regions (Table 4.2). Surprisingly even start-ups used mainly permanent employees, with only 12 per cent of all employment in new firms being of a temporary nature (Table 4.3). There are regional variations, however, indicating regional differences in labour market conditions, as well as differing regional growth potentials. New firms in both regions with favourable (Omsk, Kazan) or unfavourable SME conditions (Archangelsk) rely exclusively on permanent employment. This is contrary to Western evidence, which indicates that start-ups are either reluctant to hire employees or prefer temporary labour (Bhide 2000). In regions of relatively unfavourable SME conditions, such as Archangelsk, or in regions such as Omsk where because of the climatic conditions people are unable to survive by simply relying on subsistence activities, this can partly be explained by local labour market conditions. In such local contexts, entrepreneurs can find abundant and cheap full-time employees, while unemployed persons are ready to accept low-paid and probably insecure jobs in new enterprises.

At the same time, case studies also show that employers tend to favour permanent over temporary employment in order to increase an employee's identification with the job, as well as to allow for greater longer-term planning with respect to labour. Other reasons are the use of individual liability agreements (i.e. contracts which specify financial penalties to be paid by the employee in case of damage to equipment etc.), which were reported being used in case studies of retail enterprises and companies installing and repairing local telephone exchanges. Managers using this type of agreement would be unlikely to hire temporary employees. Case studies also demonstrate that entrepreneurs use temporary labour to 'test' new employees. For example, the manager of a retail store reported informally hiring new employees for a probation period of three months, during which time they were introduced to all the tasks in the store, including menial jobs, such as packing and cleaning vending equipment.

Employment changes 1998–1999

Despite the financial crisis in 1998, employment remained more stable in 1998–1999 than either sales or profits, at least in the short term. In order to determine their performance, surveyed SMEs were asked to evaluate their business results for the second half of 1998 in comparison to the first half. While 63 per cent and 70 per cent respectively reported suffering a decrease of sales and profits, a large share of surveyed SMEs (45 per cent) maintained stable employment; 9 per cent increased it; and one-third decreased employment. These results, which are confirmed by other surveys (see Russian SME Resource Centre 2002: 112), are comparable to Western research in that although job losses tend to increase during recession periods while the number of job gains decreases, SME performance with respect to employment is relatively stable over the economic cycle, in comparison with larger firms (Davis and

Haltiwanger 1992, Schmidt 1995, Fendel and Frenkel 1998). This is because the owners/managers of small enterprises tend to hoard labour in the short term, waiting for demand conditions to improve. In a Russian context, there is evidence to suggest that reducing wages was the first strategy used by SME owners to respond to falling sales, which the labour force was willing to accept in the absence of alternative employment possibilities.

Overall, total employment in surveyed firms declined by 4.7 per cent in 1998–1999 (Table 4.4), although there were marked differences between sectors, size groups and regions. Not surprisingly, labour changes were most pronounced in consumer-oriented sectors such as construction, trade or consumer-oriented services, reflecting the drop in demand for such goods following the Russian crisis. When asked for reasons to explain decreasing employment, entrepreneurs typically referred to ‘declining sales in the aftermath of the 1998 crisis’ as the main reason, followed by ‘increasing competition’. Employment changes also varied with enterprise size, reflecting the limited financial resource base of smaller firms. For example, micro firms decreased employment by 20 per cent, while medium firms even increased total employment by 4 per cent.

Employment changes also showed some regional variations, although at first sight the observed pattern is somewhat surprising. Instead of job losses being greater in regions where the environment was less favourable for SME development, the opposite was the case. In practice, the financial crisis in 1998 appears to have affected regions with favourable SME conditions such as Moscow city and Omsk at least as badly as in Archangelsk, which is situated in a region with rather unfavourable conditions for SME development. In Moscow, this is partly explained by the massive devaluation of the rouble, which strongly increased the demand for informal payments in hard currency. Although hard currency payments for, e.g., rentals of ‘shadow rooms’ had been in use since the early 1990s, the financial crisis resulted in a growing number of entrepreneurs being forced to accept this ‘business convention’. In order to survive, they in turn were forced to reduce their employment. In regions such as Omsk, with a relatively favourable climate for SMEs, mainly small retail traders, buying in Moscow and selling in Siberia, experienced

Table 4.4 Types of employment in surveyed Russian SMEs (1998–1999)

	Enterprise		*Employees*	
	1998	*1999*	*1998*	*1999*
Full-time permanent employment	1,065	1,065	20,585	19,793
Part-time permanent employment	256	257	1,496	1,464
Temporary employment	340	338	3,932	3,526
Total	1,661	1,660	26,013	24,779

Source: Own survey (see Appendix, Project 9, p. 241).

serious after-crisis problems, as the prices for new goods escalated while customers' incomes dropped. Moreover, employment losses only occurred in SMEs in half of the surveyed cities while in the other half, SMEs experienced modest employment gains. A similar regional pattern emerges when respondents were asked whether employment in new small firms can compensate for the overall employment loss (Table 4.5). The total compensation effect amounts to 66 per cent, with a low of 17.6 per cent in Omsk and below average shares in Moscow and Archangelsk.

In this context, survey data show that declining employment is mainly a result of decreasing temporary labour while the decline of permanent labour was considerably lower than the total decline (Table 4.5). The overall decrease of temporary employment challenges the hypothesis based on previous research that due to the turbulent environment, Russian SMEs increasingly favour temporary employees (Chepurenko *et al.* 1998, Johnson *et al.* 2000). This could be partly explained by the phenomenon of 'labour hoarding' in SMEs, mentioned earlier, where SMEs tend to keep core employees that they

Table 4.5 Employment effects in surveyed Russian SMEs by region (1998–1999)

	Employment change in existing firms 1998–1999			*Net employment effect 1998–1999*[a]	*Compensation effect*[b] *of new employment (%)*
	Permanent employment (%)	*Temporary employment (%)*	*Total (%)*		
Regions with very favourable and favourable SME conditions					
Moscow	–7.0	–5.3	–8.3	–331	41.4
Omsk	–6.1	–35.4	–9.6	–182	17.6
Regions with mainly favourable SME conditions					
Moscow oblast	+0.1	+5.9	+0.4	+64	n.a.
St Petersburg	–1.1	–15.7	–4.1	–47	69.9
Kazan	–1.5	+8.4	+0.03	+39	n.a.
Voronezh	+1.7	–1.2	+1.2	+119	n.a.
Ekaterinburg	–3.1	+0.9	–2.5	+4	n.a.
Regions with satisfactory SME conditions					
Irkutsk	–13.5	–14.5	–13.7	–58	61.8
Krasnoyarsk	+3.0	+14.7	+3.7	+20	n.a.
Regions with rather unfavourable SME conditions					
Archangelsk	–7.5	–20.1	–9.9	–82	45.7
Total employment change	–3.7	–10.3	–4.7	–414	66.4

Source: Own survey (see Appendix, Project 9, p. 241).

Notes
a Employment loss/gain in existing firms + employment in new firms. b: employment in new firms.
b Employment loss in existing firms.

know and may have trained, even in turbulent economic periods (Fendel and Frenkel 1998).

In the Russian context, this behaviour is reinforced by the problems experienced in recruiting skilled labour, which is a major concern of SME employers, mentioned in a number of surveys (e.g. IPSSA 1998, Russian SME Resource Centre 2002, Obydennova *et al.* 2000), as well as by entrepreneurs in our case studies. Skills shortages were identified as the most important labour-related constraint by respondents in the survey, having an impact on business development in nearly half of all firms. For example, the owner of a small travel agency complained about the shortage of experts who 'are really qualified to work with clients. Even the capacity to converse freely is very rare amongst employees nowadays. At times, they can hardly make themselves understood.' This helps to explain the slower decrease in permanent labour in SMEs even in a time of financial crisis, although it also reflects their ability to retain staff yet reduce their wages, made possible by the extreme nature of the financial and economic crisis in Russia in 1998.

However, at the regional level, no such clear pattern of employment change can be identified. For example, while employment changes in most survey cities occurred as a result of decreasing temporary employment, in Moscow the employment decrease was mainly a result of a reduction in the number of permanent jobs. This is mainly an outcome of higher rents for premises and office space, which may have forced many entrepreneurs to let permanent employees go, who normally require a workplace in the company. In addition, there are modest employment increases in other regions such as Moscow oblast, Kazan, Voronezh, but also in Krasnoyarsk, which represents regions with 'satisfactory conditions' for SME development. All this indicates the problems of developing an adequate regional taxonomy across Russia in order to explain regional differences in SME development (see also Maurseth 2001), especially in attempting to capture after-crisis changes in the regional institutional and economic environment, both for existing SMEs and for new firms.

Job quality in Russian SMEs

What constitutes job quality in SMEs?

Job quality is commonly described in terms of working terms and conditions within enterprises. Earnings are an important dimension of job quality, although other non-monetary benefits and working conditions, such as working hours and days, job stability and turnover, social security and opportunities for skills enhancement also need to be considered. Such factors may vary with enterprise size but also by sector, demographic characteristics, such as gender and age of employees, and the level of education and professional training (Storey 1994, Wagner 1997). Furthermore, legal regulations play a role in determining the terms and conditions of employment, e.g. through introducing minimum wages, regulating working hours, holidays and worker participation and regulating dismissals. The level of skills required for different jobs is another commonly used surrogate criterion to define job quality, where low-skilled jobs are commonly categorised as poor quality employment.

As a result, some authors have concluded that the quality of employment in small firms is lower than that in large companies, because of the generally lower level of skills required in smaller enterprises, and combined with lower wages. Such a view is supported by a review of the research evidence on the issue, which concluded that

> the evidence from both the UK and the USA suggests that, according to most measures, the job quality provided by small firms is lower than that in larger firms … wages are lower, training is less frequent and the evidence for a compensating higher level of job satisfaction is weak.
>
> (Atkinson and Storey 1994: 11)

Moreover, studies undertaken in Germany would appear to support this view (Wagner 1997, Semlinger 1995, Leicht and Castello 1998). At the same time, other research suggests that some of the differences in employment conditions in large and small firms may be associated with sectoral factors (e.g. in services the use of part-time or temporary labour is a common phenomenon) and structural shifts at the macro level, taking place in economies rather than reflecting firm-size-related factors per se (e.g. Lageman *et al.* 1999, Johnson 1991).

However, the quality of jobs does not solely depend on the skill level and economic conditions, but also on the personal satisfaction of employees, in which entrepreneurs can play a decisive role. Job content is a result of working conditions and remuneration, but also employees' assessment of future prospects, prestige and independence, the demands of the job, and interpersonal relationships (Clark 1998). In this context, work in small enterprises has often been described as including a broader range of activities than is typical in large firms (e.g. Bock 1987) and characterised by a flexible organisation and personal management (e.g. Hilbert and Sperling 1993). While some early research undertaken in Western economies portrayed the world of small enterprise owners and their employees as one where job satisfaction was high and employment relations harmonious (e.g. Bolton Committee 1971), other Western research paints a more critical picture (e.g. Rainnie 1989, Stanworth and Curran 1981). Employee relations in small firms are affected by legal regulations as well as by the type of control exerted by the employer in the firm, which has been described in terms such as fraternalism, paternalism, benevolent autocracy or sweating (Goss as cited by Storey 1994). The employer control or management style is an outcome of the extent to which employers are economically dependent on their employees and the ability of employees to resist any form of 'autocratic' employer behaviour. Age of employers and the sectoral context can play an additional role, in that it has been suggested that younger entrepreneurs are more likely to emphasise co-operative employment relations and more responsibilities for employees, which is a common characteristic of emerging or 'modern' sectors, such as computer-related activities (Hilbert and Sperling 1993), where the competitiveness of a business may depend on its human resource base.

In Russia, as in other transition economies, there is very limited empirical evidence available concerning the question of job quality in SMEs, although the high share of SME employment in the shadow economy (in early stage transition countries particularly) suggests that a high proportion of jobs may be of poor quality. Where research deals with job quality, it typically does not differentiate between SMEs and larger firms. Studies generally discuss the quality of work in terms of the private versus the state sector, although in practice most private firms are likely to be SMEs. As far as patterns of formal employment are concerned, empirical results suggest similar trends to those in Western economies (Clarke and Borisov 1999, Gimpelson and Lippoldt 1999). For example, probit estimates for Russia (based on the 1996 Russian Labour Flexibility Survey) suggest generally less secure jobs in metropolitan areas, in small firms (including small state firms); and in the 'de novo' private enterprises, although no significant differences were apparent in job quality across sectors (Lehmann *et al.* 1998). However, a growing tendency towards temporary employment might also indicate less secure jobs in SMEs. In this context, a study by Avilova *et al.* (1998) showed sectoral variations and wage differentials, with temporary employment being especially prominent in tertiary sectors and also in low-paid and non-prestigious construction jobs. However, our survey data, drawn from a wide range of Russian regions, does not confirm this as a general pattern. Finally, it should be noted that the inadequate social system in transition countries needs to be considered when assessing job quality in small enterprises, since unemployment or unpaid leave may result in employees without sufficient means of support, encouraging them to accept low wage levels.

Labour contracts in Russian SMEs

Our survey allows us to consider job quality in Russian SMEs in terms of labour contracts, wage remuneration, working time (hours and weeks), and employment relations. This section focuses on labour contracts, where most SMEs appeared to fulfil the legal requirements set down by the Russian Labour Code as valid in 1999/2000.[1] For example, the majority of surveyed entrepreneurs claimed to conclude a written labour contract with their employees, with the types of labour contract varying between firms in different age, size and sector groups, while the content of labour contracts mainly are related to enterprise size and age. Older and larger firms reported a preference for written agreements, while younger and smaller firms favoured more flexible (but illegal) agreements. SMEs in industry and construction widely practise enrolment 'on order', which involves the enterprise management simply issuing an order to employ an employee, without a formal contract despite the fact that this Soviet-type of agreement is no longer legal. This might be explained by a larger share of privatised firms in these sectors, which still use 'old' (in the sense of previously common) labour practices. With respect to the terms and conditions specified in labour contracts, contracts in larger and mature firms include more positions, thus raising the level of social protection, as well as job quality.

Survey evidence suggests that every fifth SME enrols either 'on order' or by verbal agreements, thereby violating the labour law. In a previous study with similar results, Clarke and Borisov (1999) pointed out that the prevalence of verbal contracts does not necessarily suggest a deliberate labour law violation. Instead, it may simply be a more appropriate way to regulate labour in very small firms, which implies that the legal framework in Russia has not been adapted to meet the needs of an emerging private sector. Nevertheless, while half of our surveyed entrepreneurs include essential mandatory terms in their labour contracts (such as the position and employment, remuneration terms, date of work start), only one-third also include the legally required provisions for labour protection. Consequently, in two-thirds of surveyed enterprises labour contracts are not legally valid, thereby questioning Clarke's and Borisov's conclusion (1999: 612) that 'illegal forms of contract are not widespread, even in the new private sector'. On the other hand, most surveyed entrepreneurs were willing to include non-mandatory terms into their labour contracts, which formally increased the job security of their employees. This evidence suggests that, despite their violation of the labour law, Russian SME employers are aware and willing to take over social guarantees. The example demonstrates that operating illegally does not necessarily mean that entrepreneurs are operating irresponsibly.

At the same time, enterprise case studies, based on in-depth interviews with entrepreneurs and some key employees, suggested that, in practice, few labour contracts are really used. Employers were either reluctant to talk about labour contracts or showed a lack of knowledge of what the law required in this respect. Employees typically stated that they either did not have contracts, or were unaware of whether they had contracts or not. For example, Natasha, the owner of an agency organising study tours for Russian firms, appeared surprised when asked whether she concluded written labour contracts with her employees: 'Am I supposed to do that? I didn't know', which could only partly be explained by the fact that her firm had been set up in 1991 while the labour law was introduced in 1992. Another entrepreneur emphasised that written contracts were concluded only if employees asked for them. Otherwise, work conditions were discussed orally and employees were enrolled by order, although terms of references and liabilities are set out in a job description, which is signed by each employee. All this (illegal) behaviour was summed up in the statement of another entrepreneur, who owned a small advertising agency, referring to the labour legislation as outdated:

> Therefore, we are sometimes forced to break the law, and in doing so, I realise fully well that I violate the Labour Code deliberately. This is bad. But I have no choice: if I comply with all of its articles, I shall be unable to develop as fast as is required by the market.

While the evidence reported above suggests that such labour law violations are associated with increased labour flexibility for entrepreneurs, this could leave employees with reduced job security. For example, Dimitri, who works as an advertising manager, complained that his employer unilaterally extended his probation period. Moreover, his current wage differs substantially from the remuneration, which they had previously agreed orally. At the same time, interviews with employees also demonstrated their overall job satisfaction, indicating that in the conditions pertaining in Russia in the late 1990s at least, employees cared more about having a paid job than about legal requirements, such as labour contracts and the protection which these might offer. Merely looking at the low propensity of entrepreneurs to make use of labour contracts, which is a violation of the legal requirements, does not necessarily lead to a conclusion that Russian SMEs show low job quality, since employees appeared to be satisfied and the legal requirements do not appear to be enforced. On the other hand, some of the employee interviews also indicated the effect of an asymmetrical distribution of power between employer and employee, where a lack of employment possibilities keeps employees in a company, even if job satisfaction is low. Certainly, drawing conclusions about job quality in Russian SMEs requires more than evidence based on the extent of legal compliance.

Wage policies in Russian SMEs

Various survey data show that wages in SMEs mainly depend on the region, sector and the status of employees, as well as the size of enterprise (IPSSA 1998, Obydennova *et al.* 2000, Russian SME Resource Centre 2002). Wages are highest in business-oriented services, in medium-sized firms and for managers. By contrast, they are lowest in agriculture, in trade and micro firms and also for trainees. Compared with official data, in 1999, employees of surveyed SMEs had higher wages in sectors such as construction, wholesale trade, retail trade and public catering, as well as in agriculture, science, public health, tourism, sports, culture (Obydennova *et al.* 2000). A substantial gap between the official average wage and that in the surveyed SMEs occurred in research activity, public health and cultural activities, although an even larger gap was noted in financial services, transport and manufacturing industry. It should be noted, however, that in manufacturing particularly, the calculation of official wage levels is based on wages in natural monopolies, such as energy, gas and oil industries, where SMEs are largely absent.

Case study evidence shows that a variety of approaches are used by SMEs with respect to remuneration. For example, it was reported that the wages in a small, privatised shop were determined monthly, based on the profit for the most recent period, minus taxes and payments for public utilities. In another company, which was a spin-off from a research institute, the team leader and employee mutually agreed on the level of pay for each new contract secured. Wages could also depend on the pieces produced, the anticipated scope of work and the time required for a specific order (see also Clarke and Borisov 1999); the latter method being reported by a small construction firm in Voronezh. However, this latter entrepreneur also mentioned the frequent introduction of new recommendations for construction firms from the State Department for Construction Management in the oblast. In case the firm does not adhere to them when calculating its wages, the Department threatens withdrawal of its licence, despite the fact that the rules issued are said not to be obligatory for private enterprises, thereby providing an example of the arbitrary nature of the application of regulations in some cases.

Some entrepreneurs additionally use wage incentives to encourage their employees; for example, by offering a higher share of profits to motivated employees. Once again, the study of Clarke and Borisov (1999) shows similar results. For example, the owner of an advertising company reported topping up wages with a percentage bonus of concluded contracts, although she only applies this to the most active employees. Another entrepreneur also indicated using a bonus as well as a penalty system. Penalties, which are imposed for misconduct such as being late or rude behaviour towards customers, may reduce an employee's wage by as much as 50 per cent.

Interviews with entrepreneurs and employees indicated that unofficial payments were made at virtually all firms, in order to reduce taxes and social security contributions, which was to the benefit of both employers and employees. For example, Victor, who owned a publishing house, named this kind of behaviour as normal in his particular trade: 'In a trading business the wage actually paid is several times greater than the officially calculated pay.' A common method used is to officially calculate minimum wages and then to pay a non-registered cash bonus, or contribute to the cost of meals, transportation or other employee costs. Another enterprise repairing electronic household equipment, reported hiring part of its workforce through 'franchising' contracts, i.e. these employees rent their machinery and work station from the enterprise. Interviews with employees show that they value bonus and unofficial payments, as well as pointing to other advantages of working in private SMEs. One employee, working both at a research institute and in a private spin-off company, was less concerned about the level of wages in the private firm in which he was employed than the fact that wages were paid, which he stressed was a major advantage, compared with the state-owned research institute, in which he also worked, and which often does not pay any wages for months. However, another employee, temporarily employed as a production worker in a construction firm, viewed the level of payments as crucial for any job he takes: working conditions are secondary, provided the money is good.

Employment relations and human resource issues in Russian SMEs

Although most of the literature relating to SMEs and employment has focused on the contribution of SMEs to employment generation, there is also a substantial body of research in western countries concerned with employment relations in SMEs and a variety of human resource management issues. These include questions such as: under what conditions do small firms enter and interact with labour markets? How do they recruit? How do they deal with employment related problems? To what extent do they train workers and what methods do they use? Underlying these questions is the idea that SMEs have distinctive characteristics in comparison with larger firms, which affects the way in which they use and manage labour. These characteristics include the behavioural patterns that stem from the common coalescence of ownership and management; their more limited resource base; and the lower level of ability to control relationships with elements of their external environment, compared with larger firms.

Recruitment in Russian SMEs

Research undertaken in mature market economies shows that recruitment in smaller firms is typically more irregular, less predictable, less capable of systematisation and more likely to be a critical event than in larger companies. In addition, individual small firms are less able to shape or influence local labour market conditions than larger firms. Other issues investigated concern the methods used to find and select recruits, which tend to be more informal than in larger firms, emphasising subjective criteria that are often related to the personality of the person responsible for recruitment and their informal networks (e.g. Hilbert and Sperling 1993). Moreover, since human resource management is typically the last management function to be delegated, as firms grow in size, the recruiter is typically the owner of the firm.

Evidence from Russia confirms a similar pattern, showing that small firms typically use informal recruitment methods, relying on subjective criteria when making a selection (see also IPSSA 1998). Our survey data and case studies illustrate that personal recommendations are considered crucial when staff are hired, and that SME employers mainly recruit (through) friends, relatives and colleagues. For example, the owner of a SME, specialising in the installation of local telephone exchanges, illustrated what this means in practice, when she explained that most of her employees are recruited through her brother who also works for her firm. As her brother is a mountaineer, many of the employees are mountaineers also and the owner trusts her brother not to hire bad people. Other studies confirm this evidence, showing a picture of entrepreneurs turning to relatives, friends and former colleagues rather than relying on more formal methods of recruiting, such as advertisements or the state employment centres (Avilova *et al.* 1997, Clarke and Kabalina 2000). Although there are numerous state-owned and private labour exchanges in the regions and especially in large cities, these potential sources of employees do not play a major role for SMEs in practice, because entrepreneurs consider them to be less efficient than informal sources.

In our survey, it was mainly micro-enterprises (i.e. those with fewer than ten employees) and new businesses that preferred the help of relatives and friends in recruiting their personnel, with more formal sources being more commonly reported by larger and more established SMEs. Entrepreneurs feel it is easier to overcome the problems faced in the initial phases of new venture creation with employees, who are known and considered loyal to the business owner, which is one of the main reasons they favour recruiting staff through family and friends. There were also sectoral variations, with firms in trade and consumer-oriented services showing the highest propensity to rely on informal sources of recruits (42 per cent and 36 per cent respectively), since neither sector typically needs specialised and highly-skilled employees, prioritising instead reliable employees who can be trusted to keep ‘secrets’, especially where ‘black market’ deals are concerned.

Although ‘objective’ criteria (mainly qualifications, education and former work experience) played an important role in hiring employees, Russian SME owners also stressed a variety of subjective factors such as ‘decency’, ‘initiative and energy’, ‘responsibility’ or ‘discipline and efficiency’, although there was some variation according to the employment position. In our survey, entrepreneurs were asked to state the three most important criteria they applied when selecting new employees. Professional experience and the level of skills ranked first for executives and managers. When the three most important characteristics were combined, motivation, creative abilities and discipline were the most commonly mentioned. In the case of other employees, entrepreneurs identified professional experience and discipline as the most important characteristics. When the three most important characteristics were combined, age, motivation and multifunctional abilities were the most commonly mentioned, identified by nearly one-quarter of respondents in each case.

The role of multi-tasking, which is a common requirement for employees working in small firms may be illustrated with reference to one of the cases of a small firm involved in construction, renovation and the installation of ventilation equipment and sanitary goods. The owner of this firm reported constantly looking for ‘jacks of all trades’, as his company cannot afford too many specialists. In his own words, he would ‘rather hire a “tiler” who can also do house painting, plastering and bricklaying’ than a specialist who can only undertake a single task. In addition, the entrepreneur reported preferring older, mature workers, who he considers to be more disciplined, compared with younger workers, who are typically more ambitious and pushy, as well as asking for higher wages.

Case studies can also be used to illustrate what it actually means when entrepreneurs report using informal and personalised recruitment criteria, rather than only looking for job-related skills and professional experience. For example, an entrepreneur owning a retail store emphasised his willingness to take on employees without any sales experience, provided he likes them and judges that they will fit in to his company. Another entrepreneur, involved in manufacturing doors and windows, referred to ignoring previous professional experiences because this is typically unsuitable in his firm, where modern production techniques are used. His emphasis was on a ‘good brain’, which allows employees to quickly master a new trade.

The emphasis placed in recruitment on recommendations from well-known and trusted sources is linked to a lack of institutional trust by Russian entrepreneurs (see Chapter 3, above). While a reliance on personal contacts may be a rational reaction when seeking to secure resources in a turbulent environment (Welter and Havnes 2000, Welter 2003), the strategy may be less suitable as a basis for the long-term development and growth prospects of SMEs. For example, although most entrepreneurs interviewed in the case study emphasised the benefits of informal recruitment practices in contributing to the high commitment of their employees to the business, they also stressed the difficulties of finding suitably qualified personnel from amongst their friends and former colleagues who would be needed to grow their enterprises in the long run. This is illustrated by the case of a small construction company in Voronezh, where the entrepreneur reported requiring a recommendation from someone she knows and trusts, before she will employ a new recruit who is unknown to her. However, in instances where specialist employees are required, the entrepreneur asks friends who have connections in the construction industry, although she recognised that this method of recruitment is not helping her successfully to grow her firm.

Skills issues and training in SMEs

The weak institutional environment in Russia appears to be associated with shortages of skilled labour, reported by SMEs. For example, 42 per cent of firms in another survey of Russian SMEs, engaged in intellectual and information technologies, claimed difficulties in finding skilled employees (Avilova *et al.* 1997). Although this might seem somewhat surprising in view of the generally high education level in Russia, it may partly reflect the underdeveloped nature of the system of labour training and recruitment agencies, in relation to the emerging needs of privately owned enterprises. In our large-scale survey of Russian SMEs and their employees, nearly three-quarters of surveyed SME owners and managers mentioned at least one labour-related constraint on their ability to develop their businesses; and most indicated more than one. Skills shortages rank first, having an identifiable impact on business development in nearly half of all surveyed firms. The high cost of training ranked second, being mentioned by 35 per cent of the surveyed SMEs; while a lack of skilled personnel was the third most commonly mentioned labour-related constraint.

Young and medium-sized firms more frequently reported suffering skills shortages, than other groups of SMEs, suggesting that labour-related constraints become more serious as businesses become established and seek to grow. In terms of occupations, skills shortages appeared most pronounced for executives and managers, being mentioned by 46 per cent of those entrepreneurs claiming skills shortages as a problem, while 39 per cent reported experiencing problems in recruiting production workers. Recruiting production workers appeared to be a major constraint for construction firms (60 per cent mentioned skills shortages for production workers), while sectors where ‘new’ skills are required (such as business services) complained of a lack of skilled executives. For example, more than half of the surveyed business services enterprises and nearly half of trade firms reported experiencing skills shortages for specialists. Case evidence shows that, although Russian employees have often acquired a high level of education and professional training, acquired either at higher education institutes or through vocational education, they are often unable to use their skills and/or professional experience in their present jobs. For example, one interviewed employee, who graduated from the Moscow Aviation Technology Institute, currently works as a carpenter in a manufacturing company. After graduation he started working in his profession as a design engineer, but took unpaid leave because of the low salary. He then worked as a salesman for his friend, a shuttle trader. Since plans to start a shuttle business[2] did not work out, he decided to join the present company.

While a lack of adequate employment possibilities for qualified persons is a key contextual factor, there is also a skills mismatch in the labour market, associated with the slow pace of its adaptation to the needs of the emerging private sector. Much SME development is in services and lighter manufacturing, whereas workforce skills often reflect the previous emphasis on heavier manufacturing industry and technical competence instead of customer orientation (Standing 1996). This may be illustrated with reference to an employee in a radio equipment company, which is a spin-off company created by employees from the Research Institute of Communications in Voronezh. The founder originally qualified as an engineer, yet currently works as a marketing expert on a temporary basis, insisting that he had no experience in this field when invited to apply for the job: ‘When a person is offered a job like this, it is likely they consider the human qualities of the candidate, and I do have a certain degree of communicability.’

One conclusion that emerges from the survey of SMEs is a need for improved workforce training that is more closely oriented to the needs of SMEs operating within a market environment. Research in mature market economies has shown that where small firms are involved in training, the dominant training activities are mainly concerned with the application of existing skills to the requirements of individual businesses, or the spreading of existing skills in the workplace to the employees, rather than with a systematic and formal ‘ab initio’ acquisition of skills (Atkinson and Meager 1994). This is achieved mainly (and sometimes exclusively) through on-the-job methods.

Most of the Russian firms assessed on-the-job training as the most important source of job-related skills, while skills gained through previous working experience was second. This can be explained, first, by the fact that informal and trust-based recruitment practices do not necessarily guarantee the best employees in terms of skills needed in the firm; and second, by the fact that the Russian training system fails to produce multifunctional employees, tending to neglect practical training, especially as far as new sectors are concerned; and third, that vocational training schools in Russia have collapsed in recent years. When asked which type of training they considered useful, entrepreneurs frequently pointed to a variety of short-term courses (such as computer, accountancy and training courses for sales personnel), participation in seminars, trips abroad, trainee jobs at other firms; but also to self-education. A higher education was valued more by entrepreneurs in business-oriented services than in other sectors, particularly those in trade and consumer-oriented businesses, where it was not highly rated at all. A degree from a vocational training school was valued by entrepreneurs in the construction and manufacturing sectors. Interestingly, trade and service SMEs showed the highest propensity to assess previous experience negatively, which might hint at obsolete and outdated knowledge, as reflected in the case evidence reported above.

The Russian Labour Flexibility Survey suggests that private firms have a lower tendency to train their workforce than state-owned companies (approximately 60 per cent compared to 90 per cent in state enterprises). Moreover, small enterprises have a lower propensity to train their employees than larger firms, which applies to all forms of training such as 'initial training', 're-training' and 'skills upgrading' (Standing 1996). Informal training, however, plays a major role regardless of ownership and accounted for 85 per cent of all training in the surveyed enterprises. Although there is limited empirical evidence available, some research results suggest a similar picture exists in other transition countries. For example, research results for the Baltic states show that where staff training occurs in (manufacturing) SMEs, it is more typically informal and 'on-the-job' than involving sending employees on 'off-the-job' training courses (Smallbone *et al.* 1996a).

In this context, the high share of SMEs offering informal, on-the-job training does not come as surprise. A significant minority (43 per cent) of firms in our sample reported offering training 'on the job', while a further 38 per cent offer 'off-the-job' training possibilities. However, the latter is mainly either for the entrepreneurs themselves or for accountants, and is mainly found in firms in the manufacturing and business services sectors. Case studies help to demonstrate what constitutes on-the-job training in Russian SMEs in more detail (Box 4.3). Formal training systems, as shown in the first example, are the exception, and these can apparently only be financed through co-operation with an external agency. For example, co-operation with suppliers of goods and materials through product-related seminars is a common way of training employees in SMEs, not only in Russia, but also in Western countries (Lageman *et al.* 2004). Where the company relies on informal training 'on the job', entrepreneurs often involve other employees in the process, although, as the evidence from Box 4.3 shows, this can sometimes cause problems. Employees appear reluctant in those cases, where they fear in-house competition, plus experiencing a higher workload and no (monetary) incentives for the training they offer.

Box 4.3 Examples of training in Russian SMEs

Company A: A formal training system: The manager of this small company, which services and repairs household electronic equipment, is keen on 'fostering competent managerial personnel at the firm'. It was reported that a sound training system was already in place, partly because of the firm's background as a former state-owned company. This includes regular training of employees through a business incubator and lectures at the Voronezh Polytechnic University (sponsored through the 'Eurasia' Foundation). Additionally, some of its employees are external students at institutions of higher learning, while others have the opportunity of participating in skills upgrading courses organised by the firm's suppliers of radio-electronic goods. However, employees are expected to contribute to the cost of training. The manager outlined three options of payments: the (potential) customer pays all; the costs are split between this firm and the employee, or the employees pay on their own. The entrepreneur explained that usually he did not experience any problems with this method, as it is not so much that management direct them [his employees] to take a training course, but rather they themselves respond to any opportunity to upgrade their knowledge so as to be still better conversant in Western radio-electronic goods, and therefore they are willing to pay part of the money for training.

Company B: Informal training 'on the job': On-the-job training is compulsorily arranged in this publishing house for new employees who lack special skills needed in the firm. However, employees appear reluctant to train their fellow employees. One of the employees we interviewed, a programmer, stated that he hated complying with this, referring to 'needing no competitors'. External training is only practised where employees are interested; willing to organise it themselves; and willing to pay for themselves. The firm welcomes their initiatives, but does not contribute, with the exception of paying for training for their accountant. Generally, the entrepreneur shows a biased attitude towards formal training: 'The employees undoubtedly derive certain benefits from all these courses. Yet, one cannot learn a trade attending a course; one can only obtain some additional information there.'

Company C: Informal training through specialised employees is also practised in another small firm, specialising in the installation and repair of local telephone exchanges. The owner-manager reported hiring a programmer with a good knowledge of English, as the entire technical documentation is written in English and also an electrical engineer. Besides their normal workload, both employees are responsible for introductory training within the firm. Asked whether she paid them extra for this job, the manager claimed that 'honestly, I never thought about this.'

Source: own study (Appendix, Project 9, p. 241)

Labour flexibility

SMEs are often said to be more flexible in the use of labour compared with larger firms. In this regard, we can distinguish two main types of flexibility: numerical flexibility and functional flexibility (Atkinson 1985). Numerical flexibility refers to the ease with which a firm can acquire and dispose of labour, enabling it to adjust employment levels to variations in workload. This normally implies a changing balance between the employment of 'core' (i.e. full-time, directly employed skilled workers) and 'peripheral' workers (i.e. part-time workers, outworkers, and the self-employed). The externalisation or outsourcing of production (via subcontracting) may also provide a way of achieving greater numerical flexibility, as it reduces a firm's dependence on its own 'permanent' workforce, who represent a fixed overhead cost to the firm. The achievement of greater functional flexibility relates to changes in job content and includes the breakdown of skill divisions within the workforce. It also involves reduced demarcation and the movement of workers between different tasks (i.e. a shift towards multi-skilling). This can enable a firm to make fuller use of its workforce as well as being able to adjust more easily to changes in production technology.

Labour flexibility in Russian SMEs was evaluated by asking entrepreneurs about their strategies in the event of any changes in demand for their product and services. The majority of surveyed Russian SMEs reacted to fluctuations in demand using *numerical flexibility*, although in most cases, the tendency was to retain staff if possible because of the previously reported preference on the part of owner-managers towards hoarding labour. Only a small minority (16 per cent) of respondents saw no need to resort to numerical flexibility at all, which means that most SME owners were in the habit of changing their labour input in this way, at some time. Growing monthly or yearly demand typically results in increasing working hours of existing employees, which is reflected in the fact that more than half of the surveyed SMEs reported making use of overtime working. Around one-third hire temporary employees. A declining yearly (monthly) demand results mainly in postponing or cancelling the appointment of replacement staff, followed by unpaid leave and a reduction in overtime. Dismissals play a lesser role, indicating a shortage of specialists and the tendency discussed earlier to hoard skilled labour rather than to shed it, at least in the short term, particularly in sectors where entrepreneurs find it difficult to recruit labour with the requisite skills. For example, knowledge-intensive sectors such as business services are especially reluctant to dismiss employees. The construction sector showed the highest rate of dismissals: with nearly one in three enterprises reducing their workforce monthly; and more than 40 per cent yearly.

Case studies indicate that SMEs also use *functional flexibility* to deal with skills shortages (see Box 4.4). In most of these cases, instead of searching for specialists, employees who originally were hired for simple tasks take on additional responsibilities within the firm. Moreover, looking at the professional background of the interviewed employees, one could argue that most employees show functional flexibility, as they regularly fulfil jobs which do not comply with their original tasks and/or qualifications. Interestingly, functional flexibility, as practised in many small Russian SMEs, does not only assist the entrepreneurs in solving labour-related bottleneck, but can also open up career paths for employees.

Box 4.4 Functional flexibility in Russian SMEs

Employee A: From teacher to personal assistant and salesperson: An example is Olga, who graduated from the Moscow Teacher Training School. She initially worked at a public comprehensive school, before proceeding to working as a technician at the Institute of Sociology of the Russian Academy of Sciences. Her third job had been an accountant in her brother's shop. When her brother went on tour with a small travel agency, he learned about a vacant position for an assistant manager, for which he recommended his sister. Olga started working for the travel agency in 1996, with duties which included secretarial functions, such as the execution of contracts and tourist vouchers, the acquisition of visas and general errands for the firm's management. Over the time, her responsibilities and tasks broadened, shifting from the duties of a routine secretarial and personal assistant to working with customers and concluding tourist contracts on her own.

Employee B: A cutter, who turned cleaner and then became an assistant cook: Antonia was working as assistant cook in a small retail store specialising in foodstuffs, at the time of the interview. For 20 years, she had worked as a cutter at a tailor for ladieswear, before being laid off in 1995. While searching for employment over the next year and a half, she tailored at home, in order to earn some income. She met her current employer through close acquaintances who recommended her, initially being employed in the firm as a cleaner. When the entrepreneur decided to open a room to sell half-finished material, he offered Antonia the position of assistant cook. Although Antonia values her current employment, she deeply regrets that her qualifications and previous working experiences are no longer of any value. Interestingly, she herself does not consider the job move within the firm as a promotion.

Employee C: From unskilled worker to chief manager: Igor joined his present company in 1995 as a foreman for workers laying cables for telephone exchanges. He has incomplete higher education, having spent three years at the Moscow Physical Technological Institute and a further three years at the Moscow Aviation Institute. Previous working experience consisted of several jobs, mainly as a builder during summer time. During his first year at the firm, Igor had been promoted to manager, after which the entrepreneur had created the new position of Chief Manager for him. Igor is now responsible for acquiring customers, negotiating with them, drafting and concluding contracts and general relationships with customers during guarantee periods.

Source: own study (see Appendix, Project 9, p. 241)

A form of labour flexibility that is rather specific to the Russian context is *financial flexibility*, achieved by a reduction in wages. In response to the Russian crisis in 1998, it has already been mentioned that a common initial response by firms was to reduce wages, as a form of labour adjustment, designed to reduce costs, as a key element in a firm's survival strategy. For example, Katya, owner of a pet shop, mentioned that they reduced salaries to adjust to the 50 per cent decrease of sales following the crisis in August 1998. This may be conceived as offering financial flexibility to the employer, as a short-term alternative to changing the hours worked or the total number employed. Employees accept such reductions, in the absence of either alternative employment or an adequate social security system.

Conclusions

The empirical evidence presented in this chapter suggests that SMEs are making an important contribution to employment and labour-absorption capacity in Russia, during the transition period when other sector of the economy were not creating employment. Overall, SMEs appear to rely mainly on permanent rather than temporary labour. The tendency to hold on to workers that they felt trustworthy contributed to entrepreneurs tending to hoard rather than shed labour at the time of the Russian crisis in 1998, albeit with lower wages. At the same time, empirical data also indicates that SMEs face labour-related constraints, as well as a distorted institutional and legal environment, which together hinder the ability of SMEs to fulfil their job-generation potential. This is exacerbated by regional variations with respect to the progress with the overall economic reforms, in which Moscow and St Petersburg are the leaders, while provincial capitals and, even more so, small towns and rural areas lag behind. While the conditions and business climate prevailing in the Moscow of the mid-1990s are now established in most of the regional capitals, SME development is still lagging in the peripheral regions.

While SMEs might overcome most labour-related problems in the short run through their own actions, skills shortages and other labour-market constraints are likely to impede their longer-term development and competitiveness. This is because, in the transition context in Russia, entrepreneurs need to concentrate on coping with day-to-day operational problems, rather than investing in longer-term business development. In this context, entrepreneurs in the survey considered higher product quality as their foremost priority to improve competitiveness. One of the requirements to achieve this would be to increase the supply of skilled labour to the firm, emphasising the role the Russian labour market has to play in facilitating the development of the SME sector. However, achieving this is not helped by the outdated legislation on labour issues, which appears inappropriate to the needs of privately owned SMEs, as well as incomplete, often contradictory and of a declarative nature. With respect to labour law, both survey and case study evidence demonstrate a high level of (involuntary) law violation, both on the side of employers and employees in SMEs. Overall, this indicates a need to simplify the labour legislation for SMEs to allow for legally processed contracts, as well as an attempt to ensure the interests of employees are protected.

In the context of remuneration and job safety, the high contributions of employers to social insurance and pensions funds force a considerable number of SMEs to shift wages and employment (at least partially) to the informal sector. Any attempt to shift social payments mainly onto employers would be likely to increase this trend. The problem in this regard is to strike a balance between the interests of SMEs (low labour costs and their ability to create jobs in the formal economy) and the need to protect employee rights and working conditions. Furthermore, if small enterprises are to develop on a sustainable basis in the formal part of the economy, there is a general need to review the tax burden and the effect of the complicated tax and legislative regime on enterprise development. In many western countries, recognition of the effects of compliance costs on small firms has led to regulatory simplification as a key element in SME policy. Attempts to achieve this in Russia so far have not been effectively implemented.

The easiest way of generating employment in the short term is to support the creation of new enterprises. The most immediate priorities in Russia, in this regard, are to reform and establish appropriate institutional, legal and tax frameworks and to create an economic and political environment, which encourages entrepreneurs to start firms (Johnson *et al.* 2000). A major constraint facing Russian SMEs with respect to developing and contributing to employment concerns the implementation gap, which typically applies to new laws and regulations, due to weak legislation and a weak implementation system. For example, the lack of co-ordination between federal and regional laws and a failure to control the regulatory activities of branches of federal ministries operating in the regions leaves too much discretion in the hands of local officials, with respect to interpretation of the law. The result breeds corruption and creates a climate of legal uncertainty. While the legal framework is a necessary first step, it is not a sufficient condition for supporting SME development in Russia. An even more important step in creating adequate conditions for SME development involves institution building, such as support for business organisations to allow for improved communication between SMEs and government administration. Finally, policy makers have to find an appropriate balance between the interests of employers and employees, which is a necessary part of establishing the governance mechanisms appropriate to the needs of a market economy. There is real need to tackle this issue at a political level if SMEs are to be both subject to the (employment) law and be protected by it.

5 Coping with adversity

The case of Belarus

Introduction

In focusing on Belarus, this chapter is concerned with a country where the environment for private business development is hostile, essentially because of a lack of political will and commitment on the part of government to the process of market reform. Following a review of where Belarus has reached in the reform process and an overview of the development of the private sector hitherto, the discussion focuses on regional differences in entrepreneurship in the country, where a number of distinctive features related to transition are identified, mainly with respect to the role of government. This is followed by an identification of some of the 'strategies' that entrepreneurs use in Belarus to deal with the specific and difficult operating environment which they face.

Progress with market reforms

In the early 1990s, with support from international organisations, Belarus introduced reforms to move towards a market economy, which included some price liberalisation and small-scale privatisation. However, a combination of inadequate macro-economic management, a lack of protection for property rights, and the disruption caused by the breakdown of the former Soviet Union, led to an acceleration of inflation and the collapse of GDP, as well as to the emergence of serious governance problems (World Bank 2003). Moreover, the election of President Lukashenko in 1994 brought a halt to the process of market reform, replaced instead with an emphasis on price controls and a significant share of GDP being allocated to social expenditure and subsidies. In addition, since 1994, state power has been consolidated in the executive branch of government.

Based on EBRD assessment, Belarus is one of the transition countries where slow progress has been made with respect to the framework conditions required to establish a market economy. In fact, together with Turkmenistan, Belarus is currently at the bottom of the EBRD league table in this regard and has been for many years (EBRD 2005). Interpretation of the EBRD summary indices characterises Belarus as having a modest level of large-scale privatisation (although more progress has been made with small-scale privatisation); few reforms to promote corporate governance, which is associated with tax credits and subsidy policies weakening financial discipline at the enterprise level; maintenance of price controls for important product categories, with much of public procurement being undertaken on the basis of non-market prices; some liberalisation of foreign trade, but with a foreign exchange regime that lacks transparency; limited progress with banking reforms and in the development of other financial institutions; and little progress with infrastructural reforms. In addition, it would appear that Belarusian entrepreneurs have to cope with numerous administrative interventions from the government, which not only slows down the reform process, but rather contributes to reversing it. In such circumstances, it is hardly surprising that entrepreneurship and private sector SMEs have been slow to develop in Belarus because the external environment is not an enabling one.

During the Soviet period, the Belarusian economy was oriented towards industrial production, mainly in sectors such as heavy engineering and metallurgy, with a large component for military production. However, with the collapse of the former Soviet Union, the demand for Belarusian products fell sharply, which was reflected in a continuous decline of GDP until 1995. Dependent on the former Soviet Union for 90 per cent of its energy and 70 per cent of raw materials, and with exports almost exclusively going to former Soviet republics, the Belarusian economy has been extremely vulnerable to external shocks, particularly after the human and financial consequences of the Chernobyl accident in the 1980s. Low average incomes, combined with a population of just ten million, contribute to a small domestic market, in comparison with its neighbours in Poland, Ukraine and Russia, which is one of the economic factors constraining private sector development.

Despite increasing GDP and industrial gross output (at constant prices) since the late 1990s,[1] the longer-term development of the economy is uncertain, not least because some of the positive developments can be attributed to centrally imposed, rather than market-based decisions. For example, the expansion of heavy industry exports to the NIS, particularly to Russia, which were mostly bartered in exchange for gas, continues to be one of the factors contributing to the increase in GDP. The growth rate of real GDP amounted to 11 per cent in 2004, although slowing down again in 2005 (EBRD 2005). In addition, private housing boomed because of soft state credits, leading to a growth in output in the construction sector. However, export growth has subsequently turned into a relative decline and foreign investment in the country remains at a modest level (Welter *et al.* 2008). Overall, there is little indication of sustainable attempts to restructure the Belarusian economy.

The approach to economic management in Belarus has involved keeping a majority of productive resources under state control, linked to a strong administrative system that encompasses all levels of government. Negative consequences have included excessive regulation, associated with a need to exercise control over productive assets and transactions in the economy, which has led to complex and expensive systems of inspection and control of enterprises.

Negative consequences have also included frequent changes of the rules (i.e. laws, decrees, regulations) governing business activity, which are associated with attempts on the part of the authorities to tackle the immediate problems of (state-owned) businesses.

The consequences for private sector business development are apparent in the results of a regulatory costs assessment, undertaken by the IFC, which involved a survey of 625 businesses in December 2001 (World Bank 2003). This revealed that it takes an average of 59 days to register a business in Belarus, which is more than twice as long as in Ukraine (26 days), at an average of three times the cost (i.e. $223 compared with $66). In addition, entrepreneurs in Belarus referred to deterioration in the business registration process compared with one, three and five years previously. In addition, the same study suggested that businesses in Belarus are more rigorously inspected than in other former Soviet countries. While the frequency of tax, fire and sanitary inspections was said to be comparable with Russia and Ukraine, there are additional agencies in Belarus, which add to the regulatory burden on businesses. This includes the existence of a State Control Committee, with the power and broad authority to control prices, contracts and all aspects of the operation of enterprises. Private businesses in Belarus face a permanent oversight of their affairs by state bodies, which include control over contracts between companies. The overall picture is one where businesses are never free from meddling by state officials, with little recognition of the effects of compliance costs on businesses and, more fundamentally, on the contribution of the private sector to economic development.

Development of the private sector during the transition period

In this context, it is hardly surprising that the number of privately owned enterprises remains small and their contribution to economic development limited. In the assessment of the World Bank (2003), the level of development of private businesses in Belarus lags behind all neighbouring countries. Price controls affect the profitability of private firms. SME development is also hampered by an inefficient and distorted banking system; and limited privatisation risks crowding out private sector development from certain sectors of the economy. Moreover, inadequate and imperfectly implemented legislation aggravates the situation. Bankruptcy laws are not always enforced on state companies, which means that some continue to operate despite being loss-making. This contrasts with an increasing tendency for the government to issue restrictive laws and regulations on non-state-owned businesses, which hinders the efficient development of the private sector.

As in other transition countries, the development of small enterprises in Belarus has not been constant over time. Following the adoption of the law on co-operatives in the former USSR in 1987, small non-state enterprises began to be developed in the form of co-operatives, of which 6,000 were registered by the beginning of 1991. Co-operatives represented the most politically acceptable form of non-state-owned enterprise during the first stage of the reform process, since any profits or surplus were distributed between employees (members) of the co-operative, in proportion to their participation.

However, in practice, many of the more active entrepreneurs in the early 1990s ignored the legal rules, which defined co-operatives as worker co-operatives, and instead established entities with just one or two owners and hiring labour. Since this was also a period when state-controlled prices were considerably below those of the free market, another feature of entrepreneurship at the time was the distribution of property by state officials to those close to them, often at considerable financial gain, which represented a form of institutionalised corruption. This is a particular form of the so-called 'nomenclatura' entrepreneurship described in Chapter 3, which contributed to a negative image of business ownership amongst the population at large, as well as squeezing out more legitimate forms of entrepreneurship in certain sectors.

Following the initial period of 'co-operative' development between 1987 and 1991, the period 1992–1995 may be characterised as one when entrepreneurship developed rapidly, as price controls were relaxed. For example, in the 12 months from July 1992, the number of small enterprises in Belarus doubled, mirroring the explosion of small business activity, experienced by other transition economies in the early 1990s. However, the absence of a small business support infrastructure, combined with outmoded and constantly changing legislation, contributed to what has been described as 'the haphazard development of the private sector' during the period (Godunova and Koroleva 2002). High taxation (representing up to 70 per cent of profits) encouraged informal sector activity, which is estimated to account for between 40–85 per cent of GDP in Belarus, with the precise figures varying according to the methodology employed to measure it (Romanchuk 2002).

The early 1990s also saw the establishment of a number of science- and technology-based enterprises, as the funding of state science programmes was cut and entrepreneurship was seen as one of the options for technical and scientific staff affected by these cuts. However, few survived and many of the entrepreneurs who set up technology-based firms in the 1992–1995 period, were forced to move into other activities (such as trade) because of the hostile external environment and resource constraints. This pattern is not unique to Belarus, but is also found in other former Soviet republics, where scientific research was concentrated. It is a consequence of the 'system collapse', which the demise of the USSR represented.

Godunova and Koroleva (2002) divide the development of private business in Belarus into two main stages: first, the period up to 1996, when the number of small businesses grew rapidly, albeit in the absence of a comprehensive legal framework and support infrastructure for private business; and second, after 1996, when the introduction of strict state controls over the activities of private businesses actually led to a decrease in the number of private companies. The very slow pace of privatisation, combined with an increase in the regulation of small enterprise activity after 1996, forced many small firms into liquidation and others into operating abroad in countries, such as Poland, Russia, the Czech Republic, Latvia and Ukraine, as the regulation of entrepreneurship in Belarus became tighter and increasingly centralised. The effect of an increasingly hostile regulatory stance on the part of government towards the private sector led to legislative changes in 1996, which resulted in 54 per cent of all registered enterprises becoming illegal because of new registration rules, driving many firms out of business (Zhuk and Cherevach 2000).

The required re-registration involved approximately 12,000 state companies, 63,000 private firms and 167,000 individual entrepreneurs (Skorbezh 1998), although only half of the private companies and individual entrepreneurs succeeded in re-registering their enterprises. Methods used to restrict entrepreneurship included additional requirements for enterprises to obtain licences and a more rigorous approach to the implementation of regulations by tax and other state officials towards private firms than towards state enterprises. As a consequence, the context for small enterprise development in Belarus has been (and is) a hostile one, with conditions for entrepreneurship as difficult as in any of the former Soviet republics. This is supported by evidence reported to one of the authors of this book by a group of entrepreneurs in Vitebsk in 2004, who had invested in cross-border business activity in Russia, which they explained in terms of the more benign environment for business activity there, compared with Belarus.

The overall economic environment has constrained small business development, because of the combined effect of multiple exchange rates, import/export restrictions; poor access to loans and the crisis in the late 1990s caused by the collapse of the Russian rouble. Although government claims to support small enterprises through the creation of a legal environment, the provision of soft loans and the establishment of an advisory infrastructure, in practice little are implemented and credit lines are not fully set up. In other words, an implementation gap exists between the political rhetoric and policy on the ground, which has been a recurrent feature of SME policies in other former Soviet republics (Smallbone and Welter 2001b). As a consequence, in 2004, there were only 3.4 registered small businesses per 1,000 inhabitants in Belarus. Various sources estimate the share of output contributed by private SMEs to be in the range of 6–10 per cent of GDP, with between 6–9 per cent of total economy-wide employment (World Bank 2003). Accounting for just 5–6 per cent of total industrial output, the small contribution of manufacturing SMEs and their continued stagnation has been identified as one of the major barriers to increasing the competitiveness of the manufacturing sector in Belarus.

It has been suggested that if large enterprises producing consumer goods, agricultural equipment and industrial vehicles for export are to improve their export competitiveness, the development of a network of industrial SMEs, competing to supply parts and sub-components to them is essential (World Bank 2003). Another important potential role for small private firms in a transforming economy is as middlemen (i.e. retailers and wholesalers), which are an integral part of the economic structure in a mature market economy. In Belarus, it has been suggested that the aggressive regulatory stance adopted towards this sector is at least partly ideological, reflecting a view of entrepreneurs engaged in this type of activity as speculators, not just by government, but by the population at large (Zlotnikov 2000).

According to legal definitions in Belarus, small businesses come in two organisational forms: first, small businesses as legal entities; and second, as individual entrepreneurs, without the status of legal entity. However, the size cut-offs defining what constitutes a ‘small enterprise’ varies between sectors: fewer than 100 employees in manufacturing and transport; fewer than 60 employees in agriculture and R&D; fewer than 50 employees in construction and in wholesaling; fewer than 30 employees in food catering, consumer services and retailing; and fewer than 25 employees in other sectors (Godunova and Koroleva 2002). Data on individual entrepreneurs in the country is limited to tracking their overall number and the tax receipts they generate by the Ministry of Taxation and state agencies. Based on these data, 228,000 individual entrepreneurs were reported to be registered in 2004 (Slonimski and Slonimska 2005). This only amounts to 23.5 individual entrepreneurs per 1,000 inhabitants compared to 42 in the Ukraine and 30 in Moldova, thus underlining the adverse business environment in Belarus, even in comparison with other former Soviet republics. It also indicates the problems involved in measuring the level of entrepreneurship in the country.

According to official statistics, there was an increase of almost 20 per cent in the number of registered small enterprises in Belarus between 1997 and 2002, although most of this occurred in 1998, which was the year after the change in the registration rules (Table 5.1). Between 1999 and 2001, the number of registered small enterprises actually declined, by about 6 per cent, although the number of individual entrepreneurs is reported to have increased during the same period, by about 37 per cent. In fact, Belarus is the only transition economy, in which the number of private SMEs actually decreased in 2000, 2001 and 2002 (World Bank 2003), although the total number increased again after that. Godunova and Koroleva (2002) explain the fall in the number of small firms in the 2000–2002 period in terms of the more costly and more frequently modified registration procedures for small businesses, compared with individual entrepreneurs; lower market-entry costs with lower associated risks to be borne by individual entrepreneurs; and a lower tax burden, with simpler taxation and accounting procedures.

It should also be noted that not all of the registered enterprises may actually be active. The limitation of official business registration statistics in this regard is not confined to Belarus, having previously been noted as a general issue facing transition economies (Chapter 1). According to the Ministry of Statistics and Analysis, only 25,404 of the 27,768 registered enterprises at the end of 2001 had submitted reports outlining their activities to the appropriate state agencies, leaving approximately 10 per cent unaccounted for (Godunova and Koroleva 2002). Although statistical data for medium-sized enterprises is not available in Belarus, estimates have been produced, based on data supplied by the Ministry

Table 5.1 Sector structure of small enterprises in Belarus

By sector	*Number of small business (by the end of year)*							
	1997	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Manufacturing industry	3,696	5,248	5,680	5,895	5,860	6,046	6,877	7,450
Agriculture	343	332	328	337	327	344	316	333
Construction	2,844	3,198	3,457	3,260	3,246	3,412	3,585	3,921
Transport	911	1,193	1,521	1,576	1,603	1,599	1,742	1,861
Trade and public catering	11,873	13,490	13,421	12,085	11,898	12,899	13,147	13,552
Research and development	726	665	627	543	444	414	374	324
Other	3,918	3,968	4,525	4,614	4,390	4,330	4,946	5,383
Total	24,311	28,094	29,559	28,310	27,768	29,044	30,987	32,824

Source: Belarusian Ministry of Statistics and Analysis.

of Taxation. Of the 28,347 non-state commercial entities operating in Belarus in January 2002, 90 per cent were small businesses, implying that the remaining 10 per cent (i.e. 2,943) were medium-sized companies.

Total employment in registered small enterprises increased by 23 per cent between 1997 and 2002 to approximately 330,000, representing about 9 per cent of the total workforce and generating about 8 per cent of GDP. According to Godunova and Koroleva (2002) the extent of the contribution of small enterprise to the economy has changed little since 1996. Not surprisingly therefore, Belarus lags considerably behind neighbouring Central and East European countries, as well as most of the other former Soviet republics, with little sign of any convergence.

As far as types of activity are concerned, business registration data show that in 2004, by far the highest proportion of Belarusian small enterprises were in the trade and catering sector (41 per cent); followed by manufacturing (23 per cent), mainly in engineering and metal working; ‘other’ (services) (16 per cent); and construction (12 per cent) (Table 5.1). However, there is some variation in the share of total employment in small enterprises between sectors, reflecting sectoral variations in the average size of firm, which are relatively small in trade and catering (25 per cent of total employment in small enterprises) but larger in manufacturing (39 per cent) (Table 5.2). There is no official data describing the sectoral breakdown of individual entrepreneurs, although state registration officials estimate that about 80 per cent trade in manufactured goods and food products at city markets, with the rest involved in small-scale production and in the provision of consumer services (Godunova and Koroleva 2002).

Table 5.2 Growth in employment in small enterprises in Belarus

By sector	*Number of employees in small businesses (in thousands)*							
	1997	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Manufacturing industry	87.3	108.8	124.3	128.7	128.6	125.6	146.4	156.6
Agriculture	5.5	5.6	5.5	5.9	5.9	5.8	6.3	7.5
Construction	41.4	51.8	54.1	48.5	48.6	47.9	51.9	58.1
Transport	18.0	21.2	27.5	27.9	28.3	27.5	31.7	33.4
Trade and public catering	79.9	98.3	95.9	85.9	84.3	89.2	98.3	97.8
Research and development	5.0	5.1	5.0	4.3	3.6	3.6	3.2	2.8
Other	33.1	31.1	35.8	32.5	35.4	33.5	39.2	40.0
Total	270.2	321.9	348.1	333.7	334.7	333.1	377.0	396.6

Source: Belarusian Ministry of Statistics and Analysis.

Regional variations in SME development

Marked regional variations in levels of entrepreneurship are a common feature in mature market economies (Reynolds *et al.* 1994), reflecting differences in economic structures, demand conditions and institutional arrangements, which can have implications for the orientation of the population towards entrepreneurship and the ability of the small business sector to develop (Mason 1991). However, in transition economies there are additional factors influencing the regional pattern of SME development that reflect fundamental differences between regions in the process of transformation towards a market-based system, in terms of the extent of privatisation, the attitudes of the population towards entrepreneurship and the pace of institutional change.

Research in mature market economies has also drawn attention to differences in the development paths of small enterprises in different localities and regions that reflect the adaptability of small firms to local external conditions, as part of their strategies for survival and growth (North and Smallbone 1995, 1996, Vaessen and Keeble 1995, Smallbone *et al.* 1999a, Audretsch and Fritsch 2000). Both aspects will be investigated in relation to evidence drawn from the transition context in Belarus.

Core–periphery contrasts

As Table 5.3 shows, there is a marked contrast between the city of Minsk and other locations, with a majority of registered small enterprises being concentrated in the capital. Indeed, Minsk itself accounts for 51 per cent of the total number of non-state-owned, small enterprises plus another 24 per cent of all individual entrepreneurs, compared with its 16 per cent share of the total

Belarusian population. In other words, within the context of a low level of private sector development in Belarus overall, entrepreneurship is considerably more advanced in the capital city than it is in other parts of the country. This reflects more business opportunities associated with higher average incomes in Minsk, which are three times higher than in other regions, as well as other locational advantages, superior infrastructure and a more pro-business stance on the part of local government. Nevertheless, although clear core–periphery differences in entrepreneurship development can be identified, this is in a context where the level of entrepreneurship in the country as a whole is low and the associated contribution to economic development modest. According to official statistics, employment in small enterprises only represents 15 per cent of total employment in Minsk, and 6 per cent of total output (by volume), compared with 3 per cent and 6 per cent respectively in the case of Mogilev, which is part of the country's economic periphery. In other words, regional differences exist but the dominant theme is the low level of entrepreneurship overall.

As in some other transition economies, East–West differences in entrepreneurial activity can also be identified. This is reflected in higher entrepreneurial activity being identifiable in the districts of Brest and Grodno as well as in some western parts of the districts of Minsk and Vitebsk, compared to the Eastern regions of the country. The cities of Grodno and Brest show a similar level of entrepreneurial activity as in Minsk, while entrepreneurial activities are lowest in Gomel and Mogilev. A possible negative factor influencing the entrepreneurial activity of the population in the South-East of Belarus is the radioactive contamination of the territory. The districts of Gomel, Mogilev and Brest suffered most from the accident at Chernobyl Nuclear Power Plant, and they also have a much lower level of entrepreneurship development.

Table 5.3 Regional structure of small enterprises and individual entrepreneurs in Belarus (2004)

Region	*No. of small enterprises*	*No. of individual entrepreneurs ('000s)*	*No. of employees in small enterprises ('000s)*	*Percentage of total employment in small enterprises*
Brest region	2,383	32.3	38.7	9.8
Vitebsk region	2,596	29.1	39.1	9.9
Gomel region	2,646	30.3	41.2	10.4
Grodno region	2,125	26.2	32.0	8.1
Minsk	17,035	59.6	160.3	40.4
Minsk region	3,718	27.2	52.6	13.3
Mogilev region	2,321	23.3	32.6	8.2
Total	32,824	228.0	396.6	100

Source: Slonimski and Slonimska (2005).

Regional differences in SME behaviour and performance

The regional contrast in the number of registered, non-state-owned enterprises per head of population, and in their share in total employment, is paralleled by qualitative differences in the characteristics and behaviour of enterprises. This can be illustrated with reference to some results from a study undertaken in 1998–1999, which involved a survey of 'small' enterprises (employing fewer than 200) being undertaken in Minsk (155 enterprises) and Mogilev (45 enterprises), together with a number of in-depth case study interviews in both cities (see Appendix, Project 7, pp. 239–240). Differences in the pace of privatisation and restructuring were reflected in a higher proportion of collectively owned enterprises existing in the peripheral region (i.e. Mogilev), which in turn was associated with weaker reported enterprise performance. This was revealed in the survey in Mogilev, where firms were significantly less likely to have increased sales in the 12 months prior to the interviews than their counterparts in Minsk and less likely to have assessed the overall performance of their firms as 'successful'.

The experience in other early stage transition economies is that SMEs that have been established through privatisation or collective ownership often need to go through a period of rationalisation and labour shedding, if they are to ultimately survive and develop as private sector businesses. This can give them a different development profile compared with firms formed as a result of 'de novo' business creation, which was observed in a comparative study of manufacturing SMEs in the three Baltic States in the mid-1990s (Smallbone *et al.* 1997b). In addition, higher operating costs in the peripheral region was reflected in Mogilev-based firms being significantly more likely to point to the need to reduce non-wage costs, as one of their main priorities for improving the performance of their businesses, compared with their counterparts in Minsk (58 per cent and 30 per cent respectively).

Another aspect of enterprise behaviour showing some regional variation is with respect to innovation. Innovation is potentially important to businesses, as well as to local, regional, and national economies since it represents an opportunity to gain competitive advantage which is potentially more sustainable than that based mainly on price. In terms of product innovation, the 1998 survey evidence showed a marked regional contrast between enterprises in Minsk, where 52 per cent of surveyed firms reported product innovations, compared with just 15 per cent of firms in Mogilev, where the level of innovation was consistently lower across the sector, size and age groups. This reflects the less dynamic nature of those privately owned firms established in the peripheral region, with a narrower emphasis on price in their competitive tactics than in the case of their counterparts in the capital.

Another qualitative difference in the behavioural characteristics of firms in core and periphery locations concerned the use of information and communications technology (ICT), which may be used as an indicator of the technological sophistication of enterprises. Firms located in Minsk demonstrated a higher propensity to be computer users than their counterparts located in Mogilev (99 per cent and 80 per cent respectively), although a more discriminating indicator of 'innovation' with respect to ICT is the use of the internet, which can be used to access information, as well as for promotion. Although only 16 per cent of surveyed firms in the Belarusian sample as a whole were internet users, this consisted almost entirely of Minsk-based firms (19 per cent compared with just 1 per cent in Mogilev). It reflects the inadequate telecommunications system in this peripheral region and the high prices charged by service providers there.

While in theory, modern telecommunications can help to reduce the barrier effects of distance from major markets for firms of all sizes, such benefits rely on an initial investment being made in appropriate infrastructure, which may be outside the control of the individual firm. This demonstrates that while the extent to which an individual firm is innovative may depend to a considerable extent on the attitudes, knowledge and skills of its owners/managers, a firm's ability to achieve its innovative potential is also influenced by external factors (in this case the quality of the communications infrastructure), as well as by its own ability to mobilise resources. In this case, regional variations in communications infrastructure have important potential implications for business behaviour.

One of the most important factors influencing the long-term growth prospects of any economy is the ability of its firms to develop external markets, since external sales represents an important mechanism for generating income, which allows an economy to grow. Although the 1998 survey evidence showed that the vast majority of surveyed firms in Belarus depended on their local/regional markets for a majority of their sales (with a quarter relying entirely on sales in their home region), a core–periphery contrast can be identified, with regards to their geographic market orientation. For example, surveyed enterprises based in Mogilev were significantly more likely to be regional-market-oriented than those located in Minsk, whose markets typically had wider geographical scope: 36 per cent of firms in Mogilev generated all their sales from within the home region (with a median percentage of total sales from this source of 80 per cent), compared with Minsk where only 21 per cent of firms were entirely dependent on regional sales and the median proportion of total sales generated from this source was 70 per cent. A combination of qualitative differences in the characteristics of firms in core and periphery regions (such as with respect to innovation), combined with differences in accessibility to markets outside the home region, help to explain the differences in regional market orientation between core and periphery firms.

Significant core–periphery differences are also apparent in the extent to which firms were penetrating foreign markets, particularly those in western countries. For example, in Minsk, 46 per cent of surveyed firms were exporting to NIS/CEECs and 15 per cent to western markets compared with just 15 per cent and 2 per cent in Mogilev. While this is partly associated with the smaller average size of firms in Mogilev compared with Minsk, it also reflects the disadvantages of a more peripheral regional location in terms of accessibility and poorer communications, as well as qualitative differences in the characteristics of firms that affect their sales potential in foreign markets.

Regional variations in external co-operation

In theory, co-operation (both with other firms and with external agencies) is one of the ways that small businesses can overcome some of the internal resource constraints associated with small size. At the same time, access to opportunities for external collaboration might be expected to vary regionally, as one aspect of external economies of scale. For this reason, in the 1998 survey, managers were asked if they were involved in co-operation with other enterprises, other than through transactions-based customer/supplier links. The results showed that 44 per cent of all surveyed firms were involved with partner enterprises in some form of co-operation, although this particularly applied in the case of firms located in the capital (i.e. 43 per cent in Minsk compared with 20 per cent in Mogilev). As in other respects, a clear core–periphery contrast is identifiable in the behavioural characteristics of surveyed enterprises. However, very few firms in either location (9 per cent) reported co-operation arrangements with western partners.

In combination, these results show that in a country where market reform has been slow and only partially installed, the nature and behaviour, as well as the pace, of small business development varies considerably between regions. The disadvantages faced by SMEs located in a peripheral region were particularly apparent with respect to their access to markets, since a capital city location was associated with a higher propensity to sell in national and international markets compared with firms in peripheral locations, which affects the ability of firms to grow. Firms located in core regions also found it easier to develop collaborative links with foreign firms, which in a situation where domestic market conditions are depressed and resources extremely scarce represent a possible strategy for SME survival and growth.

Role of government in the development of the private sector and support needs of SMEs

Government policy and the small business sector

As in some other transition economies, the Belarusian government officially declares SME development as one of its policy priorities. The problem is that the stated aims of policy contrast with government actions and interventions and there is an implementation gap, as far as most state programmes are concerned. As early as 1992, the government established a Fund for Financial Support to Business that was to be financed from the state budget. However, until 1996 the Fund had granted credits to only 202 enterprises, which in turn were said to have created just 200 new jobs. As a consequence, the practical impact of this particular support programme was negligible.

Since 1996 the newly founded Ministry of Business and Investments has been mainly responsible for small business support. In 1997, government officially announced that 300 billion Belarusian roubles (i.e. €105 million), together with an additional 5 per cent of the expected privatisation gains would be set aside for direct small business support. Each year, a state programme of support for small businesses has been approved by government, although the programmes remain declarative in nature, in the absence of a mechanism for implementing them and without a budgetary allocation. As a result, in a survey of 168 enterprises in Belarus, no surveyed firm reported being a beneficiary of any state programme and almost three-quarters (71 per cent) were unaware of the existence of such a programme (Smallbone *et al.* 1999c).

Hitherto, multilateral and bilateral donor programmes and measures have represented one of the main mechanisms for fostering SME development in Belarus. For example, in 1997, the UNDP endorsed a new programme for creating a small business support infrastructure, favouring the establishment of business incubators and financial support through credit unions and microcredit institutions. In addition, the IFC, in co-operation with USAID and the British government has financed business centres in Brest, Gomel and Grodno. The German government supports technology centres and also assists the Belarusian Association of Entrepreneurs in establishing a nationwide network of business consultants. In addition, the EBRD established a credit line for SMEs with loans being distributed by local banks.

Rather than providing encouragement and support for small business development, in practice, the government in Belarus appears to make life very difficult for entrepreneurs through administrative barriers and regulatory demands. This is reflected in procedures and practices that involve the use of overly complex forms and requirements; an excessive number of forms and regulatory requirements; frequent changes in forms and requirements. Excessive regulations and procedures is one aspect, but so too is the contradiction between different pieces of legislation that often exists.

Belarusian entrepreneurs are not alone in the NIS in facing administrative barriers from government, although Belarus appears more burdensome than other NIS in this regard. This is reflected in the expectations placed on the state registration agency, whose responsibilities for newly established businesses result in officials seeking to avoid future problems for themselves by demanding as many documents as possible from new entrepreneurs (Lyah and Pinigin 2003). In addition, the State Control Committee, with its sweeping powers to control prices, contracts, salaries and other aspects of business activity is unique to Belarus. As a consequence, it is reported that a Belarusian company is obliged to obtain four to five times as many licences as companies in other NIS, with it taking 30 days on average to secure a single licence. On top of this they have to deal with certification, on average 8.4 times a year, rising to 12.1 for businesses in transportation and communication and 10.9 in trade and public catering (Rakova 2003). Another example concerns the procedures for levying and reporting taxes, where profits tax is said to be regulated by 150 legal documents, income tax by 100, and property tax by 50 and VAT by 180.

A highly imperfect regulatory environment also breeds corruption for various reasons. According to Zhuk (2002), these include: a business environment which lacks predictability, because of the conflicting provision of legislation and its instability; the overly broad brief of state agencies, which places a premium on ministerial rather than public interest; a plethora of controlling agencies with extensive competencies; an excessive number of poorly regulated procedures; a guiding principle for state agencies that everything is forbidden unless explicitly allowed; low awareness of legal issues on the part of both individual citizens and state officials; an absence of a detailed procedure for the imposition of economic sanctions, which leads to violation of the principle that 'the punishment should fit the crime'. The latter gives state bureaucrats considerable scope to employ arbitrary action and abuse.

Support needs of small enterprises

Insight into the influence of some of the deficiencies in the institutional framework on entrepreneurs can be drawn from a study of the support needs of SMEs in Belarus (together with Ukraine and Moldova), undertaken between 1996 and 1998, in which both authors were involved (see Appendix, Project 6, pp. 238–239). The results show that many aspects of the institutional environment that are taken for granted in a mature market economy are still to be developed in Belarus. At the micro level, business 'support' typically refers to the external resources that a business needs to be able to draw upon from time to time in order to extend or modify its internal resource base. However, the recurrent emphasis by entrepreneurs in Belarus on the lack of a supporting environment for small business development mainly reflects the absence of stable and appropriate legal and tax frameworks in the country. For individual firms, the absence of the necessary framework conditions for private enterprise development means that their priorities in terms of support needs typically refer to what is required to maintain the day to day operation of their businesses, rather than for business development purposes.

As Figure 5.1 shows, based on managers' assessment, SMEs have a wide variety of 'support needs' that include advice to help them meet their obligations with respect to legal, tax and regulatory issues, as well as assistance in accessing resources, help in problem solving and advice with respect to wider management and business development issues. However, the nature of the external environment for business development leads managers to emphasise those types of assistance that help them to meet their statutory responsibilities and also access to finance, rather than on advice with respect to fields such as sales, marketing and product development that may help them to develop their businesses in the longer term. The former were also the most common types of external assistance that had been previously used by responding firms.

Referring to Figure 5.1, while legal advisers, accountants and tax advisers are an important part of the external business support system in mature market

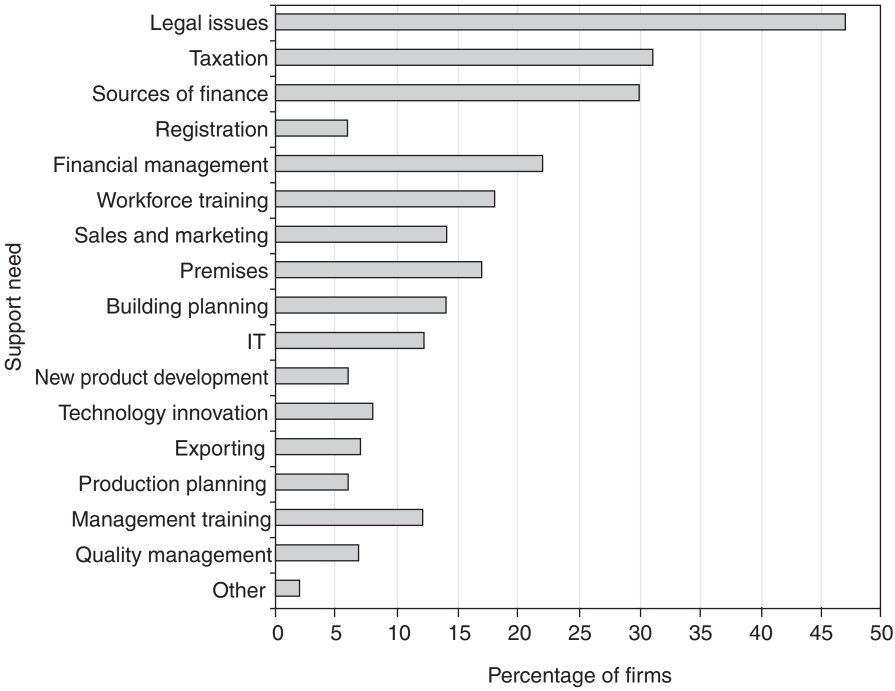

Figure 5.1 Manager's assessment of the support needs of their businesses in Belarus, 1997 (source: own survey (see Appendix, Project 6)).

economies, the particular context experienced under transition conditions can create additional support needs with respect to legal matters. Inadequate legislation from a business perspective means that external assistance is often required to assist business owners and managers find their way through the complexities of the tax and regulatory system, which helps to explain why help with legal and tax issues is at the top of the list of manager's priorities for external assistance. It also helps to explain the high level of ICT use reported by surveyed enterprises.

Unlike countries at a more advanced stage of transition, such as Poland or Hungary, Belarus has yet to establish, and make operationally effective, the institutional frameworks necessary to provide a supporting environment for small private businesses to develop. The lack of a facilitating environment for SME development is also reflected in the lack of free access to certain markets for small firms, as a result of the activities of 'nomenclatura' businesses. As described in Chapter 3, this type of entrepreneur is a distinctive feature of transition economies where progress towards market-based democracy has been limited. This means that such people are able to use their political influence to protect themselves from competition, as well as receiving preferential treatment from government, in the form of, for example, tax concessions and increased export opportunities (Smallbone and Welter 2001b).

In a Belarusian context, tax advice refers mainly to advice or consultation to enable firms to adhere to tax rules, or to complete reporting forms for tax authorities, which is made more difficult because of constantly changing requirements and tax legislation. Inadequate information, combined with frequent changes to legislation, adds to the burden of compliance costs for companies, resulting in a common need to employ consultants to enable enterprises to meet their statutory responsibilities.

It is not surprising that information and advice about sources of finance was a high-priority need amongst surveyed businesses in Belarus, regardless of age, size and sector, in view of the very low level of external finance involved in these surveyed businesses. In the survey for the Tacis project, only 8 per cent of respondents reported receiving any bank finance at start-up and 11 per cent received finance for investment purposes during the year prior to the interviews, reflecting the underdeveloped nature of a financial sector that is able and willing to finance private businesses in the country (see Appendix, Project 6, pp. 238–239). As a result, surveyed firms were either self-financed or dependent on finance raised from informal sources. While finance related constraints are a common complaint amongst SME owners and managers in many countries, the level of dependence of Belarusian SMEs on self-financing (74 per cent of surveyed firms relied solely on self-financing) can quickly result in a downward spiral of cash-flow difficulties and an associated shortage of working capital, thus constraining the long-term development of these companies. It can also lead to serious undercapitalisation, particularly at start-up, where financial resources are typically limited to those that an individual possesses, supplemented by whatever can be raised from family and friends or borrowed from informal moneylenders.

Another important policy issue facing many transition countries is the need to create the conditions to encourage more of the activity currently taking place in the shadow economy, to become more formalised. This is a particular priority in Belarus, where a combination of frequent changes in the rules and regulations governing private business activity; an unnecessary complex tax structure; combined with a penal total tax burden, make it almost impossible for businesses to be totally legal and yet be profitable. A related issue is the need to reduce corruption, which impacts on most small firms through the petty bribes that often have to be paid to officials in order to obtain licences and permits. Clearly, the promotion and protection of the rights of entrepreneurs through the law is only as good as the enforcement of the law itself. At present, the weakness of the implementation and enforcement of existing laws and regulations is a major barrier to the emergence and functioning of small private enterprises.

Entrepreneurial behaviour and SME strategies in the context of institutional deficiencies

Research demonstrates that in situations where market reforms have been slow or only partially installed, the institutional context becomes a critical factor influencing the development of entrepreneurship, since government still has to create the framework conditions for private sector development to become embedded and sustained (see also Chapters 2 and 3). In such conditions, it has been suggested that the types of entrepreneurship that can be identified, and the enterprise strategies adopted, are heavily influenced by the external environment (Peng and Heath 1996, Peng 2000) in general, and the institutional context in particular (Welter and Smallbone 2003).

Institutional deficiencies result in the widespread use of types of behaviour, which represent a specific response to an inadequate institutional environment, while also contributing to the distinctiveness of entrepreneurship in a transition context. A number of specific 'strategies' may be identified, although it is important to stress that the term 'strategy' in this context is used to describe a type of management behaviour, which represents a form of adjustment to the external environment in which entrepreneurs find themselves. It is typically implicit, emergent and based on learning behaviour on the part of entrepreneurs, rather than representing an explicit, formal strategic plan. In the rest of this section, six types of management behaviour are described, which represent distinctive responses to the external environment in which Belarusian entrepreneurs are operating. These are: prospecting; evasion; financial bootstrapping; diversification and portfolio entrepreneurship; networking; and the forms of adaptation used by entrepreneurs to cope with administrative and bureaucratic burdens. As types of management behaviour, they are not necessarily mutually exclusive.

Strategy I: prospecting

Drawing on the typology of strategies proposed by Miles and Snow (1978), Peng (2000: 178) uses the term 'prospector' to characterise firms 'with a changing market, a focus on innovation and change and a flexible organisational structure'. Peng contrasts 'prospectors' with so-called 'defenders', who are firms with narrow markets, a stable customer group and an established organisational structure. Focusing on what he describes as 'entrepreneurial start-ups', Peng refers to them being starved of capital and weak in technological capability, while being close to markets and willing to change their product/service mix in order to serve customers better (Peng and Heath 1997).

While such a description can be made to fit the Belarusian context, it is a rather idealised version of reality, in which frequent change in products/services may typically be regarded less as a positive feature associated with proactive management but rather an approach that is often forced on entrepreneurs as a necessary part of their attempt to survive, albeit made possible by the flexibility that is common in small owner-managed businesses. This can be illustrated with reference to Case 1 (Box 5.1), which although seeking to focus on its core embroidery business, has engaged in simple, but unrelated, trading activity in order to generate cash for investment in the core business initially, and to attempt to deal with a cash flow crisis several years later. The case also includes aspects of financial bootstrapping and unrelated diversification, thereby demonstrating that under such conditions, a firm's coping strategy may involve a number of interrelated elements, one of which may be characterised as prospecting.

Box 5.1 Prospecting in a transition context

Case 1: Embroidery business, based in Minsk: Co-owned by a husband and wife, who was a former Chemistry teacher, this Minsk-based enterprise started its operations in 1992 in Minsk. Embroidery was viewed as the core business activity from the outset, although by initially trading in detergents, the enterprise was able to accumulate capital that was subsequently invested (in 1993–1994) in developing hand-made embroidery products. This included the development of a design capability for products and patterns. However, following political changes in Belarus in the period 1995–1997, the number of foreign tourists declined dramatically and the demand for embroidered goods largely dried up. An attempt was made to enter foreign markets directly at this time, although this was thwarted by a lack of partners who understood the structure of foreign markets, as well as by difficulties resulting from foreign exchange controls. In 1998, the firm became involved in wholesale trade for certain types of forage and vitamin additives.

Source: own study (see Appendix, Project 7, pp. 238–239)

Strategy II: 'evasion'

Both survey and case study evidence point to the importance of 'evasion' behaviour (Leitzel 1997), which allows private entrepreneurship to exist and survive in an environment, where inadequate public law enforcement leads to arbitrariness and corruption in its execution. 'Typical' evasion strategies on the part of entrepreneurs include combining legal and informal production and/or setting up 'pro-forma' (or shell) enterprises in order to lower or avoid taxes. This can be illustrated with reference to a small firm producing and adapting computer software in Belarus, which was first registered in 1994 (Case 2, Box 5.2). The owner referred to low operating costs in his main enterprise as the major motive for registering a second enterprise in 1995, in order to increase his apparent operating costs. This enabled him to reduce apparent profits overall and his associated tax liability by channelling part of his profit to the accounts of the new entity. He uses the second firm to place pro-forma orders for services rendered to his main enterprise, e.g. for leasing computer equipment. Payments, which are transferred to the second enterprise, were later returned in cash.

Box 5.2 'Evasion' behaviour

Case 2: Software firm: Case 2 is a small software firm whose employment fluctuates according to current contracts, but which reaches 20 on occasions. The business was founded after a group of friends (specialists in applied mathematics) had successfully co-operated in 1993 to write a computer programme for a large domestic computer firm. Using a combination of income generated from this project and some personal savings, a firm was created in 1994 to write computer software, although because of fluctuating demand for the core service, the firm began to tailor ready-made software to the needs of specific customers. A combination of the high degree of value added in the activity and the dominance of labour costs in the total cost structure meant that the firm's tax liability was high. As a consequence, a second firm was registered in 1995 to provide a vehicle for channelling part of the profits, facilitated by the creation of contracts between the firms for rendering fictitious services, including the fictitious leasing of equipment.

Source: own study (see Appendix, Project 7, pp. 238–239)

As Case 2 demonstrates, one of the ways of reducing tax liability in a Belarusian context is to establish a second or third business, which is used to supply fictitious services, that appearing as accost in the balance sheet of the original company. The tactic of establishing a portfolio of legal entities as a device for reducing tax liability is not confined to transition environments, representing a form of transfer pricing. At the same time, the context in which this form of 'portfolio entrepreneurship' appears for this purpose in countries, such as Belarus, is distinctive and qualitatively different (see Case 2). Frequent changes in the tax system, combined with a prohibitive tax level, unpredictable behaviour on the part of state officials in applying tax regulations and inadequate access to external capital, encourage entrepreneurs to use evasion strategies in order to reduce their declared profits and tax payments and thereby protect the capital base of their enterprise. Tax avoidance or evasion may almost become a necessity for business survival, in situations where the level of taxation is penal, bribes for tax officials a necessity and working capital in short supply. Feige (1997: 28) characterises such actions as the 'legacy of non-compliance', which dominated most of the tolerated and non-legal entrepreneurial activities in Soviet times. Due to frequent changes in commercial laws, especially in those countries where market reform has been slow or not properly installed, entrepreneurs perceive the external legal environment as a major constraint for any entrepreneurial actions, consequently reacting to or anticipating constraints with evasion behaviour.

This can be illustrated with reference to one of the case study enterprises, producing detergents both for commercial and domestic use, which was required to apply to the government standards agency (i.e. Gosstandart) to obtain technical permission for its production. In return, the entrepreneur was 'requested' to assist in getting customs clearance for an imported car by the head of one department in the agency, which cost the entrepreneur $1,000, with a further cash payment to the head of department of $700 in cash. This sum was justified as a kind of informal contract. Formally, the agency is legally required to inspect more than 50 chemical substances, which are used to produce detergents. For a total cost of $1,700, the entrepreneur secured the registration of the company, together with an undertaking from the inspection agency not to come back for further inspections for a period of two years. Since then, the entrepreneur has periodically made payments to the same agency, in return for which they overlooked any inadequacy of the materials used to produce detergents. In addition, the entrepreneur regularly pays tax authorities in order to decrease the number and thoroughness of their inspections.

The problem is that when this type of behaviour becomes the norm, such a system diverts enterprise resources that could otherwise be put to productive use are diverted into dealing with some of the unnecessary costs associated with a deficient institutional context, apart from any possible consequences for consumers, resulting from regulations not being fully applied. This behaviour reflects insufficient formal institutions (e.g. laws, courts) to regulate business activity, as well as inconsistently applied and deficient informal rules and codes of conduct to assist in law enforcement. Both lead to mistrust on behalf of the entrepreneur, but also on behalf of state officials and society, contributing to a vicious circle as explained in Chapter 3.

Strategy III: 'financial' bootstrapping

Another enterprise reaction to deficiencies in the external environment in Belarus and other transition economies concerns the so-called financial strategies of SMEs, in a situation where access to finance from formal sources is extremely scarce. In this context, financial bootstrapping is used, which refers to the behaviour of attracting the resources needed without using external, long-term finance (Freear *et al.* 1995), at low or no cost (Winborg 2000).

Serial entrepreneurship represents one way for SMEs to accumulate the financial resources necessary to start a business in a context where the financial system is inadequate (Smallbone and Welter 2001a). In such circumstances, entrepreneurs may start with a simple business in trade or services before proceeding to more sophisticated ventures, for example, in manufacturing. Their initial sectoral preferences reflect lower entry barriers, such as low capital requirements in tertiary sectors, as well as a level of uncertainty concerning external conditions that discourages strategies which require a medium- or long-term pay-off period. In these circumstances, serial entrepreneurship represents one solution to the problem of a lack of (access to) financial resources to set up a business in more capital intensive sectors, where cash generated in one business is reinvested in a subsequent enterprise, often operating at a higher value added level. In this way, serial entrepreneurship may be viewed as a form of financial bootstrapping made necessary by a lack of availability of external funding, combined with a low level of personal financial resources when the business was first started. More positively, however, serial entrepreneurship is not only a reaction to deficient financial institutions, but also allows new entrepreneurs to 'test' their own entrepreneurial capabilities and to accumulate business knowledge and market experience.

Another form of financial bootstrapping involves borrowing from family, friends and other informal sources; although low average incomes of the population limit the extent to which substantial capital can be raised from these sources. Informal sector borrowing from private individuals is also possible, although it can be expensive in terms of interest rates. Another method is to employ at least some of the labour force informally, without labour contracts, as part of a tax evasion strategy. While such behaviour is illegal, it may be a necessary part of a survival strategy for small enterprises in a Belarusian context, by making a vital contribution to the cash flow of a business.

Box 5.3 Financial bootstrapping

Case 3: Manufacturer of bulletproof vests and protective clothing for the security industry: Having commenced trading in 1992, this Minsk-based micro-enterprise employed eight people when the director was interviewed in December 2001, with an additional three or four staff who also had other jobs and were only employed by this company when the firm had large orders. This is an innovative firm by Belarusian standards, developing one or two new products each year. At the time of the interview in 2001, it manufactured a range of seven products, including three types of bulletproof vest.

The dominant issue facing the company, identified by the Director, was a lack of finance; associated with the fact that 60 per cent of sales revenue was derived from state organisations. Public bodies tend to pay irregularly, with long delays, although they were reported to be able to meet the firm's requirement for a 30 per cent advance payment. Most of the remaining revenue came from commercial banks, which require protective clothing for their security staff. However, the reliance on public sector customers in a Belarusian context results in the firm essentially being a price-taker, even though it has no major domestic competitors.

A lack of financial resources means the firm has almost no working capital, which in turn means that orders can only be carried out after an initial advance payment has been received. In the case of public sector customers, payment may only arrive a few days before an order should be delivered. It is not practical for the firm to produce for stock, because of a combination of financial constraints and specific customer requirements, which make a degree of customisation of products typically necessary. In the absence of bank credits, and frustrated by the bureaucracy of Belarusian officials in its attempts to attract foreign partners, the enterprise only survives through its adaptability to the financial constraints imposed by its customers by working flexibly and creatively with downpayments from customers.

Source: own study (see Appendix, Project 8, pp. 240–241)

Access to finance is a problem for small businesses in many countries, particularly at start-up. However, as reported above, the level of access to external finance from formal sources in Belarus is considerably below that which is common in mature market economies, with the majority of start-ups relying on the personal savings of the founder. In addition, the distinctiveness of the transition context is reflected in the role of privatisation in business formation, since 'state enterprise capital' was the second most commonly mentioned external source (9 per cent) (Smallbone *et al.* 1999c).

In another survey of 600 enterprises in Russia (150), Ukraine (300) and Belarus (150), nine out of ten new start-ups in Belarus were financed by the owner's savings, which usually represented the largest portion of start-up capital (Bilsen and Mitina 1999). One in four new firms was reported to have sought additional capital from friends and family, with less than 10 per cent of the new private firms using debt to finance start-up. Although these figures refer to the three countries combined, they are remarkably similar to those reported for Belarus from the authors' own study.

In the authors' survey in Belarus in 1998, managers were also asked about the sources used finance any investments made in the 12 months prior to the interviews (i.e. in 1997). The results showed that a slightly higher proportion of firms had been able to access a bank loan once they were established (11 per cent), with a further 6 per cent accessing funds from relations and/or friends. Nevertheless, self-financing was by far the most common source of finance for surveyed businesses, either from retained earnings or increased personal equity. In this context, it may be suggested that some form of financial bootstrapping is a necessity for the survival of small enterprises in a Belarusian context.

Strategy IV: diversification and portfolio entrepreneurship

Previous authors have described the propensity of micro-enterprises in transition countries to diversify their activities, which some estimates have put at 25 per cent of the total number of firms in this size group in CEECs and the NIS (Lynn 1998). In sectors such as manufacturing and construction, additional activities in trade and/or service can contribute to financing the main activity of a business in a situation where access to external capital is scarce and demand may be fluctuating and uncertain. The establishment of a retail shop or market stall by a clothing manufacturer is one example. Such behaviour can also be encouraged in situations where the distribution system is inefficient and ineffective, encouraging producers to engage in direct sales.

At the same time, diversification behaviour can also be encouraged by certain institutional deficiencies, such as to reduce tax liabilities, as previously described. In addition, in Belarusian conditions, diversification commonly represents a deliberate strategy of making business success less visible to officials and those who may seek to make money from offering ‘protection’. This can be illustrated with reference to Case 4 (Box 5.4), where the owner of a successful business involved in managing and letting advertising hoarding space in Minsk was actively considering opening an upmarket coffee shop, rather than continuing to expand her core business. When asked to explain this strategy, she referred to the latter as being too risky because her successful enterprise was ‘beginning to attract too much attention of the wrong sort’. In an international comparative study involving a survey of small enterprises in Ukraine, Moldova and Belarus, Belarusian enterprises showed the highest level of reported involvement in multiple activities by entrepreneurs (80 per cent of surveyed firms) (see Appendix, Project 6, pp. 238–239). This was part of a strategy designed to secure enterprise survival involving reduced risk of interference from officials and others, rather than part of an active strategy for enterprise growth and development.

Box 5.4 Diversification behaviour

Case 4: Minsk-based advertising and promotion agency: This is a Minsk-based business, which has been trading since 2000. It is owned by a woman entrepreneur, employing four other people by 2003. While offering a number of advertising related services, the main source of revenue is from renting out space on advertising hoardings in and around Minsk. Although a very small micro-enterprise, it is necessary to ensure that the business is compliant with all relevant tax legislation and other regulations. Having successfully established itself in the market, further growth in the core business is considered too risky by the owner because it may increase the chances of unwelcome attention from officials and those offering ‘protection’. Instead, the entrepreneur is actively considering diversifying into unrelated activity by opening an upmarket coffee shop in Minsk.

Source: this interview was undertaken in Minsk by David Smallbone in February 2003

Case study evidence helps to shed light on the underlying reasoning for portfolio entrepreneurship and diversification behaviour. Reasons include evasion motives such as those mentioned above, as well as financial and economic rationale. The example of a Belarusian enterprise, which started in 1991, retailing detergents on a large-scale, illustrates the role of portfolio entrepreneurship and unrelated diversification as a financial strategy (Case 1). The entrepreneur used the wholesale trade in detergents to accumulate capital that she invested in 1993 in setting up an embroidery business, including the development of design of products and patterns. The enterprise included a school where she taught the nearly extinct handicraft of embroidery. In 1995–1997 the political situation in Belarus deteriorated, leading to a sharp drop in foreign tourism, thereby constraining the development of the enterprise. As a consequence, in 1998 the entrepreneur used an opportunity to diversify into wholesaling (this time she trades in animal feed and vitamin additives) in order to ensure the survival of her embroidery business.

Although our evidence also implies that motives for diversification strategies include the realisation of market opportunities, as well as ongoing access to markets, the role of both portfolio entrepreneurship and product diversification as a means of overcoming (short-term) financial constraints is even more important, especially with respect to enterprises with high investment and working capital needs. In addition case studies show that diversification in most cases results in a broad and apparently unrelated portfolio of activities. Unlike their counterparts in mature market economies, diversification strategies of enterprises in a Belarusian context do not mainly reflect long-term strategic considerations. They chiefly express short-term behaviour to overcome financial and environmental constraints and institutional deficiencies.

Strategy V: networking

Another common form of enterprise behaviour in transition countries is the use of networking and personal contacts, or so-called ‘*blat*’ (Ledeneva 1998), for business purposes. As explained in Chapter 3, *blat* is the name given to a system that Ledneva described as an ‘economy of favours’. It involves friends and acquaintances being tied together in a web of favours and counter-favours in order to facilitate access to commodities and services that are in short supply (Sahlins 1972). During the Soviet period, *blat* was an integral part of the everyday lives of Soviet citizens, providing a mechanism for ‘realising the hidden potentials of the system’ (Ledneva 1998). Such behaviour represents an integral part of the inheritance of citizens in countries, such as Belarus, from the Soviet period, providing a base of experience on which one of the mechanisms for dealing with resource constraints facing entrepreneurs during the transition period is based. In this context, networking can facilitate market entry and often influences the choice of business field.

Networking and personal contacts also facilitate daily business operations. Besides assisting in dealing with authorities (Barkhatova 2000, Roberts and Zhou 2000), personal contacts appear to act as a substitute for more formal marketing strategies (Frydman *et al.* 1998). Networking can be an important marketing tool in an environment where most SMEs choose not to display company signs for fear of attracting the attention of criminals and/or government officials.

Personal contacts can also play a role in recruiting employees in SMEs, as they commonly do in mature market economies, where SMEs typically use informal methods to recruit employees. In other words, personal recommendations are considered crucial in hiring staff and SME employers mainly recruit (through) friends, relatives and colleagues. This is a commonly reported feature across transition economies, which has been described in detail in the previous chapter on the Russian Federation.

The use of personal network contacts in a Belarusian context may be illustrated with a case study of a petrol station in Mogilev, undertaken in 1999 (see Appendix, Project 7, pp. 239–240). Having started trading in 1991, as a wholesaler of oil products, the owner subsequently diversified into retail sales (in 1996), focusing particularly on long-haul truck drivers. Setting up the petrol station required a licence, which the entrepreneur had easily obtained, with the help of his extensive contacts in local government. Labour recruitment had also been facilitated by the owner's friendship and wider personal networks, which he used to ensure the staff he employed were trustworthy. While an entrepreneur's contact networks represent an important potential resource for entrepreneurship in most environments, they are particularly important in a transition context, where trust in formal institutions is low and trust-based relationships are at a premium (Welter and Smallbone 2006). The emphasis placed on personal trust in networking behaviour by Belarusian entrepreneurs is linked to this overall lack of trust in institutions, with personal trust substituting for a lack of adequate and appropriate formal and informal institutions.

Strategy VI: methods used to cope with administrative and bureaucratic burdens

A recurrent theme in studies of entrepreneurship in 'early stage' transition economies is the adaptive capability of entrepreneurs to external conditions, particularly where these include serious institutional deficiencies. A good example in Belarus refers to the nature of the use of IT and also the use of tax consultants, even by very small enterprises. Both are used in order to facilitate compliance with highly complicated tax laws, which change rapidly and are often implemented in an aggressive manner by tax officials. This is reflected in surveys of Belarusian enterprises, which show a distinctive pattern of IT use, as well as a high propensity to use tax consultants.

One of the indicators that can be used to measure the technological sophistication of firms is the nature and extent of their use of information and communications technology, from simple word processing and bookkeeping at one extreme to more sophisticated applications in product design and computer aided manufacturing at the other. In this respect, the vast majority of firms surveyed in Belarus in the 1998 survey (i.e. 96 per cent) were computer users, which was significantly higher than in either Ukraine (70 per cent) and Moldova (45 per cent) (see Appendix, Project 7, pp. 239–240). Unusually, however, more firms in the Belarusian sample were using a computer to handle accounts than for word processing (91 per cent and 75 per cent respectively). This helps to explain the high proportion of Belarusian enterprises who reported support needs with respect to taxation and legal advice.

The explanation is the complicated and frequently changing reporting and accounting requirements placed on small enterprises in Belarus, which forces owners/managers to use computer software as part of a coping strategy, and/or employ a bookkeeper or accountant, even in the case of very small enterprises. While this shows how entrepreneurs find ways of adapting to difficult external conditions, such adaptation is not without cost. It is a good example where businesses are forced to allocate resources to coping with institutional deficiencies and unnecessary 'administrative burdens', thereby diverting both management and financial resources from more productive uses in the businesses. In the aggregate, it contributes to the SME sector as a whole failing to achieve its potential contribution to social and economic transformation.

Conclusions

There is little doubt that the environment for private business development in Belarus is currently one of the most difficult in the world, reflecting the slow pace of market reforms and a lack of commitment on the part of government to facilitating private entrepreneurship. While EU accession in neighbouring countries is contributing to increasing attention being paid by governments to the needs of an emergent SME sector, Belarus has been moving backwards in this regard, which is reflected in the decreasing number of private registered enterprises in the early years of the twenty-first century.

The case of Belarus demonstrates that although setting up, operating and developing businesses results from the creativity, drive and commitment of individuals, the conditions that enable and/or constrain the development of entrepreneurship are affected by the wider social, economic and institutional context, over which the state has a major influence. In this respect, Belarus is a good illustration of the institutional embeddedness discussed in Chapter 3. It is clear that Belarus has yet to install a regulatory system that is designed to facilitate business development, rather than to simply control it. This is particularly stultifying as far as the development of entrepreneurship is concerned, in view of the well-documented tendency for the costs of legislative compliance to fall disproportionately heavily on the smallest enterprises (Bannock and Peacock 1989).

As well as providing empirical evidence of the important role of external political, economic and societal influences on individual behaviour, which Douglass North (1990) has emphasised in his institutionalist perspective, the data presented also demonstrate how the types of entrepreneurship that can be identified and the 'strategies' adopted at the enterprise level are heavily influenced by the external environment in general and the institutional context in particular. While the result is undoubtedly a very challenging environment for entrepreneurs, for students and researchers of entrepreneurship it represents a fascinating laboratory.

From a policy perspective, Belarus demonstrates the importance of institutional development and capacity building, over which governments exert a key influence. An appropriate and effective institutionalisation of small business policy is still one of the main preconditions that need to be fulfilled in countries such as Belarus, if productive and sustained private sector development is to become embedded. The state has an important role to play in fostering entrepreneurship by developing a strategy for removing obstacles to enterprise creation; for establishing a facilitating environment for private sector development; and contributing to the development of appropriate market institutions, which are an important part of the business environment in a market economy. In this context, the appropriateness, effectiveness and overall quality of the legislative and regulatory framework is likely to have a greater impact on the development of the small business sector in the long run than direct support measures that are specifically aimed at helping small businesses. Moreover, the negative effects of an inadequate and poorly implemented legal and regulatory framework can impair the development of legitimate private sector activity at the expense of a burgeoning informal economy.

6 Innovation and entrepreneurship under transition conditions

The example of Ukraine

Introduction

This chapter refers to the case of Ukraine, which is another former Soviet republic where the slow pace of market reforms in the 1990s, particularly, was associated with the slow development of productive entrepreneurship. After reviewing the development of entrepreneurship and small business during the transition period, and the role of public policy in the process, the focus is on innovation in Ukrainian SMEs, based on original data drawn from a project in which both authors participated.

Economic development and SMEs during the 1990s

Ukraine is a country with marked regional variations in terms of history, demography, economic development and, in the most recent period, with respect to private entrepreneurship achievements. From a historical point of view, the country may be divided into Eastern Ukraine with approximately 70 years of socialist state and planned economy experience, and Western Ukraine, which was forcibly annexed to the USSR in 1939. Consequently, Western Ukraine was subjected to communist ideology for a shorter period of time. As a result, some authors have noted traces of a free society and market economy mentality in this region at the beginning of the transformation period in the early 1990s (Golovakha and Panina 1995, Shul'ga 1995). Such differences are partly reflected in survey data showing that in 1994 less than 4 per cent of the population in Western Ukraine claimed a communist orientation and 17 per cent a national-democratic one, compared to 15.5 per cent and 3.2 per cent respectively in Eastern Ukraine (Golovakha and Panina 1995: 14). At the same time, the eastern regions of the Ukraine have always been more industrially developed. During Soviet times, Dnepropetrovsk, Kharkiv, Donetsk, Zaporizha and Mikolaiv were known all over the Soviet Union for the production of large industrial enterprises and scientific and technological research centres and universities. The first years of transformation demonstrated that the level of industry and research development, which requires a high level of qualified human resources, apparently favoured a more rapid development of private entrepreneurship compared to the western regions.

Since the start of the transition process, the Ukrainian economy has experienced a turbulent period, accompanied by political changes such as the so-called 'Orange Revolution' in December 2004, although hopes at the time were that both economic development and democratisation will be boosted by the new government (EBRD 2005: 197). Data from the Ukrainian State Statistics Committee show that real GDP decreased continuously through the 1990s; only starting to grow again in 2000 (IMF 2003). Although 2001 was much more favourable in terms of GDP growth, the latter slowed down again for 2002, partly due to the global economic recession and partly due to the ongoing crisis of the Russian economy, which takes 23 per cent of the Ukrainian exports (Giucci and Movchan 2002). However, growth picked up again after 2003, with the EBRD estimating a 12 per cent change in real terms for 2004 (EBRD 2005: 197). Another positive development concerns barter trade, which is frequently used by enterprises in post-Soviet economies, because of a shortage of financial assets and liquidity. The use of barter trade has shown a downward trend, with its share of total sales decreasing from 43 per cent in 1998 to 4 per cent in 2002, particularly in construction, where 64 per cent of all sales in 1998 were bartered, compared to 13 per cent in 2002 (IMF 2003).

Employment is still highly concentrated in the state sector, reflecting slow and insufficient progress with the privatisation of state-owned companies. Although the private sector has gained momentum, at 30 per cent of the share of total employment, employment in private firms is still low compared to other transition countries, especially those in Central Europe. As in Russia, the development of private entrepreneurship in Ukraine started in the mid-1980s with the introduction of laws that made it legally possible for private firms to exist. SMEs were created either from scratch or as a result of privatisation. In the first case, a lack of (access to) capital forced many potential entrepreneurs to settle on activities requiring little capital, which were to be found mainly in retail and brokerage. By contrast, the pace of development of manufacturing or technology-based companies was much slower.

Box 6.1 Definition of SMEs in Ukraine

SMEs in the Ukraine are defined differently across sectors. In manufacturing and construction industries, enterprises with up to 200 employees are included; up to 50 employees in other production sectors; up to 25 employees in research and development; and up to 15 employees in retailing trade. State programmes for SME support use yet another definition, including any registered physical entity with fewer than 50 employees and a turnover which does not exceed one million Hryvnia.

Source: information from Igor Egorov

As in other transition economies, one of the processes contributing to the establishment of entrepreneurship was small-scale privatisation. For example, between 1992 and 1998, some 46,355 entities were privatised in this way, of which 82 per cent were privatised between 1995 and 1998. These consisted mainly of retail shops, service and trade departments forming small shops, small restaurants, beauty salons, dry cleaners. Currently, approximately two-thirds of SMEs are collectively owned by employees, reflecting their privatisation origin. One of the features of 'early stage' transition economies is the existence of a variety of legal forms for non-state-owned enterprises, including collectives. Only one-third are privately owned, indicating a low level of 'de novo' start-up enterprises in Ukraine, with privatisation as the main source of private enterprises. This is best illustrated by a case from one of our projects, which shows a company going through different stages of ownership, all of which were linked to the possibilities pertaining at the time for creating private enterprises (Box 6.2).

Box 6.2 From a state-owned, self-financing firm to a private small company

The company BI began trading in 1977 as a state-owned enterprise in the construction sector. Three main periods can be identified in its development:

1977–1993: BI operated as a state-owned enterprise subordinate to the Ministry of Public (Municipal) Housing, although no financial support was received from the state budget. During this period, the main types of activities undertaken were installation, assembly and maintenance of all types of domestic engineering equipment (e.g. electrical, fire prevention, security, heating systems). Similar to other state enterprises, the firm had to rely on so-called self-financing mechanisms, charging clients (including state-owned firms) in order to earn income to pay salaries, maintain their premises, and pay taxes (cf. Aslund 1991). The company was an all-Ukrainian enterprise, operating in Kiev and other cities. In 1985, the company spun out one of its units, creating another state enterprise to serve Kiev markets only, while the mother company continued serving all of Ukraine, including Kiev.

1993–1997: BI operated as a leased enterprise. As ministries were liquidated at the beginning of transformation and government officers laid off, 'human resources' were lacking to look after and control the self-financing enterprises. As a consequence, the director was advised to lease the company. Low demand and the economic crisis in Ukraine resulted in a decrease in employment from approximately 700 persons working for BI in 16 oblasts to 100 during this period.

Since 1997: BI has operated as a collective enterprise, which is owned by 94 employees including the director and managers. They selected this legal form, because they had no assets to register as a so-called closed joint-stock company, where ownership would have remained with them. On the other hand, they wanted to keep the company to themselves, which prevented them from registering as an open joint-stock company. Employees of the company remain collective owners, as long as they work for the firm. If they leave, they are obliged to sell off their shares to other employees, unless they are pensioners, in which case they are allowed to keep their shares.

Source: own study (see Appendix, Project 7, pp. 239–240).

During the transformation period, the number of registered small enterprises has increased rapidly, although most of this rise took place in the early 1990s (Table 6.1). As in Russia and other post-Soviet transition economies, small enterprise development gathered pace in the early 1990s, slowing down by 1993. The financial crisis in Russia in 1998 had a major impact on the development of private entrepreneurship in Ukraine, as it did in other NIS, because of the loss of markets, which it represented. Although in the year 2000, more than 220,000 small enterprises existed in Ukraine, plus a further 1.2 million individual entrepreneurs (and the number of small firms had risen to 295,000 in 2005), the rate of increase in the number of small firms had decreased compared with the mid-1990s. Moreover, the share of operating firms as proportion of all registered SMEs had also been decreasing, amounting to 75 per cent in 2001, compared to 96 per cent in 1996 (Akimoua and Schwödiauer 2003).

While the initial increase in the number of small enterprises represented significant progress for a country where private firms had not previously been allowed to exist, it is a very slow pace of change in comparison with most CEECs and some former Soviet republics (such as the Baltic States). SMEs still only contribute around 8 per cent total GDP and output, mainly in trade and services, in which more than half of all SMEs are operating and which contributes a major part of total SME employment. Judging by the official statistics, the level of SME development measured by most generally accepted indicators is very low, both in comparison to more advanced transition countries and also with the European Union. For instance, in 2004 the number of small enterprises per 1,000 inhabitants equalled 5.7 compared to 30 in EU countries (although this goes up to 42 per 1,000 inhabitants if we consider individual entrepreneurs), while the share of small enterprises employment is just 14 per cent of the total employment compared to about 65 per cent in the EU.

There are also regional differences in SME development within Ukraine. In most countries, SMEs tend to concentrate in the more economically dynamic regions, such as the capital regions with a good infrastructure (Lageman *et al.* 1994, OECD 1996). In this context, in Ukraine large industrial areas with a functioning infrastructure, a highly qualified manpower and research potential typically supported more rapid progress in SME development than other regions (Klochko and Issakova 1996). Kyiv, Donetsk, Kharkiv, Kherson, Mykolaiv,

Table 6.1 Indicators of small enterprise development in Ukraine (1996–2004)

Indicator	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*
Small enterprises	96,270	136,238	173,404	197,127	217,930	233,607	253,791	272,741	283,398
Individual entrepreneurs	775,000	867,000	958,000	1,061,000	1,185,000		No data available		
No. of small enterprises per 1,000 inhabitants	1.9	2.7	3.5	4.0	4.4	4.8	5.3	5.7	6.0

Source: Entrepreneurship in Ukraine 2001 and data from the Statistical Office of the Ukraine (http://ukrstat.gov.ua).

Dnepropetrovsk and Lviv serve as examples. Regardless of the geographical situation, smaller agricultural regions such as Poltava, Sumy, Khmelnitski, Chernihiv and Chernivtsy, are less developed in terms of private entrepreneurship, also suffering a higher level of unemployment.

In addition, the sectoral structure of small enterprise development is still distorted in favour of low-value activities in trade, although the share of the latter is decreasing: in 1998 around 52 per cent of all small firms were involved in trade and catering, compared to 38 per cent in 2003 (Slonimski and Slonimska 2005). In all transition countries, low entry barriers in terms of low capital and skill requirements, combined with a previously underdeveloped tertiary sector, resulted in large numbers of start-ups in trade and services in the initial years of transition (Lageman *et al.* 1994, Welter 1997, 2000). The process of small-scale privatisation played an additional role in creating SMEs in these fields. This sectoral pattern reflects an overall uncertain macro-economic environment which still favours short-term investments in sectors with a high level of profit and low barriers of entry and exit. It also encourages SMEs to operate in the informal economy, in order to reduce costs, enabling businesses to survive.

Little data is available on innovative enterprises in Ukraine. A new law on innovation was passed in October 2000, which introduced a broad definition of innovation that no longer restricted the use of the term to technological research and development. Instead, innovation is now seen as utilising and commercialising results of ‘intellectual activities’ with the aim of developing processes in all sectors of the economy. Nevertheless, existing official statistics still only consider technological innovations, defining innovation as any new equipment and new materials for technological advancement in production or processes. According to this definition the overall share of innovative enterprises in the country is low, amounting to less than 10 per cent of the total number of enterprises in the year 2000. Ukrainian light industry is the most innovative sector, with a share of innovative enterprises reaching 25.3 per cent, followed by the food industry with 16.5 per cent. The most common registered innovations were product innovations, although there are sectoral variations in this respect, with light industry showing the highest propensity to generate product innovations (e.g. engineering). In general, however, the majority of Ukrainian enterprises declared the purchase of new equipment as their main innovative activity: only 4 per cent of the Ukrainian enterprises used any other form of innovation. This reflects the fact that key innovations are often related to the introduction of Western technologies in an attempt to adjust to international standards. Moreover, process innovations are often stimulated by foreign partners assisting Ukrainian SMEs to install modern and updated technologies to save costs.

Policies to support SME development

The first step taken to promote private business in the Ukraine was the introduction of a legal framework allowing for private entrepreneurship. The Law on Entrepreneurship was adopted in February 1991, although a recognition of the important contribution and needs of small firms was not a prominent feature of government policy in the Ukraine in the 1990s. Isakova *et al.* (2003), in their assessment of government actions aimed at SMEs, described the pace of government policy development as slow. A review of government actions since transition started shows that it was only in the late 1990s that the Ukrainian government adopted laws which positively influenced small business. Although the President of the Ukraine repeatedly acknowledged the potential role of private entrepreneurship in the Ukrainian economy in public statements and documents, the low commitment of the Ukrainian Parliament to improve the existing legislation, and to make budget resources available for SME support, was a major impediment on the development and implementation of an efficient government strategy in this regard. This was aggravated by unwilling and incompetent local authorities, which saw no need to foster private enterprises (Isakova *et al.* 2003).

However, since 1996 there has been a sign of a greater commitment to small business development by policy makers, as SME development was seen as one of the possible solutions to urgent economic and social problems. Part of this is due to the fact that international policy advisers and donor organisations were constantly advocating stronger support for SMEs. In late 1996, the government announced a major tax reform in order to reduce the tax burden and improve the tax collection. More recent debates have concentrated on the introduction of a new tax code, which has removed tax advantages for those entrepreneurs who had been using simplified schemes of tax payment.

In 1997 the State Committee for Development of Entrepreneurship was re-established. This is a ministry-like institution, with a staff of 70 and a long list of responsibilities,[1] including a review of all pending and existing legislation with respect to facilitating business creation, together with support for private businesses regardless of size. The State Committee was tasked with elaborating and implementing policies, which would facilitate registration and licensing, simplifying reporting procedures, diminishing the tax burden and reducing the number of inspections by local authorities. The Committee fulfilled its tasks through drafting new legislation and initiating a broad deregulation programme, which was linked to general administrative reform. Although ministries which were previously involved in small business support still appeared reluctant to hand over their tasks and power, the work of the Committee has shown some results. For example, the licensing law which was adopted in June 2000 reduced the number of economic activities subject to licensing to 60 (Zhuk 2000).

Most small business owners perceived the overall business environment as unfavourable during the early years of transformation. This is confirmed by several survey-based studies, which have demonstrated an overall high level of ‘state capture’ in the Ukraine, although with some improvements over time (e.g. Klochko and Isakova 1996, Anonymous 1997, Gray and Whiston 1999, Hellman *et al.* 2000a, 2000b, Hellman and Schankerman 2000, Johnson *et al.* 2000, Yacoub and Senchuk 2000, Nemickas *et al.* 2002). For example, Johnson *et al.* (2000) showed that Ukrainian managers in smaller firms spent a quarter of their time dealing with government and official regulations, while more than 90 per cent of the Ukrainian companies claimed to have made unofficial payments when registering their firm. However, a Presidential Decree in 1998 appears to have reduced the number of unannounced visits to small firms considerably. A 1999 survey reported an average of seven inspections in firms with up to 50 employees and 13 in firms with 51–250 employees over six months, which is considerably lower than the frequency reported in earlier surveys, namely, 78 inspections per year for 1997 and 13 for 1998 (Gray and Whiston 1999: 43–44).

In late 2005, business associations at national and local level were asked to assess changes in the business and policy climate after the Orange Revolution. Legal deficiencies were still at the forefront of complaints about the business environment in the Ukraine, with 72 per cent of the experts mentioning insufficient legal implementation and another two-thirds are concerned about corruption (UCIPRE *et al.* 2005).

Patterns of innovation in Ukrainian SMEs

What constitutes innovation in SMEs?

One of the roles of small firms in economic development is as a source of innovation, particularly in relatively young, emerging sectors. Moreover, as markets become increasingly competitive, innovation and non-price competitive advantages become increasingly important to the ability of individual firms to survive and grow. However, any study of innovation faces a definitional problem, since innovation is a notoriously difficult concept to define. One aspect concerns the breadth of what is considered to constitute innovation, particularly the extent to which use of the term is confined to technological innovation. Another aspect concerns the extent of an innovation, which can lead to a distinction between innovation that is *new to a firm* and that which is *new to the industry, or markets* within which the firm is operating; the latter, may be further subdivided into innovations that represent something new in global terms, compared with those that are simply new to particular national or even regional/local markets. It is important to recognise that in a transition context, small firms may be innovative at a national level by introducing new products and services into the domestic market, even though these may be more established elsewhere. While such innovation may be time specific, the process helps to demonstrate how the flexibility of small organisations can provide a basis for introducing new ideas and processes into an economy.

A broad view of what constitutes innovation, which emphasises the commercial exploitation of new ideas, business concepts and methods is also necessary, when considering innovation across a broad range of sectors, including business service activities, as well as manufacturing. This is because in business services, a firm's competitiveness may depend on its ability to find creative and effective ways of addressing the needs of customers, based on interactive learning processes, rather than on 'product development', which emerges from a linear innovation process. More generally, since the number of firms that are likely to be fundamentally innovative in a technological sense is small, an emphasis on a broadly defined concept of innovation is particularly relevant in the case of SMEs, where survival and growth may depend on the innovative creation and exploitation of market niches (Storey and Sykes 1996).

The approach used in this chapter is guided by Michael Porter's view of innovation as an attempt 'to create competitive advantage by perceiving or discovering new and better ways of competing in an industry and bringing them to market' (Porter 1990: 45). According to Porter, innovation should be broadly defined to include both improvements in technology and better methods or ways of doing things, which can be manifested in product changes, process changes, and new approaches to marketing and/or new forms of distribution.

One of the factors helping to explain the heterogeneity that exists between SMEs with respect to innovation is the sectoral context that reflects the underlying technological base, as well as product/service market conditions. In this regard, Nelson and Winter (1982) differentiate between entrepreneurial and routine regimes. The former are characterised by a variety of (often new) technologies, thus fostering innovative SMEs, while the latter mainly occur in later stages of sector development. Consequently, routine technology regimes are typically dominated by mature technologies, thus favouring larger firms. In this context, Pavitt (1984) distinguishes between four categories of firms and sectors. Firms in supply-dominated sectors, such as clothing or furniture, which mainly obtain innovations from other firms, while in scale-intensive sectors (such as the food-processing industry) firms tend to concentrate on process innovations. Specialised suppliers, in sectors such as engineering or the software industry, frequently carry out product innovations, often in collaboration with customers. Finally, science-based producers (e.g. chemical industry or biotechnology) may cover the whole range of innovative activities.

This has led some authors to attempt to classify the various roles that small firms play in relation to innovative activities. Rizzoni (1991), for example, has produced a six-fold classification based on the role of small manufacturing firms with respect to technological innovation, in which the sectoral dimension is very important. These roles range, on the one hand, from 'static' small firms, in the sense of firms being largely uninvolved with innovation and showing a degree of conservatism and inefficiency; 'traditional' small firms, which play a more active role in the diffusion of innovation; to 'new technology'-based small firms at the other extreme, where small firms may play a leading role in the introduction of significant new technologies. Rizzoni's taxonomy can be used to identify the variety of roles that small firms can play in technological change, thus emphasising the heterogeneity of the experience. Similarly, Hassink (1996) has developed a typology, initially put forward by others (McKinsey and Company 1987, Rothwell 1991), to distinguish between (i) technology-driven SMEs which need to keep abreast of leading edge technologies; (ii) technology-following SMEs where technology, though important, does not have to be the most advanced available; and (iii) technology-indifferent SMEs, which are essentially craft firms and which rarely invest in new technological equipment.

Moreover, patterns of innovation in SMEs are also influenced by the characteristics of the enterprise and the entrepreneur, as well as by the prevailing business environment (Schneeweis 2000). In this regard, studies in mature market economies have indicated that the smaller resource basis of SMEs in comparison with larger enterprises (in terms of human or financial capital) could affect the extent of innovation, while the educational and professional background of entrepreneurs may directly influence the innovation propensity and the available knowledge concerning methods to innovate (e.g. Meyer 2000). Other authors have developed typologies of entrepreneurs and/or enterprises to analyse the ways in which different entrepreneurial personalities influence the innovation process (in SMEs). For example, Picot *et al.* (1989) structure the innovation process into three main stages, throughout which distinctive entrepreneurial types have to fulfil tasks such as co-ordination of information, resources or markets. Geschka (1997) describes seven types of 'innovators' using innovation propensity and capabilities in terms of resources, in order to distinguish between conservative and innovative behaviour.

In this context, the following section sets out to identify patterns of innovation in SMEs in Ukraine, based on a survey of innovative enterprises undertaken between 2000 and 2002. The survey included SMEs in three broad sector groups: medium-/high-tech manufacturing; low-technology manufacturing; and business services (see Appendix, Project 8, pp. 240–241). The chapter analyses the origins of innovative small firms and their owners, as well as distinctive characteristics of innovative firms in a transition context.

Origins of innovative enterprises and entrepreneurs

Data that describes the educational and professional background of surveyed entrepreneurs may serve as proxy indicators for their innovation capabilities and knowledge. Not surprisingly, amongst the enterprises surveyed, entrepreneurs in the business services and high-technology sector had the highest education level of entrepreneurs in any of the three sector groups: 99 per cent in business services and 92 per cent in technology-based sectors were university educated, compared with 71 per cent in low-technology manufacturing, reflecting the knowledge-based nature of business service activities and high-technology ones.

Examination of previous workplaces and work experience shows that innovative entrepreneurs in some sectors were able to draw on their own experiences when starting a company. High-tech entrepreneurs had previously mainly worked in manufacturing sectors and research; low-tech entrepreneurs in manufacturing and/or construction; whereas in the business services sectors, their counterparts had a more diverse background: 18 per cent came from a background in trade firms and a further 25 per cent from other sectors not specified.

Sectoral variations in the nature of the previous work experience of entrepreneurs, suggest considerable variations in entrepreneurial potential and knowledge exist. For example, most high-tech entrepreneurs (72 per cent) had previously worked in the state sector, although 25 per cent also had some private sector experience and less than 4 per cent had previously owned a business (i.e. habitual entrepreneurs). The latter is a very low figure, compared to 19 per cent of low-tech entrepreneurs and 27 per cent of business service entrepreneurs. In this context, research from mature market economies show that habitual entrepreneurs show an above average propensity to succeed when they start another business, due to their ability to draw on their existing networks and/or their ability to recognise business opportunities (e.g. Alsos and Kolvereid 1999, Westhead and Wright 1998). In both low-tech and business services sectors, a higher proportion of entrepreneurs had previous experience of employment in a private enterprise (27 per cent and 40 per cent respectively) compared to high-tech enterprises (21 per cent). It would appear that entrepreneurs running innovative enterprises in low-tech and business services sectors are more likely to have had previous private sector experience than their counterparts running high-tech ventures, either as employees or as business owners.

Sectoral differences can also be noted with respect to the characteristics of the innovative enterprises created. Enterprises in the business services sector (i.e. management consultants, legal advisers, accountants) were typically smaller and younger than companies in the technology-based and low-tech sectors. This is a result of the relatively recent emergence and development of the business service sector in Ukraine, while SMEs in (low-)technology-based sectors often had their origins in the privatisation processes, begun during the early 1990s. Case study evidence illustrates this in more detail (Box 6.3). Small-scale privatisation played a role in generating firms in low-technology sectors, while firms in high technology were more likely to have originated as spin-offs from scientific institutions. In the latter cases, employees of state institutions set up their own business in order to commercialise their scientific results (and most probably also with the aim of maintaining a more steady income).

Box 6.3 Establishing innovative small firms in Ukraine

Case A: From co-operative to a private SME: The company was created in 1993, in order to develop specialised software for businesses and scientific institutions. Initially operating as a scientific co-operative (in 1989–1992), the company later re-registered itself as a small enterprise. After graduating from Kiev Shevchenko University, the entrepreneur had worked in the Cybernetics Institute of the Academy of Sciences of Ukraine as Laboratory Head, maintaining his informal ties with his previous workplace. This is reflected in the fact that the key employees of the company are former specialists from the Cybernetics Institute of the Academy of Sciences of Ukraine.

Case B: An academic spin-off: This company was set up in 1992, in order to commercialise the scientific results of the Institute for Superhard Materials of the Academy of Sciences of Ukraine. In fact, the owner worked as senior research fellow in the Institute for Superhard Materials, which still owns 25 per cent of this company. The SME specialises in materials for the surface treatment of metals, stones and other materials. In 1995, the firm obtained control of three production shops of the factory that formerly belonged to the Institute.

Case C: Building a company from scratch: This service business started trading in 1995, specialising in offering consultancy in areas related to geology. Initially, commercial services were only offered in the field of geology, but subsequently it has launched a service portfolio, including management consulting and marketing. This entrepreneur previously worked at the Institute of Geology of the National Academy of Sciences of Ukraine.

Source: own study (see Appendix, Project 8, pp. 240–241)

The origins of many consulting companies in Ukraine lie in various western donor programmes of technical assistance and business development (such as USAID, TACIS). As the demand for consulting services grew, the number and quality of consulting companies increased and the range of services offered widened. However, over time, a growing number of consultancy companies emerged that were autonomous from any foreign donor-aid programme. While the development of a business services sector may be taken as a sign of a step forward in the process of transformation towards a market system, in practice the specific nature of the business environment contributed to a demand for specific types of business consultancy. A combination of the rapid pace of change and a regulatory regime that firms may need help in complying with created a demand for help from consultants to solve particular operational problems, such as taxation or accounting issues. It also created a demand for assistance in obtaining licences, permits and planning permission, which entrepreneurs need to obtain when starting up or expanding a business, when buying a new plant or factory or, perhaps, opening a chain of grocery stores.

These differences in the origin of innovative SMEs are also reflected in the ownership pattern and size distribution of the firms. Although in all three sector groups, a majority of companies were privately owned, the proportion was highest in business services (95 per cent), most of which had been established as ‘de novo’ start-ups. On the other hand, a significant minority of technology-based and low-technology SMEs show mixed ownership (i.e. state and private) or collective ownership: 21 per cent and 23 per cent respectively in the high-tech and low-tech firms. Similarly, it is mainly smaller enterprises with fewer than ten employees that were entirely privately owned, while larger SMEs had a higher propensity to have mixed or collective ownership, reflecting the fact that a higher proportion originated as privatised or restructured state firms.

Another distinctive characteristic of innovative companies is that the high-tech and low-tech sectors in Ukraine do not rely on manufacturing alone, but usually include trade or service activities as well. This provides a diversified income stream, which is a requirement in an environment, where demand is unstable and external financing is scarce (cf. also Chapter 5 on Belarus). This especially applies in the case of high-tech companies, because of their higher capital needs than firms in other sectors, which leads them to include service and/or trading activities in their portfolio. By contrast, innovative small firms in business services tend to be more focused on their core business activities. Previous studies have identified this type of diversification of activities as a strategic response by small firms to the volatile and unpredictable demand conditions that are commonly found in 'early stage' transition environments (cf. Chapter 2, also Peng 2000, Welter and Smallbone 2003). 'Innovation' in such conditions can often involve an ability to continually adapt to external threats and opportunities which, in the case of manufacturing businesses, may take them outside their core activities. In such an environment, it is also common for enterprises to completely change their activities. One such example is given in Box 6.4: here the entrepreneur changed from meat production to welding.

In some cases, the service and/or trading activities offered may represent related rather than unrelated diversification, reflecting customer demand for a comprehensive package of services, as well as reflecting the firm's efforts to maintain a more consistent income stream, by developing a regular customer base. Case studies in Box 6.4 illustrate this, showing examples of firms specialising in computer assembly, extending their 'offer' by, for example, selling their products or offering repair and servicing packages. Service firms typically supplement their portfolios by adding new and innovative services, as in the example of the auditing firm (Case C).

Box 6.4 Business activities of high-tech, low-tech and service SMEs

Case A: Diversifying the product and service portfolio: This company was founded in Central Ukraine in 1994 by former workers of military enterprises in Dnepropetrovsk. Its main activities initially were to assemble and repair computers. Since then, the company has diversified into the utilisation of used computer equipment. Service activities have started to play a larger role in more recent years, although assembling computers remains an important sphere of activity.

Case B: Similar to this case is another company, which was set up in 1992 to assemble computers, producing special electronic equipment, customising software and developing information software for transport companies. The firm also sells its own computers and acts as a distributor for brand-name computers.

Case C: This is a service firm, which started trading in 1994, initially as a financial auditing company, since the owner had a background in accountancy from his previous work in a state-owned enterprise. In 1997 it launched a new service for the collection of 'bad debts', which was unique concept for a legitimate business in the Ukrainian market at the time.

Changing the activity: *Case D* is a company that was created in 1992, initially to produce meat products. To fulfil this function, the owner built a special production plant in the Poltava region, where he owned a cottage. The owner himself graduated from Kiev University, but before starting a business worked in the Young Communist League (until 1991) and also in a science and technology co-operative. In 1994, the enterprise stopped its meat production due to a conflict with the second founder, who lived locally in the Poltava region. Specialists, who were involved in the technical side of the firm, suggested a change of the main activity. The result was a complete change so that the enterprise now specialises in welding operations, both for companies and private persons. Kiev is the main area of activities, because it is the fastest-growing region in the country, making it easier to find enough customers there.

Source: own study (see Appendix, Project 8, pp. 240–241)

The nature and extent of innovation in small Ukrainian firms

The measurement of innovation in an empirical context is a difficult task, because of the absence of objective measurement tools, which results in a tendency for researchers to rely on self-assessment of survey respondents. In this survey, all respondents were asked if they considered any of their products/services innovative in some way and, if so, what was innovative about it/them. In order to attempt to distinguish between different degrees of innovation, respondents giving a positive response to the first question were asked if they judged it/them to be innovative by the standards of their firm (i.e. new to the firm); the local market (i.e. new to the city or oblast); the national market; and/or new to markets in the NIS/CEECs, as well as in the global market.

As Table 6.2 shows, there is some difference between the sector groups in entrepreneur's *assessment of how innovative* their innovative products or services are. A considerable share of high-technology companies judged their

Table 6.2 Levels of innovation by sector group in Ukrainian SMEs

	High-tech sectors (%)	*Low-tech sectors (%)*	*Business services (%)*	*All (%)*
Local (i.e. oblast) market innovations	98	89	100	95
National (Ukrainian) market innovations	75	50	42	54
Russia and other NIS market innovations	35	13	13	19
Western market innovations	16	11	6	10
No. of respondents	84	105	100	289

Source: Own survey (see Appendix, Project 8, pp. 240–241).

Note
Respondents were allowed several answers.

innovations as innovative not only on the local and national Ukrainian markets, but also on Russian and CIS markets. This is not surprising given that some of these high-tech companies are spin-offs from specific scientific research institutes, which were clustered in certain republics such as Ukraine during the Soviet period. By contrast, in low-tech sectors and business services, innovative products and services were mainly considered innovative in relation to national or local market standards.

A minority of all firms (16 per cent) considered their product/service as being unique to the sector of the company, mainly in the high-technology firms and those in business services. The case study evidence in Box 6.5 illustrates that this refers to a broad variety of products and services new to the Ukrainian market. One such example is an electronic information system for railway clients, which has been available in Western countries for years, but which is new in the Ukrainian context (Case B). At the same time, such a comparison is not altogether a realistic one, since what Ukrainian consultancy firms are offering is a service, comprising unique and effective consulting solutions that are specific to the Ukrainian market, which western consultants would be unlikely to be knowledgeable about.

The nature of innovation in SMEs are affected by the type of technology involved and industry type (Rizzoni 1994). For example, incremental improvements in design are common in sectors with broadly standardised customer demand, such as textiles or furniture, while in the 'New Economy' sectors, innovation is likely to involve the introduction of new software products and services and/or the development of new customer segments. In addition, various degrees of innovation may be distinguished, allowing a more detailed analysis of patterns of innovation in SMEs, rather than relying on a dichotomous differentiation between innovators and non-innovators (North and Smallbone 2000).

This is reflected in the ways in which products/services were reported to be innovative. High-tech firms concentrated on innovation to 'improve quality', followed by 'technological advancement' and 'innovative redesign of a traditional product'; while low-tech manufacturing firms mentioned 'better quality', 'use of new materials' and 'the range or package of services that is offered'. In business services, the most commonly mentioned type of innovation was the range or portfolio of services offered, followed by the degree of flexibility or adaptability to customer requirements, and third 'better quality'.[2] The first answer reflects a trend towards portfolio integration across business fields, which is known for example, from large accounting firms in the US and Canada (Greenwood and Suddaby 2006), although the reasons behind this differ for small enterprises in an environment such as the Ukraine. In Ukraine, the trend is not mainly driven by a desire to sustain market share, but rather by a reaction to customer demands, resulting from the highly uncertain external environment.

Box 6.5 Examples of innovative products and services

Customised accounting programmes: Case A: The main innovation of this firm was a specialised accounting system for Windows, which had originally been developed for DOS. Each version of the programme is customised for individual customers and the original system adjusted to the requirements of particular companies. Sometimes these requirements include a system of ‘double accounting’, which is used for real and shadow calculations of the financial flows within the customer’s company. One of the competitive advantages claimed by the entrepreneur is the user-friendliness of the company’s products, especially for less experienced users of accounting programmes.

A new information system: Case B is a computer company, which was responsible for developing the electronic information system for the Ukrainian State Railway company. A key feature of the system is that it is integrated with other systems of the rail company and will also provide information remotely to customers. The company won the contract for developing this system in competition with other Ukrainian and some foreign companies.

Legal services: Case C is an SME, based in Odessa, providing portfolio services for businesses and individual entrepreneurs who are building or rebuilding stores, offices and similar ventures. It obtains all permissions, licences, architectural design, and other required documents and also provides legal advice. These services are rendered with assistance from independent experts of various organisations, emphasising the network contacts which are a major competitive asset of this firm. Previously all work was done in-house and no external experts were used, but now a range of external contacts are involved, including architects, municipal officers and construction managers. Their role is to develop the documents necessary to receive permits, approvals to start construction and/or rebuilding projects.

Geological consulting services: Case D is a company, which was the first in the Ukrainian market to offer specific geology consulting services. Its services are still claimed to be unique, despite some competition from business consultants and freelancers from the Institute of Geology, where the owner was previously employed. The firm employs experts in geology, training them to undertake consultancy in a commercial environment. The company’s services are innovative because of the effective combination of skills of professional experts in geology with general business consulting skills.

Source: own study (see Appendix, Project 8, pp. 240–241)

Evidence presented in Box 6.5 illustrates two recurrent characteristics of innovations in surveyed Ukrainian enterprises, which tend either to include an offer of product/service packages, such as after-sales services, and/or they are highly niche-focused, which to some extent protects them from increasing competition. This can be illustrated with reference to a firm offering geological consultancy services, which faced few competitors in the Ukrainian market. Such firms were often innovative in the initial stages of business development, associated with their founders bringing previously acquired skills, experience and necessary connections to the new enterprise. Such companies often sought to diversify as a means of expansion, based on the principle of 'what more can we offer our existing customers?', which increasingly applied to manufacturing companies, as well as those whose core business was in services.

Not surprisingly perhaps, business service firms showed the greatest interest in developing long-lasting customer relationships. This is reflected in some of the more successful case study enterprises, where one of their dominant strategic characteristics was recognition of the value of developing long-term relationships with their clients. In some cases, these relationships were based on exploiting institutional deficiencies (cf. Chapter 3). For example, one of the case study firms had introduced an 'early tax legislation change notification' service for clients. Constantly monitoring changes in tax legislation, as well as knowing its client businesses well, meant that the firm has been able to alert clients of tax changes relevant to them, advising them about how legislative changes might affect their operations and, if required, about how these effects could be reduced. Previously, advisory companies were much more concerned with acquiring as many contracts as possible on a one-off basis, without offering follow-up support and attempting to develop a longer-term relationship with clients.

Although considered good practice in western countries, an emphasis on developing long-term relationships with customers and nurturing customer loyalty may be considered innovative in a Ukrainian context, driven by increasing competition in the market. One of the characteristics inherited from the Soviet period was a lack of a 'market-oriented culture', reflected in a lack of attention to customer care. As a consequence, as in other markets, Ukrainian companies have been slow to recognise the value of after-sales service, associated with a traditional business model based on one-off projects.

The distinctive nature of the responses from business services firms concerning the type of innovations undertaken reflects their orientation towards producing tailor-made solutions for customers, such as customising software or offering integrated consultancy portfolios. In such cases, entrepreneurs considered the services they were offering to be innovative, since they are developed individually for customers. Once again, while the specific customisation may not be innovative by international standards, the approach itself is innovative by the standards of the Ukrainian market. The development of this type of innovation was commonly customer-led in the sense of core service clients requesting additional services, such as legal, financial, administrative or technological assistance.

The specific needs of customers in the business services and consultancy market in Ukraine can be illustrated with reference to the construction industry, which has been one of the fastest-growing sectors in Ukraine. Almost all construction markets, such as the construction of penthouses over older buildings, erecting new apartment houses, luxury mansions and renovating apartments to European standards, have been expanding rapidly. However, the ability of construction companies to exploit the growing demand within this market is influenced by their ability to overcome bureaucratic procedures within the licensing system. Mandatory licences, permits and approvals, particularly those that are required for the reconstruction of buildings, are often costly and time-consuming to obtain. As a consequence, construction firms and developers seek to obtain a licence as part of a complete package of signed approvals, by turning to specialised firms who have not only the in-house experts, but also links with government officials, procedural experience and the determination to achieve the desired results within reasonable time-span. As a result, turnkey solutions for problems such as receiving a licence or approval from a city authority are in great demand (Box 6.5). For example, one of the case study firms (Case C) employs certified architects, lawyers and experienced specialists who have personal contacts with the city authorities. This allows the firm to be effective in evaluating a project, analysing the feasibility of construction works, dealing with any dispute arising from decisions by a district authority in a law court, which are considered to be unjustified and engaging in the informal processes necessary to obtain a licence speedily. The volatility and institutional deficiencies which exist in the Ukrainian market present opportunities to entrepreneurial firms that actively monitor the changing environment and are able and flexible enough to respond to customer demands effectively. Examples include one of our case study enterprises, which seized an opportunity created by a new law on land privatisation to offer innovative services to foreign clients, by arranging joint ventures with Ukrainian partners to overcome restrictions on the foreign ownership of land.

Innovation processes in SMEs

Characteristics of innovation processes in SMEs

This section considers innovation processes in Ukrainian small firms. In a ‘socialist’ innovation system, innovation processes are understood as being linear processes, based on Schumpeter’s distinction of stages of invention, innovation and imitation (Fritsch 2001, Welter 2001). Regardless of enterprise size, most authors (e.g. Gerybadze 1982, Schneeweis 2000) distinguish three phases in the linear innovation model: first, the invention stage where entrepreneurs recognise problems and develop technical solutions; second, the innovation phase, where these solutions are applied; and third, the diffusion stage, where more firms take over technical improvements. Although stage models may be useful as analytical devices, they cannot describe and explain innovation processes in SMEs satisfactorily. In practice, phase transitions are blurred, relations between different phases are complex and recursive and various actors are involved. Moreover, innovations often emerge and are not necessarily planned ex-ante. For example, Julien (1998: 229) characterises research and development in SMEs, which he takes as a proxy for innovation, as ‘generally spontaneous (applied as needed) or sporadic’. Empirical research in the UK has suggested that less than one-fifth of innovative SMEs in manufacturing apply proactive innovation strategies, but instead mainly react to demands of customer and suppliers (Kalantaridis and Pheby 1999).

Sources of innovation

In seeking to establish where ideas for innovation in small firms come from, empirical evidence from mature market economies shows that one source involves knowledge transfer from external organisations, based mainly on informal contacts, with customers typically playing a major role (Gottschalk and Licht 2003). This is because innovation in small firms often involves developing customised solutions to customer’s problems. Internally, the entrepreneur him/herself is often the main source of innovative ideas, particularly when businesses are first established. In the case of Ukraine, the entrepreneur him/herself and employees are the most commonly reported sources of innovative ideas overall, although there is some variation between sector groups (Table 6.3). For

Table 6.3 Sources of ideas for innovation in Ukrainian SMEs

Source of idea for innovation	*High-tech sector (%)*	*Low-tech sector (%)*	*Business services (%)*	*All firms (%)*
Entrepreneur	64	64	19	49
Employees	42	41	60	48
Customers	19	30	64	39
Exhibitions/ trade fairs	33	30	8	23
Technical advisers/ consultants	31	19	11	20
Other Ukrainian firms	21	21	12	18
Family, friends, associates	14	15	16	15
Technical literature	29	10	4	13
Mass media	6	16	14	13
Internet	13	4	17	11
Trade chambers, incubators etc.	4	1	13	6
No. of respondents	84	105	99	288

Source: own survey (see Appendix, Project 8, pp. 240–241).

Note
Respondents could name up to three sources.

example, the entrepreneurs are the key source in low- and high-technology firms, compared to customers and employees in business services. Although the latter are also named as important sources by firms in the other two sectors, their share is considerably lower in comparison to business services.

The picture that emerges with respect to the sources of innovative ideas in business services is one of a sector that is highly market-led, where the knowledge-based nature of the services supplied emphasises the importance of human capital in affecting a firm's ability to successfully compete in the market. Predictably, there is a lower level of reported use of exhibitions and trade fairs, external consultants, and technical literature, as sources of innovative ideas, compared with enterprises in the other two sector groups. Although the reported use of the internet as a source of ideas for innovative products/services is higher in the business services and high-tech sectors than in low-tech activities, it is not a major source in any sector group. It should be emphasised, however, that these figures refer specifically to the use of the internet as a source of ideas for innovation and do not reflect the level of internet use overall, which was considerably higher, namely 96 per cent for firms in business services, 73 per cent in technology-based sectors and 40 per cent in low-technology activities.

In high- and low-technology firms in Ukraine, innovation processes are more dependent on the knowledge and experiences of the business owner himself, with employees providing some input. In high-tech sectors, scientific sources such as exhibitions, technical consultants and scientific literature also play an important role, reflecting the nature of the business activity in this type of sector, where entrepreneurs need to constantly update their knowledge.

In drawing on selected case studies, Box 6.6 gives more details of the different sources of innovation. The evidence presented confirms the important role of customers in this regard in all sector groups. Combining the case studies with the survey evidence suggests that customers are an underlying source of information and ideas, rather than a trigger to innovation in a Ukrainian context. Employees' participation in innovation is facilitated in firms, where the entrepreneurs install specific incentive systems, as in the case of the computer business mentioned above. In high-technology companies which are spin-offs from scientific institutions, the research which had led to the idea for the innovation had typically been undertaken in the scientific institute, often by the current business owner him-/herself, while the commercial exploitation of the innovation was undertaken in a SME, set up to developing and sell the finalised product.

Box 6.6 Sources of innovation in Ukrainian SMEs

Employee's idea and customers' demand: Case A is involved in assembling computers and its innovative activity appears to be mainly organisational in nature. The company develops complex business solutions for clients, such as changes in an entire computer network; or adapting old equipment, according to the existing laws on depreciation. With respect to the latter activity, a special division for utilisation was created, initiated by an employee, who received a bonus payment, for his efforts, as well as some promotion. This idea was based on a perceived need of companies, which had experienced problems with the utilisation of obsolete equipment. In commercialising this idea, the company itself experienced difficulties to obtain a licence.

Previous knowledge and analysis of competitors: Case B has used various sources of ideas in developing its innovation, which was the previously mentioned computer information system for the Ukrainian State Railway. One reported source was the knowledge and experience the firm had acquired over previous years. More generally, ideas for innovations were reported to emerge from contact with customers, for example, through surveys. However, it was admitted that an important source of the idea for this particular innovation was the study of corresponding systems in other countries. The firm had received an author's certificate related to this innovation, which it plans to try to patent.

Case C which was the above-mentioned geological consulting company, reported that the main origin of its innovation was the professional background of the owner, whose assessment of customers' needs led him to seek to offer a package of special services in a single portfolio. The owner and his key staff contributed to the idea of combining professional services.

Commercialising scientific results: Case D is the spin-off firm from the Institute for Superhard Materials of the Academy of Sciences, producing abrasive materials that are unique to the Ukrainian market. The composition of the materials, as well as the way of producing them, is new, and the firm is without competitors in Ukraine, or for that matter, any other NIS. This innovation could not be implemented within the Institute, as it required a more effective organisation of production. While the theoretical foundations of this innovation have been developed in the Institute by the group headed by the owner of the private company, the development of the innovative idea has been carried out within the SME.

Source: own study (see Appendix, Project 8, pp. 240–241)

Some of the evidence presented supports the interactive model of innovation, which has been shown to be more common than a linear model in the case of innovation in SMEs in mature market economies (Lundvall and Johnson 1994, Smith 1994, Asheim and Isaksen 1997). Instead of linear causality, with innovation originating from a single source, the innovation process is a complex and evolutionary process, which is open-ended. The empirical evidence reported shows that entrepreneurs typically point to several sources of innovative ideas, although the most commonly reported were the needs of customers and the previous experience of entrepreneurs and key employees. This is one aspect of complex and evolutionary processes, where elements and effects of the process are mutually constituting, arising simultaneously over time, with outcomes that are often spontaneous and emergent, albeit within a framework of planning. Aldrich (1999) emphasises learning as the key selection force of evolutionary processes, including innovation processes of this type. Learning, defined as sharing knowledge, although not necessarily based on explicit knowledge, takes place between individuals (here, entrepreneurs and employees). They exchange their knowledge and preferences and eventually modify these, using the arising new products/services to adapt the business profile and to develop the company.

Co-operation during the innovation process

Drawing on external resources from other enterprises or consultants is one of the ways that, in principle at least, small firms can extend their internal resource base, where co-operation with different partners gives access to additional human and social capital. In this context, entrepreneurs participating in the survey were asked to give details of any co-operation with outside bodies or individuals they had made use of during the innovation process.

The majority of enterprises (71 per cent) reported no involvement with any outside body or any kind of external co-operation. However, where co-operation was reported, it was more common in high-tech enterprises (51 per cent), than in firms in business services (27 per cent) or low-tech activities (33 per cent). Partners were mainly other enterprises (including joint ventures) in high-technology and business services sectors, while low-technology firms mainly used external consultants, engineers or designers, as well as buying in technology or licences from other firms.

In comparison to larger firms, research in mature market economies typically shows that SMEs are less likely to use scientific information resources, such as universities or research institutes (Harhoff *et al.* 1996), mainly due to their smaller absorptive capacity in systematically monitoring and applying external research (Cohen and Levinthal 1990). They are also less likely to be engaged in scientific co-operation (Fritsch and Lukas 1999). For example, data for German SMEs illustrates that only 8–12 per cent of the German companies used research institutions at all to obtain innovation-related knowledge (Gottschalk and Licht 2003). This is only partly due to a lack of knowledge on the side of SMEs, but it can also be attributed to a lack of common language between SMEs and scientific researchers and, in the case of universities, a range of organisational cultural constraints on the side of the higher education institution.

In this context, one would expect high-tech firms to have stronger and more frequently reported ties with universities and research institutes than their counterparts in other sector groups, because of the origin and nature of many of these firms as spin-offs of scientific institutions, where they retain close contacts to their former institute, often sharing both employees and office space. The survey data partly confirms this, with 28 per cent of the co-operating high-tech firms naming these contacts, compared to 7 per cent and 10 per cent of the low-tech and business service firms respectively. The most common forms of co-operation involving business services firms were joint-venture-type arrangements with partners and the use of external consultants. At the same time, entrepreneurs involved in business services enterprises were typically more active in participating in various professional organisations than their counterparts in the other two sectors. This was mainly because of the importance of networking as a source of contacts for possible business opportunities, as well as contributing to their professional image, rather than as a source of more tangible forms of support for innovation.

Innovating in a transition context: towards a market-oriented innovation system?

Building a market-oriented innovation system

Several research studies, conducted in mature market economies, have highlighted the role of 'innovative milieus' and national or regional 'innovation systems' in fostering innovation activities of private enterprises, drawing attention to the role of both learning (e.g. de la Mothe and Paquet 1998) and institutional environments. For example, research on Munich as a high-technology region in Germany indicates that this particular local environment is characterised by extensive inter- and intraregional linkages as well as by extensive co-operation between large and small firms (Sternberg and Tamasy 1999). Regions, such as the Cambridge region (Keeble *et al.* 1999), appear to favour innovations because they facilitate the exchange of ideas and the development of social relations, as well as more formalised co-operation, thus creating a learning environment. In this context, 'innovative milieus' are characterised as 'a set of relationships that occur within a given geographical area that bring unity to a production system, economic actors, and an industrial culture, that generate a localized dynamic process of collective learning and act as an uncertainty-reducing mechanism in the innovation process' (Camagni 1995: 320).

Research on innovative milieus emphasises the local and regional embeddedness of innovations in terms of trust and tacit regional knowledge, learning processes and informal interactions. However, spatial innovation clusters also reflect the formal institutional settings and the inherent division of labour between enterprises and institutions, in short, the innovation systems. The main characteristics of any innovation system are its enterprises, public research institutions and transfer organisations, the educational system, the legal and institutional framework and public policy (Fritsch and Lukas 1999). Patel and Pavitt (1994: 12) define a national innovation system in an even broader way as 'the national institutions, their incentive structure and their competencies, that determine the rate and the direction of technological learning … in a country', thus incorporating the 'soft' factors which constitute an innovative milieu. Cross-national differences in innovation activities then could be explained as a result of the predominant national innovation systems as well as the specific development paths of industry and enterprises (Breschi 2000). For example, some research has suggested that the German innovation system favours high-tech incremental innovations, whereas the system in the USA is more compatible with supporting radical innovations (Becker and Vitols 1997, Meyer-Krahmer 1998).

In a transition context, the 'soft' elements of an innovative milieu and the national innovation systems gain particular importance. The 'socialist heritage' (cf. Chapters 2 and 3) might influence the current institutional frame for innovation, as well as public attitudes and the general understanding of what constitutes innovations. For example, during the Soviet period, in-house research in firms played only a minor role, concentrating on applied research where it did exist (Paasi 2000). Industrial research was mainly carried out in research institutions of branch ministries; and it was only all-union enterprises that had their own research units and technical institutes (Linz 1993).

From this starting point, the main challenge faced in building a market-oriented innovation system is that it involves multidimensional change. This includes a fundamental change in philosophy from a focus on research and development to innovation in a commercial context. Such a shift needs to be accompanied by adjustments to the overall institutional framework (Smith 2002), linked to a shift from a supply-oriented system towards a demand-oriented, private sector-led system, in which private enterprises take over a task, which previously was carried out by state-owned research institutions. In transition environments, with various institutional deficiencies, government either does not recognise its role in this process, or if it does, does not view it as one of their most pressing tasks.

As a result, the main barrier for the creation of more market-oriented innovation systems in transition economies is typically not a lack of scientific research or scientific personnel; although during the transition period some research institutions have been closed down due to a lack of finance, leaving researchers without paid employment. A more fundamental barrier is the weak links between R&D, production and the market and the lack of any tradition of market-driven research (Lazzeroni 1996, Paasi 1996). This is reflected in the narrow definition of innovation which has been used in socialist innovation systems, which focuses on technology.

In this context, the rest of this section sets out to analyse barriers and support needs of entrepreneurs wishing to realise innovations and to develop their businesses in Ukraine, as well as priorities named for government policies in order to assess progress made on the way towards a market-oriented innovation system.

Barriers to innovation and business development

Not surprisingly perhaps, when entrepreneurs were asked in the survey about the main barriers to innovation, there was some sectoral variation in the pattern of response. In business services, for example, the most frequently mentioned barriers were 'adverse economic climate' (40 per cent), 'imperfection of the legislation (including taxation)' (37 per cent) and an absence of market information (30 per cent). In low-tech firms it was 'imperfection of the legislation (including tax)' (50 per cent), 'adverse economic climate' (34 per cent) and 'an absence of financial assets' (32 per cent). Technology based activities named 'imperfection of the legislation (including tax)' (50 per cent); 'an absence of financial assets' (43 per cent) and 'adverse economic climate' (37 per cent).

In other words, the main *barriers to innovation*, as perceived by entrepreneurs in the 2001 survey, were related to the *external legislative and economic environment*, rather than barriers that are specific to innovation per se. As such, they are not distinctive barriers for innovative firms, but rather reflect the unfinished nature of the transformation process in Ukraine, as well as a generally poor macro-economic environment in the country. The results of the 2001 survey of innovative enterprises are similar to those reported in earlier business surveys of a broader cross-section of SMEs, all of which show a distorted business environment, where entrepreneurs refer to taxation, registration or licensing to be major problems for business development (e.g. Nemickas *et al.* 2002, Yacoub and Senchuk 2000, Smallbone *et al.* 1999c).

While most firms prioritised legislative deficiencies as a main barrier over the years, albeit with slight improvements, *finance* was also an important constraint, identified both in the 2001 survey of innovative firms and the earlier studies cited above. In this context, it is important to recognise that innovative SMEs, particularly those in high-technology sectors, have specific financial needs compared with SMEs more generally, requiring a mix of finance from different sources. New or young high-technology-based firms are recognised to face particular problems in this respect (Acs and Isberg 1991). SMEs also have different financial structures than large firms, which typically involves a lower ratio of fixed to total assets. They are more reliant on short-term loans and overdrafts than large firms, where a higher proportion of finance is usually sourced through equity (Cosh and Hughes 1994).

In a transition context, where banks do not function well (or at all) as a source of finance for SMEs, and a support infrastructure to finance innovation is also lacking, the financial constraints on innovation reported, take on additional importance. The survey data from 2001 illustrates that only a minority of companies (16 per cent) had received any external financial support in order to realise their product/service innovation, although there was some difference between sectors in the sources used. In high-tech firms, domestic bank loans ranked first, followed by credits from family and friends. Low-tech companies rely on bank credits and credits from customers and suppliers (such as credit from customers to buy materials for clothing firm). In business services, informal credit sources dominate. None of the business service companies had used bank loans, although this may partly reflect the fact that the intangible and knowledge-based nature of innovation in this particular sector may not require large capital resources.

All this reflects a situation where most SMEs in Ukraine still cannot afford and/or access bank loans. For example, in 2000 only around 4 per cent of firms with fewer than 50 employees had received any bank credit (Yacoub and Senchuk 2000). This is a result of an ongoing weakness of the Ukrainian banking system, which was aggravated following the economic crisis in 1998–1999 (Egorov *et al.* 2002, Reppegather and Clement 2002). Banks frequently are undercapitalised, which means they are unable to provide loans, which especially affects SMEs. Over 30 per cent of the existing banks were rated to be in bad shape (Touwen 2002: 146), while a mere 15–20 per cent of the GDP was allocated as credits to the private sector (Mounier 2002: 141). In this context, a key potential role exists for public policy in seeking to address areas where the financial needs of SMEs with respect to innovation are not being adequately addressed through market mechanisms.

Although scientific and technical risks were only named by a minority of firms as a barrier to innovation, mainly in high-technology sectors (14 per cent, compared to 3 per cent and 2 per cent in the other two sectors), the picture resulting from a series of questions related to patenting and licensing indicates the issue of *intellectual property protection* as a problematic area. In this respect, the survey results show that most companies are not protecting their innovations. More than 90 per cent in the low-tech and business services sectors, as well as nearly 70 per cent in high-tech activities do not own patents or licences. Only 17 per cent of high-tech companies used patents and 14 per cent use licences, although firms in this sector group are more used to patenting their products than other firms, as they can draw on the inherited patenting system from Soviet times, where R&D products regularly were patented or certified. Regardless of sectors, patents are mainly of Ukrainian origin. A few of the high- and low-technology firms also hold patents in Russia or other NIS countries, high-techs additionally in Baltic and CEE states, and both groups in Western countries, although this applies to only two firms each.

Given the unique nature of some of the products and services, the low share of companies using protection measures is somewhat surprising, particularly in the case of firms in the high-tech sector. The main reason lies in the weak patenting system and patenting policies in Ukraine, which is mainly a result of underdeveloped legislation. So-called ‘declarative patents’ are widespread, which make the owner solely responsible for the uniqueness of his/her invention, although no patent is officially issued (Egorov *et al.* 2002). Moreover, most SMEs lack financial resources as well as the manpower and time to apply for foreign patents. This is a further illustration of the weak business environment in Ukraine, which forces entrepreneurs to focus on dealing with day-to-day problems, rather than innovation to support business development, which an effective market-oriented innovation system would encourage.

Support needs of innovative enterprises and innovation policies

In mature market economies, it is widely recognised that SMEs seeking to innovate often have ‘support needs’ which need to be addressed if they are to achieve their innovative potential and thus make a wider contribution to economic development. In this context, one of the issues investigated in the survey of Ukrainian innovative SMEs concerned their support needs and use of external support. Given the nature of innovation in the socialist period, this is an important issue, as the socialist innovation system favoured innovations in large enterprises, based on research and development. In this context, one of the problems that innovative SMEs appear to be facing in the Ukrainian context concerns the lack of adequate support policies. This includes a business infrastructure, which would assist entrepreneurs in overcoming size-related difficulties in realising innovations.

The 2001 survey illustrated that only 36 per cent of surveyed enterprises had drawn on some form of external assistance to support their innovative effort, although with large sectoral variations. Not surprisingly, it was high-technology companies which had more often used external assistance: 51 per cent compared to 33 per cent and 27 per cent in low-tech and business services respectively. The sources of external assistance used also varied between sectors, reflecting sector-specific support needs in realising innovations (Table 6.4). Technical consultants were the most commonly used external source, particularly in high-tech and low-tech sectors. Professional advisers such as accountants, banks, tax inspectors and lawyers were the second most commonly used external source of help. This applied across the sector groups, reflecting the still distorted business environment in Ukraine. Much of the use of advisory services by businesses in Ukraine is to deal with day to day operational problems, rather than to support business development. As previous studies have emphasised, much of this demand for external help is made necessary by the nature of the regulatory regime, which from a client perspective may be interpreted as an unnecessary additional cost (Smallbone *et al.* 2001a). Nevertheless, as described previously, this situation is also contributing to the emergence of a new sector of activity, which, over time, may make a positive contribution to improving the business environment.

Table 6.4 Sources of assistance during the innovation process in Ukrainian SMEs

Source of assistance	*High-tech sector (%)*	*Low-tech sector (%)*	*Business services (%)*	*All firms (%)*
Professional (accountant/ auditor, banker, tax inspector, lawyer)	21	10	14	14
Technical consultant	42	29	10	26
Non-technical consultant	8	3	9	7
Business support agency/ business centre/incubator	1	1	0	1
Sectoral or professional association/organisation	5	2	8	5

Source: own survey (see Appendix, Project 8, pp, 240–241).

Note
Respondents were able to name up to three sources.

When asked, whether there were any *types of external assistance* that would be helpful in supporting their innovative effort, entrepreneurs in high- and low-tech sectors showed a higher propensity to identify support needs (70 per cent and 69 per cent respectively) than their counterparts in business services (26 per cent). Not surprisingly, sources of finance were a major priority for high- and low-technology companies, followed by advice with regard to legal questions, which again is an indicator of the distorted nature of the business environment. In manufacturing businesses, support with sales and marketing was the next most commonly mentioned, reflecting the steps for improvements these entrepreneurs will take to develop their firms. Support needs with regard to internal management practices such as business planning or financial management and auditing are rated low on the entrepreneurs' priority scale. Only 8 per cent and 9 per cent of all surveyed firms mentioned these, interestingly most of them being high-tech companies.

Surveyed entrepreneurs were also asked about their priorities for improving the environment for innovative activities, for firms such as theirs. The 2001 survey confirms the picture emerging from earlier studies, of an unstable and turbulent environment where government policies constrain not only innovations but generally impede business development and which only changes slowly (Klochko and Isakova 1996, Smallbone *et al.* 1999c, Yacoub and Senchuk 2000, Nemickas *et al.* 2002). Regardless of the sector, 'a reduction in taxes' and 'simplification of taxes' were the foremost priority actions named by entrepreneurs in 2001, although less so in business services than in the other two sector groups. This is despite the measures taken by Ukrainian government (as described on p. 135), which have included steps to introduce simplified tax rules. A majority of high- and low-tech entrepreneurs also requested greater deregulation efforts with respect to laws (48 per cent and 51 per cent, 34 per cent in business services) and registration processes, including patenting (33 per cent and 20 per cent, 6 per cent in business services). This suggests that the deregulation campaign initiated by the Ukrainian government had not radically changed the situation facing enterprises by 2001, although an IFC survey reporting on the same year show slightly improved perceptions of entrepreneurs with regard to their environment in 2001 compared to 2000 (Nemickas *et al.* 2002).

Only few entrepreneurs explicitly named greater protection for intellectual property, as priority actions for the Ukrainian government, and most of those that did were high-tech entrepreneurs. This is because most entrepreneurs focus on immediate day-to-day problems, which is not surprising given the still fragile and turbulent business environment. Low-tech and business service entrepreneurs were more interested in a network of business incubators and business centres, than their counterparts in high-tech activities. Business services entrepreneurs cited as their foremost action for government a need to change the attitude of authorities towards small private business. This may reflect the status of business services as an emerging sector, being still new and unfamiliar to the Ukrainian economy, where government officials frequently act suspiciously towards small companies.

Access to credit is another priority for policy action mentioned by entrepreneurs, particularly by those in low-technology sectors. Business service firms were those appearing to be interested in government support designed to improve the human resource base of SMEs, such as training for employees. This is not surprising, as it is the knowledge-based nature of business services, which requires qualified personnel. Case study evidence shows how high-technology firms can draw on qualified employees from scientific institutions to meet their specialist labour requirements. As in the case of Russian SMEs, as reported in Chapter 4, in sectors new to transition economies, such as business services, it is more difficult to find personnel with the requisite skills.

In a mature market context, contemporary approaches to *innovation policy* typically focus on interaction between firms and with the institutional infrastructure, such as R&D and higher education institutions. So far, innovation policies in the Ukraine appear to be mainly restricted to support R&D, as well as to support the introduction of new technologies, which may be better characterised as a science and technology, rather than an innovation policy. Several EU-financed projects concentrate on new technologies for example in agriculture. Local government mainly supports (innovative) SMEs by creating a special business infrastructure (e.g. business incubators), often with help from international donors, although several studies have emphasised the difficulties involved in building a sustainable and self-financing infrastructure in such a way (e.g. Radosevic and Walter 2002, Bateman 2000a, 2000b).

A more market-oriented innovation policy would aim to strengthen the innovation capability and competitiveness of industries, in the face of increasing international competition. Lundvall and Borrás (1997) refer to innovation policy as aiming to promote the development, spread and efficient use of new products, services and processes in markets or inside private and public organisations. Innovation policy has wider objectives than those of science policy and technology policy, while incorporating elements from these policy areas. Whereas science policy is concerned with the development of science and the training of scientists, technology policy involves the use of scientific knowledge in the development of technology, often with an emphasis on moving into ‘higher technology’ areas of production. These policy areas focus to a large extent on formal, scientific knowledge and technological innovations, in which innovation is conceived as an essentially linear process. Recently, broader conceptualisations of what constitutes innovation have been associated with a broadening of the concept of what constitutes innovation policy, to include aspects such as market information and research and assistance to firms to commercially exploit their innovative efforts. In this view, a prime objective of innovation policy is to foster and speed up learning and innovation processes within firms, as well as between firms and with their environment.

Although a broadly defined innovation policy is a relatively new policy area, innovation policy increasingly lies at the heart of any industrial policy that aims to raise the competitiveness of national industries. This reflects the view that the strengthening of innovation activity represents an important response on the part of firms, nations and regions to globalisation process, by enhancing the learning ability of workers, firms and ‘systems’. In a transition context, such as in the Ukraine, this policy takes on special importance, as during socialism, the innovation systems that existed were focused on the needs of large state-owned manufacturing enterprises and on a system where market orientation was not a driver. Moreover, during transition it is not only a lack of support to innovate, but even more the inefficient institutional environment, which hinders small firms in realising their full innovation potential. Thus, innovation policies need to be part of a wider policy approach to fostering entrepreneurship and small business development, which includes tackling the overall deficiencies of the business environment.

Conclusions

Unlike much of the previous literature on SMEs in Ukraine, which has concentrated on manufacturing or consumer services, this chapter included data on one of the newest and relatively dynamic sectors, namely, the business service sector, in which small and very small firms are currently dominating, as well as data on high-technology firms, most of which are spin-offs from scientific research institutions. Ukraine has still some way to go with market reforms and establishment of market institutions, which are necessary to provide a basis for sustainable SME development. At the same time, the empirical evidence describes some of the more productive forms of entrepreneurship in the Ukraine; in an environment, where a good deal of unproductive entrepreneurship exists. In this regard, the chapter demonstrates that small firms are able to take a leading role in the emergence of knowledge-based activities, although this assessment needs to take into account that the evidence presented here represents SMEs that are probably amongst the most entrepreneurial in a transition environment.

The evidence presented provides a perspective on the nature of innovation in SMEs in a primitive transition context. While innovations in high-technology firms are often unique, not only in Ukrainian, but also in other NIS markets, most innovations in business services involve firms developing customised solutions to customers’ problems, often reflecting the specificities of Ukrainian conditions. Although these types of innovation may appear modest by international standards, this type of entrepreneurship warrants encouragement in Ukrainian conditions, as it represents more productive and higher value-added forms of entrepreneurial activity than is typical.

There is evidence, both from the survey evidence presented and from earlier empirical studies (e.g. Smallbone *et al.* 1999c, Isakova 1999), that as the level of competition in the Ukrainian market intensifies, entrepreneurs are increasingly looking for ways to improve the performance of their companies; for example, by seeking to update their current management practices, such as with respect to marketing, advertising and the use of technology. In this context, one of the ways of improving management decision making is to access externally sourced, professional and impartial advice. In this regard, as market reforms in Ukraine proceed, the burgeoning business services sector is likely to have an increasingly important contribution to make in the development of a market for business services.

In mature market economies, the term 'innovation' is increasingly taken to refer to entrepreneurs finding 'new and better ways of competing', with an emphasis on the commercialisation of ideas and methods. In economies that are emerging from central planning, innovation initially has more of a technology than a commercial emphasis and is typically legally defined. In this regard, the Ukrainian government only recently acknowledged a need to adapt its definition of innovation to reflect market criteria. This is an important issue particularly in the case of smaller enterprises, where innovation typically involves incremental changes based on generic technologies and often is limited to process innovations, rather than more fundamental or radical changes of products and services.

At the same time, one specific issue in a transition context which emerges from the evidence presented in this chapter concerns the nature and extent of the development of new technology-based firms which, in mature market economies, are recognised to be making a contribution to economic development that is disproportionate to their number. As state innovation systems in the former Soviet Union have collapsed, the highly qualified technical personnel that were employed in state research institutions need gainful alternative employment. Starting their own business is one option, although whether or not this is feasible depends on the extent of their commercial acumen and the extent to which the institutional context is facilitating. In this context, the empirical evidence presented in this chapter provides some successful examples of such firms in Ukraine, although their long-term development prospects may depend on improved policy support and improvements in the general business environment. The problem currently is that deficiencies in the institutional environment force both innovative and non-innovative SMEs to focus on solving day-to-day problems instead of business development.

In summary, the chapter illustrates the nature and extent of innovation and innovation processes in SMEs in a transition context, as well as the extent to which SMEs in Ukraine are able to draw on both internal and external sources of ideas, knowledge, skills and other inputs to fuel the innovation process. In doing this, they are also able to partly compensate for deficiencies in the innovation system and in the wider business environment. At the same time, their longer-term perspectives and contribution to economic development also depends on government supporting their innovative efforts by taking appropriate steps to improve the business environment and the innovation system, which allows small firms fully to achieve their innovation potential. This takes on particular importance given the fact that there is little sign of a market-oriented innovation system evolving, which includes an institutional framework to support market-oriented innovations. Although there is a high level of human capital present in many enterprises, and entrepreneurs demonstrate enormous creativity in solving their business problems despite facing a difficult environment, the lack of resources and access to support policies may restrict the potential contribution of innovation in SMEs to economic development.

Part III

Entrepreneurship and small business development in Central and Eastern Europe

7 Poland

Entrepreneurship development and EU accession

Introduction

In focusing on Poland, this chapter is concerned with the largest of the former socialist economies to join the EU in 2004. Although the scale of the dislocation represented by the transition process in all CEECs may help to explain why it is the similarities that are usually stressed rather than the differences, it is necessary to recognise that the starting point for transformation was not the same in each country. As in other aspects of the transformation process, the development of small private firms was affected by the pre-existing social and economic conditions, which resulted in different patterns of social and economic development during the transition period.

Differences between CEECs in the existing level of entrepreneurship at the start of the transformation period resulted from a number of factors, although one of the most important was the policies of the ruling communist party in a given country during the preceding period. Of particular importance for SME development was the attitude of the government to private ownership; the strength of the legal and administrative barriers encountered by private businesses; and the social attitudes that affected the willingness of the population to respond to entrepreneurial opportunities that were presented when the transformation process commenced. In these respects, Poland was more favourably placed at the start of the transformation process than many other CEECs (cf. Chapter 2). In this context, the following section summarises the development of SMEs in Poland since transformation began. This is followed by a discussion of the role of government policy in influencing the process; the implications of EU Accession for SMEs in Poland; and Poland's experience with respect to enterprise development in rural areas.

The development of SMEs in Poland

Compared with other CEECs, Poland already had a relatively large private sector during the communist period, which consisted of millions of private farms and tens of thousands of private manufacturing and service firms. The operation of private firms owned by individuals or partnerships[1] was permitted throughout the 40-year period of the centrally planned system although the scale and intensity of private sector activity before 1989 was small in comparison with that seen more recently. Although private businesses were not allowed to operate in sectors considered to be strategically important, the degree of liberalisation with respect to the toleration of private business activity in this field was much greater than in any other country within the communist bloc.

During the Soviet period in Poland, private firms were permitted to operate in fields such as crafts (services and production); small-scale retailing; freight and passenger transport; the renovation of flats and houses; and certain professional services such as dental surgeries and design studios. It should be noted however, that because of the definition of 'craft' that was used during the Soviet period,[2] the Polish 'craft sector' contained *some* small manufacturing firms that were relatively modern and well-equipped and which became a foundation for the development of manufacturing and construction activities during the transformation period. Indeed, one of the most valuable and positive characteristics of the transformation period in Poland was the vitality and will to survive of the thousands of private owners of craft and small manufacturing firms, private shops and catering establishments.

Since the existence of privately owned enterprises during the communist period may seem somewhat surprising, it is worth discussing the reasons for their survival in more detail. The ability of small 'craft' firms to survive and grow during the socialist period was affected by a number of factors. These included the inertia of the large, highly centralised, state-owned and co-operative industrial enterprises that were unable to supply huge areas of the market, thereby creating niche market opportunities for small private companies. Such opportunities existed with respect to consumer goods and services, but also with respect to the supply requirements of some large state-owned companies, forcing them to co-operate with private firms. Another contributory factor was the increasing social tensions that resulted from the shortages of numerous consumer goods and services that neither socialised production, nor imports could eliminate. This forced the government to make certain ideological concessions by giving limited permission for manufacturing and service firms to operate even though they were administratively restricted. Under the centrally planned system, imports were monopolised by the state and the constant foreign exchange deficit limited their scope.

Another key factor was the existence of a large private sector in agriculture, which again created niches for the development of Polish craft firms that could not be filled by state-owned farms or farming co-operatives. In addition, capital accumulation in private farms, together with the resources of Polish émigrés also represented sources of capital to facilitate the purchase and modernisation of machines and equipment by these firms (Piasecki and Rogut 1993). In the Polish context, such factors had a greater impact on the development of the small firm sector under communism than in some other CEECs, because of the economic and social factors referred to above.

Although the process of small business development began earlier in Poland than in some other CEE countries, one of the most dramatic features of the transformation of Poland into a market-based system has been the explosion of entrepreneurial activity, which occurred in the early 1990s, even though not all of it was regulated and operating in the formal sector of the economy.

Analysis of the development of SMEs in Poland has led to a number of distinct phases being identified (Piasecki and Rogut 1993, Piasecki 2002):

(i) An initial phase of the development of entrepreneurship, or pre-transformation phase (1980–1988): This began under the centrally planned system, following reforms introduced in the early 1980s which, by modifying the administrative and legal barriers to market entry for private businesses, paved the way for small business development. As a result, although still operating within the framework of the communist system, with many entrepreneurs at this stage coming from within communist party circles (Blawat and Dominiak 1994), the number of private firms grew from 357,100 in 1981 to 572,500 in 1988, while the number of their employees almost doubled from 654,100 to 1,287,700. During the same period the number of private manufacturing firms (including craft firms) increased from 159,600 to 231,100.[3] One of the characteristic features of this period was a rapid growth in the number of manufacturing and construction firms and a relatively slow growth of those in services and trade.

The main administrative reforms introduced during this period included the Public Enterprise Act (1981), which enabled state-owned enterprises to sell part of their assets to private individuals or entities. This led to the privatisation of certain assets from state-owned enterprises, such as repair shops in manufacturing enterprises and laundries in hospitals. Additional possibilities were created for small units to be leased by private individuals or entities from state-owned enterprises. Examples include shops, service centres, catering establishments and small hotels. Other relevant administrative reforms during this period included a Price Act (1982), which reduced state intervention in price fixing, and laws which increased the scope for foreign capital to be invested in Polish enterprises. While such reforms did not radically change the economic system, they led to a degree of deconcentration of state-owned enterprises and increased scope for private sector activity.

(ii) A period of explosion of entrepreneurship (1989–1991): Although the 1980s saw a rapid growth in the number of privately owned SMEs, the boom came in the years after 1989. The introduction of the new Economic Activity Act in 1989 abolished the legal and administrative barriers to private firms thus enabling them to operate on a similar basis alongside state-owned companies. As a consequence, the number of small private firms increased sharply during this period, from 572,500 in 1989 to 1.49 million in 1991. Most of the newly created enterprises operated in trade and industry (with an emphasis on the construction industry). As far as manufacturing was concerned, the highest growth rates occurred in traditional branches such as foodstuffs, clothing, wood products (including furniture manufacturing) and construction materials (Zienkowski 1998).

Although legal and administrative reforms enabled more private firms to be established, other factors contributed to the rapid growth in new business activity at this time, including the creation of a new socio-political climate following the elections in June 1989. More fundamentally perhaps, economic conditions created a unique set of opportunities for potential entrepreneurs, as a result of the heritage left by the centrally planned economy. Market opportunities were created by the shortage of certain products, combined with a latent consumer demand for a more varied range of products than had been available hitherto, which together created numerous niche opportunities for SMEs. In addition, the limited nature of competition in many markets also contributed to a benign environment for potential entrepreneurs.

(iii) Phase of slowing down in the rate of development of the SME sector (1992–1994): In the early 1990s, a combination of factors contributed to a more hostile environment for the development of new and small firms in Poland. These included: decreasing consumer purchasing power; growing imports from western countries; a gradual elimination of tax incentives designed to encourage new firms to be set up; the rising cost of employer's social insurance contributions; and the rising raw material and energy prices that resulted from the efforts of government to match world price levels (such as by reducing subsidies). As a consequence, the rate of increase in the number of sole traders and partnerships fell to 15 per cent in 1992 (210,000 firms) and 9 per cent in 1993 (153,300 firms),[4] associated with a reduction in the number of new businesses started, and an increase in the rates of non-survival. More hostile macro-economic conditions were combined with the effects of what Piasecki and Rogut (1994) refer to as the 'new' emerging market system beginning to regulate itself. This refers to the effects of increasing competition between firms, together with a slowing-down of the rates of new firm formation as new market opportunities became increasingly difficult to find. Competition had taken over as a key driving force in SME development, narrowing or eliminating niches, which had been controlled by SMEs established earlier in the transformation period.

(iv) Pre-accession phase (1995–2004): A marked improvement in macro-economic conditions in 1995 was associated with an upturn in the rate of new private firm formation and a decrease in liquidations. The mid-1990s also marks the beginning of Poland's preparation for accession to the EU, with the launch of a government programme: *Small and Medium Enterprises in the National Economy* (Ministry of Industry and Trade 1995). At the same time, transformation processes were proceeding, which was reflected in an increase in the relative importance of SMEs in the service sectors, compared with manufacturing and retailing. Ongoing structural changes during this period led to increased pressure on SMEs in sectors, such as food processing, which resulted in a growing share of output being increasingly concentrated in the hands of the strongest firms and those with foreign capital participation.

(v) SME development after Poland's accession to the EU: Poland's increasing integration into the EU has important potential implications for the future development of the SME sector, as they are affected by, and respond to, the

threats and opportunities of the Single Market. The sensitivity of Polish SMEs to the Single Market programme is likely to have an important influence on the future development path of the sector, as will be discussed in more detail later in this chapter.

The distinctive development path of the SME sector in Poland compared with other CEECs, had implications for the characteristics and behaviour of SME that emerged during the transformation period. For example, in a survey of 300 manufacturing SMEs, drawn from the food processing, clothing, engineering and wood products branches, undertaken in 1995, 30 per cent of the firms surveyed commenced trading before 1989; and 18 per cent before 1981. This pattern was very different from the age profile of a parallel survey of firms in the Baltic States, in which just 5 per cent started trading before 1989, mostly as a result of privatisation (Smallbone and Piasecki 1996). The age profile of the sample of SMEs in the Baltic States reflects the lack of tolerance of any non-state-owned economic activity in former Soviet republics before the start of the transformation period. A comparison of firms in different age groups in the Polish data showed that those founded during the socialist period were typically smaller than their counterparts founded during the transformation period. They were also more likely to be under family control, using 'craft'-type production methods, with less well-educated owners. Considerable heterogeneity exists within the SME sector in most countries although the unique nature of the development path of private enterprise in Poland, which included the toleration of a substantial number of small, non-state-owned enterprises during the centrally planned period, adds a specific dimension to this heterogeneity.

As in other transition economies, in the early years of transformation, the biggest growth in the number of small firms occurred in the retail, wholesale and distribution sectors. This is because of the lower capital entry thresholds that characterise such activities in comparison with manufacturing, combined with new market opportunities associated with a diversification of the economic structure and a widening of consumer choice, which encouraged new businesses to be established in these sectors. A substantial latent demand existed initially for consumer goods, which the supply-side of the economy during the centrally planned period was unable to fulfil. Many entrepreneurs in sectors, such as retailing and wholesaling, started by selling goods on the street before graduating to shops and other outlets. At the same time, part of the initial growth of the trading sector was related to price differences between Poland and Western Europe. For example, many small companies were established on both sides of Poland's Eastern borders in order to engage in various types of trading activity, although much of this activity operated outside the formal sector of the economy.

Although notoriously difficult to measure, the informal sector has been a distinctive feature of the transformation process in most CEECs. In the early 1990s, numerous unregistered enterprises emerged, which were able to reduce their tax liability by concealing at least part of their turnover. Some of these enterprises also tapped into 'black' labour markets and/or engaged in the illegal importation of goods and materials. Using such strategies, enterprises could reduce their operating costs, thereby increasing their ability to undercut the prices of formal sector businesses. Such competition forced some other private firms to react by withholding sales data and/or artificially increasing overhead costs in order to reduce their tax liability. This contributed to an increase in the scale of informal activity, by legally registered firms operating partly in the formal and partly in the informal economy. As a consequence, in the early 1990s, there was pressure to reduce the cumulative tax and regulatory burden on formal businesses, and to implement tax laws across the entire economy, in order to avoid the legitimate private sector resembling the grey market during the days of socialism (Arendarski *et al.* 1994).

The problem can be illustrated with reference to the rapid development of four open-air markets situated near to Lodz, close to the north–south motorway linking Gdansk in the north with Silesia in the south. Unpublished research, undertaken in the Department of Entrepreneurship and Industrial Policy at the University of Lodz, has shown that in the mid-1990s these markets comprised up to 6,500 units (including cars, vans and stalls and, in one case, stands in huge malls) selling a variety of products. In view of the location of these markets near to the largest textiles centre in Poland, it is not surprising that clothing goods represented one of the main products for sale, with goods typically offered for sale at prices some 20–25 per cent lower than in the city of Lodz. These markets emerged spontaneously after 1990, representing a primitive form of capitalism, which initially took the form of forward integration by new private clothing firms in Lodz, who were looking for direct-selling outlets. Later, these markets diversified into selling a wider range of products. The informal nature of much of this activity was reflected in the fact that an estimated two-thirds of the turnover of enterprises did not appear in official annual income returns. Nevertheless, the spontaneous and explosive growth of these markets may be viewed as a manifestation of the entrepreneurship that was released in the Polish economy since 1990.

Other survey evidence shows that as well as concealing their turnover from the tax authorities, private firms also hired employees illegally on a large-scale; representing between 15 per cent and 22 per cent of all employees in surveyed firms (Piasecki and Rogut 1995). The use of illegal employees was prompted partly by the high non-wage costs of legal employment, but also by the overall tax burden which business owners typically considered to be too heavy. The problem was exacerbated by a shortage of suitable sources of external funding to support firm's current and developmental activities. From the point of view of policy towards small businesses, this phenomenon is highly significant since illegal employment in Poland is mainly concentrated in very small firms (typically fewer than ten employees). These include construction firms (especially those providing repair services), small haulage companies, street and open-air market traders, catering, and small clothing companies; in other words, firms that are characterised by high labour intensity and low capital–output ratios in which financial payments are almost exclusively made in cash. Due to their large number (such firms represent over 90 per cent of all economic units), the degree of dispersal and the absence of an obligation to keep even simplified financial-accounting records (most of them do not have to pay VAT), such firms are very difficult for policy makers to monitor and control.

The extent of the use of 'black labour' by small firms has been an important policy issue in Poland, throughout the transformation period. Although illegal employment is usually viewed by policy makers as a problem to be policed and controlled, from a small business perspective it represents an opportunity to reduce the prices of goods and services, thus allowing firms to make savings which releases funds for their current operations. In such conditions, the ability of small private firms to tap into informal labour markets must be seen as a factor that enables them to survive and, in some cases, to grow. In such circumstances, the challenge for policy makers is to examine the burden of taxation and the regulatory framework that small firms face with a view to encouraging more of their activities to be channelled into the formal sector of the economy.

Contemporary characteristics of the SME sector

In comparison with more established EU member states, private enterprises in Poland are significantly smaller in size (Zienkowski 1998), with a vast majority of micro-enterprises and very few firms that are technology-based and/or engaged in high-value-added activity (Smallbone *et al.* 2001b). While this is not surprising in view of the short period of time that has elapsed since Poland was operating under the rules of a command economy, both characteristics are potential weaknesses as far as the competitiveness of Polish SMEs in an enlarged European market is concerned.

With regard to competitiveness, there have been some positive signs, as far as certain parts of the Polish SME sector are concerned. For example, exports conducted by the private sector during the 1990s developed much more rapidly than exports conducted by the public sector. This was especially true of manufacturing industry, including some highly processed goods. As a result, the private sector made an increasing contribution to Polish exports through the 1990s, accounting for 62.8 per cent of all exports in 1996 and 74.2 per cent in 1997. SMEs were particularly important in this regard, with their contribution growing more rapidly after 1994 than the growth in total exports (Grabowski 1997, Polish Foundation for Small and Medium Enterprise Promotion and Development 1997). SMEs systematically increased their share in total exports from slightly over 40 per cent in 1994 to 48 per cent in 1998, although their contribution fell after that (to 46 per cent in 2000) (Polish Agency for Enterprise Development 2001, 2002), during a period when the national trade deficit was widening.

The decreasing share of SMEs in total exports came about as a result of a more active approach to export activities by large enterprises. However, there are two worrying tendencies from a SME standpoint, which deserve attention. First, exports conducted by SMEs are based mainly on labour-intensive and material-consuming goods (compared with the structure of all Polish exports), making SMEs more sensitive to changes in the overall economic situation in the country.[5] Second, the competitiveness of SMEs has been largely based on traditional, relatively easy to imitate competitive advantages, which may be difficult to sustain, as managing knowledge and the effective use of modern computer and telecommunication technologies becomes a major source of long-term competitive advantages. In this context, there are a number of features of Polish SMEs, which need to be addressed if they are to achieve longer-term competitiveness.

The first is the small share of technology-oriented enterprises in the total number of SMEs. Although there is no statistical data that enables an accurate picture of the number of technology-based enterprises in Poland to be determined, the available evidence is that they are small in number. For example, experts estimated that there were only 600–700 technology-based SMEs in Poland in 1996 that met the following criteria: innovation and entrepreneurship; activity in a field of advanced technology; fewer than 100 employees; at least one year's presence on the market; independent, private ownership; and at least 50 per cent Polish-owned. Most of these enterprises were spin-offs run by employees of technical high school or R&D institutions, or by individual inventors and employees of various research and technical departments of large companies (Stawasz 1999). The technology-oriented enterprises are usually located in large agglomerations.

A second feature of concern is the low levels of expenditure on R&D and other innovation-related activities, since technological advancement is essential for achieving long-term competitiveness. To achieve it requires access to technological know-how, which can be measured by the level of R&D expenditures or by the number of scientific personnel. However, in practice these are both input measures rather than indicators of the results of innovative efforts and may underestimate the amount of innovation taking place in SMEs. Unlike large enterprises and state institutions, SMEs often develop new products and technologies ad hoc, which means that the contribution of the SME sector into developing innovations is often underestimated. Implementing new ideas does not always require high R&D spending, although larger sums may be necessary during later stages, to construct a prototype, for example, and test an idea directly on the market. Furthermore, R&D expenditure is typically highest in branches of industry, where the role played by the SMEs is the smallest, especially in production of chemicals, coke, tobacco products, vehicles and other transportation equipment, as well as in oil refining.

In view of the low level of expenditure on R&D and other innovation-related activities, it is perhaps not surprising that Polish SMEs appear to have a relatively low level of innovation compared with their EU counterparts, relying mainly on their own resources, which is unlikely to be sufficient in the knowledge-based economy. Research on the regional structure of external sources of innovations shows that the most active external co-operation may be observed amongst SMEs that are located in areas, which are rich in R&D potential and possessing a relatively well-developed infrastructure for SME development. However, most product innovations are financed using the SMEs' own resources (Grudzewski and Hejduk 1997, Bittnerowa 1999, Piasecki *et al.* 1998).

Another related characteristic is that modern information and communications technologies are only used to a limited extent. The development of a modern economy is based around knowledge, which has become the most important production resource, outdistancing both capital and labour. Knowledge is understood as an effective way of using information or as result-oriented information (Drucker 1999). Information, as defined above, becomes the key source of lasting competitive advantages. Thus it may be stated that the extent to which Polish SMEs are able to use ICT effectively, will determine their competitiveness, as Poland becomes increasingly integrated into the EU's Internal Market.

Although there is evidence to suggest that the use of ICT by Polish SMEs is increasing (especially amongst the larger ones) (Piasecki *et al.* 1998, 2000, Piasecki and Rogut 1999), it is still less intensively used by Polish SMEs than by their EU counterparts. A survey of SMEs in different European countries showed Poland to have one of the lowest percentages of SMEs that have access to email: 72 per cent of surveyed enterprises, compared to 95 per cent of SMEs in Holland, Finland, Sweden and Norway and 90–95 per cent of SMEs in Ireland, Great Britain, Italy, Spain and Malta (Polish Agency for Enterprise Development 2002). On the other hand, in terms of the extent to which the internet is used for displaying companies' websites, Polish SMEs were performing similarly to the European average.

The role of government in SME development

The early days of transformation

The pace of SME development in Poland during the transformation period was remarkable, by any standards; reflecting the rapid pace of market reforms compared with many other transition countries. For example, according to EBRD criteria, Poland has achieved an advanced stage of transformation to a market economy, particularly with respect to the extent and effectiveness of legal reforms, privatisation, price liberalisation and the liberalisation of trade and foreign exchange (EBRD 2005). As a result, private sector SMEs have been able to develop much more rapidly in Poland than in the former Soviet republics, for example, where market reforms have been slower and there was an absence of previous experience of the market system.

Although the commitment of the Polish government to market reform has been a key factor in providing an enabling environment for private sector development, another factor was the starting point at the beginning of the transformation period. Unlike former Soviet republics, Poland had an established base of recent private sector experience that acted as an enabling force when the process of transformation to a market economy was initiated.

In view of the success of Poland in developing a SME sector during the transformation period, an appropriate question to ask concerns the role of government in this process. Essentially, the role of government in Poland in relation to the development of small private enterprises, for most of the transformation period, can best be described as facilitating rather than causal, since until the late 1990s, there were few direct interventions by the state in this field. Not surprisingly, in the early stages of transition to a market economy, the scale of the task of transformation focused the attention of government on immediate priorities, such as macro-economic stabilisation, the privatisation of state-owned companies and banking reform, rather than on assisting the development of small enterprises directly.

More fundamentally perhaps, there was an underlying commitment to a neoliberal ideology in the economic policies adopted in Poland during the 1989–1994 period which emphasised the potentially harmful effects of state intervention in the market process (Colclough and Manor 1993). This was epitomised in the Balcerowicz Plan, which was launched on 1 January 1990, representing a comprehensive reform package designed to transform Poland's economy into a market-based system. Strongly influenced by the IMF, the Balcerowicz Plan incorporated a range of liberalisation and stabilisation measures (including a liberalisation of prices, deregulation of domestic and foreign trade and a reduction in most subsidies to state-owned enterprises). It represented a 'short, sharp shock' to the Polish economic system, causing an immediate rise in prices and a rise in unemployment and a fall in output. Although the number of small private enterprises increased dramatically in 1990 (for example, the number of start-ups increased by 60 per cent between January and August 1990), these were mainly in retail and trading sectors, encouraged by the 'small-scale' privatisation of the state-owned retail sector. In fact, the number of manufacturing enterprises actually declined during this period.

As in most other countries in Central and Eastern Europe, the development of SME policy in Poland has not been considered a priority task until recently. Initially, promoting individual enterprise and providing encouragement and support for the establishment of new economic units was an integral part of reorienting social awareness and attitudes towards the development of private sector activity in general, rather than a promotion of small businesses as such. A key role for the state in the early stages of the transformation period was to draft legal regulations to enable the development of private sector businesses of all sizes by eliminating legal and administrative barriers to market entry. In the case of Poland, it is clear that this process contributed to an explosion of entrepreneurial activity in the early 1990s; although it would also appear that subsequently state regulations, taxes and social insurance also contributed to a slowing down of the rate of new firm formation, as well as to an increase in the death rate of firms and an apparent growth in informal sector activity (Piasecki and Rogut 1993).

Having facilitated the establishment of (small) private firms by removing legal and bureaucratic restrictions, the approach of government towards the SME sector in the 1990s was enabling rather than interventionist, which can be explained by a number of factors. In the first place (as in other Central and East European countries), the scale of the task presented by the transformation process focused the attention of government initially on more immediate policy priorities, such as macro-economic stabilisation programmes, the privatisation and restructuring of the large state-owned companies and banking reforms (Arendarski *et al.* 1994). In addition, the institutions and organisations representing the interests of entrepreneurs in Poland were too weak to exert any real pressure to formulate a small firm's policy; and the weakness of the small business lobby is compounded by the reluctance of Polish businessmen to co-operate with politicians. An additional factor was the view on the part of government that because an explosion of new business activity occurred in the early stages of transformation without direct government support, it was not necessary to intervene to promote and support entrepreneurship. Furthermore, the limited amount of reliable data on the nature and extent of SME activity which combined with the paucity of scientific analyses provided a relatively weak evidence base for policy development.

Although a series of policy statements emerged in the early 1990s expressing 'support' for the SME sector, there were few tangible actions on the part of government and little sign of any strategic thinking until the announcement of the programme of support for SMEs in 1995 (Ministry of Industry and Trade 1995). Various SME support organisations were established at a regional level during this period, including incubators, business support centres and innovation and technology centres, mostly supported by foreign donors such as the World Bank, USAID, the EU's Phare programme and the British Know-How Fund (Karowska and Mrozinska 1993). In addition, so-called regional development agencies were established, which totalled 61 in 1996, of which 47 had a regional and 14 a local orientation (OECD 1997).

Although the actions taken by government to support SME development in Poland during the early stages of the transformation period were limited, and a guiding strategy absent, when foreign aid programmes are included, a number of specific measures and programmes aimed at SMEs can be identified (Karowska and Mrozinska 1993). Such measures included:

a *Direct support measures at the national level*, focusing on offering 'soft' bank loans to unemployed people to set up businesses.
b *Local/regional incubators* to support unemployed people to start a business. Although resource constraints limited the workspace component in some of these incubators, training courses in business skills were offered to unemployed persons, paid for by the local Labour Office using a World Bank loan (Lalkaka 1994).
c *Business Support Centres* were established under the EU Phare programme, offering business information, business training courses and subsidised consultancy to firms with fewer than 100 employees.
d *The Foundation for Socio-Economic Initiatives* set up 14 agencies throughout Poland that offer advice to unemployed people wishing to start a business and also to existing businesses wishing to expand.

e A *Polish-American Small Business Institute* was set up in 1990 with the help of USAID to train small firms' managers and to offer business advice.

Thus at the early stage of transition, a limited number of direct support measures were introduced at the national level, with a focus on reducing unemployment, but without any overriding strategy. In addition, there were also a number of apparently unco-ordinated initiatives at the sub-national level, offering mainly start-up support and dealing with relatively small numbers of clients. Although at an early stage of transformation, it may be sufficient to remove legislation and administrative barriers to facilitate the spontaneous growth of the SME sector, at a more advanced stage in the transformation process, the development of a competitive SME sector may require a more proactive policy approach.

A strategy for SME development

Subsequent developments suggest that the need for the state to adopt a stronger role in this respect was recognised on the part of government. In June 1995, a policy document entitled 'Small and Medium-Sized Firms in the National Economy' was approved by the Council of Ministers, which defined the policy of the Polish government towards the SME sector (Ministry of Industry and Trade 1995). This document was significant because it was the first of its type to be produced during the transformation period in Poland, and was important in providing a policy framework for the future development of the SME sector. Government recognition of the need to formulate a clear policy for the SME sector was based on its acceptance of the growing importance of this sector in the national economy and the need to remove barriers that hamper its further development. An active government policy to support the development of the SME sector became an important part of the state's strategy for promoting welfare and employment. The aim was to create favourable political and legal and economic conditions to stimulate the productive development of SMEs (Ministry of Industry and Trade 1995).

The document also outlined those areas where measures would be supported by government. The most important of these were: first, creating the conditions to facilitate the setting up and development of SMEs; second, reducing the risks of conducting economic activity; third, increasing the competitiveness of SMEs; and fourthly, developing financial services for SMEs. As a result of such measures, the government expected that the conditions in which Polish enterprises operate (irrespective of their size and legal or organisational form) would be stabilised; that firms would get access to funds earmarked for development and that Polish law would be harmonised with the standards required in the European Union. The programme for the period 1995–1997, contained in the document, included four main instruments (see Box 7.1). This programme was funded partially from the state budget and the rest from the EU's Phare programme.

Box 7.1 Government support programme for SMEs, 1995–1997

Legal instruments: revision and amendment of legislation with respect to their impact on SMEs and their compatibility with EU regulations; drafting a new 'Industrial Act' that included such issues as: a definition of SME; the principles of conducting economic activity; regulations concerning economic self-government and employers organisations; formulating legal principles to govern the establishment and operation of financial institutions dealing with local funds of credit guarantees for SMEs; drafting laws concerning business registration.

Financial instruments: drafting a 'Tax Law' with the aim of formulating a taxation model which will be clear, simple in settlement and understandable to entrepreneurs; developing a system of loan guarantees; drafting criteria for assistance for SMEs; supporting SMEs in rural areas by means of preferential credits.

Organisational instruments: support for the establishment and development of local funds for credit guarantees; mutual assurance societies and non-bank financial institutions; system of industrial co-operation; establish a Fund for SME Promotion and Development whose goal is a rational use of foreign assistance funds for supporting SMEs

Information and training instruments: support for the development of regional institutions to promote SME and for access to technology and industrial design; promotion of activities aiming to increase the competitiveness of products; support for education system through programmes to promote entrepreneurship; elaboration and implementation of systems of continued monitoring of the condition of SME and their sensitivity to changes in financial instruments

Source: Ministry of Industry and Trade 1995

It must be recognised that alongside traditional objectives of SME policy (such as employment generation), specificities of the transformation period also affected the context for SME policy. Examples include socio-political issues, such as the development of an entrepreneurial class consisting of small business owners (and not just white-collar workers), which is an integral part of developing a pluralist democracy. An additional and specific objective for SME policy in a transition economy is the creation of conditions to enable small and medium-sized enterprises to contribute to an effective use of the means of production: through privatisation or reprivatisation; the liquidation or bankruptcy of state-owned enterprises; and/or through a more efficient use of resources compared with state-owned firms.

Although direct intervention from government in support of SMEs was largely absent, in the initial stages of transformation, the commitment of the state to the process of market reform was perhaps its most significant contribution to the development of the SME sector. Significantly however, the desire to join the EU gave an important incentive to develop a more comprehensive policy towards SMEs, reflected in the 1995 policy programme, in which the development of government policy towards SMEs was reported to have become necessary in the light of Poland's accession to the EU, especially where there is a possibility of including Polish enterprises in EU programmes (Ministry of Industry and Trade 1995).

In order to facilitate this programme, the Polish SME Foundation (subsequently to become the Polish Agency for Enterprise Development – PAED) was established in 1995, with a brief to 'create an environment conducive to SME development in Poland in co-operation with government institutions and business organisations' (Ministry of Industry and Trade 1995).

Nowadays, government policy towards small and medium-sized enterprises is contained in a document entitled: *Government Policy Guidelines for Small and Medium Enterprises, 2003–2006* (Polish Ministry of Economy, Labour and Social Policy 2003), which built on earlier government policy. The aim was to stimulate economic activity in the SME sector in order to increase employment and improve SME competitiveness, particularly with regards to their ability to operate in the Single European Market. The policy is implemented through the application of various types of instrument in four main areas: initiatives to foster enterprise development; the improvement of the legal and administrative environment for SMEs; the development of the institutional environment; and promotion of the consolidation of companies and their international operations. An important aspect of the current programme of SME support is to provide SMEs with access to expert advice to facilitate business development through the use of subsidised advisory services.

The institutional framework for delivering support to SMEs comprises public institutions and 'not-for-profit' organisations, as well as commercial organisations. The PAED has an overall co-ordinating role, being responsible for the establishment and enforcement of standards for the operation of institutions active within the institutional support system for SMEs, as well as for co-financing initiatives undertaken by these institutions. The PAED is a government agency (under the Ministry of Economy), which widened its scope after merging with the Polish Technology Agency and Polish Agency for Regional Development in 2002. The task of the PAED is to manage funds assigned from the State Budget, and from the EU, for the support of entrepreneurship and the development of human resources, with particular consideration given to the needs of SMEs. Its objectives include the implementation of economic development programmes in the fields of SME development, exporting, regional development, the promotion of modern technologies, job creation, human resource development and measures to counteract unemployment (www.parp.gov.pl/en/). Many of the financial instruments administered by the PAED hitherto have been funded under Phare or other EU programmes, although free information and consultancy services are financed from the state budget, made available to SMEs through local Consulting and Advisory Centres. By 2005, approximately 140 of these Consultation Centres were in operation, functioning as the first points of contact for SMEs with the support system. As well as providing free information services, the role of advisers in these centres is to identify available assistance programmes and provide information on the conditions for granting this assistance.

The PAED does not maintain regional offices, but rather operates in co-operation with regional and local partner institutions, recruited through competitive selection procedures in each region. These partners are known as Regional Financial Institutions (RFIs) and are mainly regional or local development agencies, or other institutions with a track record in the field of SME development. The role of these Regional Financial Institutions is to implement PAED policies with respect to SMEs, for which purpose each runs a Consulting and Advisory Centre. Each vovoidship[6] has one RFI, which co-operates with the local authorities in the field of entrepreneurship development. All RFIs are registered with the National SME Services Network. The activities of these RFIs focus on the following areas: management of regional SME development programmes; co-operation with the PAED on the implementation of national programmes; provision of free information services for SMEs though Consultation Centres; co-ordination of a network of Consultation Centres at the vovoidship level.

The National SME Services Network has been operating since 1996, with some 180 co-operating outlets by 2005. The network consists mainly of regional and local development agencies, business support centres, chambers of commerce and industry and local not-for-profit organisations, which deliver services directly to the SME sector. The network is an open system with new institutions joining each year, provided they can meet the required quality assurance standards. National innovation centres operate as a subset of organisations within the SME services network, offering technology transfer and related services to SMEs. Other elements in the SME support system include European Information Centres, which offer information services related to EU legal regulations and also with respect to potential international business partners; Credit Guarantee and Loan Fund Centres, which offer financial services linked to their respective roles.

However, studies of support services for the SME sector have demonstrated the underdeveloped nature of the SME support services in Poland, compared with other EU countries (Ministry of Economy and Labour, Polish Agency for Enterprise Development 2004: 310, 311). This is reflected in the lower level of reported use of 'support services'[7] by SMEs in Poland, although the level of expressed demand is stronger or equal to the EU average (ibid.: 333). Financial services and professional information services are the types of support most strongly demanded. Clearly, if Polish SMEs are to take advantage of the opportunities presented by EU membership and deal effectively with any emerging threats, it is important they have access to a range of good quality advisory and training services. At the same time, the role of public policy in this regard needs to be assessed in the context of existing market-based provision.

The operation of the SME support system may be illustrated with reference to export promotion and associated support, drawing on a study undertaken in 2003 (Smallbone 2003). The system of export support and promotion in Poland was in the process of review at this time, as part of a new national export development and promotion strategy. The context for this was a recurrent trade deficit, which although declining after 2000, was still running at about $6 billion to $7 billion annually. While the root causes may lie in structural problems, reflected in low international competitiveness and the weakness of the Polish export offer, the lack of a coherent support system for Polish enterprises, insufficient co-ordination of efforts between central, regional and local institutions and the low level of export development and promotional funds did not help (Smallbone 2003). At the firm level, a stronger commitment to marketing and improved marketing methods were identified as potentially important contributors to improving the performance of Polish SMEs in international markets. Increasing attention paid to quality certification was another priority issue.

Grants are available to enable exporters and potential exporters to participate in foreign trade fairs and missions, as well as for firms to create and implement export development plans, together with 'soft' support in the form of access to export market information and advice. Nevertheless, the successful use and application of such support measures is dependent on the effectiveness of the business support system. In this regard, a review of export promotion and support for SMEs in Poland referred to 'fragmented support, lacking in cohesion and strategic vision; in other words, many details but little strategy' (Smallbone 2003: 26). Fragmentation on the supply side makes it difficult for SMEs to find their way through the system and as in many other post-socialist countries, the approach appears legalistic and institutional rather than customer-driven. It appeared that the Polish SME support system lacks customer orientation, because there is no agency with strong links to companies, which means that many potential beneficiary companies may be unaware of the support that is on offer. In a comparison with the Netherlands, a Dutch technical adviser, who was interviewed as part of the export policy review, suggested that rather than emphasising meeting spending targets operating within the rules, which is the approach in countries such as the Netherlands and the UK, in Poland, the priority of staff is simply to administer the rules.

Implications of EU accession for Polish SMEs

EU membership represents a major challenge for a country, such as Poland, and its businesses, particularly in view of the fledgling nature of much of the private SME sector there. Membership of the EU involves integration across various fields, with implications for the external environment in which business is conducted. Apart from the effects on increased market integration, more specific implications stem from the implementation of the recommendations contained in the EC's White Book (European Commission 1995), which refers to the preparation of Central and East European countries for integration into the

Single European Market. This requires a complex process of adaptation of legislation, regulatory systems and methods of certification and standards to meet EU requirements. The second source of potential implications of accession to the EU stems from the continuing process of transforming the economies in new member countries into market-based systems. This involves institutional reform and development, as well as legislative reform, together with the continued development of a competitive private sector.

While accession-related changes have important potential implications for firms of all sizes, it can be argued that the distinctive size-related characteristics of SMEs[8] are likely to affect their ability to identify, cope with and respond to new sources of threat and opportunity. These characteristics include their more limited internal resource base and the greater degree of uncertainty faced by SME managers, because of their lesser ability to shape and control their external environment (e.g. Gibb 1983). In this respect, the experience of existing EU members states at the time of the completion of the Single European Market in 1992 can offer some potentially valuable insights into the issues that SMEs in candidate countries are likely to face (Smallbone *et al.* 1999), although their impact is likely to vary according to the competitiveness of SMEs in particular sectors at the time of EU entry.

In considering the specific sources of threat and opportunity for SMEs in new member countries of the EU, the focus here is mainly on the first order, direct effects (apparent at the time of entry), which is what firms will need to navigate successfully if they are to achieve the potential gains of EU membership over time, although the longer term dynamic effects are also recognised. Essentially, first-order effects involve trade effects stemming from increased market integration, associated with the removal of non-tariff barriers (NTBs). This will contribute to new export opportunities on the one hand, but also to increase in competition in domestic markets on the other. While a reduction in the problems associated with physical barriers to trade is of potential benefit to all firms, SMEs are less likely to be able to capitalise on the opportunities afforded by market integration than larger firms. Factors such as a shortage of management time and a more limited capacity to employ specialist management expertise reduces the ability of SMEs to scan, analyse and respond to major environmental change, which accession to the EU represents.

In addition, since increases in competition are likely to occur in market segments that were previously sheltered from competition (e.g. by distance), SMEs are likely to be vulnerable to the threat from large firms that enjoy economies of scale in production, marketing and distribution. Since the greatest potential benefits of increased market integration within an enlarged Europe would seem to be presented to larger firms, the small number of large private firms combined with the disproportionate number of micro-enterprises that exists in Poland must be of concern to policy makers.

The experience in Western Europe at the time of the completion of the Single Market was that increased competition in domestic markets was a much more common Single Market effect than increased export opportunities. At the same time, the nature and extent of this increase varied considerably between sectors, not least because of sectoral differences in the level of pre-existing internationalisation (Smallbone *et al.* 1999b). The evidence from Western Europe also suggests that the main market integration effects operate to the potential advantage of the strong and to the disadvantage of weaker SMEs. For example, firms that are already proactively managed, and with an existing presence in foreign markets, are in the best position to take advantage of any new foreign market opportunities. In comparison, firms that are focused on regional or domestic markets niches, and in which managers are complacent or dismissive about any market integration effects impacting on their businesses can be in for a shock.

Apart from the trade effects stemming from market integration, SMEs also face effects that stem from the harmonisation of technical standards. This is because once they have to fully conform to EC directives, SMEs are subject to harmonised regulations, whether or not they are exporting. This differs from the pre-Accession situation in new member states of the EU where firms, which were serving domestic markets solely, were only subject to domestic regulations. Clearly, this is likely to pose the greatest threats where the gap between existing national regulations and EC standards is large. This typically varies considerably between sectors, because of differences in the nature and extent of national regulations and controls. For example, whereas firms in the clothing industry face few national regulations that are sector specific, those in the food industry, which is typically highly regulated at a national level, face regulations designed to control food hygiene, the composition of food products and the conditions in which food is produced, stored, distributed and sold. As a result, the implications for firms of the harmonisation of national with EU regulations are likely to be more extensive in the case of food than in the clothing sector. While the harmonisation of technical standards and regulations applies to firms of all sizes, it may be argued that the disproportionate effect of the burden of compliance costs of meeting particular legislative requirements makes this of particular concern to smaller firms (see Chapter 2).

The pressure to increase quality standards (particularly quality assurance) also comes from foreign buyers, which although not a process that is narrowly tied to increased market integration is likely to be encouraged by it. For example, based on experience in Spain and Portugal in the early 1990s, as the retail food sector becomes an increasing target for large foreign supermarket and hypermarket chains, increasing pressure is placed on small retailers. Unless domestic food-processing SMEs are able to meet the demanding quality standards of these large retail firms, they will source from abroad. This was the experience of Portugal in the early 1990s, with major knock-on effects on SMEs in the domestic food-processing industry (Smallbone *et al.* 1999d).

The year 1995 was an important date in the development of the Polish SME sector, because the intensification of efforts aimed at Poland's integration with the European Union dates back to that year. A complex process of harmonisation of Polish laws and regulations with those of the EU, combined with a continuation of the transformation process itself,[9] contributed to changes in the operating environment facing Polish enterprises, irrespective of their size. Full integration of Poland with the EU implies potential benefits resulting, in particular, from the removal of barriers and restrictions in the movement of goods and services, labour and capital, and from the acceleration of restructuring processes in many sectors. On the other hand, it also poses a requirement of increasing competitiveness.

Alongside the longer-term competitiveness issues raised earlier, Polish SMEs also face the short-term costs of adapting to new regulatory requirements, although as mentioned previously, the implications vary considerably between different sectors. As companies have to adhere to EU regulations, whether or not they are generating foreign market sales, the impact will fall most heavily on enterprises operating in sectors where the difference between EU and previous national regulations are the greatest and where there are few offsetting potential gains associated with the removal of NTBs.

An example of a sector, which is highly sensitive to this threat, is foodstuffs, in which as far as SMEs in Poland are concerned, internationalisation is at a low level and the implementation of European standards is still mainly in the future. As a result, the need to adapt to European standards is likely to be costly for Polish SMEs, while they will have to face intensified competition from large and medium enterprises based in the EU.[10] At the same time, even in this sector, the level of internationalisation is steadily increasing, caused mainly by the rapid expansion of western super- and hypermarket networks. If Polish foodstuff producers want to survive in this market, they must meet European quality standards and particularly the requirements with regard to quality assurance certification. Otherwise they face being squeezed out of the Polish market by foreign suppliers, as was the case in Portugal in the early 1990s. As a result, Polish SMEs that want to remain in food processing face a need to increase capital spending on investment, as well as increased expenditure to achieve quality assurance certification.[11]

The domestic road-haulage sector in Poland is another example of a sector, which will be affected by the costs of adapting to EU standards, which in this case relate to environmental protection, welfare regulations, and health and safety standards. For example, adapting to EU regulations, which specify the length of time that a driver may work, requires that appropriate tachographs are purchased and installed, as well as acquiring devices for reading them. Furthermore, the costs of labour will also increase, as more vehicles will need two drivers. It is estimated that the freight transport industry in Poland is made up of about 135,000 vehicles with load capacities over 3.5 tonnes, around 30 per cent of which did not have tachographs installed prior to EU entry. Each company will need to spend up to 2,500 PLN per vehicle in order to install the required devices in all vehicles, which on its own is unlikely to threaten the existence of a company, unless it is already close to bankruptcy (Office of the Committee for European Integration 2001). However, it is much harder to estimate the number of additional drivers that will be necessary, particularly in the case of very small firms, where there is limited scope for rotating drivers between vehicles.

Adapting to EU standards in the technical, environmental, insurance, taxation and safety fields also leads to additional costs for domestic transport firms, resulting from road tax, the cost of adapting vehicles to exhaust fume emission and technical safety standards, as well as adopting European welfare standards, which include maximum driving time and periods of obligatory rest. It is estimated that one-third of all Polish haulage firms will not be able to carry these additional costs (Bielecki 2001), which may, in turn, lead to consolidation amongst the smaller hauliers. The situation is different for the international transport companies, since they are already obliged to abide by EU regulations and may prove to be very competitive because of much lower operating costs (mainly drivers' salaries). For example, such companies already control 80 per cent of runs between Poland and Germany. However, when all aspects are concerned, the difference in costs between Polish firms and their EU counterparts is not that great (€0.85 per km in the EU and €0.70 per km in Poland). Although the cost of maintaining vehicles is on average about 60 per cent higher in the EU than in Poland, European agents are able to improve their competitiveness through better efficiency of work and greater specialisation (Bielecki 2001).

In terms of the potential longer-term dynamic effects of EU entry, econometric estimates[12] suggest that the pressure of additional costs and the resultant changes in the competitiveness of Polish industry during the first five to seven years of membership depend on the choice of scenario (Czyżewski *et al.* 1998). It is possible that the competitiveness of all Polish sectors will decrease slightly, although the trade creation effects between Poland and the EU may compensate for that decline. In this scenario, sectors such as machinery production, metal goods production, the construction industry, waste management and paper and cellulose production are likely to be in the weakest position.[13]

However, a different scenario is also possible,[14] which assumes a faster growth of productivity and hence only a slight increase in the pressure of additional costs. In this scenario, inflationary pressure resulting from rising costs only slightly increases, while certain labour-intensive sectors, which are less technologically advanced, may even become more competitive. This creates a favourable environment for enterprises operating in those sectors, particularly exporters. Under such conditions opportunities are likely to increase for SMEs operating in sectors such as the production of office equipment and computers; production of electrical machinery; production of radio, television and telecommunication equipment; leather treatment and production of leather goods; production of non-metallic goods; production of precision and optical medical instruments; production of clocks and watches; and production of fabrics.

Changes in competitiveness will result in trade creation and trade displacement effects, which will in turn impact on the labour market. In the long term, they may become important factors contributing to a major restructuring of the Polish economy, associated with adaptation to the needs of a larger, internal market. Evidence of restructuring is already apparent in the concentration processes, which are already affecting some sectors in which SMEs operate. The foodstuffs sector is probably the most spectacular example of this, resulting in a growing market share for the strongest enterprises economically and of those enterprises which are backed by foreign capital. On the other hand, the market share of weaker competitors in this sector is constantly shrinking, as a growing number of companies go into liquidation (Urban 1997). Developments in the Polish milk industry confirm these tendencies, with attempts to create the first dairy giant, to compete in an enlarged European Internal Market (Trusiewicz 1999).

The processes of restructuring are also dependent on the intensity and direction of foreign direct investment (FDI), which is currently concentrated mainly in manufacturing activities (42 per cent of all FDI), in sectors such as foodstuffs,[15] transport equipment and the production of non-metallic goods, which in combination account for two-thirds of all FDI in manufacturing (Ministry of Economy 2001). Other sectors, which attract FDI are financial brokerage (23 per cent of all FDI) and transport, warehouse and communication (11.6 per cent of all FDI). The experiences of Ireland and Portugal show that foreign investments may encourage the development of technologically advanced sectors, which can include co-operation between domestic and foreign companies. In Ireland, foreign investment also contributed to the development of technology-based sectors, although this demonstrates the risks that accompany foreign investments in cases where industrial policies of the government are not successful in strengthening domestic companies, which become increasingly open to foreign competition. The result may be a dual economy, which is characterised on one hand by a highly effective, technologically advanced sector, where production is rapidly growing but dominated by foreign companies and, on the other hand, by local firms which are less competitive. It is necessary to maintain the domestic industrial base and promote co-operation between local companies and foreign investors in order to achieve the maximum benefits of such investments (Buigues *et al.* 1990).

SME development in rural areas[16]

In assessing the current and future development prospects for Polish SMEs in the context of Poland's membership of the EU, it is important to recognise spatial differences, which include distinctive issues facing enterprise development in rural regions. Previous authors have drawn attention to the lack of attention paid to rural entrepreneurship in transition economies (Kalantaridis and Labrianidis 2004), at least in those countries where market reforms have been slow or incomplete. In Poland villages and rural areas account for more than 90 per cent of the total land area of the country and contain some 40 per cent of the total population (Piasecki and Rogut 2004: 271). Moreover, agricultural employees represent approximately 26 per cent of the total Polish workforce. Rural development issues are particularly challenging in those areas located in proximity to the country's eastern borders, because of the combination of rural and regional disadvantages that exist there. Restructuring effects associated with integration into the EU's Internal Market are likely to lead to a spatially uneven distribution of jobs losses, which can be expected to be the most severe in the eastern regions, where agriculture is still a major source of employment. Stimulating new jobs through entrepreneurship is likely to be particularly challenging in these areas.

At the same time, Polish rural areas are far from homogeneous, with three main types of region identified by Piasecki and Rogut (2004: 271–272):

- i Regions containing mainly small farms, with non-farming activity providing the main source of income. Agriculture in these regions is the main source of income for only 10–20 per cent of the population and unemployment is significantly above the national average.
- ii Regions characterised by a large proportion of rented land, which was previously controlled by state farms. The population in these areas includes a high percentage of former workers on state-owned farms, who are now largely unemployed. This depresses family incomes, with implications for the level of aggregate demand locally and for business opportunities in the local market.
- iii Regions characterised by lower densities of enterprises in the agriculture and food sectors. They contain two-thirds of all Polish farms, which includes approximately 400,000 that are estimated to have the capacity to adapt to changing market conditions.

Outside agriculture, enterprise activity in rural areas is mainly focused on food processing, together with some small-scale manufacturing and services, which includes activities connected to agriculture, making it often seasonal in nature. It is reported that entrepreneurship in rural areas involves mainly self-employment and micro-enterprise activity, driven by the need to boost household incomes, rather than by a desire to establish long-term economic activity (Piasecki and Rogut 2004: 273). This is what writers, such as Scase (1997, 2003), have described as ‘proprietorship’.

Developing entrepreneurship in Poland’s rural areas is a challenging prospect, particularly in ‘peripheral, traditional villages with small populations’ (Piasecki and Rogut 2004), because of a number of structural weaknesses. The main barriers identified by Piasecki and Rogut in this regard include: first, a low capacity for capital accumulation, resulting in a lack of foreign capital for investment; second, a high proportion of farms that lack the capacity to adapt to changing market conditions; third, undeveloped supply chain linkages between agricultural producers, wholesale firms and food processing firms; and fourthly, the education level of the rural population, which is significantly lower than that of their urban counterparts. In combination, these factors constrain the development of entrepreneurship in Poland’s rural areas, which increases the need to generate opportunities for diversification into non-farming economic activity as an alternative source of employment. It is difficult to see how the situation can be changed radically without policy interventions that lead to substantial investment of external capital in activities, which will provide new business opportunities for local entrepreneurs.

Entrepreneurship development is currently recognised by the Polish government as a key element in their current strategy for developing rural regions, with planned measures that include infrastructural modernisation; the creation of jobs outside of agriculture; the promotion of training opportunities for young people in rural areas. Support has been provided through pre-Accession policies, first within the Phare and Sapard programmes and then based on EU Structural Funds.

A more detailed picture of the nature and extent of entrepreneurship development in Poland's rural regions may be gleaned from empirical evidence drawn from a study of rural districts in the neighbourhood of Bialystock and Zary, by Piasecki and Rogut, as part of a larger international collaborative study of entrepreneurship in Europe's peripheral rural regions. In the Polish context, the Bialystock district (which is situated on the border with Belarus) is an example of a region characterised by relatively low densities of enterprises in the agriculture and food sectors (i.e. a type iii rural region), while Zary (situated on the border with Germany) is characterised by a large share of rented land that previously belonged to state-owned farms (i.e. a type ii rural region). Both districts are located in Poland's economic periphery, with relatively high unemployment and an education and transportation infrastructure that is below the national average.

The empirical work undertaken in 2001 in these two rural districts included surveys of approximately 500 households in each district, as well as surveys of 100 of the more growth-oriented enterprises in each case. The aim was to assess the entrepreneurial capacity of these districts and the challenges facing entrepreneurship development. The results showed that although both rural districts represent areas characterised by a poor entrepreneurial tradition, marked differences could be observed in the propensity towards entrepreneurship, although in both cases it was significantly below the national average. Essentially, in the Zary district, the household survey showed some 16.5 per cent of the population to be engaged in some form of entrepreneurial activity, compared with just 8.5 per cent in Bialystock. Piasecki and Rogut explain this in terms of a more benign business environment in Zary and better communications, compared with Bialystock, where aggregate demand was depressed by a predominance of subsistence style agriculture.

The overall conclusion reached by these authors was that together with other surveys in Poland, the study showed entrepreneurship in rural areas to be still in the early stages of development, mainly because of the lack of an enabling environment, in terms of technical infrastructure, poor access to markets and a lack of a business support infrastructure. This is supported by evidence from the survey of existing enterprises, which showed that only a handful of firms had either sought or received external support of any kind, including external sources of business information and advice.

The survey of existing enterprises, which were selected to represent the more growth-oriented firms within their districts, showed most private firms to lack dynamism. Most were very small enterprises, operating within traditional sectors, offering low-value-added products and services, mainly to local markets. Moreover, the intensity of IT use was low and very few firms had been able to access external capital. Most of the firms surveyed had been set up during the period of the so-called 'entrepreneurship explosion' in Poland. More positively, however, the household surveys showed relatively high levels of interest amongst the rural population in both districts in starting and running a business, although this must be interpreted in the context of low levels of alternative employment opportunities in many cases.

This analysis of entrepreneurship development in Poland's rural areas emphasises the spatial imbalances that can involve urban-rural as well as interregional contrasts. While recognising the diversity of experience in Poland's rural areas, accession to the EU is likely to reinforce and perhaps widen existing disparities, in the absence of strong policy intervention. This will need to include institutional development and capacity building to enable local and regional authorities to adopt a proactive and effective role in promoting entrepreneurship as a driver of economic development in rural Poland.

Concluding remarks

The evidence presented in this review of Poland's experience over the last 20 years paints a picture of remarkable change, as the country has moved from involuntary membership of the Soviet bloc to EU membership. While the pace of development of the SME sector hitherto has been impressive in comparison with many other post-socialist economies, major challenges remain. In this regard, a major strategic priority is the need for more SMEs to focus on higher-value-added products and services, which has implications for business and innovation support policies, as well as for labour markets.

8 From the former Soviet Union to membership of the European Union

The case of Estonia

Introduction

This chapter is concerned with a country in which the pace of transformation since 1990 has been impressive by any standards. One of the recurrent themes running throughout this book is the diversity of experience that exists between different transition economies in the nature and extent of the development of entrepreneurship and small businesses, since 1990. In this context, Estonia is a particularly interesting case, because, as a former Soviet republic, all non-state-owned enterprise was illegal until 1987 when industrial co-operatives were allowed to trade alongside state-owned companies. Unlike Poland, for example, where a relatively large private sector existed during the socialist period, no such recent experience of private enterprise existed in the Baltic States prior to the start of the transformation process. As a consequence, apart from a few joint ventures, and firms set up in the late 1980s as industrial co-operatives, the vast majority of SMEs in Estonia and her Baltic neighbours have been established since 1990. While it can be argued that Estonia's small size (i.e. approximately 1.4 million people) and its ability to exploit its historic ties with its Nordic neighbours represent distinct advantages compared with some other CEECs, the pace of change from a centrally planned to a market-based economy is impressive.

Below, a summary description of the development of the SME sector in Estonia to date, highlighting distinctive features, such as the high level of export orientation, is presented. The rest of the chapter focuses on institutional change associated with Accession to the European Union; the changing role of government policy in relation to SME development over time; and the state of the SME sector in the country at the time of Accession, based on a representative large-scale survey.

The context

Following independence in 1991, government policy in Estonia has been underpinned by a free market philosophy and a commitment to the institutionalisation of private ownership and market reforms. Rapid privatisation meant that by the end of 1996, most large enterprises had been sold, with attention turning to the utilities such as energy, telecommunications, railways and ports, although progress with the privatisation of land was hampered by a complicated restitution procedure. Since 1991, Estonia has also had a liberal trade policy, in which trade barriers and tariffs have been abolished. This has contributed, on the one hand, to a growth in exports and, on the other, to an inflow of duty free imports, which have been exploited by both domestic and foreign manufacturers. In addition, the associated increase in competition in the domestic market has accelerated the pace of restructuring. Estonia's success in attracting foreign investment has been an important enabling factor contributing to the success of its economic reforms and the structural transformation of the economy, facilitated by the government's strong commitment to privatisation and the establishment of an open and transparent environment for business.

As a result, on most indicators of market reform, Estonia typically scores highly in comparison with other CEECs and former Soviet republics. For example, based on EBRD assessment, 80 per cent of GDP by 2005 was contributed by the private sector (EBRD 2005). In addition, progress with small-scale privatisation and the development of a foreign exchange system has been rated as 'meeting the standards and performance norms of advanced industrial countries (EBRD 2001). Estonia also scores highly on the 2002 Index of Economic Freedom, being ranked fourth in the world in 2002 and sixth in 2003, being classified overall as a 'free market economy' (O'Driscoll *et al.* 2003).

One of the key factors influencing the rate of formation of new enterprises and the ability of existing firms to survive and grow is the nature of macro-economic conditions, particularly in the initial stages of the transformation process. Hostile and unstable macro-economic conditions, particularly when combined with low domestic purchasing power, uncertainties over property rights and slow privatisation, can discourage entrepreneurs from committing resources to investment in long-term projects (such as in manufacturing enterprises). This, together with a shortage of financial resources, helps to explain why in many countries in the early stages of the transformation process, low entry threshold activities (such as simple trading) can appear more attractive to potential entrepreneurs than manufacturing.

In this regard, an early empirical study of manufacturing SMEs in Poland and the Baltic States concluded that by 1995, external conditions in Poland and Estonia were encouraging from the point of view of the development of manufacturing SMEs. This was reflected in the higher proportion of surveyed firms that were increasing both sales and employment in the period December 1993–1995, compared with their counterparts in both Latvia and Lithuania, where the pattern of employment change was much more mixed and fewer firms were able to increase their penetration of foreign markets. (Smallbone *et al.* 1996a). This was also reflected in aggregate economic data, which showed that manufacturing output had started to recover in Estonia in 1995, after a period of continuous decline since 1990. Not only that, but SMEs had been playing an important part in the process.

In terms of macro-economic trends, following a sharp contraction of output after the restoration of independence in 1991, economic recovery started in the second half of 1994, with growth (in real terms) reaching 4.3 per cent in 1995 and peaking at 9.8 per cent in 1997. Since then, real growth rates have been lower, although with the exception of 1999, they have remained positive. Key factors associated with this performance were the rate of inflowing foreign investment, export activity by Estonian firms and an increase in domestic demand, related to an increase in real incomes. Nevertheless, as in most other former Soviet republics, GDP in real terms still remained below its 1989 level for some years (2003 in the case of Estonia) (Figure 8.1), although by 2006 it had grown to 140 per cent of its 1989 level (www.ebrd.com/pubs/factsh/country/ estonia.pdf).

One indication of macro-economic stability is the rate of inflation. In this regard, Estonia's record is an impressive one, with a steady decline in consumer prices (annual average) since 1993 to reach 3.3 per cent in 1999, since when it has been subject to minor fluctuations between 0.5 per cent and 6.0 per cent (EBRD 2005). Both strong demand and increased price stability are important factors contributing to the development of an environment that encourages entrepreneurs to invest.

Economic change and restructuring through the 1990s had important implications for the labour market in Estonia, with the demand for labour decreasing steadily after 1991. Total employment fell as GDP declined during the initial period of transition, but continued to decline even when GDP began to recover (Figure 8.1). The employment rate[1] fell from 73 per cent (807,800) in 1991 to 58 per cent (604,500) in the year 2000 (Statistical Office of Estonia 2000). Alongside this decline in total employment, the level of unemployment (on the basis of the Estonian Labour Force Survey) increased rapidly until 1995, stabilising at about 10 per cent of the total labour force until 1999, when it began to increase again to reach 13.6 per cent in 2000 (Statistical Office of Estonia 2001). Employment started to increase only in 2001 and achieved a growth of 3.8 per

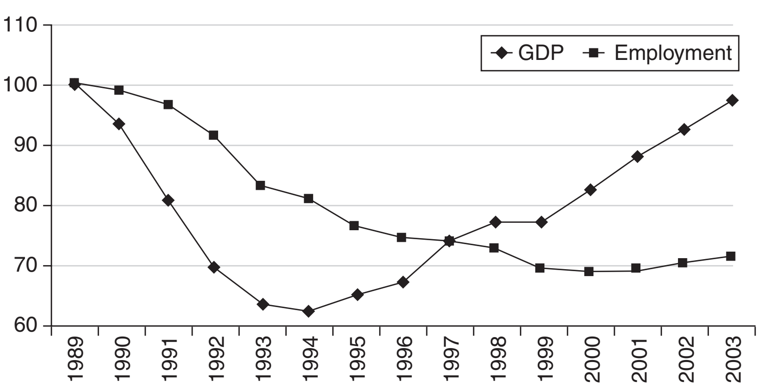

Figure 8.1 GDP and employment change in Estonia (1989–2003) (source: Statistical Office of Estonia).

Note
100 per cent = total employment in 1989.

cent during the period of 2001–2003, compared with the number of employees in 2000. As a result, the unemployment rate fell to 10.1 per cent in 2003 (Statistical Office of Estonia 2004).

As in other transition economies, a key issue facing the emerging private sector in Estonia has been the mismatch between the demand and supply of labour, because of the changing nature of demand and inelastic supply. A decline of employment in some sectors and a growth in others has implications for the demand for different types of labour skills. Data from a survey of manufacturing SMEs in 1995 pointed to the existence of a skills mismatch in the labour market, with implications for unemployment, but also for the ability of firms to grow (Appendix, Project 2, pp. 236–237). Employment in manufacturing and agriculture has been falling during the transformation period, while jobs in services have increased. Unfortunately, despite a decrease in the unemployment rate, long-term unemployment has been increasing, with nearly 46 per cent of unemployed people reported to have been without work for at least one year; and 66 per cent for two years or more (Statistical Office of Estonia 2004). Unemployment problems are typically worse in peripheral areas (such as Southern Estonia and the North-East region), particularly in counties where there was a concentration of industry or agriculture in the pre-reform period.

The development of the SME sector

Changes in the economic and legislative environment in the early 1990s led to a rapid increase in the number of private enterprises in Estonia, encouraged by the relatively simple conditions for establishing enterprises. At the same time, the ease of entry led to the registration of a large number of enterprises that either never actually started trading, or commenced trading but were unable to survive in the market. A relatively successful privatisation model also contributed to the initial increase in the number of private enterprises, so that by 1995, 90 per cent of all Estonian enterprises were in private ownership. The rapid increase in the number of private sector enterprises in Estonia through the 1990s is impressive by any standards, particularly when it is considered that contemporary private sector development only really dates from the start of the process of administrative reform in 1987. Nevertheless, the level is still below that of EU countries: 43 per 1,000 inhabitants in 2002[2] compared with an average of 51 in the EU.

In terms of sector characteristics, two-thirds of the 79,220 registered entrepreneurs (including both enterprises and sole traders) at the beginning of 2004 were in services, 14 per cent in manufacturing and 20 per cent in primary sectors (mainly agriculture) (Statistical Office of Estonia 2004). The concentration in services partly reflects the relatively low entry thresholds in this type of activity compared with manufacturing, but also the pattern of demand for consumer services that were largely unobtainable during the Soviet period. In fact, new businesses that were first registered in the year 2003 were even more concentrated in services than the existing business stock: 75.7 per cent compared with 11.6 per cent in secondary sectors and 12.6 per cent in primary activities (Centre of Registers, Ministry of Justice of Estonia). These figures demonstrate that one of the roles of the emerging private sector has been to contribute to changes in the economic structure, particularly with respect to the development of new businesses in trade, transport, financial and other business services.

As in mature market economies, the vast majority of private enterprises are very small, micro-enterprises employing fewer than ten persons. On the basis of the National Tax Board database, 78.2 per cent of active enterprises in the year 2002 were micro-enterprises, with 17.7 per cent small and 3.3 per cent medium-sized. However, this figure understates the role of micro-businesses, because of the exclusion of a large number of sole traders from the National Tax Board database. The proportion of the total stock of enterprises consisting of small and very small enterprises has increased during the 1990s, particularly those employing fewer than ten, because of a decrease in the total stock of enterprises employing ten or more since 1997 (Table 8.1). As a result, the average size of active enterprises (excluding sole traders) has decreased from 22 employees in 1994 to 12 employees per enterprise in 2002, calculated on the basis of National Tax Board information.

In terms of employment, SMEs[3] accounted for about 56 per cent of total employment in 2002.[4] Moreover, as Table 8.2 indicates, the proportion of total employment in the enterprise sector found in small (and particularly very small) firms has increased considerably, while that in large and medium-sized firms has declined. This is partly explained by the continued restructuring of medium and large enterprises and partly by an increase in the number of very small firms.

Although the pace of SME development since 1990 has been rapid, there are significant regional variations in enterprise development, which is reflected in the total stock of privately owned SMEs, but also in the rate of new firm formation. This is not surprising since even in mature market economies, the more prosperous regions may generate up to three times the number of new businesses per head per annum compared with peripheral regions (Reynolds *et al.* 1994). In Estonia, Tallinn and the surrounding Harju County accounted for 59 per cent of operating businesses in 2002, which included 51 per cent in Tallinn compared with its share of 29 per cent of the total population. As a result, the number of enterprises per 1,000 population in 2002 was 76 in Tallinn and Harju County (Centre of Registers data) compared with just 18 in Ida-Viru County (an old industrial region). Moreover, the regional gap appears to be widening, since Tallinn accounted for more than half of the total number of businesses actively operating in Estonia in the year 2002, compared with just 5 per cent in Ida-Viru County (National Tax Board data).

The slower pace of development of entrepreneurship in Estonia's industrial and agricultural regions compared with the capital city reflects serious interregional and urban–rural imbalances in private sector development, but also differences in the pace of wider transformation processes, which are observable in most transition economies to varying degrees. According to the Estonian Ministry of Economic Affairs, businesses located in the core counties of Harjumaa, Pärnumaa and Tartumaa account for almost 76 per cent of the total business

Table 8.1 Number and structure of enterprises by employment size group in Estonia (1994–2002)

Number of employees	*Number of enterprises*								
	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
0–9	13,826	19,069	19,647	20,718	20,530	20,541	23,429	25,532	27,508
10–49	5,322	6,217	6,366	6,482	6,448	6,215	6,106	6,134	6,225
50–249	1,353	1,448	1,345	1,307	1,257	1,203	1,128	1,135	1,158
>249	265	227	204	189	175	178	177	159	159
Undetermined						1,398	506	219	114
Total	20,766	26,961	27,562	28,696	28,410	29,535	31,346	33,179	35,164
	Structure of enterprises								
	1994	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
0–9	66.6	70.7	71.3	72.2	72.3	69.5	74.7	77	78.2
10–49	25.6	23.1	23.1	22.6	22.7	21	19.5	18.5	17.7
50–249	6.5	5.4	4.9	4.6	4.4	4.1	3.6	3.4	3.3
>249	1.3	0.8	0.7	0.7	0.6	0.6	0.6	0.5	0.5
Undetermined	0	0	0	0	0	4.7	1.6	0.7	0.3
Total	100	100	100	100	100	100	100	100	100

Source: National Tax Board.

Note
Table excludes sole traders but includes farmers.

Table 8.2 Employment by enterprise size group in Estonia

Number of employees									
Size groups	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*
0–9	47,505	65,485	67,189	70,122	69,586	74,650	78,233	80,759	82,957
10–49	111,981	125,990	128,435	129,920	128,421	127,566	124,886	125,434	126,956
50–249	134,091	140,282	129,962	124,308	116,698	115,443	109,594	111,375	114,549
>249	152,012	131,635	123,887	117,543	106,955	111,381	106,278	101,615	103,877
Total	445,589	463,392	449,473	441,893	421,660	429,040	418,991	419,183	428,339
Share of employees, %									
0–9	10.7	14.1	14.9	15.9	16.5	17.4	18.7	19.3	19.4
10–49	25.1	27.2	28.6	29.4	30.5	29.7	29.8	29.9	29.6
50–249	30.1	30.3	28.9	28.1	27.7	26.9	26.2	26.6	26.7
>249	34.1	28.4	27.6	26.6	25.4	26	25.4	24.2	24.3
Total	100	100	100	100	100	100	100	100	100

Source: National Tax Board.

stock, with only 24 per cent in the other counties. In addition, 55 per cent are concentrated in the three largest cities, with almost half in Tallinn.

An open economy with export-oriented SMEs

One of the most important factors influencing the long-term growth prospects of any economy is the ability of its firms to develop sales in foreign markets, since this represents an important mechanism for generating external income, which contributes to the ability of the economy to grow. In the case of Estonia this is particularly important because of the limited size and scope of the domestic market and also because of the need to replace traditional markets in the former USSR. Although government has recognised that foreign trade is a key factor influencing the rate of economic growth, it has sought to promote this through a liberal foreign trade policy, with minimal intervention. In this context, government support for export activity has tended to focus on 'soft' measures, such as improving access to information and advice, through business support centres, rather than through the use of direct support measures.

Estonia's exports grew rapidly in the late 1990s, with those to the EU and OECD member states increasing the most rapidly. Detailed analysis shows that Estonia's main foreign trade partners are Finland and Sweden, which together accounted for 52.8 per cent of total exports in 2000, although falling to 40 per cent in 2002 (Statistics Lithuania 2003: 17) While this pattern demonstrates the growing integration of Estonia into the Baltic region, such a high level of dependence makes the Estonian economy highly susceptible to changes in economic conditions in neighbouring countries. In this regard, the decrease in the share of total exports destined for Finland and Sweden after 2000 reflects a growth in exports to other Nordic and Baltic countries, as well as to Western Europe, including Germany, UK and the Netherlands. As total exports grew, the share destined for the Russian market fell from 22.4 per cent in 1994 to just 2.4 per cent in 2000, although it increased slightly after that to 3.4 per cent in 2002 (Statistics Lithuania 2003). The 1990s also saw a change in the structure of Estonian exports, with 'foodstuffs' declining in relative importance and 'machinery and equipment' increasing their share. This was associated with a geographical shift in the locus of foreign market activity, as Estonian engineering firms, for example, became increasingly involved in subcontract work for contractors within the EU.

At the same time, the share of re-exports in total exports is high, reflecting the use of Estonia as a low-cost production base, partly associated with an increase in foreign investment. Together with strong domestic demand, this has led to a rise in imports associated with the improvement of production capacity and quality. The growing involvement of Estonian firms in subcontracting is part of a wider internationalisation of production, driven by the needs of large enterprises to find ways of reducing their production costs. For example, significantly lower wage levels in Estonia compared with Sweden and Finland have contributed to a substantial shift of some of the more labour intensive operations from these other Nordic countries into Estonia. Although the geographical distance is only 100–200 kilometres, the wage differential between Estonia and Sweden and Finland is about 5–6 times (Statistical Office of Estonia (2001: 23). For Estonian firms, producing intermediate components on a subcontract basis for EU customers helps to avoid some of the problems and costs associated with quality certification and testing, which producers of final products are liable for. Moreover, in constructive partnership-type arrangements, the contracting firms can help their subcontractors to improve their quality standards. At the same time, there has been some decrease in the share of re-exports in relation to total exports since 2001, which is explained by a reduction in the volume of subcontracting in ICT sector by Nordic companies, on the one hand, and the increasing competitiveness of Estonian enterprises to export to foreign markets, on the other.

Low domestic purchasing power, associated with a small domestic market and low average income levels, means that the structure of domestic demand in Estonia is characterised by a high proportion of income being spent on basic goods (e.g. food). This means that niche-focused firms aiming to sell high-value-added products must inevitably seek foreign markets, often at a relatively early stage in their development. Survey evidence from the mid-1990s shows that Estonian manufacturing SMEs responded quickly to the opportunities presented by western markets, although the studies also reveal certain potential weaknesses which stem from the methods used to service foreign markets, in some cases, as well as the size-related barriers which SMEs face when seeking to develop or increase export sales (Smallbone *et al.* 1999b). Nevertheless, the scale of the reorientation of markets during a relatively short period is impressive.

Although large enterprises export a higher proportion of their total output than SMEs, the number of SMEs (in all three size groups) that are involved in foreign markets has also increased (Table 8.3).

Survey evidence suggests that Estonian SMEs more rapidly reorientated their sales towards new foreign market opportunities than their counterparts in Latvia or Lithuania, influenced by the more liberal trade policies (Jurgenson *et al.* 2003). Low domestic demand combined with the absence of customs duties on imported goods resulted in strong competition for limited domestic sales, thus forcing firms to seek market opportunities elsewhere. In addition, macroeconomic conditions stabilised more rapidly in Estonia in the 1990s than in her Baltic neighbours. However, in the late 1990s, the key issue facing Estonian exporters and potential exporters was achieving and maintaining competitiveness in the context of an enlarged EU market. Expansion of the European Union's internal market, associated with the inclusion of new members from Central and Eastern Europe, will intensify the internationalisation trends in the transition economies. The increasing integration with the European Union has a considerable potential impact on the economic environment on the development of entrepreneurship in Estonia.

It is widely recognised in western countries that smaller firms face certain size-related disadvantages in identifying and exploiting foreign market

Table 8.3 Exporting enterprises and total exports by enterprise size groups in Estonia (1999–2002)

Firm size group	*Exporting enterprises*				*Total exports, %*			
	1999	*2000*	*2001*	*2002*	*1999*	*2000*	*2001*	*2002*
Micro-enterprises	2,616	2,789	2,859	2,935	10.7	10.1	10.2	10.5
Small enterprises	1,808	1,796	1,864	1,839	24.2	23.8	22.5	23.6
Medium-sized enterprises	561	518	583	590	39.5	39.1	38.6	38.2
Large enterprises	109	105	98	95	25.4	27.0	28.7	27.7
Undetermined enterprises	67	12	4	3	0.2			
Total	5,161	5,220	5,408	5,462	100.0	100.0	100.0	100.0

Source: Ministry of Economic Affairs and Communications (2003).

opportunities. Moreover, because of the potential contribution of export sales to economic development there is a strong case for policy makers to prioritise policy support for SMEs with respect to exporting, which is recognised in most mature market economies. The main barriers that managers in Estonia surveyed in 1997 perceived to increasing export sales were the strength of competition in foreign markets and the lack of information about these markets. More detailed analysis revealed the limited marketing experience and capability of surveyed firms, which is a particular constraint when firms attempt to develop or increase export sales. This is demonstrated by the fact that few exporting firms had engaged in active research to inform themselves about foreign markets. Instead, the main sources of foreign market knowledge were existing customers, informal contacts with other businesses, trade fairs and exhibitions, and the media, that partly reflects the emphasis on subcontracting-type relationships as a means of accessing foreign markets in the clothing industry. Significantly, business support agencies had only been used by a small minority of firms (11 per cent) as a source of information about foreign markets. As a result, one of the main policy priorities in Estonia, identified at the time, was to develop a high-quality business support infrastructure that will enable SMEs to sustain and deepen their involvement in foreign markets as well as providing a means of support for firms seeking to enter such markets for the first time.

Another aspect of open markets relates to FDI. The sources of FDI follow a similar pattern to Estonia's trade flows, with Sweden (41 per cent of total stock by the end of 2002) and Finland (27 per cent) representing the main partners (Eesti Pank 2003). In practice, in combination, the four Nordic countries account for nearly 74 per cent of the total FDI stock. The main sectors in which inward investment is concentrated are banking and financial services (27 per cent of the total stock by the end of 2002), which is explained by the strong presence of Nordic banks in Estonia; transport, storage, and communications (23 per cent); manufacturing (19 per cent); and the wholesale and retail trades (13 per cent). Based on various studies, most foreign investors in Estonia are seeking access to neighbouring EU and Baltic markets (Varblane 2001), although the relatively low production-cost base in Estonia is also a key attraction. In terms of outflows, Estonian investment into the other two Baltic States accounted for 75 per cent of the total stock of Estonian FDI by the end of 2002.

Developing an institutional framework

The development of an appropriate institutional framework is an important part of the process of market reform, involving the creation of both private and public sector institutions, which in the latter case needs to operate in a market-oriented fashion. In general, the institutionalisation of business support includes the development of institutions on three levels: macro, meso and micro (Welter 1997).

In Estonia during the 1990s, two ministries (the Ministry of Economic Affairs and the Ministry of Internal Affairs) were mainly responsible for implementing the main tasks connected with the support programmes for SMEs at the *macro level*, with three other Ministries (for Finance, Agriculture and Social Affairs) also involved, through their responsibilities for supporting regional and enterprise development. From 2000, the responsibility for enterprise support was centralised under the Ministry of Economic Affairs and Communications, with the aim of making more effective use of the resources available for enterprise support, on a regional as well as on a sectoral basis.

The public sector business support infrastructure was also restructured in an attempt to make it more efficient, transparent and accessible. Seven foundations, together with the Tourist Board, under the administration of five different Ministries, were integrated into two new organisations, namely Kredex (the Credit and Export Guarantee Fund) and Enterprise Estonia. Enterprise Estonia has responsibility for implementing public business support measures, and through the Regional Development Agency, the responsibility for supporting the local business development centres.

Considerable progress has also been made in developing the institutional framework for enterprise development at the *meso level*, which includes the banking system. Although access to finance remains a reported constraint on SME development in Estonia, there is evidence that the supply of finance is improving. The improved supply of finance has been associated with changes in ownership, so that all the main banks in Estonia are now foreign-owned. This has contributed to a wider range of financial products being offered to enterprises, with leasing, for example, becoming increasingly popular. It has also contributed to the development of an increasingly competitive market in which individual banks are seeking ways of increasing their market share.

Evidence of the improving supply of finance for SMEs includes the announcement, in February 2002, of a new financial product by the Eesti Ühispank (Union Bank of Estonia) branded 'Vitamin'. The product represented an innovation in the Estonian market in terms of the flexibility it offers SMEs to choose between alternative types of financing, according to their needs and circumstances. SMEs do not need to have collateral in order to access 'Vitamin' finance, although the equity share in the firm's balance sheet must be at least 20 per cent. Significantly, the initiative emerged following a series of Round Table meetings, organised by Kredex, which involved representatives of the banks, the Ministry of Economic Affairs and SME representatives. The development of 'Vitamin' was also assisted by the involvement of Kredex, in the form of guarantees, which reduces the banks exposure to collateral risk.

The capacity of the banking system to provide finance for SMEs has been assisted through co-operation with international agencies. For example, the EBRD and the EU signed a loan agreement with *AS Sampo Bank* in December 2000 to provide €10 million for lending to SMEs, through loans of up to €125,000 and lease agreements. By the end of October 2001, 181 loans are reported to have been drawn down under this scheme, totalling €4.8 million, with an average loan size of €27,000.[5] One of the distinctive features of this programme was the provision of technical assistance and systematic training for bank staff, for example, in loan evaluation, sales and marketing, by the consultants appointed by EBRD to deliver the programme. The Estonian *Hansapank* and the German bank *Kreditanstalt für Wiederaufbau* also had a loan contract for a total of €25 million (EEK 400 million), to enable Estonian and Latvian SMEs to obtain loans that are slightly below market rates (1–1.5 per cent) (Korpan 2002). The aim, as in the case of the EBRD/EU project, was to attempt to increase the supply of longer-term loan financing to SMEs.

Although the banking system is evolving, the venture-capital market remains weakly developed. Indeed, financing the business sector through the capital market is still in its infancy, with only a handful of medium and large companies currently listed on the Tallinn Stock Exchange. While some medium-sized firms are benefiting from limited financing from this source, small firms are not, with low levels of reported awareness. Informants suggested that if small firms are interested in external equity they look to informal sources, such as large firms and/or individuals in their locality, rather than to formal venture-capital companies.

Since its establishment in 1993, the leasing market has developed rapidly in Estonia, becoming an important funding alternative to bank loans for entrepreneurs. The majority of leasing companies in Estonia are subsidiaries of banks, which means that the establishment and development of the leasing market is inevitably connected with the changes in the banking market. Banks encourage leasing as a method of financing, mainly because it represents a form of asset-based financing, offering a means of overcoming the shortage of collateral faced by many SMEs seeking bank loans, particularly those at or close to start-up. Leasing is an established and growing source of enterprise finance in the Estonian market, with an estimated 20 per cent share of total investment in equipment and machinery.[6]

The institutional framework at the *meso-level* also includes a number of unions, associations and chambers, established by special interest groups, mainly on the basis of voluntary membership. Some of these, such as the Chamber of Commerce and specialised sector-based organisations have been the main source of support for businesses in the process of exploiting foreign markets, in particular. This is important because the effective institutionalisation of SME policy depends on the development of business organisations to represent the interests of entrepreneurs and businesses, acting as an interface between individual businesses and government. In this regard, quarterly round tables are held between the Prime Minister and the four main bodies that represent businesses in Estonia: the Chamber of Commerce (EKTL); the Employers Association (ETKL); ESEA, which represents large enterprises; and EVEA, which represents the interests of SMEs. Representatives of these organisations also meet regularly in the SME Advisory Council, which is a body chaired by the Ministry of Economic Affairs and Communications.

The main representative body for businesses is the *Estonian Chamber of Commerce*, which is a non-governmental, non-profit organisation, based on voluntary membership and taking up succession of the 1940 abolished chamber organisation. Membership is open to any registered company and was reported to have reached 3,145 by 2001, or about 11 per cent of the estimated number of registered enterprises. Although membership includes firms of all sizes, 49 per cent are reported to be very small firms (fewer than ten employees) and a further 38 per cent small enterprises (10–49 employees), drawn from a diverse mix of sectors. Fee income charged for services is reported to account for about half the annual budget of the Chamber, with the rest coming from membership fees, which are scaled according to the size of company. The main activities of the Estonian Chamber of Commerce are, first, to represent the interests of its members in policy formulation, by commenting on new draft legislation and participating in the various consultative forums with government referred to above; and second, offering services to members. The portfolio of services of the Chamber of Commerce includes: collecting and processing information about foreign and domestic customers; hosting a Euro Infocentre and business library; offering partner search facilities; assisting clients in the preparation of foreign trade documents; offering consultancy services; running short courses, particularly on legal and foreign trade-related issues.

The positive benefits of joining and participating in the Chamber of Commerce may be illustrated with reference to Case X (Box 8.1).

Box 8.1 Case X: a wholesale food company based in Tallinn

Established in 1993, the core business is distributing food products, mainly in the domestic market and to a lesser extent in Latvia and Lithuania. The firm supplies approximately 1,000 customers, ranging from small retailers to large supermarkets. Although the customer base was described as stable, the entrepreneur stressed the highly competitive nature of the retail market, predicting that not all their customers survive.

The entrepreneur was positive about her participation in the Chamber of Commerce, mainly because of the opportunities it had presented for networking. One of the specific benefits mentioned referred to information about bad paying customers, whose details would be passed on to competitors in order to prevent them getting away without paying again. It was stressed that there is mutual benefit in this form of co-operation, even between competing companies. The respondent explained that communicating information about bad paying customers to competitors helps to improve the business environment, which is a common interest. Participation in the Chamber of Commerce is a means of achieving this.

Source: case supplied by Dr Urve Venesaar

A second representative body for Estonian businesses is the Estonian Association of SMEs (EVEA), which is a NGO representing SMEs and self-employed people. The lack of a strong recent tradition of entrepreneurship in Estonia, combined with limited experience of self-governing organisations, affects the perceptions of business owners towards membership organisations. This may help to explain why the membership of EVEA was only about 500–600 in 2002, representing only about 1.7 per cent of the estimated number of active, registered firms. An EVEA informant compared this with the situation in Finland, where a comparable organisation was reported to have some 86,000 members, or 37 per cent of the total SME population. EVEA's main activities are focused on the lobbying and representation function and training.

The low level of membership of business associations is also reflected in a survey of more than 1,900 Estonian SMEs, undertaken in November–December 2002[7] (Jurgenson *et al.* 2003). One of the features of the institutional structure in mature market economies is the existence of business and professional associations to carry out a lobbying function and/or to provide certain services for their members. The survey results show that less than one in five (19 per cent) of all Estonian SMEs were members of such an organisation. As in mature market economies, significant differences were observed in the propensity of SMEs to be members of a business or professional association, between firm size groups (0.001 level), ranging from 62 per cent of medium-sized firms, to 29 per cent of small, 17 per cent of micro-enterprises, and 10 per cent of the self-employed.

The results indicate that only a small minority of firms employing fewer than ten, which make up approximately 78 per cent of the total number of enterprises in the Estonian economy, are members of a business association to represent their interests in the policy process. The Estonian Chamber of Commerce was by far the most commonly reported business organisation, accounting for 32 per cent of firms referring to membership of some business organisation, or 6 per cent of all firms, although more firms were members of some form of sector-based organisations (44 per cent and 7 per cent respectively). Although considerable progress has been made with respect to the institutionalisation of SME policy in Estonia, the low level of membership of business associations and similar organisations means that the majority of SMEs are not part of the key elements of this process.

At the *micro level*, institutional development has focused on the development of a network of business development centres; most of which were founded between 1993 and 1996 with foreign funds, supplemented subsequently with local resources. Previous evaluation has identified a number of weaknesses in the donor-financed network, including poor relationships with local authorities and other relevant institutions (such as banks) in many cases, and the overall impact of these business development centres within local business networks appears to have been weak. Other problems identified include the ongoing dependence of these centres on subsidies, the poor advertising of their services, and the fact that hitherto their activities have been mainly limited to dealing with start-ups (Phare 2000). As a result, the business support network has subsequently been the subject of reform, both to improve the quality and effectiveness of services delivered to SMEs but also to improve the administration, management and cost effectiveness of the support institutions.

Government policy and SME development

Compatible with its commitment to a liberal market economic management policy in the 1990s, the overall role of government in relation to private sector SME development in Estonia has been facilitating and enabling rather than proactive and causal. For example, during the initial phase of transition, government was responsible for administrative and legal reforms, which made it possible for privately owned enterprises to exist, although for a time the continuous nature of the reform process contributed to an unstable and uncertain environment for business. It also took some time to revise the tax system completely, which meant that the development of small private enterprises was initially constrained by the remains of a tax regime inherited from the Soviet period.

In this context, until recently, direct support measures to support SME development in Estonia have been noticeable by their absence, although it can be argued that SMEs have benefited indirectly as a result of other public policies. For example, while market and trade liberalisation have not been specifically aimed at SMEs, these policies have contributed to increased opportunities for them to sell in foreign markets, as well as helping to make Estonian SMEs more attractive to foreign partners.

Since independence in 1991, the encouragement of FDI has been one of the priorities in Estonian economic development policy, which has also had indirect benefits for the development of SMEs. The encouragement of FDI is reflected in the elaboration of laws on ownership reform, foreign investment, privatisation, the creation of special incentive programmes and the adaptation of regulatory frameworks to meet internationally agreed standards. As a result, FDI inflows grew in per capita terms from €450 in 1996 to €2,969 by the end of 2002,[8] making it one of the highest accumulated FDI levels per capita in Central and Eastern Europe.

Estonia is generally viewed as having few restrictions on foreign investments, offering high levels of freedom to foreign investors and the protection of property rights. Throughout the 1990s, foreign investors and their investments were granted ‘equal rights and obligations’ with their domestic counterparts, with freedom to repatriate profits, dividends and invested capital. Estonia does not prohibit foreign investments in any sectors or activities, although certain activities are subject to licensing. However, any such restrictions apply equally to Estonian and foreign companies, under the same conditions. Foreign firms established in Estonia are treated similarly to their domestic counterparts, for example, by an income tax regime that excludes reinvested earnings of companies from the corporate income tax base, thereby encouraging reinvestment.

Evolution of SME policy

Although for most of the 1990s, government did not pay special attention to SMEs in its policy portfolio, foreign aid programmes (supported by donors such as Phare and NUTEK) contributed to the establishment of business support centres. This led to the development of a number of programmes for SME support being approved by government from 1996/1997, offering credits, the development of training and consultancy programmes, financial support for the existing business advisory and entrepreneurship development centres, as well as some export support and support for innovation. In contrast to the initial stages of transition, by the late 1990s, government policy was beginning to place more explicit emphasis on encouraging and supporting SME development, although its impact on the ground appears to have been limited, with surveys showing small numbers of firms benefiting or even aware of these programmes. Where assistance with export marketing, for example, had been received, it was typically from consultants based on a market transaction, rather than from or supported by a public or quasi-public agency and rarely involved any form of financial assistance (Smallbone *et al.* 1999b).

However, impending Accession to the EU contributed to a more active policy stance on the part of government. This is reflected in the Estonian Enterprise Policy document, covering the period 2002–2006, which recognised first that SMEs may suffer from size-related market failures in comparison with larger firms; and second, the potential contribution of SMEs to job generation and regional development. The stated aims of Enterprise Policy were: to promote entrepreneurship; to create new jobs; to improve the competitiveness of Estonian businesses (Estonian Ministry of Economic Affairs 2002: 3). In other words, the government recognised the potential contribution of SMEs to both economic competitiveness and social inclusion, which are currently the cornerstones of policy in the EU. It has also adopted the EU size categories of very small (0–9 employees); small (10–49 employees) and medium-sized (50–249) enterprises.

The Estonian government recognises the need to promote and support the creation of new enterprises, particularly since the number of registered trading enterprises per 1,000 population is below the average for the EU. As a result, several measures have been targeted at new business start-ups and potential entrepreneurs, as well as supporting existing enterprises. The main priority activities for SME policy at the time of Estonia's accession to the EU were (Estonian Ministry of Economic Affairs 2002: 20–21):

i *The development of human resources*, to reduce regional and structural unemployment, and to raise the quality of labour. Measures to achieve these include: training support; advisory support, to increase the competence of both managers and workforce in small and very small enterprises; and to seek to encourage more positive attitudes towards entrepreneurship amongst the population at large.

ii *Improved access to finance*, mainly for start-ups and existing businesses with high growth potential. Measures targeted at the latter include loan guarantees and investment support to assist business development in less developed regions.

iii *The development of the business support infrastructure.* A well-functioning state support infrastructure is seen to be an essential if SMEs throughout the country are to gain access to support measures. In addition, support is given to the creation of incubators aimed at encouraging start-ups and industrial parks targeted at higher-value-added activities.

iv *Improved access to business information.* This includes information about state support measures, information about business-related developments in the EU and possible co-operation partners through Euro-Infocentres. New methods of disseminating information are being considered, including an information portal (i.e. Aktiva) and an SME forum.

v *A reduction in administrative burdens.* Government recognises that the regulation of business activity must be simple and transparent, and without unnecessary administrative burdens.

These five principles form the basis of annual three-year action plans, which are co-ordinated with the state budgeting process. These action plans include short-term objectives and priorities, together with the required funding sources and the procedures for monitoring and evaluation. The linking of an enterprise strategy to rolling action plans, which in turn are linked to the budgetary process, may be viewed as an innovative and positive step in policy development in Estonia. This because it offers a mechanism for avoiding the trap of policy becoming simply declarative, with an associated implementation gap, which has been a common feature of SME policy in a number of transition countries, particularly during the early years of transition. It can also provide a basis for the government to produce a Single Programming Document (SPD), facilitating access to resources from EU Structural Funds. The influence of accession to the EU can also be detected in the administrative reform of institutions, which led to the creation of Kredex and Enterprise Estonia, since this reform involved the separation of policy formulation from policy implementation, which is recognised as good practice within the EU.

The need to improve financing opportunities for SMEs is one of the five stated priorities areas identified in the current SME policy document. Specific financial measures include: first, start-up aid, which comprises non-repayable financial assistance, advisory services and training, and is to be implemented through Enterprise Estonia; second, loan guarantees for businesses with insufficient security or track record, implemented through Kredex; and third, direct guarantees for small loans, aimed at start-ups, micro-enterprises and small firms, also implemented through Kredex. The aim is to encourage banks to become more interested in dealing with these types of firm by reducing the cost of processing and managing loan applications. This will be achieved by the initial selection of loan applications being undertaken by consultants, or agency staff in the county business development centres. The final financial measures relate to investment support for infrastructure for business in less developed areas.

In addition to specific support measures that are specifically aimed at SMEs, the latter can also benefit from support targeted at other activities, such as internationalisation (Kredex, through the Export Credit and Guarantee Fund) and technological innovation (Estonian Innovation Fund). Other priority areas include the development of human capital; the development of the business support infrastructure; and improved access to information.

Regulation

One of the key roles of government in a market-based system is to create a facilitating environment for private business development, to enable it to make a positive contribution to generating employment and economic development. At the same time, the state also has an important regulatory function: to ensure that business operates within certain rules that seek to balance the need to encourage and promote enterprise with a need to protect wider social interests and the public good. Establishing an appropriate balance has been the subject of considerable debate in mature market economies, with some emphasising the need to minimise government regulation and control of business activity by the state (e.g. Bannock and Peacock 1989), while other remain unconvinced of its harmful effects (e.g. Storey 1994). In a transition context, establishing an appropriate balance is doubly difficult because of the lack of any tradition of the state as a regulator of business activity.

One of the most important aspects of the regulatory framework is the process of business registration, which, in Estonia, is regulated by the Commercial Code. For a business to be included in the Commercial Register, it is necessary to draft a Foundation Agreement, which all founders must sign and obtain endorsement from a notary. Upon foundation, a business bank account must be opened, into which the minimum share capital required[9] must be paid before the company can be registered. An application for registration of the enterprise must be submitted within six months of the conclusion of the Foundation Agreement.

Once a business commences trading, it is required to submit an annual financial statement to the Centre of Registers, containing a summary of its audited accounts within six months of the completion of the fiscal year. However, some very small enterprises are exempt from the auditing requirement, if they are sole proprietors or private limited companies, with annual sales of less than about €65,000[10] and share capital of less than €2,500. The Ministry of Economic Affairs and Communications has reviewed registration procedures in an attempt to reduce the length of time required to start a business. One of the current barriers is the capacity of individual local authorities to process applications for licences, particularly in Tallinn where the rate of new business formation is highest.

Licences are required by businesses wishing to engage in specific activities, such as mining, public utilities, reconstruction of railways, airports, ports and dams, long-distance telecommunications, retail sales of pharmaceuticals, production of alcohol and tobacco, gambling, banking. A number of different ministries are involved in this process, according to the nature of the activities concerned. The same requirements and procedures apply to all enterprises, regardless of size, although in practice it may be argued that compliance costs fall disproportionately on smaller firms, for the reasons described earlier.

A similar principle applies with respect to a firm's compliance with labour laws, including minimum wage legislation, which applies to all employers regardless of the numbers they employ. Not surprisingly, there is evidence that some small firms seek to avoid this 'burden' by using strategies such as employing some labour illegally, paying part of the wages to staff 'cash-in-hand' and/or employing some workers part-time rather than full-time (Casale 1999). As in many other countries, the role of trade unions in the SME sector is weak and most workers are employed on the basis of individual contracts.

Although there is little distinction made in employment legislation between firms of different sizes, there is an employment policy action plan (Estonian Ministry of Social Affairs 2002), which includes a number of proposed actions in recognition of the greater potential burden of compliance on small firms. Its proposals include a review of the administrative burdens of employment legislation on SME; a reduction in the overhead costs of employing additional workers for SMEs; and making special provisions for SMEs with respect to minimum wage legislation, taxation and redundancy legislation. It would appear that the Estonian government recognises the need to reduce the regulatory burden on new and small firms to encourage enterprise.

Tax policy for enterprises

Another important area of government policy with important potential impacts on entrepreneurship development is taxation. The current tax system in Estonia is based on tax reforms undertaken between 1991and 1994, which involved the creation of a completely new tax system with a flat-rate income tax (26 per cent) and VAT to be levied at 18 per cent. Within the framework of tax laws, the tax system comprises both state and local taxes, imposed by local councils on the areas for which they have administrative responsibility. The main taxes at the state level affecting enterprises are social security tax, income tax and VAT. Only employers are currently liable to pay social security tax, although it is proposed to change the system so that in future this liability will be shared with employees, as it is in most EU states. The current rate is 33 per cent of total payroll expenses (i.e. salary plus the value of any non-monetary benefits offered to employees, plus 0.3 per cent unemployment insurance), which represents a significant additional labour cost for all employers, although likely to fall particularly heavily on new and small firms.

The current Income Tax Act,[11] which came into force on 1 January 2000, made some changes in the taxation of business. However, since this date enterprises and registered legal persons are only taxed on distributed, and not retained, profits, in an attempt to stimulate job creation by encouraging firms to reinvest. Businesses are required to register for VAT when their net annual sales reaches EEK 250,000 (approximately €15,000), which appears relatively low compared with many EU countries. However, many enterprises choose to register for VAT soon after they register with the Commercial Registry, since this enables them to reclaim any VAT paid on their purchases. Businesses registered for VAT are required to make a monthly VAT return.

As far as SMEs are concerned, it is frequent changes in tax laws and regulations, which can contribute significantly to increasing compliance costs. In this regard, it has been reported that since 1990 there have been 227 changes to tax laws and 392 changes in other tax regulations (Eesti Maksumaksjate Liidu Juhatus 2001). Although it may be argued that the creation of a completely new tax regime during the initial transition period may have been the main reason for the instability in tax legislation, it is important that the importance of the principles of simplification and stability are recognised, together with that of consultation with representatives across the enterprise sector about any new tax legislation.

The state of the SME sector at the time of EU accession

This final section is based on a large-scale survey of 1,912 Estonian SMEs, undertaken in late 2002.[12] The results of the survey are used selectively to contribute to an assessment of the current state of SME sector in the country, in terms of its characteristics, strategies and development problems, in the period immediately prior to Estonia's accession to the EU. Particular attention is paid to the constraints identified by entrepreneurs on their ability to develop their businesses, sources of finance and awareness and use of business services.

SME profile

With 79 per cent of all enterprises comprising very small firms (0–9 employees) and 17 per cent small (i.e. 10–49 employees), the size distribution of Estonian enterprises does not look significantly different from that in a mature market economy (Figure 8.2). In terms of sectors, services (i.e. accommodation, catering and finance) account for the largest proportion of firms; followed by retailing; manufacturing; wholesaling; education and health care; transport and communications and construction. In view of the relatively short recent history of private sector development, it is perhaps not surprising that Estonian enterprises have a relatively young age profile. In December 2002, 20 per cent were less than three years old; 35 per cent were between four and seven years old; 33 per cent between eight and 11 years old in 2002; and 9 per cent were 12 years old or more. Nevertheless, while still lacking the number of well-established SMEs that exist in a more mature market economy, the age profile of the Estonian SME sector is maturing in comparison with the mid-1990s, when it consisted mainly of very young firms.

Two key performance indicators included in the survey were first, sales turnover in 2002 compared with 2001; and second, whether or not the firm was profitable in the previous year. These are combined in summary form in Table 8.4. Accurate financial data are notoriously difficult to obtain from SMEs, which means that the use of simple nominal categories for profit/breakeven/loss and increasing/decreasing/stable turnover are justifiable indicators of SME performance. Table 8.4 shows that slightly less than half of all surveyed firms (45 per

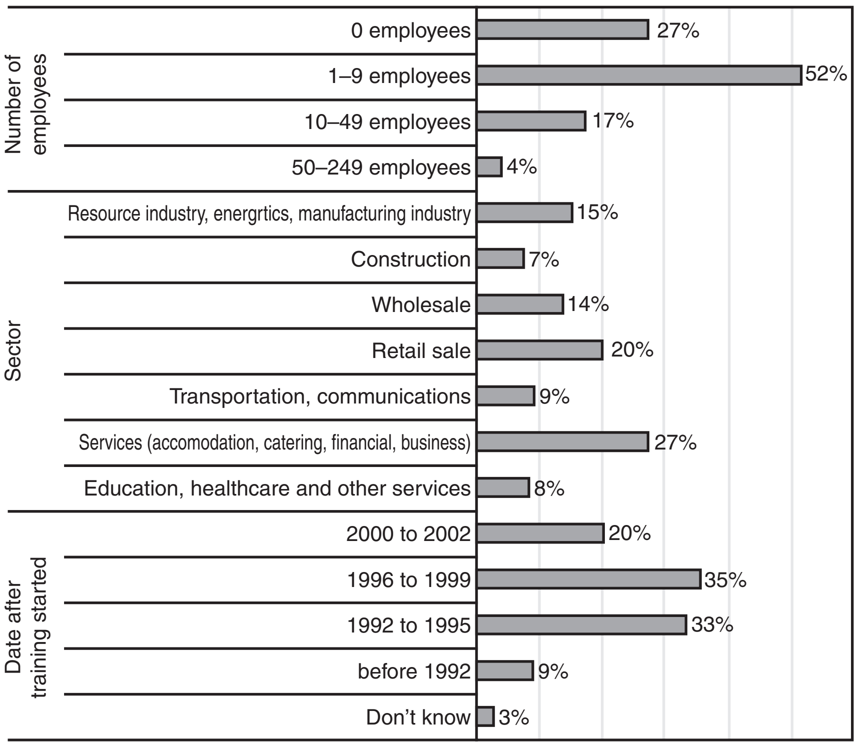

Figure 8.2 Profile of Estonian SMEs (2002) (source: Jurgenson *et al.* (2003)).

cent) had been able to increase sales in 2002 and, in one-fifth, sales had actually declined. This is not a particularly healthy situation, since some growth is almost certainly necessary for firms to survive in the longer term. On this evidence, 55 per cent of SMEs experienced stable or declining sales; 11 per cent combining lower sales with a lack of profits. Nevertheless, approximately two-thirds reported profitability, although one in five were loss-making.

Not surprisingly perhaps, differences in business performance can be observed between different enterprise size groups, with very small firms (0–9 employees) being outperformed by small firms (10–49 employees), which in turn were outperformed by medium-sized firms (50–249 employees). This is reflected in the proportion of firms in the different size groups to report profits in 2001: from 65 per cent of very small firms; 79 per cent of small; to 82 per cent of medium-sized companies. It is also reflected in the proportion of firms to have increased sales in 2002 compared with 2001: 42 per cent, 55 per cent and 59 per cent respectively.

One in five SMEs reported being involved in making some sales in foreign markets, although, once again, there are significant differences between firm size

Table 8.4 Summarising the performance of surveyed Estonian SMEs (2001–2002)

	Increased sales		*Stable sales*		*Decreased sales*		*All responding firms*	
	No.	*%*	*No.*	*%*	*No.*	*%*		
Profit	570	32	414	23	253	14	1,237	68
Breakeven	64	4	105	6	43	2	212	12
Loss	179	10	119	7	65	4	363	20
All firms	813	45	638	35	361	20	1,812	100

Source: Jurgenson *et al.* (2003).

groups (0.001 level), ranging from 17 per cent of very small firms, to 35 per cent of small firms to 55 per cent of medium-sized enterprises. This compares with 25 per cent of businesses in a comparable survey of SMEs in the UK that were generating 6 per cent of total annual sales from foreign sources (Michaelis *et al.* 2001). There are also significant sectoral differences in the propensity of SMEs to be involved in export markets (0.001 level): highest in manufacturing (47 per cent) and transport and communications (31 per cent) and wholesaling (26 per cent); and lowest in education, health care and other services, retailing and construction (8 per cent each). Although only 8 per cent of all SMEs had some foreign ownership, not surprisingly, these firms were more likely to be involved in foreign markets than firms that were entirely domestically owned (53 per cent and 46 per cent respectively).

Manager's assessment of the main constraints facing their businesses

One of the indicators of the extent to which the transformation process has contributed to the emergence of market-based conditions and institutions, is the nature and extent of the constraints on business activities, reported by entrepreneurs. Surveyed respondents were asked to assess the importance of a number of potential constraints on their businesses during the 12 months prior to the interviews, on a five-point Likert scale from 'a very important problem' at one extreme to 'not a problem at all' at the other. The main constraints identified by SMEs across all sectors in the 2002 survey are summarised in Figure 8.3, which shows that the most commonly perceived constraints were: finding a market; taxes; availability of finance; crime; labour skills; and administrative/regulatory burdens.

Since previous survey results are available for manufacturing SMEs, from 1995 and 1998 this enables any change in the reported constraints over time to be noted. As Figure 8.4 shows, 'finding markets' has remained a consistently reported concern of entrepreneurs in manufacturing firms between 1998 and 2002. At the same time, taxes, supply issues, administrative barriers and infrastructure have grown in relative importance, while workforce skills and the availability of finance have significantly decreased as problem issues.

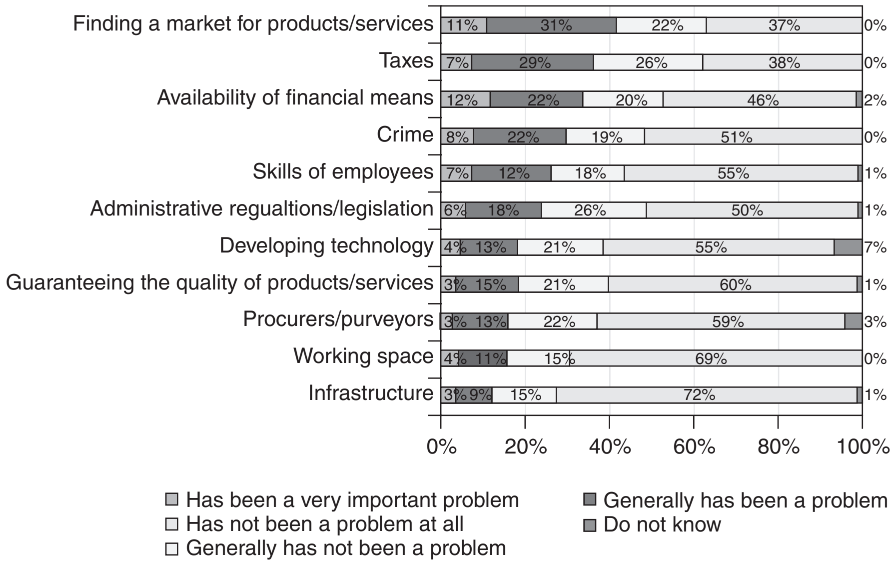

Figure 8.3 Constraints on business development identified by surveyed Estonian firms (2002) (source: Jurgenson *et al.* (2003)).

In an earlier survey in 1995, involving manufacturing SMEs in Poland and the Baltic States (Appendix, Project 2, pp. 236–237), the most commonly mentioned constraints identified by the 100 Estonian entrepreneurs interviewed were the level of taxation (by 39 per cent); weak domestic demand (by 32 per cent); the strength of competition in the domestic market (30 per cent); the need to modernise equipment (30 per cent); and a shortage of external finance (by 22 per cent) (Smallbone *et al.* 1997a). This comparison shows that, although taxation has remained a concern for Estonian entrepreneurs, over time it has been replaced by market-related factors as the most commonly perceived constraint, with crime emerging as an increasingly significant problem. With 5 per cent real GDP growth in 2001 and 4.0 per cent in 2002, it is difficult to explain the rise in the relative importance of demand and market-related factors primarily in terms of short-term macro-economic conditions. It would seem that the concerns of Estonian entrepreneurs are increasingly reflecting growing competition associated with emerging market conditions, as well as the commonly reported weaknesses of SMEs with respect to marketing. It is significant that problems associated with finding markets for products/services were consistently reported across the firm size groups.

Employee skills-related issues was identified as a problem by 26 per cent of firms surveyed in 2002, although only a small minority (i.e. 7 per cent) identified it as a major problem. However, more detailed analysis shows that this is an issue which is significantly related to firm size, with medium-sized firms

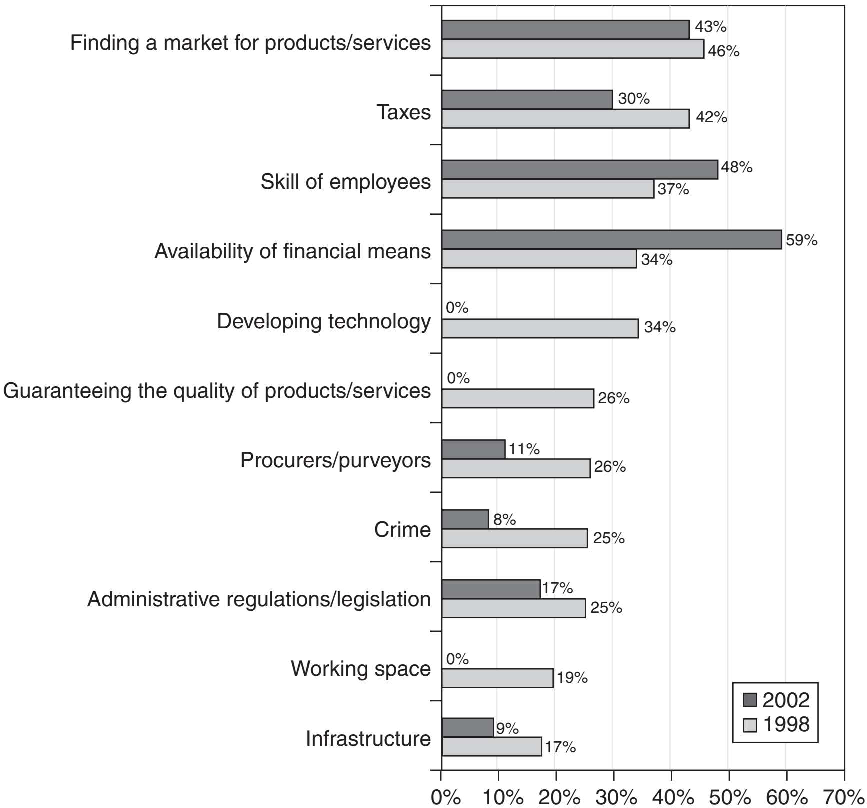

Figure 8.4 Constraints on business development identified by surveyed manufacturing firms in Estonia (1998 and 2002) (source: Jurgenson *et al.* (2003)).

showing by far the highest propensity to report this: 57 per cent compared with 21 per cent. This is compatible with the results of previous research in mature market economies, which shows a tendency for most human resource-related problems to increase in importance with increasing firm size, at least until the human resource management function begins to become more formalised and, ultimately, separately identified and managed (Atkinson and Meager 1994).

When managers were specifically asked to evaluate the degree of ease or difficulty with respect to recruiting particular types of employee on the labour market, 42 per cent referred to the difficulties in recruiting skilled workers; 22 per cent describing it as very difficult. If firms stating they had no need for skilled workers are excluded, the proportions rise to 60 per cent and 32 per cent respectively. These results suggest that there are deficiencies in the operation of the labour market as far as SMEs are concerned, at the time of Estonia's entry to the EU. Not surprisingly perhaps, the problem is sectorally concentrated to some extent, with skills-related problems highest in manufacturing (74 per cent referring to difficulties and 39 per cent describing it as very difficult; construction (67 per cent and 34 per cent respectively); and wholesale firms (65 per cent and 38 per cent). There are also significant spatial variations (0.05 level) in the reported frequency of skilled labour shortages, with firms located in towns outside Tallinn and the larger centres appearing to experience the most problems: 69 per cent and 37 per cent respectively; compared with large towns, such as Tartu, Parnu and Narva (63 per cent and 33 per cent); Tallinn (57 per cent and 29 per cent); and rural areas (53 per cent and 30 per cent).[13]

These results suggest there is currently a mismatch, both sectorally and spatially, between the supply and demand for labour in Estonia, emphasising the importance of prioritising the reform of the vocational training system. However, since this is likely to take some time to produce results, the short-term solution may be to encourage business owners to train their existing employees. In this regard, when asked what proportion of their employees had been involved in in-service training during the previous 12 months, 59 per cent of respondents reported having trained at least some of their employees; and 47 per cent at least some of their managers. Not surprisingly, there was a high degree of correlation between firm size and the propensity of firms to have been involved in management and/or employee training.

Comparison of the extent to which Estonian enterprises had been involved in training their employees in 2001–2002 with results from a similar survey of enterprises in EU member states in 1998 (European Commission 2000), actually shows Estonian firms to have been more likely to report they had been involved in training their employees. This might reflect the reported shortage of workers with the required skills, as well as the legacy of transition in Estonia, where the labour market is still adjusting to the needs of the emerging market economy. At the same time, the survey results provide some evidence to suggest that a culture of training is beginning to develop in the Estonian SME sector, which in the majority of cases involves external organisations delivering formal training courses.

Sources of finance

One of the most commonly reported constraints by SME owners/managers in many countries relates to finance, although deeper analysis is typically required in order to understand the extent to which it reflects demand rather than just supply-side deficiencies. In order to give an up-to-date picture of the sources of finance used at start-up, in the 2002 survey, businesses founded in, or after, 2000 were asked to identify the main sources of finance used when the businesses were started. The results show that only 21 per cent of all new businesses had received some form of external finance at start-up from a formal source (such as a bank), although this rises to 32 per cent if loans from family and friends are included. This is significantly below the level of external finance used by start-ups in a UK context, where approximately 35–40 per cent of start-ups access bank loans (e.g. Ram *et al.* 2002). As a result, the vast majority of new business start-ups in Estonia are still reliant on self-financing, in a context where the scope for accumulated, or inherited, wealth is less than in most mature market economies.

Where some external finance (other than from family and friends) was accessed, it was typically in the form of a bank loan (52 per cent of all new firms reporting some form of external finance, or just 11 per cent of all new firms); equity from local sources (25 per cent and 5 per cent respectively); some form of state financing (i.e. a loan, a loan guarantee or a grant) (by 11 per cent and 2 per cent respectively); and foreign equity (9 per cent and 2 per cent respectively). Although the overall pattern of distribution between sources of finance is not significantly different from that in a mature market economy, the overall level of dependence on self-financing, including family and friends is higher than in a country such as the UK.

At the same time, the picture with regard to established businesses appears somewhat different. In the 2002 survey, all respondents were asked if they had applied for bank finance during the three years prior to the interviews. In practice, 25 per cent of all firms reported seeking bank finance on at least one occasion during this period, although this was significantly higher amongst SMEs than amongst micro-enterprises (46 per cent and 20 per cent respectively). Almost two out of five firms that had sought some bank finance during this three-year period had done so on more than one occasion (39 per cent or 4 per cent of all firms). Significantly, however, it appears that the majority of firms applying for bank finance (82 per cent) actually received at least part of what they were seeking, although it may have taken them more than one attempt to achieve it. In fact, more than two-thirds of firms received all they were asking for on each occasion, with only 19 per cent being completely unsuccessful the first time. These results suggest that access to finance is not mainly a supply-side failure, as far as established SMEs are concerned, unless a high proportion of businesses are being put off applying for external finance because they believe their application will be refused. The results reported below suggest there may be demand-side deficiencies, with a need to educate Estonian business owners about the importance of adequate financing for their businesses, and how to obtain it, if they are to operate successfully, with potential to grow.

When firms that had not sought bank loans were asked the reasons, 74 per cent of respondents did not perceive any need for external finance. Other responses mentioned by a significant minority of firms included ‘insufficient collateral’ (10 per cent), high interest rates (8 per cent) and other external funding sources used instead of bank loans (4 per cent). These results suggest that the financial constraints on business development, which were identified by almost one in three of all surveyed firms, only partly reflect a supply gap in the market for SME finance in Estonia. While it can be argued that a strong perception amongst SME owners that applications for bank finance are likely to be turned down is likely to contribute to reducing the incentive to apply, the reported evidence is, first, that most entrepreneurs in Estonia actually applying for bank

Table 8.5 Sources and types of external finance used by Estonian firms (1999–2002)

Source	*No.*	*%*
Leasing company	543	28
Bank (Loan)	398	21
Family & friends	169	9
Factoring	49	3
Other foreign	46	2
Other local	36	2
Foreign mortgage	30	2
State subsidy	17	1
Loan guarantee	12	1
Other	7	–
At least one external source	985	52
At least one formal external source[a]	891	47
No. of respondents	1,912	100

Source: Jurgenson *et al.* (2003).

Note
a i.e. excluding family and friends.

finance receive at least some of what they are looking for; and second, that most entrepreneurs who do not apply for bank loans explain this in terms of a lack of perceived need. The results confirm that any attempts to increase the supply and availability of different types of finance in Estonia need to be at least matched by initiatives designed to increase the level of effective demand for it, linked to a wider strategy of building the competitive capacity of Estonian SMEs.

Respondents were also asked if their business had actually used external funds from a range of specified sources during the three years prior to the interview. As Table 8.5 shows, 52 per cent of all surveyed firms reported using some form of external finance during this period, falling to 47 per cent if family and friends are excluded. The table emphasises the increasing role played by leasing in the Estonian market for SME finance, referred to earlier, since this was the most frequently mentioned source. Not surprisingly, the table also shows that it was common for firms to be accessing finance from a number of sources, since 985 businesses received funds from a total of 1,307 external sources during this period.

Access to information and business advice

The survey also sought to assess the extent to which SMES in Estonia were using external sources of business information and advice, since developing a market oriented system of business services is one aspect of the institutional change required during the transition period (see p. 201). As far as information about potential business clients is concerned, the most commonly reported sources were 'word of mouth' (60 per cent), followed by the internet (30 per cent) and 'other media' (27 per cent). Significantly, formal business support organisations, such as Chambers of Commerce, business and professional associations, and local enterprise centres were only mentioned by a handful of respondents as a source of potential clients (circa 2 per cent in total). The emphasis on 'word of mouth' indicates that informal network contacts are the predominant means of obtaining information about customers in Estonia used by SMEs of all sizes: medium (69 per cent); small (61 per cent); and micro-enterprises (59 per cent), indicating the role trust plays for business relations (Venesaar 2005). At the same time, the internet is gaining in importance for this purpose, although, once again, there is a positive association between firm size and reported use of the internet.

Only one in five firms could recall searching for information about public sector grant programmes. Not surprisingly perhaps, the sources of such information were quite different from those reported as a source of information about potential customers. In the case of state grant programmes, it was the internet (58 per cent of those seeking grant information), other media (27 per cent), local enterprise centres (12 per cent) and training courses (5 per cent) that featured most prominently, with 'word of mouth' being mentioned by 11 per cent of firms.

When respondents were asked about the types of information they experienced difficulties in obtaining, the two most commonly mentioned were first, information about state regulations and legislation; and second, information about state financial support schemes. Information about potential customers and new markets, which is in third place, was mentioned by far fewer respondents than state regulations and programmes. Certainly, there would appear to be a need to improve the availability of information about both state regulations and public support programmes, on the basis of this evidence.

One of the ways in which SMEs can overcome some of their internal management resource constraints is through the effective use of external advice and consultancy. The survey indicated that 39 per cent of Estonian SMEs reported using some form of external advice in 2002, which is significantly less than the 56 per cent reported in a recent survey of SMEs in the UK. Significantly, however, the most frequently mentioned fields of advice used were legal advice, accounting and taxation, which are all mainly linked to the daily operation of businesses rather than to business development and/or strategic issues. The most commonly used sources of advice and consultancy were private consultants (42 per cent of users), business partners (35 per cent) and friends/family members (19 per cent), rather than banks and accountants (9 per cent each), which are the frequently reported sources in some mature market economies, such as the UK.

It is clear from these results that the market for business advice and consultancy is still developing in Estonia, with deficiencies apparent on both the demand and supply sides of the market. The results also suggest a rather 'arms-length' type of relationship between banks and SMEs in Estonia, reflected in the very low level of use of bank managers as sources of business advice, as well as the limited development hitherto of Estonian entrepreneurs recognising the potential benefits of professional advice and consultancy to the development of their businesses.

Awareness and use of public policy measures

Government direct support for SMEs currently includes targeted financial assistance for start-ups, loan guarantees and training subsidies. However, the take-up of these measures is reported to have been modest. As a consequence, one of the issues investigated in the 2002 survey was the extent to which business owners are aware of what public policy assistance is available. The results show that just over three-quarters of surveyed enterprises reported knowing of the existence of state support measures, although only 12 per cent claimed to have a good knowledge. At the same time, the survey revealed that only a very small proportion of respondents had ever benefited from some form of state support programme (3 per cent), such as start-up assistance (1.3 per cent), a training subsidy (1.3 per cent), a loan guarantee (0.6 per cent) and/or infrastructural support (0.4 per cent), with a very small proportion of firms benefiting from more than one of these.

Part of the problem would appear to be that Estonian entrepreneurs are simply unaware of what is available, although this is less of a problem with start-up assistance (where 25 per cent were unaware), compared with other types of support. For example, in the case of infrastructural support, more than half of respondents (59 per cent) were unaware; 47 per cent in the case of the loan guarantee scheme; and 39 per cent in the case of training subsidies. However, the information gap is wider than these figures suggest, since approximately half of those respondents that reported awareness of support measures had only a very vague knowledge of what was on offer. Clearly, one of the weaknesses of SME policy revealed by the survey is the low level of entrepreneurs' awareness of what is available, although this is not a problem that is confined to transition or emerging market economies.

Although a majority of respondents claimed some awareness of state support measures, there was less specific knowledge about which agencies or organisations to use, in order to access them. For example, 71 per cent of respondents stated that they did not know which organisation to approach if their firm wanted to make use of one of the specified state support measures in the future. Those respondents that claimed to know which agency to approach mainly referred to either their local enterprise centre (10 per cent) or Enterprise Estonia (7 per cent), the Ministry of Economic Affairs (3 per cent), the internet (3 per cent), Kredex (2 per cent) and a bank (2 per cent). Self-employed people and micro-enterprises were typically less able to name an appropriate agency than SMEs.

Although survey respondents did not necessarily associate a local enterprise centre with access to a government business support programme, 51 per cent of all respondents were able to name the local enterprise centre that is closest to them. However, only 12 per cent reported ever having used the services of their local business centre. The reasons given by firms for using a local enterprise centre were 'to obtain information' (6 per cent of all respondents), followed by 'to fill in application forms for business support' (3 per cent), 'business counselling' (3 per cent), 'to receive training' (2 per cent) and 'to participate in seminars or other activities' (0.5 per cent). This compares with data from a survey of 2,000 SMEs in the UK in 2001, in which 5 per cent reported using Business Link as a source of advice during the previous 12 months; and two-thirds of non-users reported being aware of it (Michaelis *et al.* 2001).

In terms of the actual use of local enterprise centres, while a majority of users (72 per cent) described their last contact as useful (or very useful), a significant minority (25 per cent) described it as not useful, although there was some variation in the user's assessment between different types of use. Significantly, approximately 30 per cent of those seeking information, applying for assistance and receiving counselling or consultancy (a core service) rated the local enterprise centre assistance as 'not useful'.

In order to improve the dissemination of information to SMEs about state programmes and government regulations, a new web portal called *Aktiva* was introduced in 2002 by Enterprise Estonia. The survey results suggest that the creation of this information portal was a good initiative and a potentially useful tool for disseminating various types of information to businesses. It should contribute over time to increasing awareness and knowledge amongst entrepreneurs about state support programmes. This is particularly the case, since the survey shows almost all Estonian SMEs (91 per cent) now have internet connections, although less than one-third of these reported being aware of the *Aktiva* site (30 per cent of internet users or 27 per cent of all firms). Predictably, a smaller number had actually used the site (31 per cent of those knowing about it or 9 per cent of all firms), although about one-quarter of those that had made use of it (72 per cent) judged it to be a useful facility. Clearly, the satisfaction of existing users is an aspect that Enterprise Estonia should actively promote in order to increase awareness levels overall and to encourage more of those knowing of the existence of the site to actually make use of it.

Administrative burdens and regulatory issues

One of the key policy issues facing governments in transition economies is to establish a system for regulating business activity that protects the wider public interest, while not placing unnecessary administrative burdens on enterprises. In this regard, one of the specific priorities is to establish an efficient and effective system for registering and licensing new businesses. The evolving nature of the regulatory environment in Estonia may be illustrated with reference to case Y (Box 8.2).

Box 8.2 Case Y: food processing and wholesale firm based in Tallinn

Founded in 1992, the business deals with processing and packaging nuts and dried fruit and is also involved in some wholesale activity. Since the business had been operating for more than ten years, the entrepreneur was in a good position to be able to assess changes in the nature of the regulatory environment over time. His overall assessment was that when the business first started trading, a lack of adequate legislation, combined with a lack of stability, contributed to an uncertain business environment. However, by 2003, he judged that legislation had significantly improved and the legal environment stabilised.

Although he referred to the inflexibility of some officials in interpreting their responsibilities, which he interpreted as reflecting a lack of understanding on the part of officials of the problems, facing small firms, his comments were similar to those made by small business owners in many mature market economies. Improvements in the regulatory environment were matched by a reduction in competition from enterprises operating partly or mainly in the shadow economy, which he said had been a problem in the past, although many of these firms were now operating legally, as competitors in the market.

Source: case supplied by Dr Urve Venesaar

In this regard, businesses set up during or after 2000 were asked in the survey to assess how long the initial registration and licensing procedures had taken. In a majority of cases (55 per cent), these procedures were reported to have taken less than one month, with a further 31 per cent reporting the process took between one and two months. In 9 per cent of cases, respondents reported experiencing delays of more than two months. The most time-consuming procedure at the start-up stage was reported to be entry into the Business Register. The speedy and efficient registration of new businesses is a current priority for enterprise policy in the EU. In this regard, a recent study reported that the average time for completing the administration of new business start-ups in the EU was 12 days for individual enterprises (highest 35 days; lowest one day) and 24 days for private limited companies (from 35 days maximum to seven days minimum) (Centre for Strategy and Evaluation Services 2002). This suggests that, although moving forward, Estonia still has some way to go to achieve average EU standards, with respect to the registration and licensing procedures for new businesses.

In order to assess the extent to which regulatory compliance was an ongoing issue for businesses once they become established, all survey respondents were asked if legal or regulatory issues had constrained their business activity. Unlike the early stages of transition, when legal and administrative barriers are typically one of the most frequently reported constraints on SME development, only 26 per cent of surveyed respondents reported that some law or regulation was constraining their business activities. While no single area of regulation dominated, apart from taxation, it is the total regulatory burden that needs to be monitored and evaluated, and not just the impact of individual regulations. This is a particular concern for smaller businesses, because of the disproportionate effects of compliance costs associated with their more limited internal resource base, compared with larger enterprises, offering less scope for developing a managerial division of labour.

The survey showed that, overall, it was small and medium enterprises (i.e. 10–249 employees) that showed a higher propensity to report a regulatory burden than self-employed or micro-enterprises. This particularly applied to their greater tendency to point to problems with health and safety (associated with their larger workforce), and customs (associated with their higher propensity to export compared with smaller enterprises), but also to environmental protection and licensing.

Conclusions

There is little doubt that in Estonia, the development of an emerging SME sector has been one of the key features of the transition period. It is also clear that membership of the EU has involved significant changes in the operating environment for SMEs, containing threats as well as opportunities, exposing them more fully to the pressures of international competition, but also to the need to comply with EU standards and regulations. Moreover, these potential impacts faced the new member states of the EU at a relatively early stage in the development of market-based systems, which contains many deficiencies (particularly in institutional terms) and a SME sector with many characteristics that reflect its fledgling status. In this context, the evidence presented in this chapter points to some of the priorities for policy makers, if the contribution of SMEs to economic development in the country is to be strengthened.

The pattern of constraints on business development reported by entrepreneurs shows a change in emphasis from the mid-1990s, when institutional constraints predominated. While many of these institutional constraints (e.g. taxation) remain a concern for entrepreneurs, it is competition and market-related issues that have grown in importance, reflecting the progress that has been achieved in the process of transformation towards a market economy. However, this underlines the importance of raising marketing knowledge and skills in SMEs, in order to better equip them to cope with market pressures, as well as exploit emerging, new market opportunities.

Another aspect of the change in the balance of constraints reported by entrepreneurs relates to finance, which was not perceived as such a major constraint by SME owners in 2002 as it was in the 1990s, at least as far as established SMEs are concerned. The 2002 survey results show that most firms actively seeking bank finance received at least some of what they were looking for. The results also show that the overall pattern of distribution between sources of finance is not significantly different from that in a mature market economy, although the overall level of dependence on self-financing, including family and friends, is higher, particularly at start-up. The degree of reliance on self-financing is an issue when the effect of relatively low income levels, compared with more advanced EU countries, is considered on the ability of new entrepreneurs to accumulate sufficient start-up capital.

The survey data reported here provide some evidence that the SME sector in Estonia was going through a fairly difficult period at the time of the country's entry to the EU. While some of this may be due to short-term factors, increasing competition helps to expose underlying weaknesses in marketing in Estonian enterprises, as well as underlying structural factors influencing their competitiveness. Increasing integration into the EU market may further exacerbate these effects. The survey evidence confirms the importance of foreign markets to Estonian SMEs (particularly those involved in manufacturing), because of the limited size and scope of the domestic market. At the same time, the subcontract type arrangements that tend to be used by Estonian SMEs that are heavily dependent on foreign markets, together with the marketing weaknesses revealed in the SME sector as a whole, points to the need for policy support, which aims to improve the marketing competencies of SME managers, as well as increasing the emphasis placed on higher order competitive advantages.

One of the current challenges facing Estonia's policy makers refers to the labour market, where there appears to be a gap between the supply of workforce skills available and the types of skill required by the emerging SME sector. This emphasises the importance of prioritising the reform of the vocational training system, paying attention to the specific training needs of SMEs in particular sectors. Improvements to the vocational training system also need to incorporate a spatial component, since the survey evidence demonstrates the particular problems experienced by SMEs in smaller towns. This issue emphasises the importance of joining up policies between different government departments. Improving the availability and take-up of appropriately skilled workers is a priority for enterprise policy, not least because it is a particular problem for medium-sized businesses. Medium-sized companies are a potentially important segment of the business population, affecting Estonia's ability to exploit the opportunities and respond to the threats from membership of an enlarged EU. The current penetration level of foreign markets by medium-sized manufacturing firms, for example, illustrates this.

Although considerable progress has been made with respect to the institutionalisation of SME policy in Estonia, the low level of membership of business associations and similar organisations means that the majority of SMEs are not part of this process. The Ministry of Economic Affairs and Communications and its partners might encourage more businesses to join business associations by actively promoting its contact and communications with membership organisations, particularly when tangible potential benefits for businesses emerge from such dialogue. These organisations can also act as intermediaries in terms of helping firms to access external consultants.

Another issue concerns the market for business information, advice and consultancy in Estonia, which is still underdeveloped, with both demand- and supply-side deficiencies. Where SMEs are using external advice, this is more commonly sourced informally than formally and is typically assistance to help a business to operate and meet its statutory obligations, rather than to support business development. Although a structure of business associations and a

Chamber of Commerce is emerging in Estonia, very few SMEs appear to turn to these as a source of information and/or business advice. In addition, the private sector consultancy is in its infancy, as far as SMEs are concerned.

In this context, there is a priority need for public policy to contribute to addressing the existing deficiencies in this market and to help to build market capacity, such as through the use of a subsidised consultancy scheme. The creation of Enterprise Estonia and Kredex are positive institutional developments, as is the attempt to upgrade the quality of the local business support centres, although to do this effectively requires the development of an effective monitoring system to ensure quality control. At the same time, the survey evidence suggests there is still some way to go in establishing an effective business support infrastructure, illustrated by the significant minority of SMEs using local business centres as a source of information, advice and/or consultancy, who were dissatisfied. The survey also revealed a need to more actively disseminate information about those support programmes that are available, which currently have very low penetration levels, based on low levels of awareness, both of the programmes themselves and of who to approach to access them.

Beyond this, the key policy priorities emerging from the chapter are: first, a need for government to work closely with the financial institutions to improve access to finance for new business start-ups; second, a need to continue to improve the efficiency of registration procedures and practices for start-ups; third, to develop effective regulatory impact assessment procedures for new legislation affecting businesses, as well as to monitor the total regulatory burden on established SMEs; and fourth, to improve the dialogue and penetration of the micro-enterprise sector, which accounts for the bulk of the Estonian business sector, but which is systematically underrepresented in current support programmes and initiatives and relatively disadvantaged on most indicators.

Part IV

The way forward

9 Conclusions

Without doubt, the collapse of the Berlin Wall and the events that followed it contributed to a systems change in Central and Eastern Europe and the former Soviet Union of enormous proportions. The scale and scope of what has occurred is such that history is likely to judge it as comparable with changes such as those associated with the collapse of feudalism or the social and economic effects of the Industrial Revolution. The extent of the system collapse is illustrated by the number of former Soviet republics which have struggled to restore GDP per head to its 1989 level, in real terms.

In this context, it is hardly surprising that the establishment or re-establishment (depending on the country) of private enterprise has not been a smooth process. Indeed, it is rather remarkable to see the progress that has been achieved in many countries, which only 20 years ago were operating under central planning. In this final chapter, the aim is to draw out some of the emerging themes running through the previous chapters, together with the implications for entrepreneurship theory and future policy development.

Diversity of experience along a common path

Not surprisingly perhaps, this selective review of the development of entrepreneurship and small business in former centrally planned economies has revealed considerable diversity, as well as a number of recurrent features. The diversity of experience largely reflects varying degrees of progress with, and commitment to, market reform on the part of governments, which is reflected in the nature and extent of institutional development and the policy context for entrepreneurship in different countries. Additional contributory factors include differences in the starting points for transformation, associated with differences in the extent to which certain forms of entrepreneurship were tolerated during the centrally planned period, as well as some differences in the processes of change during the transformation period itself, such as the type of privatisation used.

As a result, it is important to recognise a distinction between, on the one hand, countries where the process of market reform is advanced, such that they may be better described as emerging market economies and, on the other hand, countries where the basic framework conditions for a market economy are still to be achieved. In practice, a growing gap can be identified between these two groups of countries, particularly where there appears to be no current political will to move towards a market-based economy (as in Belarus). In the latter case, external conditions encourage unproductive, and even destructive, elements of entrepreneurial behaviour. This means that some of the potential contributions of entrepreneurship to economic development may remain unfulfilled and are likely to remain so as long as the present totalitarian regime in the country is in power.

This difference between post-socialist countries is not surprising because it is equally mistaken to consider so-called market economies as uniform, particularly with respect to the role of the state in the economy. As a consequence, it may be appropriate to think in terms of a continuum from central planned economies at the one extreme to liberal market conditions at the other, with individual countries situated at different points along it. In the context of former socialist economies, the precise positioning along this continuum is heavily influenced by the extent of the commitment of government to market reforms in the post-socialist period. This is demonstrated through their actions with respect to progress with privatisation; the extent to which there is price liberalisation; and the role of government with respect to the creation and effective operation of market institutions as well as their attitude towards entrepreneurship. As previous chapters have demonstrated, countries that made the decision to join the EU have shown their commitment to making such reforms, which was a fundamental requirement of the accession process.

At the same time, the development of entrepreneurship in post-socialist economies also shows some recurrent features, reflecting underlying similarities in the structural changes that these economies have been facing. These characteristics include the explosion of entrepreneurial activity that occurred in many transition economies at the start of the transformation period. As private enterprise became legal, combination of new market opportunities (particularly in retail and service activities) that appeared overnight and necessity, caused by system collapse, encouraged enterprising people to engage in entrepreneurial activity, albeit much of it of a low-value-added nature for a variety of demand- and supply-side influences.

A second recurrent feature is the predominance of very small enterprises, with few medium-sized and even fewer large private enterprises, except in those cases where foreign-owned enterprises have been attracted. This has been noted as a weakness in many of the new member states of the EU, affecting the ability of the SME sector to respond to new market opportunities and cope with any new sources of threat. But the absence of a strong domestic large-firm sector is perhaps an even greater barrier, since it affects the nature and extent of business-to-business supply opportunities for domestic SMEs, compared with their counterparts in mature market contexts.

A third general characteristic is the core–periphery contrast in entrepreneurial activity that exists in most post-socialist countries, with capital cities typically experiencing considerably higher levels of new business creation per head than peripheral regions. Some of the explanation for this can be found in regional variations in purchasing power and thus effective demand; differences in the economic structure; and in the socio-economic profile of the population, which is similar to the situation in mature market economies. However, other contributory factors are more specific to a transition environment, such as variations in the pace of privatisation and restructuring, variations in the institutional environment and greater access to potential partners abroad through the capital city gateway.

While the features identified above apply to some extent to most transition economies, other factors show more variation between countries, reflecting differences in their position along the path towards market reform. A key characteristic in this respect is differences in the pace of institutional development, particularly when the actual behaviour of institutions is considered (in terms of market orientation), as well as simply whether or not they exist. Institutional development includes, but is not confined to, the time taken to build an effective business support infrastructure. More fundamentally, it also includes the policy process itself, both of which have been influenced by the accession process in new member countries of the EU, which has helped to increase the differentiation between the two groups of countries described above. A related feature is the time taken to establish a culture of enterprise and an ethical code of business behaviour that matches good practices in mature market economies. These issues are related because penal laws and regulations on business, together with a failure on the part of legislators and officials to accept the legitimacy of private business and its potential contribution to the wider society, encourage avoidance behaviour on the part of entrepreneurs, which may in turn appear socially irresponsible to some in the society at large.

Implications for entrepreneurship theory

Although the characteristics of entrepreneurship that can be observed under transition conditions contain many distinctive features, and most of the literature on entrepreneurship and small business development in post-socialist economies tends to stress its distinctiveness, it is important to consider the implications of the growing base of research evidence for ‘mainstream’ entrepreneurship theory. Theories of entrepreneurship need to be robust enough to accommodate the various forms of entrepreneurship that emerge in a variety of circumstances. In this regard, recent authors including Davidsson (2003) and Baker *et al.* (2005) have emphasised the need for entrepreneurship research to acknowledge the heterogeneity of environmental conditions, outcomes and behaviours that exist, thereby providing a rationale for assessing the implications of empirical investigations undertaken in various transition contexts for mainstream entrepreneurship theory. The discussion in the previous chapters suggests that although entrepreneurship in a transition context may have distinctive features, it is not unique, as entrepreneurial behaviour displays similar features whatever the external environment. However, what is clearly different is the specific interplay and balance between individual entrepreneur/firm behaviour and the external environment, which changes as the process of market reform unfolds. This emphasises the importance of recognising the embeddedness of entrepreneurship in its social context, of which the transition environments described in this book are examples.

In this context, a review of the applicability of theories and concepts, which have been developed largely with reference to market economies, is necessary from the standpoint of their usefulness and applicability in a context where market conditions are only partially established. Such a review leads us to suggest a number of key propositions. As in mature market economies, entrepreneurship in transition conditions depends on individual goals and self-perceptions of entrepreneurs with regard to opportunities for venture creation and development, as this influence the steps entrepreneurs take to set up and/or expand their venture. All of these in turn are affected by the values and conventions within the host society, as well as by the background of entrepreneurs, who in the early stages of transition, at least, have no prior experience of entrepreneurial activity in a market context. At the same time, the absence of relevant market experience may be partly mitigated by the human capital they often possess, reflected in higher education qualifications and some experience of management in many cases. Entrepreneurs who are able to draw on social capital in the form of previous network and 'old' contact links, have additional resources to help them cope with the various institutional deficiencies that are common in countries where progress with market reform is limited.

Another key proposition concerns the importance of the institutional environment, not just in influencing the extent, to which entrepreneurship develops, but also the forms that entrepreneurship takes and the behaviour patterns exhibited by entrepreneurs. For example, in environments, where institutional settings are not clearly defined, as in 'early stage' transition countries, (nascent) entrepreneurs face high levels of uncertainty and ambiguity in their operating environment. As a result, they tend to cope by relying on learned behaviour from their previous experience, such as a reliance on personal network contacts and/or avoidance strategies, which are to some extent path dependent. Although such behaviour enables enterprises to survive, and perhaps grow, in the short run, it might not provide a sound basis for enterprise development and growth in the long run.

Emphasising the role of the institutional context in shaping entrepreneurial actions draws attention to the potential role of institutional change in creating opportunities for entrepreneurship, as it opens up new fields which entrepreneurs can pursue. However, institutional change may also trigger and/or reinforce norm-deviant behaviour at the individual level. Conflicts within institutional settings may encourage entrepreneurs to revert to familiar and known courses of actions (learned behaviour), based on the requirements of a previous institutional environment, thus contributing to 'lock-in' situations where path dependency prevents entrepreneurs from adapting to new contextual conditions. Fostering productive entrepreneurship in such 'locked-in' situations requires a degree of relearning. Institutional change itself may trigger entrepreneurial learning, but the learning capability of entrepreneurs and businesses influences the nature of the response. Vicious circles might develop because institutional change itself is influenced by the perceptions that relevant actors have regarding the overall institutional framework and any need to change its elements.

Detailed empirically based studies of entrepreneurship in transition environments have produced findings that have implications for wider debates. One example is to challenge the use of typologies, which crudely classify individuals as either 'entrepreneurs' or 'proprietors'; and/or 'necessity-' or 'opportunity'-driven. Although the criticism is not specific to a transition context, when such classifications are applied in transition conditions, it tends to lead to the conclusion that proprietorship is more common than entrepreneurship, because entrepreneurial behaviour in the form of new venture creation and development tends to be necessity rather than opportunity driven.

At the same time, case study evidence shows that a combination of a high level of human capital and rapidly changing external conditions can result in so-called 'necessity-driven' entrepreneurs, or proprietors, identifying and responding to opportunities. While it may be argued that this type of analysis is misleading in any context, because it fails to recognise the learning capability of individuals and is divorced from a social context, the transition environment emphasises its limitations. In addition, unless qualified, analysis which fails to recognise the process nature of venture creation and development is likely to lead to a misleading picture of the role of entrepreneurship in social and economic transformation for policy makers. In other words, research in transition countries provides strong support for the recent trend in entrepreneurship research to focus on studying entrepreneurial processes, set within their social context.

As emphasised previously, the scale of the dislocation to social, political and economic systems that occurred in countries in Central Europe and the former Soviet Union at the start of the transformation period was enormous, with implications for the nature and extent of the opportunities presented to (nascent) entrepreneurs. At this time, when a new institutional framework was in the process of being established, Schumpeterian opportunities were presented as markets were in the process of being created and the unpredictable and unstable nature of the emerging environment encouraged entrepreneurs to introduce new and creative combinations. However, as the transition process proceeded, the nature of entrepreneurial opportunities presented evolved. For example, the Kirzner type of opportunities, where entrepreneurs act as arbitrageurs, became more apparent in later stages of transition, where markets had been developing and flows of information, ideas and knowledge from mature market economies represented an important source of innovation for entrepreneurs.

With regard to the recent debate on whether opportunities are enacted or independently exist in the environment, in an 'objective' sense, the evidence presented throughout the book underlines the need to acknowledge a role for both perspectives (cf. also Gartner *et al.* 2003). In early stages of transformation, particularly, deficiencies in the external environment ‘created’ many opportunities for potential entrepreneurs. At the same time, the evidence reviewed also illustrates the subjectivity of many entrepreneurial opportunities, which are linked to the social context, shaped by the inheritance from the socialist period, as well as by processes operating during transition the transition period itself. For future research, this emphasises the importance of viewing entrepreneurship as a learning process, where entrepreneurs change their behaviour in reaction to changes in their external environment, or in anticipation of this. In this perspective, entrepreneurship is understood as a non-linear process with feedback loops between individual behaviour and the environment in which it occurs. This draws attention not only to the individual component of entrepreneurship, but also to its institutional embeddedness. This, in turn, emphasises the need for caution when applying entrepreneurship theories and concepts, which have been elaborated in the context of a mature market economy to explain the entrepreneurship phenomenon in situations where the framework conditions for a market economy are still to be established.

One of the issues raised by an attempt to assess the extent to which theories and concepts of entrepreneurship developed in a market economy context are appropriate in transition conditions concerns the nature of the evidence base on which to develop or test theories and apply concepts. In this regard, Scase (2003) refers to a lack of reliable data leading to, amongst other things, what he describes as ‘extremely unreliable estimates of the real significance of entrepreneurship and small business ownership in a transition context. However, while secondary data constraints, and the difficulties of systematically conducting empirical research in some of the former Soviet republics should not be underestimated, the challenge for researchers is to develop methods and approaches that are appropriate to the context in which they are being used, as well as to the research questions they are addressing. Large-scale surveys *can* be undertaken in transition circumstances, and can produce potentially useful results, provided they are interpreted in the context in which the data were gathered, with the limits to generalisation clearly defined. At the same time, such methods can benefit from being used in combination with more process-oriented qualitative approaches, which on some issues (e.g. those related to conditions of employment and the use of employment contracts in Russian SMEs) can produce quite different results than those based on survey responses (Welter and Smallbone 2003).

The importance of robust methodologies cannot be over-emphasised, in any context, although research methods often need to be adapted to the specificities of local circumstances. The unsuitability of telephone-based interviews in some environments is a good example, since a lack of ‘institutional’ trust leads to a reliance on personal trust to establish relationships. As in business itself, ‘cold-calling’ by researchers may be unacceptable, because the institutional context does not enable credentials to be accepted without personal knowledge or recommendation. Arguably, however, such a practice represents poor research practice in any context and should not be encouraged. As a consequence, with the exception of the large-scale survey, reported in Chapter 8 on Estonia (which was commissioned by the Ministry of Economy and Communications), all other studies that involved primary data collection, were based on face to face, personal interviewing, as part of large-scale surveys and/or in-depth case studies.

Entrepreneurship and public policy

The emphasis given above to the conceptual significance of the embeddedness of entrepreneurship also applies to a consideration of public policy and its role in relation to entrepreneurship development. This does not require a different interpretative framework to one that would be appropriate in a mature market context, although its application produces different results. For example, analysis of the role of public policy in entrepreneurship development in a post-socialist context requires a broadly based approach to defining what constitutes policy, as presented in Chapter 2. To do otherwise, and focus solely on policies directed at entrepreneurship or small business development, would produce a misleading assessment of the role of government.

This is not a different conclusion from one that is likely to be reached in a mature market context, where negative impacts of regulatory policies, for example, are sometimes alleged to outweigh any positive benefits of interventions targeted at small firms. The difference is more a question of the extent of the influence of government across the full range of policies and actions associated with them. As the case of Belarus demonstrates, a failure on the part of government to establish the basic framework conditions for entrepreneurship shows how the balance between firm or entrepreneur characteristics and external influences (in this case government), is quite different compared with mature market economies, such as the UK or Germany.

In this context, an institutional perspective may be used to explore the role of the state in entrepreneurship development in different environments. Laws and the legal system in total represent prominent examples of formal institutions, which although varying between countries for constitutional reasons, are partly, if not entirely under the influence of government. Changes in laws can create new opportunity fields for entrepreneurs, such as when property rights are introduced, thereby allowing private ownership to exist. On the other hand, a deficient legal infrastructure (e.g. with implementation gaps; a lack of suitably qualified judges and economic courts) can restrict entrepreneurship development. This is especially important where what has been described as an ‘institutional void’ (Polishchuk 1997) allows for discretionary actions on the part of administrative authorities to occur, thereby fostering rent-seeking, corruption and non-compliant or deviant (entrepreneurial) behaviour. Formal institutions influence the nature and extent of entrepreneurship development in mature market economies, but in a transition context, their (negative) influence can be a dominant force.

Variations in the nature and extent of entrepreneurship across different environments reflect variations in the particular settings of institutions and enforcement mechanisms (Oliver 1991). While formal institutions are enforced by coercive mechanisms, which are mainly set down in government rules; informal institutions are enforced by normative and mimetic mechanisms. Normative mechanisms assist in creating legitimacy, which is of particular importance for nascent entrepreneurs and entrepreneurs in environments, where newness of the concept of entrepreneurship that is legal may be a potential liability, hampering its acceptance in the wider society. Clearly, the stance that government takes in dealing with entrepreneurship influences the extent to which involvement in entrepreneurship is an acceptable and legitimate form of behaviour.

Normative pressures, as codified in informal institutions, regulate entrepreneurs' behaviour and restrict their options, often forcing compliance, even when they have to employ illegal actions (Leitzel 1997). Such informal institutions (or codes of behaviour) are, to a considerable extent, path dependent, since during the Soviet period, the individual bureaucrat was the ultimate decision making authority, rather than relying on the law or a written regulation. This inheritance, combined with regulatory shortcomings and implementation gaps with respect to the new institutional frame, have negatively affected the development of productive entrepreneurship during the post-socialist period in countries such as Russia and Belarus.

The chapters on Estonia and Poland provide additional, if rather different, evidence of the role of government and public policy in entrepreneurship development in post-socialist economies, driven to a considerable extent by the process of Accession to the EU. The development of entrepreneurship has been a key element in the process of social and economic transformation in the EU's new member states from Central and Eastern Europe, particularly during the pre-accession period, facilitated by administrative and legal reforms and later by a degree of institutional change. This was driven partly by the need for Accession countries to meet the conditions for entry laid down by the EU, and partly by the desire on the part of the accession countries themselves to have the institutional conditions in place that would enable them to successfully access EU Structural Funds to facilitate the further restructuring that their economies needed.

At the same time, institutional capacity building has proved to be the most challenging aspect of the reform process and one that is central to the continued development of entrepreneurial capacity in these countries. Relevant institutions include those associated with implementing the framework conditions described in the chapter on Belarus. These include the regulatory bodies, tax authorities, and licensing and registration offices; but also institutions such as banks, accountants and other professionals involved in providing business services; together with development agencies; and self-governing bodies such as Chambers of Commerce.

Reference to Chambers of Commerce and self-governing organisations draws attention to issues of 'governance', which is a versatile term, referring to the exercise of power in both a corporate and a state context. Our focus is on the latter interpretation, embracing actions by various public bodies, including executive organisations, assemblies (such as national parliaments) and judicial bodies. Governance is concerned with the rules, procedures and practices affecting how power is exercised. This means it embraces both formal and informal institutions, in the Douglass North sense, including their legitimacy and effectiveness, which can have important implications for the development of entrepreneurship.

In countries such as Estonia and Poland, the path to EU Accession has highlighted issues of governance, as part of an attempt to improve the effectiveness and legitimacy of institutions at an EU level (Commission of the European Communities 2001). One of the key principles relates to participation, which draws attention to the nature and extent of the dialogue and co-operation between the state and representatives of entrepreneurs, at different stages of the policy process.

In mature market economies, self-governing, self-regulating organisations act as professional intermediaries in the process of dialogue between government and entrepreneurs, in order to ensure that the interests of the business community as a whole (and not just those of large firms) are taken into account in the decision making of public authorities at different levels. While Chambers of Commerce existed during the socialist period, they were effectively arms of the state, dominated as they were by large state-owned companies. As a consequence, Central and Eastern European countries have lacked a recent tradition and experience of self-governing organisations, which has represented a particular challenge, as far as building institutional capacity in the transition period is concerned.

Although Estonia and Belarus share a common heritage in that they were both part of the former Soviet Union until 1990, the period since then has seen a marked contrast emerging with respect to the exercise of power by the state and the associated governance mechanisms. Unlike Estonia, where there have been significant developments with respect to increasing the openness of public institutions, participation by entrepreneurs in policy formulation, and in the accountability of public institutions, in Belarus, the state continues to play a dominant role in the economy, with the majority of enterprises and banks still under state control.

Not only is the legislative and regulatory framework complex and frequently changing in Belarus, but significantly from a governance perspective, many economic activities are regulated by Presidential decrees, which often contradict existing laws (EBRD 2006). Regulations commonly take the form of so-called ‘recommendations’, such as lending rates for banks (both state-owned and private) and recommended price levels. This type of interference is reminiscent of the Soviet period, when authoritarian control by the state over the economy was the norm. Not surprisingly, this type of action is associated with an absence of entrepreneur involvement in the policy process, apart from Chambers of Commerce, which as mentioned above are essentially arms of the state in a Belarusian context, dominated by large state-owned enterprises. This is part of a wider absence of accountability in the country, with poorly defined roles of the public institutions involved in regulating private business activity; and a frequent lack of connection between policy pronouncements and actions by the state, particularly with respect to financial support measures.

The theme of diversity around common themes, which runs throughout the book, also applies to the current priorities for policy makers. Clearly, the specific policy priorities for entrepreneurship and small business development vary between individual countries, mainly reflecting their development path over the last 20 years. However, a key underlying theme is the importance of institutional development and capacity building, over which governments exert a key influence. In former Soviet republics, such as Ukraine, Belarus and the Russian Federation, establishment of an appropriate and effective institutionalisation of small business policy is still one of the main preconditions that need to be fulfilled before productive entrepreneurship can become embedded. This includes strengthening the role of regional and local authorities in promoting and facilitating entrepreneurship, since it is at the local level that public policy and institutional influences touch entrepreneurs most directly.

At the same time, developing effective institutional arrangements for the governance and support of entrepreneurship and small business development is a challenge faced in all countries, including mature market economies. The state can facilitate entrepreneurship by removing obstacles to enterprise creation; establishing a facilitating environment; and contributing to the development of appropriate market institutions. However, what this means in practice varies enormously between countries, according to differences in the parameters set by the framework conditions.

For example, many of the new EU member countries, including Estonia, are currently attempting to build a market-oriented innovation system to support higher-value-added entrepreneurship and SME development. This is an institutional and policy priority, which more established EU members may have more experience of but cannot claim to have completed successfully. Increasing the level of involvement of higher education institutions, for example, in developing links of various sorts with the business sector, is a policy priority throughout the EU and not just in new member countries. Not surprisingly, perhaps the policy priorities of new member countries are converging with those of more mature economies in Europe, while those of most of the former Soviet republics remain at a more basic level.

So, when considering the role of public policy in relation to entrepreneurship development in countries at different stages of market development, some underlying similarities can be identified, but there are also some clearcut differences. The latter are particularly associated with whether or not the basic framework conditions for private sector development have been established, since differences in policy priorities between the former Soviet republics and new member states of the EU are beginning to appear wider than those between the latter countries and existing member states of the EU. This suggests that what was described as a continuum from centrally planned to liberal market economies earlier, may be a discontinuous or stepped development path, rather than continuous.

Final thoughts

To return to an issue raised in the Introduction to this book, there is a strong case for questioning the validity of the term 'transition', since it implies knowledge of when transition starts and when it ends. More specifically, 'transition' specifically implies change towards a target state or outcome, whereas the evidence presented throughout this book illustrates the variety of country experiences with forms of entrepreneurial behaviour throughout Soviet times and the unique paths of development since the Soviet system collapsed. In practice, the book is concerned with entrepreneurship in countries which share a common history of central planning, but not necessarily a common destination.

To conclude, it seems appropriate to return to the key underlying question, namely the actual role of entrepreneurship and small business development in post-socialist economies in practice. This is a theme discussed in Chapter 2, where the potential contribution of entrepreneurship and SME development is described in terms of job generation, a more diverse economic structure, innovation and the generation of external income for the economy. Alongside this, reference was made to those who appear to dismiss the contribution of small enterprise development to economic transformation as comprising little more than petty trading.

However, in making such an assessment, it must be recognised that even in mature market economies, it is a minority of enterprises that contribute the majority of new jobs; and a minority that are innovators and export earners. As a consequence, it is important not to place unrealistic expectations on what the SME sector can contribute to transformation, particularly where the policy environment is not sufficiently facilitating. For example, the nature and extent of innovation in SMEs is heavily dependent on the qualitative characteristics of the innovation system, the shaping of which is largely outside the influence of the individual entrepreneur or SME owner. In addition, the absence of a strong large enterprise sector is a major disadvantage faced by growth-seeking SMEs in a post-socialist environment, compared with their counterparts in mature market economies, because of the implications for supply chain opportunities in the respective contexts. This draws attention to the importance of strategic thinking on the part of policy makers that incorporates a medium- and longer-term perspective.

Appendix

Summary of the main research projects referred to in the book

1. *Title:* Creation of Small and Medium-Sized Enterprises in Poland, Hungary, the Czech Republic and the Slovak Republic
Duration: 1993–1994
Project Aims and Methodology: The aims of this project were to take stock of and analyse the structures and development perspectives of SMEs since transformation started in the early 1990s; to evaluate support policies and programmes; and to develop policy recommendations for country governments, as well as for the German Ministry.

The methodology employed involved desk-based research of literature and statistical material in order to review the development of the SME sector to date; to identify challenges SMEs had to cope with during the transformation period; and to assess the overall environment for SME development. Empirically, the project involved interviews with a total of 576 enterprises in the four countries, plus selected case studies. In each country, three regions were selected: the capital and its environs; a medium-sized town with up to 200,000 inhabitants; and a small town with up to 30,000 inhabitants. The regional samples were stratified according to sector and size. Interview guidelines contained questions regarding the characteristics of entrepreneurs and enterprises, an assessment of external framework conditions and problems arising throughout the entrepreneurial activities as well as support drawn on.
Funder: German Federal Ministry of Economics (BMWi)
Co-ordinator: Dr Bernhard Lageman (RWI Essen)
Team: Wolfgang Dürig (RWI Essen); Dr Friederike Welter (RWI Essen); Dr Werner Friedrich (WSF Kerpen)

2. *Title:* The Survival, Growth and Support Needs of Small Manufacturing Firms in Poland and the Baltic States
Duration: 1995–1996
Project Aims and Methodology: The aims of this project were to analyse the factors influencing the survival and growth of manufacturing SMEs in Poland and the Baltic States; identify the support needs of manufacturing SMEs at different stages of their development in these countries; and make practical policy recommendations designed to increase the rates of survival and growth of this

type of firm. The methodology employed included a literature review; an analysis of the key features of the external environment affecting SME development in each of the four case study countries; and a survey of 600 SME owners/managers (300 in Poland and 100 in each of the Baltic States).
Funder: EU Phare (ACE), contract no.: 94 0743R
Co-ordinator: Professor David Smallbone (Middlesex University)
Partners: Professor Piasecki (University of Lodz); Dr Urve Venesaar (Estonian Institute of Economics); Laimonis Rumpis (Institute of Economics, Latvian Academy of Sciences); Danute Budreikate, (Academy of Sciences, Lithuania); Professor Francesco Adamo (University of Turin)

3. *Title:* Internationalisation, Inter-Firm Linkages and SME Development in Central and Eastern Europe
Duration: 1996–1998
Project Aims and Methodology: The aims of this project were to identify the effects of increasing internationalisation of markets on SMEs in the food and clothing sectors in Poland, Bulgaria and the Baltic States; evaluate alternative options facing them to service overseas markets and the management issues that need to be addressed if these are to be successfully implemented. The project resulted in practical policy recommendations to policy makers in each of the partner countries, designed to assist SMEs in responding positively to any new opportunities and threats presented by the forces of increasing internationalisation.

The methodology employed involved desk-based research to identify the existing levels of internationalisation of the food and clothing industries in the countries featuring in the study; any evidence of changes that were occurring; the role of SMEs within these sectors; together with data describing the business support infrastructure. Empirical work included surveys of SME managers in all countries participating in the study, using a harmonised interview schedule. In CEE partners, a total of 377 interviews were conducted face-to-face with SME managers: 120 in Poland; 133 in Bulgaria; and 122 in the Baltic States (divided between Estonia, Lithuania and Latvia). In the UK, 100 telephone-based interviews were conducted, while in Greece 50 firms were interviewed face-to-face. Interviews with selected key informants were also conducted in each country. In addition, two workshops were held at the start and end of the project involving academics from outside the project team as well as policy makers, practitioners and some entrepreneurs.
Funder: EU Phare (ACE), contract no.: 95 2168R
Co-ordinator: Professor David Smallbone (Middlesex University)
Partners: Professor Piasecki (University of Lodz); Professor Atanas Damyanov (D Tsenov University, Svishtov, Bulgaria); Dr Lois Labrianidis (University of Macedonia, Thessaloniki); Dr Urve Venesaar (Estonian Institute of Economics)

4. *Title:* Conditions for SME Development in Poland in Comparison with Those in EU Countries
Duration: 1998
Project Aims and Methodology: This study compared the conditions for running SMEs in Poland with those in EU countries. Based on secondary source material, the methodology employed involved comparing Poland with 'core' countries in the EU (e.g. UK and Germany) and also 'periphery' countries (e.g. Portugal and Greece). The aim was to identify any existing differences; sources of threat and opportunity for Polish SMEs as a result of integration processes; and identify any future problems for SME development and its environment. The main business environment conditions compared included: macro-economic conditions; taxation; costs; education levels; research and development activity; legal conditions and support policies for start-ups and established businesses; environmental protection; infrastructure and public procurement.
Funder: Polish SME Foundation
Co-ordinator: Professor Piasecki (University of Lodz, Poland)
Partners: Anna Rogut and Edward Stawasz (University of Lodz); Professor David Smallbone and Steven Johnson (Middlesex University)

5. *Title:* The Implications of Poland's Accession to the EU on Polish SMEs
Duration: 1998–1999
Project Aims and Methodology: The aims of this project were to assess the impact of economic integration of the enlarged EU market on the Polish SME sector, including compiling a catalogue of possible effects. The project was divided into three stages: Stage One, analysing the impact of integration processes on the SME sector from the moment the European Treaty came into force (i.e. 1991) till the end of 1998. Stage Two identified the main opportunities and threats for SMEs connected with the integration process and forecasts concerning the influence of integration on SMEs were made. Stage Three involved formulating recommendations concerning desirable changes in policy, both in the pre-accession period and after Poland joined the European Union. The methodology involved secondary data and desk-based analysis.
Funder: Polish SME Foundation
Co-ordinator: Professor Piasecki (University of Lodz)
Partners: Professor David Smallbone (Middlesex University); Anna Rogut (University of Lodz)

6. *Title:* Identifying the Support Needs of Small Enterprises in Ukraine, Belarus and Moldova to Develop an Agenda for Policy at the National and Regional Levels
Duration: 1996–1998
Project Aims and Methodology: This project was concerned with the barriers to starting, running and developing small businesses in Ukraine, Moldova and Belarus, in an attempt to define the support needs of small firms in different sectors and at different stages of their development. Using an empirically based

methodology, an analysis of the factors influencing the ability of small firms to survive and grow was used to define the support needs of small firms, which were related to what was offered by support agencies and private sector business service providers. In each country, surveyed firms and service providers were selected from two contrasting regions, in order to identify both national and regional level policy issues.

As well as a reviewing key literature, the methodology employed comprised the following elements.

a A survey of business service, consulting and training organisations in two cities in each country in 1997.
b A survey of small business owners/managers comprising three groups of firms: recent start-ups, survivors and non-survivors from three sectors: manufacturing, construction, and selected services. Face-to-face interviews were undertaken between March and October 1997 with a total of 619 entrepreneurs: 350 in Ukraine, 168 in Belarus and 101 in Moldova. In each country, the programme of interviews included a minority of firms that had ceased trading. In order to capture some of the spatial diversity in small business development, in each country surveyed firms were selected from two contrasting regions (capital city and a second region).
c Interviews with selected key informants in each country to discuss some of the survey findings. These interviews were undertaken in 1998.
d A comparative analysis of the data obtained in order to evaluate the extent to which the support that is currently offered meets the needs of small firms in different sectors and locations and also of firms at different stages of development.
e The development of a policy agenda and elaboration of recommendations for policy makers and institutions to develop and deliver 'support' at the national and local level.

To be included in the study, firms needed to employ not more than 200 (core) employees, although most employed considerably fewer.
Funder: EU Tacis (ACE) Programme, contract no.: T95–4139R
Co-ordinator: Professor David Smallbone (Middlesex University)
Partners: Friederike Welter (RWI Essen); Nina Isakova and Yuri Klochko (Academy of Sciences, Ukraine); Elena Aculai (Academy of Sciences, Moldova); Anton Slonimski (Institute of Economics, Belarus)

7. *Title:* The Contribution of Small Businesses to Regional Economic Development in Ukraine, Moldova and Belarus
Duration: 1997–1999
Project Aims and Methodology: The aims of this study were to analyse the pattern of development of small businesses in Ukraine, Belarus and Moldova focusing on regional variations; to identify the roles that small businesses perform in regional development, together with the characteristics of firms

associated with each of these roles; and to make recommendations to policy makers in each country designed to enhance the contribution of small firms to regional economic development. In addition to desk-based literature review and analysis of secondary data, the methodology involved empirical investigation comprising a survey of 643 small private firms, spread across the three countries, together with 94 in-depth case studies. Both survey and case study elements included enterprises located in core and periphery regions. The survey covered four main sectors, namely manufacturing, services, and trade and construction firms. Since one of the aims of the study was to examine the various roles that small firms play in regional economic development, the survey samples were stratified in order to avoid the study becoming dominated by firms in retail, wholesale and basic services. As a consequence, the sectoral mix of the national samples was not entirely representative of the small business sector in each country, with manufacturing considerably over-represented.

Funder: International Association for the Promotion of Co-operation with Scientists from the Newly Independent States of the Former Soviet Union (INTAS), contract no.: UA-95–266

Co-ordinator: Professor David Smallbone (Middlesex University)

Partners: Dr Friederike Welter (RWI Essen); Dr Nina Isakova and Yuri Klochko (Academy of Sciences, Ukraine); Dr Elena Aculai (Academy of Sciences, Moldova); Dr Anton Slonimski (Institute of Economics, Belarus)

8. *Title:* Innovation, Small and Medium Enterprises and Economic Development in Ukraine and Belarus

Duration: 2000–2002

Project Aims and Methodology: This project sought to describe the pattern of innovation and use of technology in Ukrainian and Belarusian SMEs in selected manufacturing (high-tech and low-tech) and service sectors (business services); gain greater understanding of the processes of innovation and use of technology in these firms and identify the factors which inhibit innovation; identify the conditions which encourage innovation and technological development in Belarusian and Ukrainian SMEs and identify best-practice cases with respect to innovation and successful technological development.

The methodology employed included surveys of SMEs in each country, using a harmonised interview schedule. To be included in the survey, firms needed to be predominantly privately owned and employ fewer than 250. The samples were stratified between three sector groups: medium-/high-technology manufacturing, low-technology manufacturing, and produced services. Approximately 300 firms were interviewed in each country, divided equally between the three categories. Case studies of innovative SMEs were also conducted (30 in each country), the main aim of which was to investigate the process of innovation in SMEs in more detail and identify factors that inhibit innovation at the micro level. These interviews were semi-structured and included qualitative as well as some quantitative data.

Funder: International Association for the Promotion of Co-operation with Scientists from the Newly Independent States of the former Soviet Union (INTAS)
Co-ordinator: Professor David Smallbone (Middlesex University)
Partners: Dr Friederike Welter (RWI Essen); Dr Igor Egorov (Academy of Sciences, Ukraine); Dr Anton Slonimski (Institute of Economics, Belarus)

9. *Title:* Employment, SMEs and Labour Markets in the Russian Federation and Moldova
Duration: 1999–2001
Project Aims and Methodology: This project investigated employment, SMEs and the labour market in selected transition economies, on the basis of empirical research in two countries, i.e. the Russian Federation and Moldova. Using a survey-based methodology, supplemented by aggregate data extracted from official data sources, the study aimed to provide insights into the quality of employment in SMEs as well as the number of jobs provided. Job quality aspects included: employment relations in SMEs; the kind of employment SMEs offer; and the skills that SMEs demand in different sectors, size classes, and regions.

The methodology used involved a review of key literature and relevant empirical studies; an analysis of secondary data at the aggregate level; micro-level surveys of SME owners and their employees; and an analysis of institutional structures and policies that influence labour market conditions. The micro-level analysis involved a two-stage survey approach. The first stage was a postal survey of SME owners/managers in different Russian and Moldovan regions, in order to provide a quantitative database. The second stage involved case studies of SME owners/managers and their employees, in order to provide additional qualitative insights. Institutional analysis was directed towards analysing the relevant institutional frameworks in Russia and Moldova using information on laws, training systems, relevant support policies and programmes and interviews with selected key informants.
Funder: International Association for the Promotion of Co-operation with Scientists from the Newly Independent States of the Former Soviet Union (INTAS)
Co-ordinator: Dr Friederike Welter (RWI Essen)
Partners: Professor David Smallbone (Middlesex University); Dr Alexander Chepurenko (Russian Independent Institute for the Study of Social and Nationalities Problems, Centre for Socio-Economic Research, Moscow); Dr Elena Aculai (Academy of Sciences, Moldova)

10. *Title:* Female Entrepreneurship in Ukraine, Moldova and Uzbekistan
Duration: 2001–2003
Project Aims and Methodology: This project focused on female entrepreneurship in Ukraine, Moldova and Uzbekistan, in an attempt to assess its contribution to economic and social development in these countries. The specific objectives were to describe the nature and extent of female entrepreneurship in relation to their role in economy and society; identify barriers impeding and factors enabling female entrepreneurship; gain greater understanding of the role

of female entrepreneurs during the transformation towards a market-based economy; and evaluate selected policy and support measures for (women) entrepreneurs.

The methodology employed an extensive literature review, in addition to empirical investigation. The latter involved surveys in each country, of women entrepreneurs but also of a male control group in each case. The surveys were divided between core and periphery regions in each country. In addition, case studies of female and male entrepreneurs were conducted (90 in total), in order to investigate the businesses of female entrepreneurs and their strategies for business survival and development. Evaluation of selected support measures, either targeted at, or which had implications for, women entrepreneurs, were also conducted.

Funder: International Association for the Promotion of Co-operation with Scientists from the Newly Independent States of the Former Soviet Union (INTAS)

Co-ordinator: Dr Friederike Welter

Partners: Professor David Smallbone (Middlesex University); Dr Aculai (Academy of Sciences, Moldova); Dr Nina Isakova (STEPS, Ukraine); Professor Dr Natalja Schakirova (Association of Business Women, Uzbekistan)

11. *Title:* Entrepreneurial Strategies and Trust: Structure and Evolution of Entrepreneurial Behaviour Patterns in Low Trust and High Trust Environments of East and West Europe

Duration: 2001–2003

Project Aims and Methodology: This project investigated entrepreneurial behaviour in different cultural and institutional milieus in Eastern Europe, in order to identify differences both in comparison with Western European economies and also between Eastern European countries themselves. The central hypothesis was that trust has an important impact on entrepreneurship in various ways. Co-ordinated from Germany, the project included Russian, Estonian and Italian partners as well as the UK, selected to represent so-called high trust and low trust environments.

Funder: The Volkswagen Foundation, Germany

Co-ordinator: Professor Hans-Hermann Höhmann (University of Bremen); Dr Friederike Welter (RWI Essen)

Partners: Professor Alexander Chepurenko (Higher School of Economics, Moscow); Professor David Smallbone (Middlesex University); Dr Urve Venesaar (Tallinn Technical University); Dr Gabi dei Ottati (University of Florence)

12. *Title:* Technical Assistance on SME Survey and Policy Issues to Estonian Ministry of Economic Affairs

Duration: 2002

Project Aims and Methodology: The main aim of this project was to develop a methodology for a comprehensive survey of SMEs in Estonia and to assess existing secondary sources of enterprise data from the standpoint of providing a basis for comparison with EU countries. The project led to a survey of almost

2,000 SMEs in Estonia, some analysis of which is included in this book.
Funder: European Commission through framework contract with West Midlands Enterprise.
Co-ordinator: Professor David Smallbone (Middlesex University)
Partners: Dr Urve Venesaar (Tallinn Technical University)

Note:
The titles and affiliations listed above refer to the situation at the time the projects were undertaken, some of which have changed subsequently. Where changes are known, the current titles and affiliations of named individuals are:

Professor David Smallbone, Small Business Research Centre, Kingston University
Professor Friederike Welter, University of Siegen
Professor Lois Labrianidis, University of Macedonia, Thessaloniki

Notes

1 Introduction

1 Phare was originally created as the Poland, Hungary: Assistance for Restructuring their Economies (i.e. Phare) programme, although it has subsequently been extended to cover ten new member states of the EU.
2 ACE refers to Action for Co-operation in the field of Economics.
3 The Tacis programme was launched in 1991 to provide grant financed technical assistance to 12 countries of Eastern Europe and Central Asia, with the aim of enhancing the transition process.
4 INTAS refers to the International association for the Promotion of Co-operation with Scientists from the Newly Independent States of the Former Soviet Union.

2 Entrepreneurship, SME development and the transformation process

1 The surveys started in 1999 but included questions referring to the previous three years.

3 Entrepreneurship in transition economies: a conceptual review

1 There has been a debate around the extent to which Soviet society fostered this homo sovieticus and how this might have affected entrepreneurship in the transition process. It resembles the nature-versus-nurture debate of entrepreneurship teaching. Soviets themselves recognised this phenomenon (cf. the manifold descriptions in the novel written by Sinovjev 1987). During the transition period, most researchers viewed individual behaviour as resulting mainly from situational influences compared to attitudinal ones (e.g. Shiller *et al.* 1992).
2 *Blat* describes a pre-Soviet phenomenon, which gained new importance and meaning during Soviet and post-Soviet times. Ledeneva (1998: 11–12) refers to interviewees remembering *blat* as far back as the 1930s, while Rehn and Taalas (2004) refer to it originating from the forms of mutual aid, which a pre-revolutionary rural society relied upon. However, the term and its meaning are difficult to accurately translate into English. In pre-revolutionary times, its meaning referred to criminal activities (Ledeneva 1998: 12), although *blat* as used in Soviet and post-Soviet times differs from bribes and corruption.
3 For a review of empirical studies and research streams focusing on the enterprising individual cf. Shook *et al.* (2003); for studies, which broadly fall into the category of opportunity recognition research, cf. Shane (2003). However, Gartner *et al.* (2003: 103) adopt a critical stance regarding this concept, stating that 'There appears to be a bandwagon (…) in the entrepreneurship literature for positioning opportunity as a fun-

damental aspect of the phenomenon of entrepreneurship.' This might result in fruitless discussions on how to define opportunities, as is known from the discussion on entrepreneurial characteristics.

4 Although Kirzner often referred to discovery in connection with entrepreneurship, this does not contradict what has been said with respect to him implicitly presenting an enactment perspective. On the contrary, he appears to employ both perspectives.

4 Employment in new and small firms: the example of the Russian Federation

1 The new Labour Code of the Russian Federation was adopted in December 2001, and came into effect from January 2002 onwards. Cf. Russian SME Resource Centre (2002: 296).

2 Shuttle businesses are trading activities across borders, where entrepreneurs (often illegally) import goods and sell them on the local market. This type of business can be highly profitable, if somewhat risky. It also is sometimes used to make up for a lack of finance in the main business line.

5 Coping with adversity: the case of Belarus

1 Even allowing for 1–2 per cent overestimate of GDP in Belarusian national accounts (EBRD 2000).

6 Innovation and entrepreneurship under transition conditions: the example of Ukraine

1 In 2000, the Committee was restructured and renamed as 'State Committee of Ukraine in the Issues of Regulatory Policies and Entrepreneurship', aiming at strengthening its role in deregulating the Ukrainian system and the regional outreach.

2 All respondents were invited to identify up to three ways in which their products/services were innovative.

7 Poland: entrepreneurship development and EU accession

1 It should be noted that whereas non-commercial partnerships operated throughout the entire post-war period, commercial partnerships began to appear on a wider scale only in the second half of the 1980s.

2 During the Stalinist period, the term 'craft' was often used to describe a variety of different types of production and service activity since it appeared less exploitative in a Marxist sense and thus more ideologically palatable than 'small private firms'. 'Crafts' were defined as a type of economic activity in which the craftsman (owner of the firm) participated directly, performing the same operations as employees hired by him.

3 Central Statistical Office Statistical Yearbooks for the years 1982–1989, Chapter XXI, Table 10.

4 Central Statistical Office, Statistical Yearbooks for 1994, Chapter LXII, Table 26.

5 It is significant, as more than 66 per cent of exports conducted by the SMEs are derived from manufacturing sectors (Polish Agency for Enterprise Development 2002).

6 A vovoidship is a Polish administrative unit. Poland is divided into 16 vovoidships.

7 In the study in question, 'support services' were defined as: originating in a public policy initiative; provided by either a public institution or by a private institution operating under a mandate from a public body; targeted at SMEs; are of a non-financial nature.

8 Based on EU definitions, SMEs employ fewer than 250 people. Very small (or micro-enterprises) employ 1–9, small 10–49 and medium-sized firms 50–249.

9 In particular: (1) privatisation and the restructuring of economy; (2) a policy of rapid and balanced economic growth and gradual harmonisation of macro-economic indices with the Economic and Monetary Union's criteria; (3) streamlining the activities of institutions; (4) implementing provisions of the European Treaty.

10 More details on the opportunities and threats for the foodstuffs industry may be found in Chechelski and Morkis (1999), Urban (2000).

11 However, this will mainly be a short-term effect. Research, which was carried out in the UK in 1993 and then repeated in 1997, confirms that this will be the case (Smallbone *et al.* 1999).

12 Estimations of the changes in competitiveness of 26 branches of Polish industry were based on: (i) an analysis of the cost structure in particular branches; (ii) the probable cost increases resulting from integration with the EU (technical standards, quality checks, health and consumer protection, etc.; welfare costs; environment protection; an increase of real wages; appreciation of PLN); increased cost of energy carriers, increased competition; (iii) lesser pressure of additional costs, resulting from the decline of prices on certain materials and services (the prices will fall as a result of greater competition on the market) that the companies require as well as from an increased efficiency of work.

13 This scenario assumes slow progress with reforms, long transition periods, which will result in limited attempts of restructuring and a rapid growth of unemployment, moderate economic growth and stable macro-economic environment. In this scenario the government strives for quick membership in the EU, long transition periods and large transfers.

14 The structural reforms will be carried out quickly, the budget deficit will be limited, privatisation will continue, the state's role in providing stable conditions for economic activity (including the inflation ratio) will be minimised. The government strives to achieve liberal access to markets and long transition periods for solutions, which are threatening the competitiveness of Polish enterprises and products, while accepting only small transfers.

15 Foreign capital is allocated very selectively in this sector; it concentrates on soft drinks, other foodstuffs, fruit and vegetables, as well as dairy products.

16 This section is based on work undertaken by Professors Bogdan Piasecki and Anna Rogut as part of the project The Future of Europe's Rural Periphery: the Role of Entrepreneurship in Responding to Employment Problems and Social Marginalisation, funded under EU5th Framework Programme for Research, Development and Demonstration Activities – a six-country study co-ordinated by Professor Labrianidis of the Department of Economics, University of Thessaloniki, The authors are grateful to their Polish colleagues for providing access to this material.

8 From the former Soviet Union to membership of the European Union: the case of Estonia

1 The employment rate is defined as the share of employees from the number of working-age population (i.e. 15–69 years).

2 This is based on data from the Centre of Registers, Ministry of Justice of Estonia, which includes some businesses that are temporarily not trading. If National Tax Board data are used the figure is 26 per 1,000 inhabitants, since this is based on current tax returns which means that more non-trading businesses are excluded. Some sole traders are also excluded.

3 This data only includes active enterprises. Since sole traders are excluded, total employment in the enterprise sector is underestimated. However, one advantage of the database is that it avoids double accounting of people operating in more than one enterprise or activity.

4 Employment according to the Estonian Labour Force Study was 579,300 persons in 2002.

5 Based on an interview with a consultant from Graham Bannock and Partners, who have the contract to implement the programme in Estonia. The project is an SME financing facility, developed jointly by the EBRD and the EU, for co-operation with banks in accession countries. Under this programme, finance is available for private sector SMEs (normally employing fewer than 100 employees), owned by Estonian residents. Financing can take the form of term loans, overdrafts or leases, up to a maximum of €125,000, for a maximum maturity of five years.

6 Interview with representative of the Estonian Leasing Association.

7 The survey was conducted on behalf of the Ministry of Economic Affairs and Communication. A total of 1,912 enterprises were interviewed by telephone. A stratified random sampling design was used, with the actual results from the sample survey weighted to make them representative of the total population of SMEs in the country.

8 See www.stat.ee/files.aw/id=76424/lithuania_latvia_and_estonia_key_indicators_2000_2002.pdf

9 This varies according to the legal form adopted.

10 The formula for exemption is that net sales must not be more than four times the minimum sales threshold for VAT registration.

11 Income tax was introduced in 1994.

12 The survey was undertaken in December 2002. It was designed by David Smallbone and implemented by a market research company on behalf of the Estonian Ministry of Economic Affairs. To be eligible for inclusion in the survey, enterprises needed to be independently owned, employ fewer than 250 and operate in either the secondary or tertiary sectors. All sectors were included, except for those engaged in agriculture, fishing and forestry. Respondents were sampled from two databases of the Commercial Register (i.e. on businesses and sole proprietorships). A stratified random sampling design was used, with the actual results from the sample survey weighted to make them representative of the total population of SMEs in the country, based on quotas for 28 cells (i.e. four size groups: 0, 1–9, 10–49, and 50–249 employees and seven fields of activity based ion the NACE classification).

13 All these percentages are related to the total number of firms that stated that they had a need for skilled workers. Firms that stated they had no need for skilled workers were excluded.

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