



POLICY NOTE FOR WORKING PAPER 5.18

BUSINESS CULTURE, SOCIAL NETWORKS AND SME DEVELOPMENT IN THE EU NEIGHBOURHOOD

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OBJECTIVE

In recent decades, economic growth in economies around the world has become increasingly dependent on the dynamism of small and medium sized enterprises (SMEs). Analysts have noted the significant role of SMEs in both advanced and transition economies in areas such as job creation, innovation and competitiveness (Acs and Audretsch, 1993; Storey, 1994). SMEs have a particularly important role to play in the process of job creation in transition economies since they may generate jobs for those who are dismissed from large firms undergoing restructuring or privatisation (Tyson, 1995; Bartlett and Hogget, 1996; Kolodko, 2000). The creation of a new SME sector may therefore play an important role in the process of economic regeneration and job creation. In the context of high unemployment and a declining role of large state firms this aspect has been especially important in the transition economies of the European Neighbourhood Policy (ENP) area. In the transition countries, the entry of new entrepreneurial firms has been an essential element of the transition from state-managed economies based on large enterprises to more dynamic and competitive economies based on the entry of myriad small firms in all sectors of their economies (Wachtel, 1999). There is some empirical evidence that entrepreneurial activity has had a positive effect on growth in transition economies (Berkowitz and DeJong, 2005).

However, a number of problematic issues have acted to hold back the development of entrepreneurship and the entry and growth of SMEs in the transition countries, and especially in some of the ENP countries. Firstly, innovative high-growth SMEs, sometimes called 'gazelles', seem to thrive in economies in which institutional structures emphasise the importance of freedom from government interference, a feature that is more likely to characterise the business environment in developed market economies than in emerging and transition economies (Valliere and Peterson 2009). This represents a challenge for policy makers in ENP where government has only recently become rather more supportive of the small firm sector and

entrepreneurship. Secondly, in the ENP countries, the entry and growth of small firms has been held back by state policies that have been ambiguous about support for new entrepreneurs (Barkhatova, 2000). This has been due to the close political connections between ruling elites and the large firm sector, which has created closed economies in which powerful monopoly interests have encouraged the persistence of significant barriers to entrepreneurs to establish new firms in many sectors. Monopolies and powerful coalitions have sought to stall reforms and preserve the status quo to maintain privileged positions gained during the chaos of the early stage of transition (Bartlett, 2012).

SCIENTIFIC/ RESEARCH METHODS

The paper investigates the barriers to entrepreneurship in the ENP countries focusing on (i) the motivations of entrepreneurs, (ii) institutional factors that limit new firm entry and growth and (iii) the role of social capital, networks and institutional embeddedness in explain differences in performance among entrepreneurs in different countries. Data are taken from the International Finance Corporation (IFC) database on small and medium sized enterprises, the World Bank Ease of Doing Business database, the World Bank Enterprise Survey and from national statistics offices to explore these factors using cross-national comparisons of relevant statistical indicators.

POLICY VALUE - ADDED

The removal of barriers to entry and growth is an important focus of policy to stimulate entrepreneurship in the transition economies of ENP. Moldova and Ukraine still have a long way to go in liberalising their economy (Bartlett et al. 2012). The situation is not much different in the non-transition economies of North Africa. In all ENP economies therefore, the liberalisation of the business environment is needed to stimulate the further development of the small firm sector.

However, it should also be noted that the state has an important constructive and supportive role to play in establishing the basic institutional framework in which entrepreneurship can flourish, new firms are encouraged to enter the market, and established firms have appropriate incentives to undertake investment and generate employment opportunities (Tyson et al. 1994; Smallbone and Welter, 2001b, 2010a, 2010b). In addition to macroeconomic stability and secure property rights, governments need to establish an effective institutional support structure for the development of the SME sector (Kolodko 2000). In particular the establishment of formal institutions to monitor and enforce competition, and reduce the ability of large monopolistic firms to stitch up local markets is an important element of building the institutional framework supportive of a dynamic market economy and economic growth. The Croatian government began to develop an institutional support structure for SMEs in the 1990s, passing a Law on the Encouragement of Small Business Development in 2002. A national strategy for SMEs was adopted in

Macedonia in 2002. As yet, such national strategies have not been adopted in the ENP countries.

However, progress with creating a formal institutional framework for the support for SMEs is not the whole of the story. The missing ingredients include informal institutions, which either promote or hinder the development of small businesses, including factors such as the extent of corruption, informal norms of business behaviour, and the extent of the informal economy. In addition, the degree of interpersonal trust is an important factor. A legacy of ethnic tension can undermine such trust relationships and make it difficult for entrepreneurs to do business on the basis of arms-length anonymous contracting. Instead they are reduced to a smaller circle of business partners who they know personally and can trust to do business with them. Such trust is hard to rebuild if rent-seeking clan or social networks of the former nomenklatura elites that reinforce the political connectedness between the large firm sector and the political elite. Such political connectedness supports the monopoly positions of local tycoons, and provides both overt and hidden barriers to small business entry and growth. This drives up business costs and reduces the quality of goods and services, reinforcing the lack of international competitiveness of most economies of the region. Policy makers will need to address these issues in a serious way if the potential of the small firm sector to promote economic growth, in an increasingly difficult global market environment, is to achieve its full potential.

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