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

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OBJECTIVE

In recent decades, economic growth in countries around the world has become increasingly dependent on the dynamism of small and medium sized enterprises (SMEs). This is especially important in the transition economies of the European Neighbourhood Policy (ENP) area in the context of economic crisis and rising unemployment. However, a number of problematic issues have acted to hold back the entry and growth of SMEs in the transition countries of the ENP region. Firstly, innovative high-growth SMEs, sometimes called ‘gazelles’, thrive where institutional structures emphasise the importance of freedom from government interference. This represents a challenge for policy makers in ENP where government has only recently become more supportive of entrepreneurship. The paper sets out an approach to analysing the development of SMEs in transition countries in the Eastern Neighbourhood Policy (ENP) countries. It distinguishes between approaches focussed on (i) the motivations of entrepreneurs, (ii) the business environment in which firms operate, and (iii) the cultural and social networks within which they are embedded. The paper reviews the literature on these three approaches and available evidence on relevance to understanding the performance of small and medium sized enterprises (SMEs) as main agents of entrepreneurship in the ENP countries with a focus on the Eastern Partnership region and in particular on Moldova and Ukraine.

MAIN RESULTS AND POLICY IMPLICATIONS

The removal of barriers to entry and growth is an important focus of policy to stimulate entrepreneurship in the transition economies of ENP, but Moldova and Ukraine still have a long way to go in liberalising their economy. 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.

Several specific findings emerged from the research. Firstly, the research revealed that entrepreneurship in Ukraine is predominantly of the non-dynamic “push” variety

(sometimes called “necessity entrepreneurship”): the incidence of sole proprietorship being generally higher in regions with a higher rate of unemployment.

Secondly, the analysis has also shown that most countries of the region have entry density rates below 2%. Egypt and Algeria have the lowest entry rate in ENP. The exceptions are Croatia Georgia, Macedonia and Russia, each of which have entry density rates above 2%, suggesting that these economies have developed a more pro-enterprise business environment than other transition countries in the region.

Thirdly, the research also showed that five of the ENP countries are in the top 50 of the global ranking in the ease of starting a business including the Caucasus countries and Belarus. However, Moldova and Ukraine are ranked far lower, between 50th and 100th place with Moldova placed close to the bottom of the rankings. Moldova is particularly badly placed concerning the number of procedures required to start a business, while Ukraine is badly placed in relation to the time taken to start a business.

Fourthly, the research also showed a positive relationship between the ease of starting a business and the rate of small firm entry in the Balkan and Eastern Partnership region, with a more conducive business start up regime being associated with a higher rate of small firm entry.

Fifthly, the research revealed that access to finance is a key constraint on business activity in the region, specifically in Croatia, Moldova, Macedonia and the Ukraine, while corruption is a stronger barrier to business activity in Moldova and Ukraine than in Croatia and Macedonia.

Overall, the research showed that the state has an important supportive role to play in establishing the 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. 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. 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 SME sector for economic growth.

However, in the ENP region several factors hinder the establishment of such a facilitating institutional framework for SMEs, including informal institutions such as the extent of corruption, informal norms of business behaviour, and a large informal economy. In addition, the low degree of interpersonal trust makes 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. But trust is hard to rebuild if rent-seeking clan or social networks of the former nomenklatura elites reinforce political connectedness between large firms and the political elite. Such connectedness places both overt and hidden barriers to small business entry and growth. This drives up business costs and reduces the quality of goods and services, thus reinforcing the lack of international competitiveness of the 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.