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Business Culture, Social Networks and SME Development in the EU Neighbourhood

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Business Culture, Social Networks and SME Development in the EU Neighbourhood

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Abstract

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.

Keywords

Institutions, entrepreneurship, SME, transition, growth

JEL Classification

P2, O40, C33

1 INTRODUCTION

In recent decades, economic growth 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 et al., 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. The shift away from a reliance on large firms to generate economic growth has been a global phenomenon over the last three decades. Thurik and Wennekers (2004) characterise this as a shift from a 'managed economy' of large firms in the immediate post WWII years, to an 'entrepreneurial economy' of small and medium sized firms in the 1980s onwards. This entrepreneurial style of economy was initially developed in the USA and the UK, where SMEs were agents of innovation and flexible responses to rapidly changing consumer demand. They also played an important role in the Southern European countries such as Italy, where SMEs organised in industrial districts were the main agents of the remarkable economic growth of the Emilia Romagna region in the 1980s and 1990s. The emphasis on the central role of SMEs has more recently come to dominate policy thinking throughout the EU. 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; Kolodko, 2000). 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).

2 SMALL FIRMS IN THE ENP: PREVIOUS RESEARCH AND DATA

Since 1989, the transition countries in the ENP region have experienced a rapid growth in the number of new small firms in the private sector as pent up demand for firm formation was released by the newly liberalised environment following the collapse of communism. By 2011 there were 48,541 registered private companies in Moldova. Of these, three quarters (75.5%) were micro enterprises with fewer than 10 workers, and a further fifth (18.9%) were small enterprises with 10 to 49 employees (Popa, 2013). Thus altogether, some 94.4% of firms were ‘small’ in the conventional definition. Only 3.1% of enterprises fell into the category of medium size (50-249 employees) of which there were 1,502, while 2.5% were large firms of which there were 1,204. In Ukraine, the vast majority (93.7%) of registered enterprises were small sized (similar to Moldova); only 5.7% of firms were medium sized and just 0.6% were large. For comparison, in the EU-27, 92% of firms were micro enterprises, 6.7% were small, 1.1% were medium and 0.2% were large sized (Eurostat, 2011). Thus, even after twenty years of transition, the ENP countries still had a business structure still slightly more skewed towards large firms than the average for the EU economies.

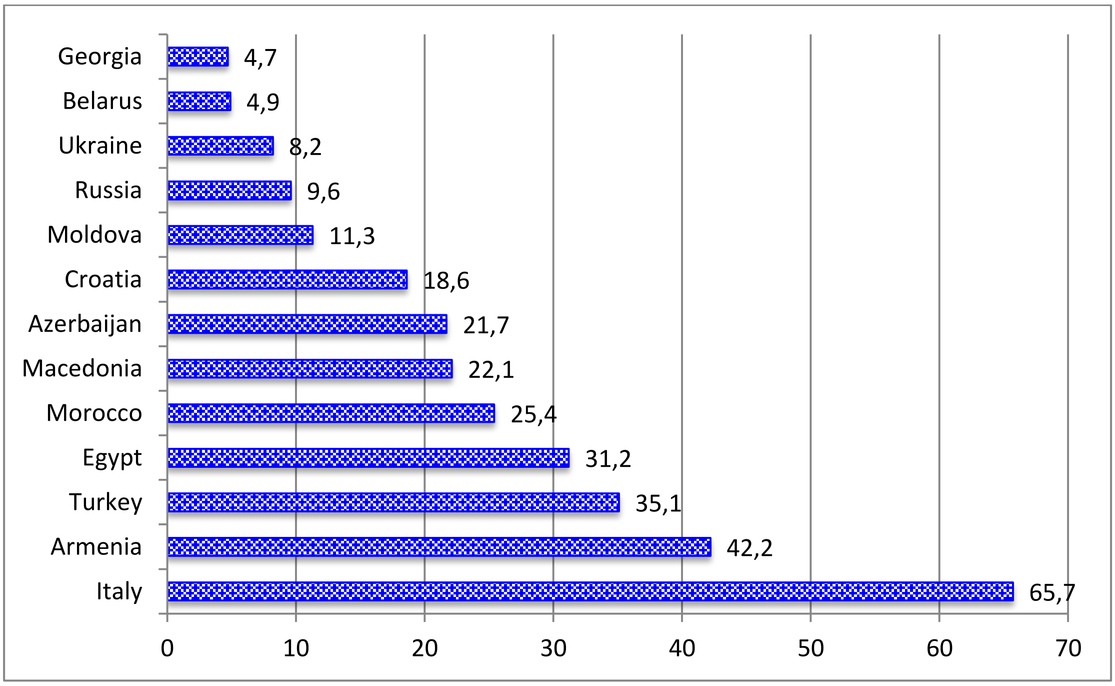
Although only a minority of firms in Moldova and Ukraine are large, these firms accounted for 42.3% of employment and 65.4% of turnover. SMEs accounted for the remaining 57.7% of employment (medium sized enterprises for 17.9%, small enterprises for 22.8% and micro enterprises for 17.0%). The Ukrainian economy has a very similar size distribution of enterprises with 43.3% of workers employed in large enterprises, while 30.1% were employed in medium sized enterprises and 26.6% in small enterprises[1]. For comparison, in the EU-27, employment was distributed across firm size classes as 29.0% employed in micro enterprises, 20.5% in small, 17.2% in medium and only 33.3% in large enterprises. Thus, in the ENP countries, employment in large firms is a full ten percentage points higher than in the EU.

The new entrepreneurs have faced many obstacles to developing their businesses. One of the principal barriers to growth was the lack of finance from the underdeveloped banking system. The limited available bank finance was mainly channelled to the large enterprise sector, while loans to small enterprises were provided at high interest rates with heavy collateral requirements. Larger firms attempted to establish and maintain dominant or monopoly positions, making use of close connections between the economic and political elites, which themselves rotated between positions of political and economic power. This convergence of political and economic power made it relatively easy for the large enterprise sector

[1] Data from State Statistical Services, Ukraine, 2012.

to establish and maintain monopoly positions and influence economic policy in ways inimical to the development of the competitive small business sector, and there was relatively little policy impetus for the promotion of small firms in most of SEE states throughout the 1990s. Moreover, much of the growth of entrepreneurial activity that has taken place has been concentrated in the cities and major urban agglomerations. Relatively little entrepreneurial activity has taken place in rural areas (Kalantaridis et al., 2007; Bartlett, 2009)

Figure 1: Density of firms per thousand population



Source: IFC online database, 2012 (data refer to 2008)

Due to varying entry rates among countries, substantial differences emerged in the density of SMEs. In countries were the barriers to firm entry were greatest, the density of firms per thousand population was relatively low. In 2008, the density of enterprises per thousand population was extremely low, below 15, in several of the Eastern ENP countries, including Belarus, Georgia, Moldova, Russia and Ukraine. An intermediate group of countries had densities between 15 and 25 per thousand, including Azerbaijan, Croatia and Macedonia. Countries of the southern ENP as well as Azerbaijan and Turkey had densities between 25 and 50. These were still below the density of firms in Italy where small and medium sized firms had played such a strong role in economic development, and where the density reached 65 firms per thousand population. The data demonstrate the more conducive environment to small business in Italy compared to the transition economies of the ENP region, and highlight the significant barriers that have existed to the creation of new businesses in those countries.

Using data from the IFC database there appears to be a weak positive link between firm density, and the level of development, as measured by Gross National Income per capita. A regression of firm density on GNI per capita yields a small positive coefficient on the GNI per capita variable but there is a very low R-squared (of 0.0665. This suggests that the entry of new firms may be partially linked to the level of economic development, but that many other factors are involved in determining whether a country has a thriving SME sector that is capable of generating jobs and supporting a dynamic economic growth path. From the data presented in Figure 1, it seems that in the Eastern ENP countries entrepreneurs face many difficulties in establishing their presence on the post-socialist market.

3 THE MOTIVATIONS OF ENTREPRENEURS

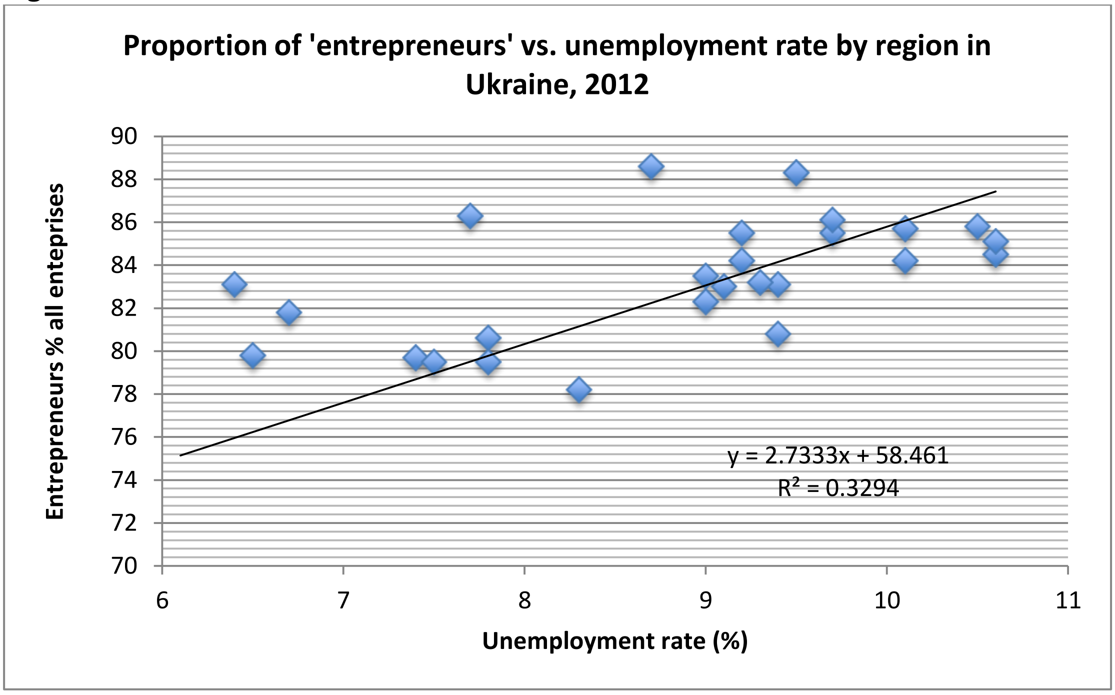
Much attention has been given to the motivations of entrepreneurs. While it might be expected that motivations of aspiring business owners after the collapse of communism in the soviet space would be different from those in the West, early studies seemed to show however that aspirations were little different. One study of Russian entrepreneurs found their main motives to centre on a wish for job satisfaction and for independence (Ageev, 1995). In the climate of raising unemployment, many new small firms were established. A variety of motives drove people to start a new business. Both ‘pull’ and ‘push’ factors were involved. People very often did not have a choice since they needed money for everyday life. Sole proprietorships have increased in numbers in most of the ENP states due to the relative simplicity and low cost of the procedure.

Two main factors drove this growth of self-employment. The first was poverty, which pushed unemployed or marginalized people into self-employment in sectors such as retail trade or small retail kiosks with low prospects for growth. The second was the response to new opportunities, which pulls 'high-expectation' entrepreneurs into dynamic segments of the economy (Storey 1994, Bartlett and Hoggett 1996)[2]. Research into self-employment in transition contexts has suggested that self-employed persons with employees are more likely to be dynamic and upwardly mobile entrepreneurs, while self-employed individuals working on their own account are more likely to be struggling to make ends meet (Earle and Sakova 2000; Hanley 2000). Both of these types of entrepreneur can be observed in ENP. High unemployment and weak social security systems have pushed many people into self-employment as a means to ensure a living, while there are also many cases of adventurous individuals who have been pulled into self-employment to take advantage of the new market opportunities opened up by economic liberalization.

Some indication of the strength of push versus pull factors in stimulating entry into self-employment can be gained by comparing the incidence of self-employment to the rate of unemployment. In Ukraine, four-fifths of businesses were registered as 'natural enterprises – entrepreneurs' in 2012, in other words they were sole proprietorships or self-employed businesses. In order to identify whether these entrepreneurs established their firms as a result of push or pull factors (i.e. whether they are necessity or opportunity-driven) we ask whether the incidence of unemployment in a region leads to a higher incidence of such entrepreneurship. Figure 2 plots the incidence of 'entrepreneurs' (sole proprietors) against the level of unemployment across regions in Ukraine in 2012. The relationship between these variables is positive, with an R-squared of 0.33. This suggests that the entrepreneurship in Ukraine is predominantly of the push variety – the incidence of sole proprietorship being generally higher in regions with a higher rate of unemployment.

[2] These push and pull factors are frequently characterised as factors of 'necessity' and 'opportunity' entrepreneurship respectively.

Figure 2



Source: data from the State Statistics Service, Ukraine, 2012 (see Appendix 1)

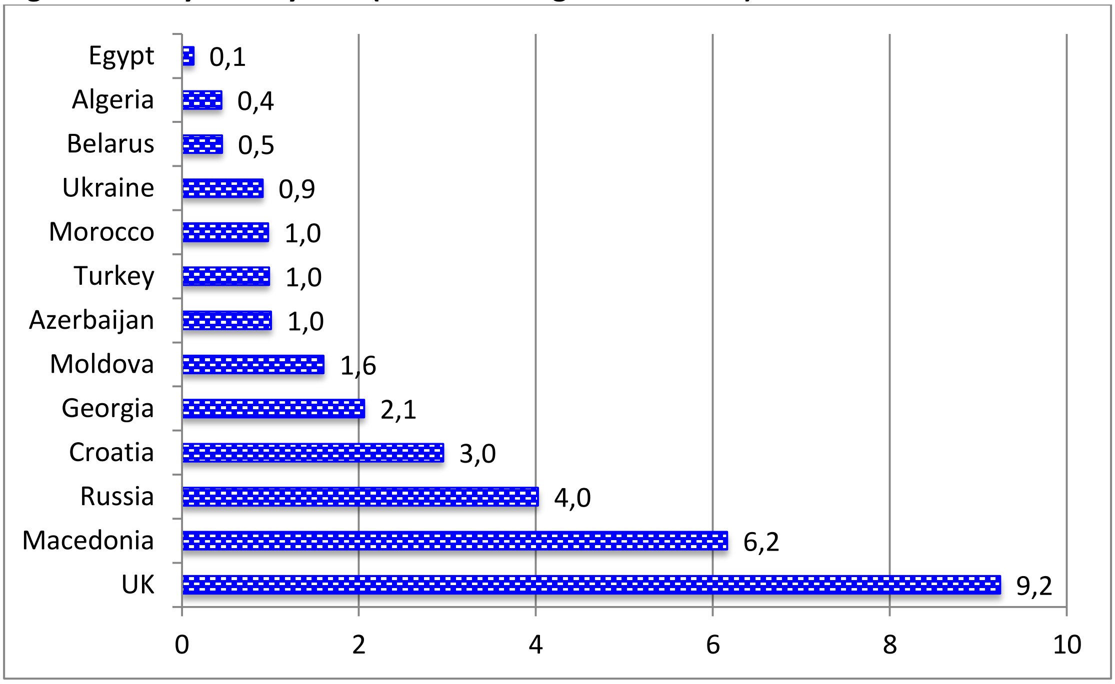
Motivational factors may have held back the development of entrepreneurship in the ENP countries. It is sometimes argued that the communal work culture established during the socialist period treated the individual as part of a group, devolved of individual initiative and responsibility. The lack of an entrepreneurial tradition in the ENP countries, a legacy of a longer period of communist rule than in other transition economies, has held back the development of entrepreneurship in this region (Kihlgren, 2003). The embedded legacy of the socialist past has made individuals less self-reliant than in the capitalist West, a factor that has held back the development of entrepreneurial activity in many post-socialist countries of ENP (see Figure 3 for example) (Bauernschuster et al., 2012). These attitudes have continued during the transition period, and entrepreneurs found it difficult to obtain permits to start a business, to find premises, and were often harassed by unannounced inspections (Johnson, et al. 1999).

4 INSTITUTIONAL FACTORS: BARRIERS TO ENTRY AND GROWTH

Many analysts have explained the difficulties facing entrepreneurs in transition countries in terms of the unfavourable business environment that they face. The explanation is sought in terms of the inadequately developed institutional framework within which entrepreneurs operate. The institutions that are involved are typically viewed as the formal institutions related to the legal system, the judicial system and the courts (especially in relation to the enforcement of contracts) and the administrative and bureaucratic hurdles that hinder the activities of entrepreneurs (Manolova et al., 2008). Several researchers have pointed out that entrepreneurs may also influence and act upon those institutions (Henrekson and Sanandaji, 2011; Welter and Smallbone, 2003, 2011). The ability of entrepreneurs to alter the institutional framework means that the barriers posed by institutions are not fixed for all time but is in a dynamic state of flux. Hence the empirical observations of the influence of such institutional barriers tend to change over time.

Comparable cross-country data on entry density rates taken from the World Bank Group Entrepreneurship Survey 2010 are presented in Figure 3. The entry density is the number of new firms created in each year as a percentage of the working age population (see Klapper et al. 2009). The data show that Egypt and Algeria have the lowest entry rate in ENP. Most countries of the region have entry density rates below 2%, well below the benchmark case of the UK, which has practiced a very liberal business regulatory policy for many years. The exceptions are Georgia, Croatia, Russia and Macedonia which all have entry density rates above 2%, suggesting that these economies have recently developed a more pro-enterprise business environment than other transition countries in the region.

Figure 3: Entry density rate (annual averages 2004-2009)



Source: World Bank Enterprise Survey online data 2010

The main causes of slow entry and growth in the transition countries in the region have been financial and institutional barriers (Bartlett and Bukvič 2002). The 'finance-first' view holds that financial constraints have been the most significant barrier to the entry and growth of small enterprises (Pissarides 1999). In the absence of a well-developed capital market, firms that wish to expand are constrained by the amount of initial capital at the disposal of the owner and by the amount of profits available for reinvestment. The absence of external finance was especially important in the transition economies in which banks initially had little experience in lending to small firms and found it easier to lend to politically well-connected large enterprises. Absence of collateral to guarantee a bank loan was a further significant barrier to obtaining external finance.

In contrast, the 'institutional view' holds that no amount of finance will assist small firms if institutional constraints inhibit entry and growth. Especially problematic have been the political networks and ties that link banks to the state and to larger enterprises, and that divert investment finance from profitable small firms to large loss-making companies supported by political connections. In addition, a lack of effective property rights inhibits entry of new firms and reduces investment in established firms. Consequently, the growth of new enterprises will be lower when institutional barriers are high and property rights are weak (McMillan and Woodruff 2002). The scope of such institutional barriers is wide. The most significant are inadequate property rights, but other issues are also relevant including administrative costs, costs of obtaining licences, delays in registering a company, the need to pay bribes to inspectors and so on. Property rights are especially weak in the ex-Yugoslav countries where inheritance laws have produced multiple ownership of land and properties among members of extended families which, combined with migration and poor cadastral records, often makes identification of owners a difficult and cumbersome process. Aidis (2005) points to the inter-relatedness of institutional barriers, which complicates attempts to overcome their adverse effects on economic development.

4.1 Evidence on barriers to entry

Institutional factors have been argued to have a strong effect on the rate of entry of new small firms. Djankov et al. (2002) find that heavier regulation of entry is generally associated with greater corruption and a larger unofficial economy. In Croatia, entry rates slowed down following an initial surge in the early stage of transition (Čučković and Bartlett 2007). In Russia, Aidis et al. (2008) found that the weak institutional environment explains the relatively low level of entrepreneurship, whether measured in terms of the number of start-ups or the number of existing business owners.

In response to this line of argument, corrective policies have reduced many of the barriers to business entry and have created a more favourable investment climate. In Macedonia recent reforms have led to major improvements in the ease of doing business, which propelled the country to the top ten in a list of global reformers compiled by the World Bank in 2010. The World Bank survey on the ease of doing business focused on a number of indicators that are relevant to the issue of business entry. The most recent survey carried out in 2008-9 covers 183 countries including those in ENP. Although it only covers limited liability companies based in the capital cities, the information provided is useful in gauging progress in reform, and in benchmarking the ease of starting up a business in different countries.

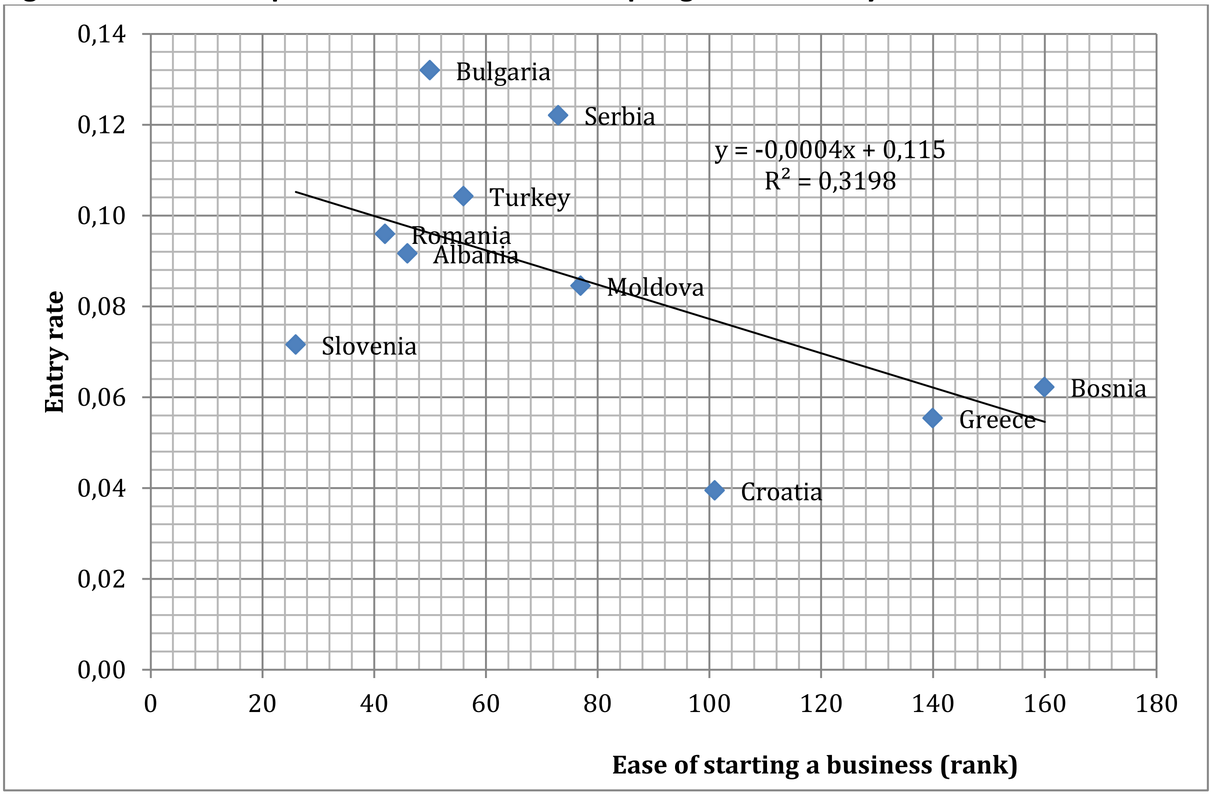
Table 1: Ease of starting a business

Country	Starting a business (rank)	Number of procedures	Time taken	Cost (% income per capita)
Macedonia	5	2	2	1.9
Georgia	7	2	2	3.8
Belarus	9	5	5	2.3
Armenia	11	3	8	2.5
Azerbaijan	18	6	8	2.3
Egypt	26	6	7	10.2
Ukraine	50	7	22	1.5
Turkey	72	6	6	10.5
Croatia	80	6	9	7.3
Moldova	92	7	9	5.7

Table 1: Ease of starting a business in selected ENP and ACC
Source: World Bank Ease of Doing Business Database 2010

Table 1 shows the results of the survey for the ease of starting a business. Four of the ENP countries shown in the table are in the top 50 of the global ranking (Armenia, Azerbaijan, Armenia and Georgia), i.e. the Caucuses countries and Belarus. Moldova and Ukraine were ranked between 50st and 100th 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. Costs of starting a business are however lower in these two countries than in Egypt or Turkey.

Figure 4: Relationship between business start up regime and entry rate



Source: Source: World Bank Ease of Doing Business Database 2010 and World Bank Group Entrepreneurship Survey 2008

Figure 4 shows the relationship between small firm entry and the ease of starting up a firm as measured by the World Bank surveys for a set of countries in South East Europe. It shows a positive relationship between the two variables, with a more conducive business start up regime (indicated by a lower value of the horizontal axis) being associated with a higher rate of small firm entry. The relationship is not exact, and explains only two fifths of the variation in entry rates, indicating that other factors are involved such as industry structure, and other non-institutional barriers to entry. It also points out that some countries are somewhat impervious to regulatory changes, and Croatia and Slovenia in particular seem to underperform in terms of entry rates, given the regulatory environment which their entrepreneurs face. Klapper et al. (2009) find a similar relationship for a larger group of countries worldwide.

Aidis et al. (2010) have used GEM data to examine the relationship between new firm entry and a variety of institutional factors. They find that strong property rights play an important role in facilitating the entry of new firms. The extent of the financial sector also has a positive influence on new firm entry. However, these effects differ between more and less developed countries, with entry in high-income countries being more dependent on the quality of institutions than in low-income countries. The influence of institutional factors also seems to have a stronger effect on the entry of 'opportunity' entrepreneurs than on 'necessity' entrepreneurs, perhaps not surprisingly.

4.2 Evidence on the barriers to the growth of small firms

Barriers to the growth of small businesses have been one of the main themes of research into the relatively slow development of the small business sector in many transition economies (for a critical review see Doern, 2009)[3]. Recent analysis of surveys carried out in a large sample of transition economies have shown that the force of these financial barriers has diminished in many countries as transition has progressed, and that in the higher middle income countries the most significant barriers to business are now a lack of skilled labour and infrastructure gaps (Mitra et al., 2010). However, the global economic crisis that hit the region at the end of 2008 has once again brought financial constraints to the fore, as bank credit has dried up on a global scale. In ENP there is some evidence that small businesses are in increasing financial distress, and that the proportion of non-performing loans in the business sector is on the increase.

The ENP countries seem to face many barriers to growth. In the latest World Bank survey on the ease of doing business, Ukraine ranked in 137th place while Moldova was in 83rd place. In contrast, among the candidate states, Macedonia is in 23rd place while Croatia is in 84th place. While progress has been made in improving business legislation over the last decade in Moldova, its impact the business environment has been minimal (Popa, 2013). The Strategy of reform of the regulatory framework for

3 The references in this literature include for example Aidis (2005), Bartlett (2003), Bartlett and Bukvič (2002, 2003), Brown et al. (2005), Pissarides (1999) and Pissarides et al. (2003).

entrepreneurial activity launched in 2007 aimed to reduce administrative regulations and the financial and time costs borne by entrepreneurs to open, operate and close a business. The reform strategy initially fuelled optimism among entrepreneurs concerning the ease of doing business. But with time, the reform has passed through multiple stages ("Ghilotina I", "Ghilotina II", "Ghilotina 2+" and soon "Ghilotina III) and has almost lost its credibility. Despite five years of continuous reform, Moldova still offers a less favourable environment for doing business. Although the country moved up three positions in the Doing Business 2013 ranking, progress was registered only in three areas (protecting investors and marginal improvement in resolving insolvency and registering property), while all other aspects have worsened (Table 2). Moreover, the spectacular improvement in the 'investors' protection' rating is not consistent with the general perception that property in Moldova is not well defended by the law. The national media is full of stories of attempts at hostile corporate takeovers, corporate scandals, and CEOs lack of responsibility[4]. Also, despite the improved ranking for some components of the doing business survey in recent years, there has been little improvement in terms of procedures and time needed.

Table 2: Doing Business 2013, Moldova country profile

Topic Rankings	DB 2013 Rank	DB 2012 Rank	Change in Rank
Ease of doing business	83	86	3
Dealing with Construction Permits	168	165	-3
Getting Electricity	161	159	-2
Registering Property	16	17	1
Getting Credit	40	38	-2
Protecting Investors	82	114	32
Paying Taxes	109	106	-3
Trading Across Borders	142	141	-1
Enforcing Contracts	26	24	-2
Resolving Insolvency	91	95	4

Source: Doing Business, The World Bank

Given the progress achieved in the adoption of a suitable regulatory framework for business activity in Moldova, the main causes of current deficiencies seem to be the poor implementation of laws and the poor functioning of regulatory institutions,

[4] Popa A., Lupusor A., Prohnitchi V. (2012). *MEGA no. 7*, Chisinau, EXPERT-GRUP;

particularly of the National Agency for the Protection of Competition (Popa, 2013). Although this agency was established in 2007 it has proved itself to be incapable of ensuring fair competition on the market. Moreover, the legal framework for protection of competition has been totally inadequate for the current state of economic development. In an attempt to improve this situation, the Moldovan Parliament passed two important laws in the competition area in 2012: the law on competition and the law on state aid. However, their effective implementation requires institutional strengthening, including (i) consolidation of the capacities of the National Agency for Competition Promotion and (ii) training judges to make rulings according to the provisions of the new laws[5]. This consequently implies the need for an effective justice sector that can ensure the functioning of all other structures of the economy.

Table 3: Share of firms evaluating the following aspects as major constraints for their activity, 2009

	Croatia	Moldova	Macedonia	Ukraine
Access to finance	18.3	19.5	26.9	10.0
Inadequately educated workforce	17.0	15.7	3.4	4.4
Access to land	2.7	10.4	1.8	4.6
Corruption	8.8	10.1	1.4	10.6
Tax rates	15.8	9.0	4.4	17.5
Practices of the informal sector	13.5	7.1	31.3	10.2
Political instability	6.4	5.9	6.8	23.2
Business licensing and permits	3.5	4.5	5.5	5.9
Electricity	2.6	4.5	3.8	1.1
Tax administration	4.1	4.5	0.9	3.2
Customs and trade regulations	1.2	4.4	1.9	2.8
Transportation	0.3	1.6	0.0	0.2
Courts	3.3	1.2	5.7	3.0
Crime, theft and disorder	1.3	0.9	5.4	3.1
Labour regulations	1.2	0.7	0.9	0.3

Source: BEEPS 2009, EBRD; Note: Data for Croatia is for 2007; data for Ukraine is for 2008;

[5] Popa A., Lupusor A., Prohnitchi V. (2012). *MEGA no. 7*, Chisinau, EXPERT-GRUP;

Moreover, the most recent Business Environment and Enterprise Performance Survey (BEEPS) shows that Moldova has the greatest constraints on business activity in several categories: access to land (10.4% of firms evaluated it as a major constraint), customs and trade regulations (4.4%), electricity (4.5%), inadequately educated workforce (15.7%) and tax administration (4.5%), which is consistent with the results of the 'doing business' survey in which the most problematic issues are getting electricity, paying taxes and trading across borders (Table 3).

The importance of financial constraints to growth can be explained by a number of factors (Bartlett and Bukvič, 2003). Firstly, banks perceived small firms as high credit risks and typically required two or three times the value of a loan as collateral. Commercial banks often preferred to lend to larger firms, due to political connections as well as limited capacity to evaluate credit risks presented by small firms. Bank credit was often provided on a short-term basis at a relatively high cost (Kraft 2002), and owners of small firms therefore often self-financed their business investments. However, since Kraft's survey was carried out this situation has changed dramatically as most banks in the region were taken over by foreign banks. Credit to businesses expanded rapidly in many ENP countries, while the rate of interest fell, generating booming economies, which powered along at rapid growth rates through much of the 2000s.

5 SOCIAL CAPITAL, NETWORKS AND EMBEDDEDNESS

The previous sections have focused on the subjective motivation of entrepreneurs and on the business environment in explaining the pace of SME growth. In this section we identify an alternative approach that seeks to understand the performance of SMEs on the basis of their embeddedness in the social structure, mutual links within networks and dependence on social capital. In his analysis of social capital Bourdieu (1986) discusses how membership in groups, culture and the status of an individual are interrelated and how they reproduce and legitimatise each other. Bourdieu's analysis shows how networks, under the pretext of equal treatment, support institutions that reproduce those same networks. Inter-firm networks have been important elements of the organisational structure of most capitalist economies and have provided a strong underpinning for the emergence of high-growth innovative small enterprises (Lipparini, and Sobrero, 1994; Lechner and Dowling, 2003). They formed the underpinning of the remarkable economic progress made in the Italian region of Emilia-Romagna ain the 1970s and 1980s on the basis of industrial districts.

Social networks, established under communism played an important role in the development of entrepreneurship in the ENP countries (Batjargal, 2006). In Russia, the exchange of mutual favours called *blat* has been a source of personal connections that enabled entrepreneurs to draw on the resources of the state (Ledeneva, 1998). The informal institution of *blat* depended on the existence of trust generated through established socialist-era networks in the ENP countries. Unpaid labour and community-based exchange remain important element of everyday economic life in Ukraine and other ENP countries (Williams, 2012). Inter-firm networks have been less well developed in transition economies following the collapse of communism and the general disorientation and disorganisation of pre-existing social relationships (Franičevič and Bartlett, 2001). Evidence from other transition environments supports the argument that social networks can be an important facilitator of productive entrepreneurial activity. On the basis of a large enterprise survey covering 600 firms in two countries, Rus and Iglić (2005) found that business relations between small firms in Slovenia were based more on arms-length trust relations, while in Bosnia and Herzegovina business relations were based more on interpersonal trust relations. They concluded that in less-developed post-conflict Bosnia business owners were less willing to make business contracts with strangers than was the case in Slovenia, a country that had made more progress in transition. This lack of trust in anonymous business partners has increased the transaction cost of doing business in Bosnia in relation to Slovenia. Similar arguments have been applied in the case of emerging economies (Danis et al., 2011).

However, in Russia and other ex-Soviet countries, social networks have had a dual nature. The positive aspect of networks has supported economic development and growth through trust relations which have substituted for missing institutions, while they have also had a more negative aspect in the form of 'clan' relationships that have supported redistribution and asset stripping of privatised enterprises (Dinello, 2001; Puffer and McCarthy, 2007; Welter, 2012). In the early years of the transition period, members of the socialist *nomenklatura* often formed networks that supported the capture of large companies that were a legacy of the socialist era (Batjargal, 2003). Thus, while the political system changed, political elites did not. Socialist elites turned easily into national elites exchanging one type of collective ideology for the other. They continued to run the state and economy without any knowledge or experience of market economy and democratic institutions. Instead of developing state and market institutions as separate entities they blocked institutional change. Transition economies, as well as developed economies, need a partnership between state and market to develop to be able to grow (Tyson et al. 1994, Smallbone and Welter 2001a). However, a legacy of distrust in the state has continued in the ENP countries, as has a legacy of corruption within state institutions (Raiser, 1997).

Under socialism, unemployment and inflation introduced social differentiation and inequalities despite high social spending. For the majority of people the only networks they could rely on were family and friends. Fukuyama (1995) has argued that networks based on honesty, commitments and reciprocity have positive externalities for the broader society. Entrepreneurs therefore often rely on trust within their networks; in transition economies this has often substituted for missing institutions such as reliable courts and the rule of law (McMillan and Woodruff, 2002). Insecure property rights have inhibited growth in both Russia and Ukraine in comparison with transition countries in the Central European region (Johnson et al., 2000). In Ukraine, as well as elsewhere in ENP, 'nomenklatura' businesses have been formed on the basis of political influence that protects market niches and mobilises resources, leading to rent-seeking and the wide-spread phenomenon of unproductive entrepreneurship (Baumol, 1990). Furthermore, the state has often allowed connected entrepreneurs to gain resources through privatisation and to secure monopolistic markets or state subsidies (Smallbone and Welter, 2001b).

The World Bank and IFS Enterprise Survey has revealed that cultural barriers (lack of trust, need to bribe officials) and administrative barriers (too much bureaucracy, too many licences required and so on) are important impediments to growth in ENP countries. Based on an analysis of data from the GEM database, Aidis et al. (2008), argue that Russia's business environment has affected the development of business networks to the relative advantage of entrepreneurial insiders (those already in business) to entrepreneurial outsiders (newcomers) in terms of new business start-ups. Also examining the Russian case, Batjargal (2003) found that 'relational' and 'resource' embeddedness has a positive influence on entrepreneurial performance, whereas 'structural' embeddedness does not affect firms' performance directly. Having many weak ties and having network relationships that enables entrepreneurs to mobilise financial resources from rich and powerful contacts has a positive effect on business performance.

Finally, numerous studies have emphasised the role of corruption in holding back business growth (Aidt 2009; Tonoyan et al., 2010). Corruption in the region has also been a concern for the EU, especially when it extends beyond the petty corruption of bureaucrats into the higher sections of society including politicians and high government officials, undermining administrative efficiency necessary for adherence to Single Market regulations.

It should also be pointed out that the existence of twinning arrangements between local authorities in ENP countries and countries with the EU are also likely to lead to an expansion of business networks and a mobilisation of social and cultural capital to support the growth of firms and the development of local economies.

6 POLICY CONCLUSIONS

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.

Overall, the research has shown 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. For example, 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, in the ENP region several factors hinder the establishment of such a facilitating institutional framework for SMEs, including 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. 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 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, thus reinforcing the lack of international competitiveness of most 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.

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Appendix 1. Regional data on unemployment and entrepreneurship, Ukraine

	Unemployment rate	Number of entrepreneurs
Ukraine	**8.4**	**79.6**
Autonomous Republic of Crimea	6.7	81.8
Cherkaska	10.1	84.2
Chernigivska	10.6	85.1
Chernivetzka	8.7	88.6
Dnipropetrovska	7.4	79.7
Donetska	9.0	82.3
Ivano-Frankivska	9.1	83.0
Kharkivska	7.8	79.5
Khersonska	9.3	83.2
Khmelnytzka	9.5	88.3
Kirovogradska	9.4	80.8
Kyiv city	6.1	53.7
Kyivska	7.8	80.6
Luganska	7.7	86.3
Lvivska	8.3	78.2
Mykolaivska	9.0	83.5
Odeska	6.5	79.8
Poltavska	9.4	83.1
Rivnenska	10.5	85.8
Sevastopol city	6.4	83.1
Sumska	9.2	85.5
Ternopilska	10.6	84.5
Vinnytzka	9.7	85.5
Volynska	9.2	84.2
Zakarpatska	9.7	86.1
Zaporizka	7.5	79.5
Zhytomyrska	10.1	85.7

Source: State Statistical Service, 2012