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# **THE DEVELOPMENT OF ENTREPRENEURSHIP AND SMALL BUSINESS IN TRANSITIONAL ECONOMIES**



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## ABSTRACT

This paper looks at the emergence of small and medium-sized enterprises (SMEs) in the transition economies of Central and Eastern Europe and tries to evaluate the policies that rendered their growth possible. The issues dealt with are as follows:

- Development of the institutional and macroeconomic framework conditions for the formation of the private sector;
- Development trends of the private sector: the scope and structures of the private sector, the rise of self-employment and the survival chances of the newly emerging private sector;
- Limitations and barriers to the development of private sector SMEs-vocational training, management qualifications, financing of enterprises, role of the state administration, implementation of the new economic legal framework and the competitive situation facing SMEs;
- State policies relating to SMEs-measures aimed at the improvement of the institutional and infrastructural framework conditions for the fostering of private sector initiative and the enterprise-related policies of the government;
- Development of support networks at micro-level establishment of business support centres, transformation of existing support networks; and
- Proposal for a national policy on SMEs development-establishment of a National Enterprise Promotion Agency, Regional Enterprise Support Centres and local Satellite Support Centres.

# THE DEVELOPMENT OF ENTREPRENEURSHIP AND SMALL BUSINESS IN TRANSITIONAL ECONOMIES

## **Introduction**

The development of small and medium sized enterprises (SMEs) in central and eastern Europe has received relatively little attention in comparison with other aspects of the economic transition process, such as the issue of privatization. But SMEs do in fact have a key role to play in the restructuring of former centralized economies. One of the normative conclusions reached by the UN Expert Group Meeting on Privatization and Regulation in Developing Countries and Economies in Transition held in New York between 16-18 February 1999 was that every privatization should encourage a wider share ownership whenever possible. The establishment of a broad ownership through the development of independent commercial enterprises, a good number of which are SMEs, creates the social basis for a competitive economic system. SMEs, moreover, are absorbing a considerable proportion of the labour force released by state firms in their adaptation to the new economic system. The creation of a healthy SME culture also helps to counteract the distorted firm size structure typical of central planning, a structure characterized by a predominance of large firms and allocation decisions made by central authorities. This paper looks at the emergence of SMEs in central and eastern Europe and attempts to evaluate the policies that rendered their growth possible. Various issues are discussed in this context, such as the development of the institutional and macroeconomic framework; the rise of self-employment; limitations and barriers to the development of private sector SMEs; state

policies regarding SMEs; the development of support networks; and finally a proposal is made for the establishment of a National Enterprise Promotion Agency, Regional Enterprise Support Centers and Local Satellite Support Centers.

## A. Privatization and the macro environment

### Institutional Framework and Reforms

The task of economic reform in the central and eastern European countries during the transition to a market economy had two components:

- Basic institutional reforms, without which a market economy cannot function, had to be implemented. These included the creation of commercial and contractual freedom, legal guarantees for private property, and the establishment of a legal system for a market economy.
- The problems of economic restructuring had to be addressed. With the collapse of the old system in the transition economies their economies were released from the constraints of central planning. They entered into a situation where the mechanisms of a market economy were not yet working properly. Additional difficulties arose from the weakened ability of the state to exercise regulatory and organizational functions. As a consequence, macroeconomic destabilization occurred initially in all the transition economies—production collapsed, unemployment increased, and inflation rose very rapidly.

A number of transition economies, in particular the economies of central Europe, have made remarkable progress in setting up institutions for a market economy.

Decisive steps towards the replacement of the centrally-planned economic mechanisms of allocation by market-based processes of economic coordination were taken in virtually all the economies of central and Eastern Europe. These steps included the lifting of restrictions on the free exchange of goods and services and on the allocation of factors of production, the liberalization of

most prices, the abolition of prevailing foreign trade restrictions for the private sector, the reform of the banking system, and the partial establishment of currency convertibility.

Money and capital markets were introduced through the abolition of the monopolistic banking structure in a centrally planned economy and the introduction of a two-tier system. Newly-created private domestic banks and subsidiaries of foreign banks have now been added to the large commercial banks, which have been taken over by foreign banks in a number of cases. The commercial banks still maintain a dominant position in terms of domestic deposits and credit business. The competitive situation within the banking sector, however, is gradually improving with the appearance of domestic and, above all, foreign private banks. The financial situation of the major commercial banks still has to be regarded as critical owing to excessively low equity provisions across the board and the extent of defaulting loans. Notable progress was made in the strengthening of capital market institutions, which were virtually non-existent prior to 1989.

In 1989/1990, the year of transformation, none of the economies had a complete concept of the privatization process. Even though the privatization experiences of western industrial nations and developing were known, the scope of the task of transferring a large proportion of the economy into private ownership in a relatively short period of time was unknown. One has to ask how the privatization of state enterprises has affected the development of microeconomic restructuring. On the one hand, budgetary discipline among firms has hardened as the lending conditions of the commercial banks have tightened up. It is no

longer possible for (state) enterprises to resort to an automatic credit line.

At the same time, direct subsidies paid from the state budget were largely abolished. In part, however, new subsidies have replaced the ones formerly operating under the centrally planned system. They include the tolerated non-payment of taxes and social security payments by insolvent firms, debt relief, and credit subsidy programmes.

The performance of privatized companies shows that the formal transfer of formerly state-owned assets to individuals and corporate bodies does not, in itself, provide a sufficient guarantee of success for the restructuring of enterprises. In many cases, following privatization, the old relationships and links between managers of former state enterprises, government employees and bank officials have remained intact and are exploited by company representatives in their private interest. The general problem is that the transfer of assets does not automatically create structures of "corporate governance" that could guarantee a thorough restructuring of the enterprise.

Among the transition economies of central and eastern Europe the starting conditions for the private sector were very different. Hungary, for instance, had already had many years of experience in experimenting with reform, which, as early as the mid-1980s following the start of perestroika, had led to the emergence of the elements of later transformation (e.g. increased independence of many state enterprises and the creation of a two-tier banking system). In Bulgaria deep economic reforms did not make any progress during the 1994-1997 communist government.

The new institutional framework for private economic activities—the introduction of commercial and contractual freedom, legal ownership guarantees, the lifting of

restrictions on private economic activities—fundamentally changed the economic environment for individual economic activity. Private entrepreneurial initiative was allowed to develop for the first time. This could take place through the formation of new companies, as well as through the restructuring processes occurring within collective and state enterprises.

The stimulus for the growth of the private sector from the development of the macroeconomic environment can be evaluated as follows:

- On the one hand, the aggregate demand impulses arising from the drop in production, the release of labour and the decline in real income during the first phase of the reforms were initially more likely to be negative.
- On the other hand, private firms were given good development opportunities in a number of economic sectors by the gaps in demand created by the collapse of the centralized economic system. This was particularly true of consumer and production-oriented services, the productive artisan trades, transport and construction.

The creation of commercial freedom and the abolition of the regulating mechanisms of a centralized economy changed the framework conditions under which private initiative operated. For this reason, the transition to a market economy not only offered potential entrepreneurs opportunities unknown before, but also demanded considerable adaptation by existing private enterprises.

### **Impact of Privatization Policies on SME Development**

Since the onset of economic liberalization, very dynamic development has occurred in the private sector in central and eastern Europe. Private firms have gained considerable economic importance in the

national economies of all transition countries in the region. The highest increase can be seen in the successor states of former Czechoslovakia because of the method adopted of mass privatization and coupon privatization.

Precise indications of production and employment in the private sector are difficult because of inadequate statistical recording of small and medium-sized enterprises in official statistics.

#### Problems in the statistical recording of the private sector

The weakness of official statistics in recording the private sector have differing effects. The statistical inclusion of former state firms in the private sector following the conclusion of formal privatization procedures, as well as transformed co-operatives and capital companies with large state shares, leads to a certain over-estimation of the importance of the private sector. Conversely, the gaps in SME statistics and the existence of the informal economy counteract these effects by underestimating its extent.

The privatization policies of the central and east European countries in transition differ particularly in the disposal of large state companies and in the treatment of the issue of restitution of assets. The effects of the privatization process on the form and development of small and medium-sized enterprises can be evaluated under the aspects of "small" privatization, restitution, and "large" privatization.

#### "Small" privatization

Within the centrally planned economies, only a relatively small proportion of the total national capital assets were units which could be part of the "large" privatization. An equally large, if not larger, proportion comprised small firms. These small units

were important for the development of the SME sector for a number of reasons:

- They potentially formed the basic stock of newly created private firms
- The assets represented by these units could be used by future entrepreneurs as security for generating loan finance

The "small" privatization provided a significant stimulus to the development of private entrepreneurship, above all during the initial years following economic liberalization. The psychological effect of these privatization measures should not be underestimated. The disposal of formerly state-owned retail units and small firms had a significant direct effect on the daily life of the population. The sale of shares of large companies into private ownership, on the other hand, did not generally have the same immediate impact.

#### Restitution

The return of nationalized companies to their former owners or their heirs offered, first, the possibility to prove to the public the validity of the new ownership regulation, based on the principle of private ownership. Secondly, it could also be expected that among the beneficiaries of a generous restitution regulation, there would be a relatively large number of people who were both able and willing to become commercially active. In contrast to The Russian Federation, the temporal break between the nationalization and the reinstatement of family firms was not so great that it could not be overcome. Thirdly, the return of expropriated assets strengthened popular support for the reform process. In this respect, a fundamental difference that increased the level of popular acceptance can also be identified vis-à-vis the reprivatization in East Germany: in contrast to the situation in the new German

federal countries, the restitution demands did not come from external applicants.

#### "Large" privatization

The effects of "large" privatization on the development of the SME economy can only be described by taking into account the company structures in centrally planned economies. The company structures created in central and East European countries over past decades were dominated by large enterprises to an extent unknown in any industrial country organized on market economy principles.

Newly established firms were created as large as possible, far above the minimum or optimal company size. This was considered efficient and progressive.

Medium and small firms were combined in ever larger organizational units, while the existing state enterprises were concerned with internalizing upstream and downstream production functions in order to protect themselves against the unreliability of centrally-planned supplies.

Within the framework of so-called "large" privatization, large and medium-sized companies were privatized and, due to the externalizing of company functions, small companies also. Widely differing methods were chosen for this form of privatization. The former Czechoslovakia implemented a form of mass privatization that had never been undertaken before, viz. the virtually free distribution of interim certificates in lieu of shares to the population. Bulgaria has followed this example in its first and second waves of privatization in 1996 and 1997. However, direct sales, public tenders and auctions were carried out at the same time. The Czech example is mentioned because the results of its privatization campaign were the most successful among the transition economies. A drawback of this privatization

method could still emerge, however. Within the adopted privatization procedure the problem of corporate governance and the question of capital supply in the nominally privatized firms has not been sufficiently resolved.

#### Self-employment trends

The development of self-employment is an important indicator of the success in creating a market economy. The setting-up of many small companies indicates the extent of private initiative and illustrates that the young market economies are capable of correcting the significant deficits in the SME sector.

The development of self-employment in the central European transition economies since 1990 is remarkable. The newly created firms have fundamentally altered the structural basis of the national economies and provided significant impulses for economic development. Both "pull" factors—income and development opportunities in economic activity—and "push" factors—unemployment, low and restricted unemployment benefits, comparatively weak social security nets—have contributed to the growth of self-employment.

#### SME development prospects

Over recent years, not only have an extraordinarily large number of new firms been created in the private sector, but many of these enterprises have also been forced to cease their economic activity after only a short period of time. Those private economic activities whose market entry was associated with relatively small investments are particularly affected, as company liquidations do not require great capital expenditure.

The experience of mature market economies shows that it is not unusual to see high fluctuation rates in sectors dominated by



small firms in economic sectors with diverse size structures. Market turbulence is even more likely in the young market economies where relationships are in general less well established and the setting up of new firms is often associated with very high risks. However, when small and medium-sized companies in many sectors have come under increased competitive pressure, related partly to the continued entrance of new competitors, it has not yet resulted in significant waves of company collapse. This is even more remarkable given that SMEs, in comparison to privatized large firms and state enterprises, cannot usually rely on the helping hand of the state in emergencies. The overall medium- and long-term development prospects for small and medium-sized firms in the central and eastern European countries are very favourable. Development opportunities for private SMEs in most sectors are by no means exhausted. Both in manufacturing and in the service sector there is enormous scope for new business formation. The trend seen in the 1990s towards a restructuring in plant and company size is likely to continue. In manufacturing, the shift in favour of small and medium-sized firms will only gain momentum in the course of microeconomic restructuring of privatized firms. Experience of enterprise development has shown that newly created firms are characterized by a particularly notable dynamism and ability to adapt, while privatized firms and existing state enterprises have had considerably more difficulty with commercial restructuring. SMEs are the most important potential solution for labour market problems, which are likely to become more accentuated as progress in the micro-economic restructuring of large former state firms continues.

## B. Micro-level barriers to SME development

### Engendering entrepreneurship in the former centrally planned economies

One of the most important preconditions for the success of the transformation process is the existence of entrepreneurial talent in the population. Both the extent of the latent reserve of entrepreneurial expertise in the population and the influence of the cultural and social environment must be considered in assessing the importance of the potential in this area.

Discussion of these issues is still continuing. Some experts consider that the era of central administration and economic planning has considerably shaped the norms, value judgements and social orientation of the population, and thus has adversely influenced their entrepreneurial spirit.

The opposite view, however, concludes that cultural influences do not have a fundamental effect on the entrepreneurial potential of populations in different countries, and that entrepreneurial ability is evident in many types of society. According to the latter view, differences are caused rather by the framework conditions for economic activity such as the nature of property rights.

In Hungary and Poland, for instance, relatively minor steps towards liberalization in the 1980s led to a rapid increase in private economic activity. In Poland the number of small firms doubled between 1981 and 1988, contributing over 22 per cent of GNP. The population, therefore, was reacting positively to changes in the framework conditions. Similar trends, where the introduction of commercial freedom has rapidly increased the number of people operating a business venture, are evident in

all the countries of central and Eastern Europe, and serve to confirm this theory. It should be stressed that in terms of the relevance of experience gained under the centrally-planned economic system, the training ground for future entrepreneurs was very limited. An underlying understanding of the market and corresponding practical experience is lacking in the majority of firms—both those from the era of central planning and also newly created enterprises. Entrepreneurial potential exists in all central and eastern European transition economies. However, many preconditions which would allow this potential to develop and grow freely are not met. Problems can be identified in the restructuring of socialist vocational training and further education systems, as well as in the financing of SMEs. A further serious impediment to fostering entrepreneurial potential is the continued distorted market structure, in particular in the industrial sector, and the resulting lack of competition. Further obstacles are state bureaucracy and administration and the difficulties of applying new economic laws which have been introduced in all the transition economies. These problems will be discussed below.

#### Human capital and training systems

At the start of the process of transformation there was a serious lack of human capital with marketing or business management know-how and experience of an enterprise culture. The training systems, both for vocational training and further education, were fully integrated into the state socialist structure and were oriented towards the needs of predominantly nationalized large industry. The content of vocational training was characterized by the general and ideological rather than the vocational

components. Key qualifications in management, employee motivation, strategic planning and marketing were only given to an elite who were marked out for promotion in firms similar to integrated plants. Consequently there has been, and in many instances still is, no training policy concepts or formulation of such training strategies. In addition, technical obstacles have emerged from the abolition of traditional training structures, i.e. the problems of financing and the lack of qualified instructors. Large firms, which were the main providers of vocational training and further education in the socialist training system, have either been liquidated or are mainly concerned with their economic survival. Local authorities, which could replace them, mostly lack capacity, and firms are not yet able to fill the need for practical vocational training. The state alone has been made responsible for training but it still does not recognize the need to transfer responsibility and tasks to SMEs. A clear legal basis for the operation of private firms in the area of training, as well as the operation of an overarching higher authority, such as the chamber organization in Germany or Austria for example, which can set minimum standards for the training content of private firms, is still lacking in all the countries. Competence in the area of training is shared by a number of institutions including training ministries, sectoral ministries and local training authorities. This leads to problems of coordination and friction in the formulation of new curricula as well as the revision of existing training methods. This is a problem in the transition economies of eastern and south-eastern Europe where political instability and frequent changes of government have meant that the overall charge of training at the highest level has been neglected for a long time, and

personnel fluctuations at middle and lower levels have been the norm rather than the exception.

In addition to the further vocational training offered by the state and large companies, an increasingly large market is emerging for commercially available training services. These private further training organizations are not subject to quality assessments from management and business schools. The requirements for legal authorization and approval to continue commercial activity are based principally on formal criteria that are comparatively simple both to regulate and to fulfil, for example availability of premises, teaching materials and sufficient training staff. Apart from these potential problems of quality in the content of the training, commercial firms do offer important advantages over the state and, to some extent, company training suppliers. The majority of private training firms operate locally and can be flexible not only with regard to market requirements but can also address firm-specific questions and needs. The very high level of new firm formation is evidence of the existence of a considerable entrepreneurial potential in the economies of central and eastern Europe. This potential will only play a major economic role in the medium to long term if the requirements for a sufficiently qualified and flexible labour force can be met.

The future provision of human capital requirements in quantitative and, above all, qualitative terms will necessitate a significantly greater participation of the private sector, and of SMEs in particular. In this respect, training ordinances, including those that have been reformed or renewed, must be considered to a greater degree at the political and top administrative levels and implemented much more rigorously. A side measure could be the concentration of

responsibilities and competencies in the training field, currently divided across a range of state authorities, training ministries, school authorities and independent non-state bodies. This does not imply that the practical vocational components of training would necessarily have to be carried out by companies. It would be conceivable that practical vocational training could continue to be given in training centres and educational workshops, but with a stronger input from the business sector in the formulation of the content of training, performance tests, etc.

It must be noted, however, that the current options for SMEs to make such an input are particularly limited. It is necessary to make private firms more aware of the medium- to long-term significance of their contribution to the area of vocational training. A strengthening of the position of independent representative bodies in the economy could help provide the information and explanatory services. As long as there is no compulsory membership of the chambers, and only a small number of firms choose to be members, it is questionable whether the chambers will become equal partners in the area of vocational training.

Financing small and medium-sized enterprises

During the era of central planning, private savings and capital acquisitions were permitted in Hungary, Poland and the former Czechoslovakia, though they were limited in scope.

Entrepreneurs cannot usually develop a long-term stable financial basis from personal savings, nor does self-financing tend to provide sufficient capital for investment. The access of SMEs to credit facilities from banks and financial support programmes is still limited. In addition,

there remains an overall lack of risk capital. This situation not only slows down the creation of firms and the privatization process, but also it has a negative impact on business operations such as financing working capital or investment.

There are a number of reasons for the financial difficulties faced by SMEs. A large part of the problem is rooted in the role of the banking system, both under the former socialist system and following the completion of the restructuring process. The former monopolistic banking system is being transformed into a two-tier structure with central and commercial banks.

The problem of the banking reforms lies in the microeconomic restructuring of the newly created or privatized commercial banks, and in the expansion of the services offered. Many of the new banks are illiquid as they have insufficient equity capital and debtors are unwilling or unable to service their loans. The banks have not yet accumulated the necessary technical skills to make adequate credit assessments.

Defaulted loans, both new loans and those dating from the centrally-planned economy, hinder the provision of adequate capital when combined with the continued lack of central bank refinancing.

The lack of institutional infrastructure at the regional level, i.e. the absence of branch offices, creates further difficulties for SMEs. With the division of the former state bank, the numerous branch offices were distributed among the successor institutions. The still underdeveloped competitive structures in the banking industry create a further financial bottleneck. In the Czech Republic and Hungary a few large, former state institutions dominate the market, both on the credit and investment side. This concentration offers SMEs no alternative

options, and the best credit opportunities for them still lie with private foreign banks.

The lack of expertise in the banks in small-scale credit provision, as well as the continued existence in many banks of centralized and rigid decision-making mechanisms are important factors in the frequent negative credit decisions against SMEs. As they are usually unable to provide the demanded level of security, the banks are often cautious in their negotiations with the firms and tend to avoid risk.

Market structures, competition policy and lack of Regulatory Framework

Competition cannot be mandated through state regulation. It is only possible where market participants, who are willing to compete, can come together. In this respect even a functioning and efficient competition authority, with responsibility for creating economic relationships, would be completely overburdened. If the starting point of market economic development is a highly monopolistic and oligopolistic market structure, far-reaching restructuring of the markets is necessary before real competitive relationships are realisable. Decisive stimuli for overcoming competitive deficiencies, which are evident in all economic sectors at the start of market economic development, can be expected from four principal developments:

- market entry of many private SMEs
- opening of markets to foreign competitors
- denationalization or privatization of the economy
- competition legislation and a functioning authority for competition control as supporting measures for the process of restructuring.

In all four areas significant progress has been made since 1990 in the four transition

economies of central Europe, viz. Poland, Hungary, Slovakia and the Czech Republic. The economies of eastern and south-eastern Europe are lagging behind their central European counterparts.

The market entry of private firms led relatively quickly to major changes in market structures, and thereby the competitive situation of substantial parts of the young market economies. Dynamic growth of new start-ups since 1990 has been the most important factor in the creation of functioning markets.

The opening of markets to foreign competitors, a policy practiced particularly in Poland, but later also widely practiced in Hungary and the former Czechoslovakia, has resulted in considerable improvements in the competitive situation in these economies. The effect on sectors producing internationally tradable goods and services, i.e. the manufacturing sector, is even more significant given the limited size of these economies. In this respect the liberalization of foreign trade was a fundamental turning point.

The denationalization of the economy and the restructuring of the ownership system have developed differently in each country and sector. Privatization measures have contributed considerably to the competitive situation in individual sectors.

Competition legislation on western models or amendments to laws dating from the centrally-planned economy were passed in all the countries concerned shortly after market liberalization. Following the introduction of competition legislation, cartel authorities were created which have since gained considerable experience. The principal task of the competition authorities in the transitional economies differs in one central area from that of their western counterparts. The focus of the latter

authorities is on ensuring the maintenance of functioning competitive relationships, whereas competition authorities in central and eastern Europe are faced with the task of contributing to the realization of competitive market structures.

In summary, a significant improvement in the competitive situation has been achieved over the course of recent restructuring efforts, certainly in comparison with the initial position at the beginning of the 1990s. This has been based principally on the market entry of numerous small and medium-sized enterprises, the opening of the markets and progress in denationalization. The introduction of competition legislation, which now approaches the standard of mature market economies, and the related creation of cartel authorities, have all had a positive effect. However, the activity of cartel authorities has made only a limited contribution to date to the level of competition. It is obvious that there are only limited practical opportunities for the competition authorities to improve the competitive environment in sectors where the situation is particularly critical. Competition policy in the transitional economies is essential to the long-term development of a free market and should be regarded as a vital supporting measure to the change in the system of ownership and to micro-economic restructuring. Its use, however, as the central political instrument for the realization of free competition in the former centralized economies is not appropriate.

Interaction with the state bureaucracy and administration can cause many difficulties for small and medium-sized enterprises in the young market economies. Despite the establishment of commercial and market freedom soon after liberalization, none of the countries could call upon an embedded

government administration that was confident with the procedural regulations of state activity within a market economy. The state administration therefore cannot satisfactorily adopt the role of provider of public services in the economy. This would, for instance, include the registration of companies, approval procedures, the acquisition of industrial land, planning consent, the provision of public goods, industry control, and activities of the tax authorities.

The public administration had to adjust itself to new requirements created by either completely new circumstances. This required a learning process during which new regulations were required. Parts of the old state administrative apparatus became superfluous, such as economic planning and control authorities, while others had to be newly established or fundamentally reorganized.

The necessary process of adjustment required by the above could not be achieved without some friction. The employees of the state administration were as unable to deal with the new economic legislation as the owners of private firms and potential entrepreneurs. The essential problem still is the rather tense mutual relationship between state employees and the commercial sector. Individual entrepreneurs, who have often suffered mistreatment by representatives of state institutions, have great difficulty in recognizing in their counterparts the supposed helping hand of the state for private initiative.

#### C. Policies for the development of SMEs

The case for government support of SMEs

An indigenous entrepreneurial class can only develop when potential entrepreneurs have a positive institutional and economic environment for their activity. Policies

aimed at improving the institutional and macroeconomic framework conditions are of primary importance for the development of an indigenous SME sector as already discussed. However, the question arises regarding the extent to which the state should introduce active measures for the support of private firms on top of shaping the framework conditions.

The intervention of the state in supporting the development of the private sector is necessary in central and eastern European countries for the following reasons:

- Private initiative has been systematically suppressed over past decades. The restrictions on private economic activity have had an important influence in shaping the training and vocational orientation of commercially talented individuals and the accumulation of private savings. This appears to justify that the state should attempt to address the negative effects of former state action.
- As much of the dynamic for the young market economies can be expected to come from the newly created small and medium-sized enterprises.
- In all young market economies the state uses considerable financial resources to support the transformation of state enterprises. Privatized firms often benefit from state assistance measures. In addition, assistance for the formation of new firms and SMEs in all the transition countries is only a fraction of the state aid for (former) state enterprises.
- SMEs are structurally disadvantaged compared to large former or still state-owned companies owing to company and market structures established during the communist era. Assistance is

therefore justified on the basis of compensating for this disadvantage.

- Assistance measures aimed at individual firms should meet the following conditions:
- They should be part of a coherent overall programme for the assistance of the private sector, including assistance not only for individual firms and for infrastructure development, but also for the improvement of the framework conditions of commercial activity.
- Assistance for individual firms should always be linked to clear conditions and monitored effectively.
- When the initial difficulties of transition to a market economy have been overcome, assistance measures may become increasingly selective. In those areas that show highly independent and dynamic development, company-specific assistance should quickly become superfluous. The highly differentiated conditions for SMEs in the manufacturing sector, however, are likely to justify assistance in this area in the longer term. Particular attention should be given to those areas of assistance aimed at addressing specific institutional deficits, for example, the provision of risk capital.
- The nature of the assistance programme will depend on the extent to which it is oriented towards providing initial impulses for personal initiative in individual entrepreneurs. A possible state-paternalistic programme of long-term subsidies to small firms would address the economic initiative of individuals and create a generally problematic environment for private economic activity.

In relation to the development chances for small and medium-sized enterprises, it must be assumed that these firms are considered as key to the successful development of the young market economies. Assistance measures for the SME sector are more important under the conditions of system change than in developed market economies. However, a trend is emerging which sees SME policy principally as support to “needy” SMEs. Given that a comprehensive subsidization of small and medium-sized enterprises is not possible for financial reasons, and the current practice of assistance leads to unwanted market distortions, a reorientation of SME policy is required towards help for self-help and creation of positive framework conditions (e.g. equal opportunities in access to capital markets, provision of industrial estates, consultancy services). International assistance could take a more active role in this area. It could focus on the following areas, which are divided between framework conditions and concrete assistance measures. Improvement of the framework within which SMEs operate

Establishment of a regional structure for economic assistance. All centrally planned economies were over-centralized. SMEs operate predominantly at regional or local level, and the real problems of these firms vary from place to place. For this reason an appropriate structure must be set up in the regions to support the development of SMEs (regional economic development agencies, business incubator units, consultancy, industrial land, transport infrastructure). Consultancy and support in the further development of the credit sector. Considerable restrictions still confront the access of SMEs to credit markets. Credit guarantee programmes could be helpful in

this area in addition to consultancy assistance.

**Guarantee of fair competition.** The growth of the SME sector is hindered by the continued underdevelopment of competition policy. The remaining soft budgetary limits in some areas contribute to the maintenance of monopolistic market structures and discriminate against those enterprises that do not enjoy any form of state protection. International assistance in this field should concentrate on the further development and implementation of competition policy. However, at the same time it is necessary to assist the transition of state-assisted companies into a competitive environment and to compensate them for related job losses.

Support for the further development and implementation of economic and social law. Although the basic framework conditions have been created, further transfer of knowledge is required for the further development of these conditions and their practical implementation. Principal requirements include the development of White Books and consultancy from international experts.

**Restructuring of the education system.** The restructuring of the vocational education and training system is one of the most important tasks of international assistance.

Create assistance measures for SMEs

International organizations should generally not become involved in the direct subsidization of SMEs. The improvement of the institutional conditions allowing easier access by SMEs to capital markets is more important. However, some measures directed specifically to individual enterprises, such as credit guarantee programmes, can be helpful, inasmuch as access to capital markets is restricted by lack

of equity capital or structural shortcomings in the banking system.

The second important area of action in the direct assistance to companies is the establishment of effective support, consultancy and training structures in individual regions.

**SME support networks at grassroots level**

The lack of adequate support networks

Private entrepreneurs in market economies can usually rely on a wide network of support from self-help organizations, commercial business-related services and institutions providing state assistance. Such networks are very important for the creation, growth and restructuring of private firms. A support network comprises the following organizations:

- Providers of advisory services such as training and further education facilities, including both non-profit-making organizations and commercially active service firms.
- Economic infrastructure institutions, particularly in the financial sector, e.g. banks, stock exchanges.
- Chambers of commerce, industry and economic associations that represent business interests.
- New firm or incubator centres, and technology transfer centres in state, private or mixed ownership.
- State development agencies at national, regional and local levels.

In relation to these support networks, two significant problems can be identified:

- The existing institutions are not sufficiently adapted to the requirements of a market economy, both in qualitative and quantitative terms.
- Certain support organizations, such as employers associations and technology centres, are widely lacking.



Restructuring Chambers of Commerce

As self-help organizations, chambers assume an important role in the transition process. They serve as a source of both information for private firms and practical help for the creation and management of businesses. Chambers, therefore, can reduce the difficulties of the transformation period, which are often linked with considerable legal uncertainty on the part of the individual entrepreneur.

The problems associated with the establishment or restructuring of the chambers system are diverse and affect each of the transition economies. Considering their weak financial basis, chambers are able to operate only over a limited area and tend to concentrate on the large cities. They are able to offer only restricted services. In addition to their limited range and significance, the low value placed on them by employers must be taken into account. Low chamber membership is not just a reflection of lack of business confidence, but is also linked to the abolition of compulsory membership. In relation to this, one of the fundamental questions facing the creation of a chamber system in the transition economies of central and eastern Europe is the nature of membership and the appropriate chamber model.

The chamber model characteristic of Anglo-Saxon countries is based on voluntary membership and, in this sense, complies with the wishes of private entrepreneurs. They would have considerable reservations about the system of compulsory membership which was prevalent in the centrally planned economies. Voluntary membership in the framework of transition to a market economy leads to a significant reduction of financial resources for the chambers and

difficulties in meeting their consultation and representation responsibilities.

The financial security and independence of chambers, however, could be guaranteed in the long term on the basis of the Continental European model of compulsory membership. This system also addresses the problem of "free-riders", who benefit from the success of the representation of business interests without making any related financial contribution.

The model of voluntary membership could prove to be more advantageous to transition economies. The chambers then have the time and opportunity to establish relations based on trust with both businessmen and the state authorities. This could facilitate the long-term improvement of the services on offer, the attraction of new members and the establishment of the work of the chambers on a solid financial and political base.

Poland and the Czech Republic, for example, currently favour voluntary membership. Hungary on the other hand re-introduced compulsory membership.

Government assisted centres for enterprise development and technology transfer

The basic idea behind state-assisted centres of business development and technology transfer is the exploitation of synergy effects through horizontal and vertical cooperation between firms. The clustering of firms can contribute to a reduction of costs for individual enterprises, both through the introduction of work-sharing processes and in the area of overheads through the common use of business-related infrastructure.

State assistance usually includes the creation of SME-related infrastructure and providing the opportunity for its use at a reduced cost. This includes the provision of low rent and accessible industrial and office premises, the subsidized use of office equipment, the offer

of advice and consultancy services or administrative support for companies. The value of such centres lies in the following:

- The incubator principle strengthens individual initiative and increases the development opportunities for SMEs, in which the role of the state is limited to the provision of infrastructure.
- The competitive chances of individual firms can be increased through reductions in costs and increased synergy effects in the area of know-how through practical work-sharing processes. Cost reduction in administration through the common use of office-related infrastructure is particularly advantageous in the start-up phase.
- Both the competitiveness of individual firms and the competitive capability of entire local sectors can be enhanced, providing both commercial advantages for individual companies and development opportunities for the respective city or region.

The area of further education and management qualification in the transition economies is characterized both by the closing of traditional state facilities for further education and the establishment of a private further education market. The new private institutions, which are often limited to local areas, are most relevant to the owners of SMEs, as they specialize in providing expertise necessary for a market economy, such as management, data processing, bookkeeping and foreign languages. However, the provision of these mainly private services does not necessarily mean the rise in qualification standards of entrepreneurs. There is a lack of standards of evaluation against which qualification programmes and facilities can be measured.

Also, the fact that the self-administered organs of the economy, e.g. chambers, are not yet fully functional must be taken into consideration. As the range of chamber activities is limited, information regarding the best further education institutions is not often readily available.

**Proposal for a national policy on SME development**

A number of transition economies of central and Eastern Europe have undertaken a fundamental administrative and legal reorganization in order to create the conditions for a prosperous market-oriented economy to develop. However, a government can only attempt to create the necessary conditions for this to happen: it cannot develop the economy by itself. There is now a need for institutions which will enable entrepreneurs to seek out and take advantage of the conditions available in order to create and build up prosperous, wealth creating enterprises, thus benefiting not only themselves, but the nation as a whole.

National Enterprise Promotion Agency (NEPA) and its functions

This institution, whatever name it may take, has a quadruple task to perform:

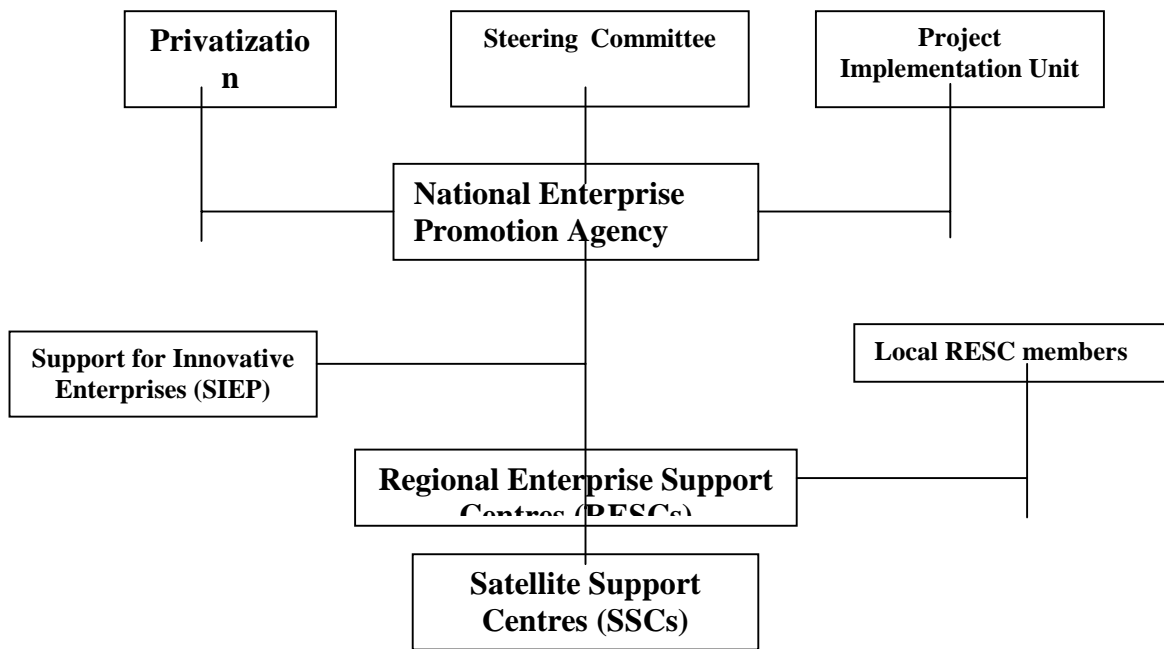
- Implement the government's policy on SME development;
- Represent SMEs themselves and bring their views and aspirations to the attention of the government, and advise on the best ways to stimulate SME development;
- Actively promote and facilitate a business environment, in which SMEs have access to individual opportunities, national as well as international; and
- To underpin all this, it arranges for the education and training of a new class of entrepreneurs and professionals.

On a national level, the policy on SME development should include assistance for the creation and delivery, through the NEPA, of a fully integrated business support programme. This programme could then enable NEPA to provide a range of national programmes in support of business creation and development, facilitating particularly those difficulties relating to:

- access to appropriate credit/capital;
- access to business information (suppliers, competitors and markets);
- up-to-date business management techniques;

- management accounting, budgeting and cost control;
- market research and marketing;
- access to export markets;
- access to suitable premises and land;
- quality assurance and control;
- access to government and large enterprise contracts;
- competitive access to inputs;
- packaging; and
- human resource development.

The organigram below shows the institutional set-up of a National Enterprise Promotion Agency.



Project Organization:

Once the national SME development programme has been initiated, it will need to be fine-tuned, and individual workplans will have to be established. These workplans (see below) need to allow for the immediate

definition of what *results* are expected to be achieved, *how* they are intended to be achieved (main activities), and how progress and achievements can be *measured and evaluated* (indicators).

	NEPA established and offering national programmes, projects and services in accordance with SME national policy.
Main activities	<ol style="list-style-type: none"> <li>1. Create a Steering Committee.</li> <li>2. Select, appoint and train senior staff.</li> <li>3. Determine services to be rendered and organize them.</li> <li>4. Coordinate and render services to SMEs and represent them.</li> <li>5. Help NEPA to develop into a separate and independent agency.</li> <li>6. Train NEPA staff and consolidate institutional sustainability.</li> </ol>
Indicators	<ol style="list-style-type: none"> <li>1. By month 3, NEPA Steering Committee and senior staff appointed</li> <li>2. By month 4, staff trained and business plan approved.</li> </ol>
Assumptions	<ol style="list-style-type: none"> <li>1. That qualified directors and senior staff are available</li> <li>2. That NEPA can be transformed into an independent agency.</li> </ol>

Comments

*Staffing.* The director and senior staff of NEPA could be seconded by the Privatization Agency. Although it is assumed that the staff of the Privatization Agency is private sector-minded and will have appropriate professional experience, small and medium enterprises, in particular micro-enterprises and start-up situations, have their special dynamics and characteristics. The overall success of NEPA, and indeed the entire programme, will therefore depend strongly on the selection and preparation of the local counterpart staff. NEPA must be able to respond rapidly and effectively to the needs of the SMEs through simple but effective operating procedures. Adequate training and on-the-job practical experience will be a critical success factor to form a competent and dynamic team of local NEPA and Regional Enterprise Support Centre experts.

*Central implementation body.* NEPA is expected to be the implementation agency for the government’s SME policy. While this may be necessary in the transition stage, NEPA would withdraw from direct

implementation in the medium term in order to concentrate more on the business of facilitation, coordination and overall policy direction. Implementation would gradually be taken over by the Regional Enterprise Support Centres (RESCs), which would be able to respond more quickly and effectively to clients' needs. The Support for Innovative Enterprises (SIEP) programme shown on the organigram above could also be decentralized to the RESCs after a relatively short introduction period.

*Independence from Government and Privatization Agency.* Independence of the Privatization Agency itself from central government could be a positive indicator of greater flexibility and business-minded professionalism. The fact that the steering committee includes members from the private business sector, the financial sector and academic institutions is a condition for NEPA to operate as independently as possible. Eventually, self-help and professional organizations, chambers of commerce and the like should take over the NEPA's function.

	<p>WORK PLAN - RESULT 2</p> <p>Regional Enterprise Support Centres (RESCs) are created together with village-based Satellite Support Centres (SSCs)</p>
Main activities	<ol style="list-style-type: none"> <li>1. Identify locations for RESCs</li> <li>2. Identify and select RESC management boards from private and public sector</li> <li>3. Select and train qualified RESC managers and staff</li> <li>4. Provide office facilities, equipment and supplies</li> <li>5. Develop business plans</li> <li>6. Identify local sources of finance for RESC activities</li> <li>7. Eventually establish SSCs, support them and train staff</li> <li>8. Establish effective means of communication and reporting between NEPA, RESCs and SSCs to facilitate cooperation and networking.</li> </ol>
Indicators	<ol style="list-style-type: none"> <li>1. By month, a given minimum number of RESCs fully operational</li> <li>2. Business plans containing budget projections available</li> <li>3. By a given month, all RESCs fully operational</li> </ol>
Assumptions	<ol style="list-style-type: none"> <li>1. Sufficient local funding can be found to maintain RESCs</li> <li>2. RESCs cooperate with already existing SME organizations</li> </ol>

#### Comments

*Main implementation level.* The more SME support programmes go in search of the client the more successful they are. As a consequence, most direct project implementation will naturally be done through the RESCs. Bearing in mind the scarcity of staff with practical experience in the areas where the Regional Enterprise Support Centres will operate, there will clearly be a need for intensive training and facilities for practical demonstration.

*Institutional integration and locations of RESCs and SSCs.* While benefiting from close contacts and support from NEPA, RESCs and SSCs should become an integral and active part of the local economic framework. There will be a need for close collaboration with all governmental and non-governmental support institutions in order to be able to take the benefit of collaborative synergies.

While the obvious place for the location of RESCs will be in the principal centres of population and economic activity, at the beginning there will be a need for considerable regular supervision and control until staff have acquired sufficient experience and confidence to be able to operate satisfactorily.

As for the SSCs, these should be very small—even informal—organizations at first, whose principal function will be to alert the RESC as to the presence of business opportunities. They should therefore be located very close to the RESCs—or at least within easy communication reach. If SSC personnel prove able to work effectively without direct supervision by RESC staff, some planning and programming tasks may be decentralized and delegated to the SSC level.

*Need for training and demonstration.*

Training, preparation of local counterparts and practical demonstrations are a vital

element of the project's implementation. Training will have to cover all aspects of business management, including start-ups, credit, marketing and institutional strengthening.

The training staff should render advisory services to private sector organizations such as chambers of commerce and professional associations in order to improve their services for members with a view to strengthening institutional viability and sustainability.

*RESC boards to be private sector dominated.* It is recommended that the boards of the RESCs consist of members from the private business sector. In this way representatives of the business community can actively influence RESC policy and its relevance to

the clients. Special attention will have to be given to the selection of private sector representatives who are able to speak for their respective sectors as a whole as opposed to only their individual business needs. In the long run, local private sector organizations could take over some of the NEPA's and RESCs' responsibilities.

*Sources of finance.* Over the long run, the financial sustainability and self-sufficiency of the programme will depend on how well it has prepared the RESC system to render relevant services and on clients' preparedness to pay for services provided. In order to sustain private business sector interest and secure continuation of the programme, services provided must *be easy to obtain, and should produce visible benefits in the short term.*

*Collaboration with donors, banks and local NGOs.* RESCs will have to work closely with donor agencies, local banks, institutions, local NGOs in the area of SME development and self-help groups.

Collaboration with local banks will benefit both RESCs and the local banking community. Banks themselves can be a source of business information and would be able to provide clients for RESCs' services. The RESCs on their part would be able to improve the "bankability" of the banks' clients.

The NEPA, Regional Enterprise Support Centres and Satellite Support Centres may assume a catalytic function in establishing self-help organizations, such as chambers of commerce and professional associations. Even though a national concept for such private sector organizations need not necessarily exist, the enabling function for institution-building is of great importance to the sustainability of such a SME support system and SME representation at all levels of government.

*Demonstrations, study tours, exchange of experiences.* Study and demonstration tours to successful SME service centres, e.g. in Hungary, Slovenia, the Czech Republic or Poland, or to European Union countries such as Italy, Austria, Germany or Greece, could be very effective tools to demonstrate the coordination between governmental and non-governmental support institutions for private sector development.

*Effective monitoring and evaluation system.* Standardized control and monitoring procedures will need to be set up to enable NEPA to exercise close supervision of all RESC activities, as well as enabling it to measure the programme's impact on the SME sector. While suitable reporting systems will have to be implemented, there will have to be a programme of frequent on-the-ground visits to RESCs and their clients. Of particular concern will be credit monitoring and the follow-up on late payments or payment defaults.

<p>Main activities</p> <p>Indicators</p> <p>Assumptions</p>	<p><b>WORK PLAN – RESULT 3</b>                  An appropriate credit scheme for business start-ups and early growth SMEs is designed, developed and is functioning in a pilot stage.</p> <ol style="list-style-type: none"> <li>1. Independent experts undertake feasibility study</li> <li>2. Determine most appropriate market sectors and methods of reaching them</li> <li>3. Establish operational procedures, internal systems and controls, and reporting and monitoring procedures,</li> <li>4. Arrange procurement channels.</li> </ol> <ol style="list-style-type: none"> <li>1. By given month, operating procedures are defined</li> <li>2. By a given month, a given volume of business has been undertaken</li> </ol> <ol style="list-style-type: none"> <li>1. The feasibility study confirms that a credit scheme is appropriate</li> <li>2. Sustainability criteria for SME credits are applicable.</li> </ol>
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Comments

*SME performance monitoring.* Credits will frequently be diverted to uses other than those intended. The credit scheme, however, should not establish a procurement service for SMEs, making payments directly to suppliers on behalf of the borrower. Purchase of equipment and raw materials is a fundamental entrepreneurial function and should be left to the entrepreneur. Strict but transparent procedures for obtaining credits and for subsequent control and follow-up are an important means of generating confidence and lead to a good repayment climate. In order to anticipate and avoid problems, frequent and close contact between credit officers and clients is essential. In addition, confidence can be built by granting a series of small short-term credits, and by gradually increasing amounts and terms as the client proves willing and able to pay. Credit schemes should therefore allow for a learning process. Initial short-term loans followed by longer-term loans after successful repayment on schedule, with small amounts to start with, gradually

increasing as knowledge and confidence in the client grows.

*Implementation of credit scheme.* Frequently, the implementation of the credit scheme will be in conjunction with credit lines which already exist, each of which will have its own particular requirements and procedures. It is advisable to harmonize local procedures for their use, and facilitate access to them by SMEs. One way to streamline administrative procedures could be to provide the National Enterprise Promotion Agency with a legal mandate to harmonize the different credit lines supplied by a variety of international donors, agencies and commercial banks. Although the credit scheme will be administered by the Regional Enterprise Support Centres, there will be a need for cooperation with local banks. There will be a considerable need for staff training within the banks themselves to ensure speedy and correct handling of SME credit business, and to avoid situations where bureaucracy becomes a major obstacle to small enterprise development. In the transition economies of central and eastern Europe the legal situation in the past

has, in many instances, not created a *private sector credit culture* where repayment of credit is an obligation to be enforced rigidly. In a number of economies SME lending schemes show low repayment rates.

*Approach to SME credit.* In the management of a credit scheme, interest charges must be realistic. In order for the scheme to cover its costs out of operating income and to maintain its real net worth, clients must pay market rates of interest. It is often believed that subsidized rates are necessary for small and micro-businesses to survive. Such a policy, in many instances, however has proved to be counterproductive.

The “price” of a credit must therefore include: its basic financing cost, a charge for the risk involved, operating costs (including depreciation of assets if appropriate), a charge to cover local inflation and the scheme’s profit. If any of the above elements is not covered, there is a risk that the fund will eventually disappear and the credit scheme will founder. The first principle for any SME credit fund, therefore, is to maintain the value of the fund. Clients should therefore be prepared to pay a realistic market price for their credits and provide acceptable collateral or a guarantor.

Normally start-up credits should be granted only after the client has successfully completed one of the training courses offered by the Satellite Support Centres (SSCs). A successful SME credit fund can only be sustained through intensive training of both credit officers and staff and shareholders of SMEs participating in the programme. For this purpose, NEPA, RESC, SSC and bank staff will be trained in the characteristics of small scale credit and the management of non-traditional collateral. They will be instructed on how to teach new entrepreneurs the proper use of credit. Repayments should be frequent and scheduled according to the cash flow possibilities of the client’s business. Credit terms must be enforced rigorously, if necessary, by taking legal action. The credit scheme should endeavour to spread its loans over as many sectors and economic activities as possible, thereby reducing the risk of simultaneous non-payments that could eventually jeopardize the credit scheme's operation. In addition the instrument of a separate credit guarantee scheme for newly created and start-up enterprises could be used.

	<p><b>WORK PLAN - RESULT 4</b>                  A special Support to Innovative Enterprises Programme (SIEP) established and functioning</p>
Main activities	<ol style="list-style-type: none"> <li>1. Identify sectors and areas with major potential for rapid growth</li> <li>2. Define conditions for SMEs to qualify as “Innovative Enterprises” (IEs)</li> <li>3. Identify and train personnel within NEPA to handle Ies</li> <li>4. Train RESC personnel to identify potential IEs at an early stage and notify NEPA</li> <li>5. Assist IEs in preparing business plans, accessing credit, markets ,etc.</li> </ol>
Indicators	<ol style="list-style-type: none"> <li>1. Conditions for SMEs to qualify for IE treatment defined by a given</li> </ol>



Assumptions	month 2. Special services for IEs defined and available by a given month 3. By a given month, a given number of IEs identified and receiving support from the SIEP programme. 1. Sufficient potential that IEs exist 2. Benefits received at least equal to costs of the programme
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Comments

*Definitions.* The SIEP programme will clearly address those production units, new or existing, which intend to enter a new market, or introduce a new product or service hitherto unavailable locally, ie. the so-called “non traditional” areas of business. It is expected that in many cases the RESC or SSC project advisers will themselves identify opportunities which will then be implemented by local SMEs. The following characteristics would be the most common among innovative enterprises:

- low-volume, high-value products
- preferably export oriented
- introduction of new—but simple—technology
- short lead time from initial investment to first delivery of products to market
- flexibility (ie. ability to change or modify products rapidly if market requires)
- non-traditional (ie. the project opens up a new market, new product or new service)
- possibility of attracting foreign partners (as shareholders, managers or with purchase contracts.

*Programme implementation.* In the case of the so-called SIEP, the emphasis cannot only mean raising money for new investments and company start-ups. There will be a strong need to prepare business

plans and do product research, market and technical analyses. Close collaboration with foreign suppliers and purchasers is likely to be necessary. Initially there should be on-the-job training for managers. This will be very time-consuming. Although SIEPs should start to offer services as soon as possible after programme launch, some lead time should be allowed before specific projects are identified and implemented. Failures of SMEs selected for SIEP support should be kept to a minimum. It will therefore be necessary to establish channels of cooperation with other organizations with a view to providing initial capital or credit for the investment and providing additional sources of assistance. At a more advanced stage, projects will need increased support. SIEP should have the necessary authority to decide on a case-by-case basis whether to give additional support or to withdraw from a project. For this purpose close monitoring will be necessary. SME shareholders and managers should be aware that SIEP support is limited and it is they, rather than NEPA or the aid agencies, who are finally responsible for the survival of their enterprises. Through NEPA and the SIEP services they will be introduced to alternative sources of finance and international markets, as well as appropriate training.

	WORK PLAN – RESULT 5 Support to Government is offered to improve accounting standards
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Main activities	<ol style="list-style-type: none"> <li>1. Establish a standard approved accounting procedure for use by SMEs</li> <li>2. Require all SMEs receiving support from NEPA to use this accounting procedure</li> <li>3. Provide training and literature on approved standard accounting practices and procedures</li> <li>4. Establish standard performance reporting procedures for all SMEs using services of RESCs and/or NEPA</li> </ol>
Indicators	<ol style="list-style-type: none"> <li>1. A standardized accounting and bookkeeping procedure is established</li> <li>2. By a given month, a given number of SMEs are using it</li> </ol>
Assumptions	<ol style="list-style-type: none"> <li>1. The proposed accounting system is supported by Government and is compatible with accepted national accounting standards.</li> <li>2. SMEs and other enterprises use it.</li> </ol>

	<p>WORK PLAN - RESULT 6</p> <p>An incentive policy is developed to encourage informal sector entities (ISEs) to join the formal sector</p>
Main activities	<ol style="list-style-type: none"> <li>1. A study is carried out to determine the advantages and disadvantages of the informal sector <i>vis à vis</i> the formal sector</li> <li>2. Identify incentives most likely to encourage ISEs to join the formal sector</li> <li>3. Propose measures to Government</li> <li>4. Propose policy measures to encourage creation of private self-help organizations such as chambers, professional associations, co-operatives, etc.</li> </ol>
Indicators	<ol style="list-style-type: none"> <li>1. Informal sector participation in the economy is reduced</li> <li>2. At least a given percentage of the people trained under schemes provided through NEPA remain in the formal sector</li> <li>3. Authentic SME self-help organizations are created.</li> </ol>
Assumptions	<ol style="list-style-type: none"> <li>1. ISEs want to join the formal sector</li> <li>2. ISEs and SMEs want to “speak with one voice”</li> </ol>

Comments

*Implementation.* Analysis of comparable conditions in the formal and informal sectors is needed, as well as recommendations to the government. At first sight it would appear that, apart from taxation, excessive administrative and regulatory requirements drive many enterprises to operate in the informal rather than the formal sector. There

is clearly a need to advise government as to the formulation of an appropriate policy to deal with this phenomenon. The development of private self-help organizations such as chambers of commerce and professional associations is often the best way to encourage participation in the formal sector and to provide for sustainable economic development. In the

long run the RESC system itself could be transformed into a privately-owned self-help organization.

Human Resources Development

Central to the whole project is the need for training and development at all levels. There are three groups of people for whom intensive training should be provided:

*Staff of NEPA and the RESC.* Enable them to understand the particular needs and aspirations of SMEs and to deliver the assistance that will be needed.

*Businessmen and members of SME community.* Train them to manage and develop their businesses successfully and sustainably. Target groups are:

- *existing and potential entrepreneurs.* Improve their skills and enhance their understanding of underlying business economics. Specific attention should be given to new business creation and expansion and modernization of existing enterprises.
- *personnel of enterprise support institutions and banks.* Assist them to render more efficient services to the SME sector, thereby creating a better environment for SME development and growth.

Training sessions should involve simulated business games, practical fieldwork and preparation of budgets and operating plans, group dynamics of participants and feed-back from bankers and professionals. During the training, participants prepare business proposals on their own, test their ideas, judge the viability of their proposals and prepare operating plans based on their own assessment and decisions. The training should eventually help entrepreneurs to understand the practical elements of doing business, to develop strategies and plan their business, to take decisions and accept

responsibility and, in short, to develop their practical skills as entrepreneurs.

*Local trainers.* Trainers should be prepared to offer on-going training services after this programme has ended, thereby ensuring the sustainability of the government's SME development policy. Training has to be made available in such a way that access to it is available over the long term to as large a group of participants as possible.

#### **D. Conclusion**

The rapid expansion of the small business sector is proving to be a dynamic factor in support of economic revival. Despite the persistence of obstacles to small business development in most of the transition economies of central and eastern Europe, remarkable progress has been made in constructing a macroeconomic and legal framework within which private entrepreneurs can prosper. In the next phase of transition policymakers should consolidate these achievements and design specific policies for SMEs to reduce the remaining barriers to small business expansion.

Favourable legal and economic framework conditions are required to support the entrepreneurial spirit that has developed since economic reforms were introduced.

The barriers, however, to the development of an effective SME sector are manifold:

- There are gaps in the financing of small and medium-sized enterprises, both in the start-up phase and in later growth. Although considerable progress has been made in the banking and financial system since the abolition of monopoly banks and central planning, financial systems have not yet fully developed to meet the new needs of business financing. Small and medium-sized

enterprises are in a more difficult credit position than the large state enterprises.

- Vocational and technical training systems have improved substantially. Considerable gaps still exist, however, in the areas of finance, commerce, business management and entrepreneurial training.
- The competitive situation is far from positive for small and medium-sized enterprises, in particular in the manufacturing sector, which is still dominated by large companies.
- State administration is itself undergoing adaptation in the process of transformation of the economic system. In many cases it is still insufficiently oriented towards its new tasks within a market economy.
- Although the basis for the new economic system has been put in place in most of the transition economies of central and eastern Europe, the practical implementation of the legal framework for a market economy is still lacking. Long periods of adaptation should be expected before the new legal norms are rooted in the thinking of entrepreneurs and the population in general, and before they are fully implemented by legal authorities.

In most recent years, national governments as well as regional administrative authorities have implemented local state consultancy facilities, business development centres, technology parks and economic development agencies in economically

disadvantaged regions. It should be noted, however, that considerable further development is required in this area. The effective implementation of assistance measures has in many cases been halted by financial and administrative difficulties. Despite these obstacles, more effort has to be made to include the local and regional dimension of SME policies by tailoring assistance measures to specific needs and situations. Such policies should involve a wider range of national, local, governmental and non-governmental organizations and should tailor assistance measures to meet particular needs. They should, for example address issues relating to infrastructure (e.g. banking, transport, telecommunications), the climate for business investment and the availability of qualified human resources. The collaboration between support institutions, banks, private suppliers of business-related services and further training facilities, in particular at the local level, needs to be significantly improved. The horizontal cooperation of economic development agencies with each other, as well as with local authorities, Chambers of Commerce and business associations, has to be considerably strengthened. The same applies to joint action between municipal, local, regional and national facilities in the vertical cooperation between support institutions, economic self-help organizations and authorities of the state administration.



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