

## Session 4

### Promotion of SMEs

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## **Problems of Development of the SME Sector in Poland during the 1990s**

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## Promotion of SMEs

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### 1. Introduction

For any country, the implementation of significant policy change is challenging, but for countries in transition, implementing major policy shifts poses special challenges. Although the proposed policy change may be recognized as necessary and vital by many, it may face widespread opposition, or it may be undertaken without the benefit of adequate resources to get the job done.

One of Bulgaria's goals after the World War II was industrialization, understood as economic, technical and technological development along the way to progress and "modern societies". Private property and market institutions were abolished. Industrialization, technical and technological modernization were sought within the central-planned state economy. The dominating idea was that the state ownership was the best form of management. Compensation of labour was based not on its effectiveness, but on government decrees and state regulation, thus destroying labour motivation. The economic and social status did not depend directly on labour efforts or educational degree. In this way traditional Bulgarian respect for proverbial Bulgarian industriousness was done away with, as there is no basis for their stimulation and assessment. In the late eighties this model was totally exhausted. The society faced with the need of a transition towards democracy and market economy.

So in the down of profound economic changes in 1989, the private ownership had a symbolic presence in the economic life.

The development of the private sector is a primary condition for the transition to market economy. That is why the appearance of the stratum of entrepreneurs is an essential characteristic of society's transition. This stratum has been established in the conditions of intensive changes in the structure of society and in legal norms. The market economy institutions are not fully built yet. The former value orientation and changes in them have their imprint on the personality features and the social status of entrepreneurs, and on the society's attitude towards them.

The encouragement of small business aims at solving fundamental economic tasks, since the filling out of the economic space with small and medium-sized enterprises, sole proprietors and businessmen is a key component of the structural reform. The small business quickly adapts itself to the changing economic conditions. It can utilize local resources, thus enlivening the economy of regions and settlement. It thus acts as a generator of economic growth for a sustainable development.

The small business solves social tasks, being practically the sole alternative to the growing unemployment due to the restructuring of the economy.

The assertion of small business also solves political tasks, as it is the one of the pillars of the democratic society, with the middle class being its backbone. The economically independent proprietors can oppose the attempts at authoritarian structures.

## 2. SME development in Bulgaria 1989-1999

The development of a vital and competitive private sector is an inseparable element of the structural reforms in Bulgaria. The emergence of SME private companies and the creation of an entrepreneurial spirit are all parts of new business culture and the democratization of society. Small and medium businesses are major vehicle for the creation of new jobs, for the development of a more dynamic market, the formation of a middle class, a competitive and market-orientated economy. Regrettably, much less support and attention was allocated to the SME sector compared to other elements of the structural reform process.

Unlike to some of the East European states, Bulgaria embarked on a market orientated transformation with full domination of the state property in the national economy (at the end of the 80s the share of the private sector in the gross national product was merely 5%, according to 1992 National Statistics institute data). The then effective Constitution did not allow the right of private property, while private business activity was possible only through self-employment and within strictly defined limits and sectors – handicrafts, agriculture, cattle breeding and services.

The emergence of private business in Bulgaria was marked with the adoption of Council of Ministers's Decree N 35/1987 and the Decree N 56/1989 for Business Activity. A large-scale registration process of private companies – mainly sole traders, began in 1990. The highest number of registered private companies was measured in 1991-1993. Data from the balance sheets of the economically active private firms in Bulgaria (in 1995 they were 194 800) shows that more than half of them (54.2%) operated in trade. In 1995 more than one third of the companies functioned in the field of industry, construction and transport.

The distribution of the companies according to the number of employees shows that the private business was predominantly the family type. Up to three persons were employed in 90% of the firms according to 1995 National Statistics Institute Company Information and reports. Only 1% of the companies had more than 50% employees. More than 1.2 million people were employed in the private sector.

The socio-psychological characteristics of the Bulgarian entrepreneur differ by year. In 1990 most of the businessmen were motivated by quick achievement of profit. 40% of the owners of private companies sought self-realisation and public recognition in 1992. Ensuring the family living and the economic necessity were the main incentives in 1995.

The economic policies after 1990 – although evidently controversial, created relatively favourable conditions for the development of the private sector. The prices were liberalized; the state monopoly in foreign trade was abolished; real estates were restituted and privatization began. At the same time the weak control over the banking system, the currency policies and the increasing taxation burden undermined the normal functioning of the private sector.

The period 1996-1998 was the most difficult for the Bulgarian economy. After two years of modest economic growth (1994-1995) in the first half of 1996 the financial sector plunged into a deep crisis, affecting the entire economy. As a result, in 1996 and 1997 an extremely strong decline of the GDP, continuously increasing levels of inflation reaching even hyperinflation levels in the first two months of 1997 and an excessive decline in the real incomes were reported.

In 1996 the GDP decreased by 10.1%, which represented the most significant decrease of this indicator since 1991. In 1997 a new reduction of the GDP by 7% was registered, which was entirely due to the severe crisis in the first half of the year. The GDP decline in the first quarter of 1997 was 22.7%, and 13.3% in the second quarter compared to the same period in 1996. In 1996 the economy registered the highest decline of the gross value added in trade (-21.5%) and construction (-20.8%). This was due to the significant reduction of the internal demand related to the rapid decline of real incomes and the exceptionally low investment activity both of companies and households. The only two sectors that registered growth in 1996 were forestry (5.8%) and communications (8.1%). Communications and transport (zero growth in 1996) were the only sectors having positive rates through all the years after 1991. These two sectors are also among the ones with the highest labour productivity in Bulgaria. In 1997 the sharpest decline of value added was again reported in trade and construction<sup>1</sup>. These two sectors proved to be affected to the greatest extent by the severe economic crisis in the country. It influenced negatively the private sector development due to its high share in these two industries (about 80% of the gross value added in trade and about 70% in construction). In 1997 agriculture and the production and distribution of electricity, gas and water registered an exceptionally high growth (respectively 37.1% and 23.7%). The traditionally well performing industries in the service sector – communications and transport, registered growth too.

The dynamics of the components in the final consumption of the GDP indicates that in the period 1996-1997 the reduction in the gross fixed capital formation was most significant (by more than 20% annually). The low investment activity was determined both by the unstable macroeconomic environment, limiting to a great extent the planning horizons of the companies, and by the high prices of the investment goods. In 1996 the collective consumption dropped significantly (-35%) followed by the government expenditure (-22.6%). During that period the budget was encumbered by large interest payments on the government debt, along with non-specific expenses related to the bank crisis. At the same time the opportunities for external financing of the budgetary deficit were limited. In 1997 a strong decline was registered in the household's final consumption expenditures (-17.2%) due to the drastic reduction of real incomes in the first months of the year.

In the second half of 1997, immediately after the newly elected Government started to implement its economic policy whose major component was the introduction of the Currency Board, the Bulgarian economy started to stabilise. In the last two quarters of 1997 a 2-3% growth rate was registered. Over the next two years the economic growth continued. Thus, in 1998 the GDP increased by 3.5%, and in the first nine months of 1999 the preliminary data of the National Statistical Institute (NSI) indicated a 2% growth.

In 1998-1999 the anticipated 4-5% growth rate was not reached. This was caused by a sequence of external shocks that affected the Bulgarian economy. The Asian crisis at the beginning of 1998 affected the dynamics of the Bulgarian economy through the reduction of external demand and the international prices of some key commodities. The Russian crisis in 1998 had even stronger negative impact on the Bulgarian economy as some countries in the region greatly devalued their national currencies.

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<sup>1</sup> The reduction in Gross Value Added in forestry (-44.6%) and the financial services in 1997 (-74.6%) were significant. The decline in forestry, hunting and fishing was due to the great reduction in wood processing and the closing of "Ocean Fishing" company in 1997. The decline in the financial services sector was related to the big differences in the nominal interest rate spreads in 1996 and 1997, as well as to the stabilisation and the subsequent fixing of the foreign exchange rate.

In 1998 a GDP decline was registered only in the third quarter compared to the same period of the 1997. Thus, the external demand, which was the engine of the modest economic growth in the 1994-1995 period, as well as the driving force for the growth of other CEE countries, failed to induce a GDP growth and on the contrary – had a negative effect. Actually the growth of the GDP was boosted by the increased household demand generated by the real increase in incomes, as well as by the higher investment demand. The latter began growing in the third quarter of 1998.

The traditionally well performing sectors – transport, communications, agriculture and forestry experienced the highest growth in 1998. The industrial sector registered growth as well, which was due mainly to the private sector development. It is very likely that the enterprises privatised over the previous years have contributed to the gross value added growth in the sector.

In 1999 the pace of the economic growth slowed down. The Kosovo crisis added its effect to the two external shocks experienced in 1998, which negatively influenced the development of traditionally strong sectors such as transport. However, the results in the first nine months were higher than the expected and the latest data indicate a GDP growth of 2.5% in 1999. The major contribution to the increase of this indicator is the gross fixed capital formation (28.9% for the nine months of the years), as well as the increased household consumption (8.7%).

Over the period 1996-1999 the Bulgarian economy experienced periods of varying price level dynamics. In 1996 the inflation accelerated abruptly. At the onset of the year prices used to increase by 1-2% monthly, and after May 1996 the average monthly increase was in the range between 15-25%. At the year-end, when the economic crisis deepened, Bulgaria faced a hyperinflation cycle. In January 1997 consumer prices raised by 43.5%, while in February another 242.7% were added.

The appointment of a Caretaker Government, which started the implementation of an economic policy, pursued later by the Government appointed by the newly elected National Assembly, as well as the introduction of a Currency Board Arrangements in mid 1997 were the major stabilising factors on the prices' dynamics. Monthly inflation rates dropped in the second half of 1997 to about 1%. The stabilisation of prices continued in the next two years and the inflation rate in 1998 was 1% (December 1998/December 1997) and -6.2% in 1999 (December 1999/December 1998).

The main framework of the Currency Board arrangements was laid down in a number of regulations outlining the new monetary policy to be implemented by the Government and the Central Bank. In fact the Currency Board limits the opportunities of the Government and the Central Bank to influence the macroeconomic indicators through the instruments of the monetary policy and shifts the emphasis mostly to the fiscal, income and foreign trade policies.

The advantages of the Currency Board for the small and medium-sized enterprises are as follows:

- Stabilisation of the macroeconomic environment and its improved predictability, which allows better planning of operational and investment activities of enterprises;
- Possibilities for real incomes increase and hence internal demand and consumption. Certainly, whether the increased internal demand would be satisfied by the domestic producers depends to a great extent on their competitiveness.
- Stabilisation of the macroeconomic environment which may decrease the cost of credit and thus improve the access to capital *ceteris paribus*. This process is further supported by the withdrawal of the Government from the internal credit market. The extent to which commercial banks will increase credits to non-financial enterprises in the country will depend on other factors too, which are not related directly to the Currency Board arrangements such as the efficiency of the judicial system, the quality of business projects; the reputation of companies, etc.;

- A complete internal convertibility of the national currency has been achieved. Local economic agents do not encounter any problem in obtaining foreign currency. In general, there are no obstacles to exchange the national currency to the reserve currency and in fact there are no difficulties to the exchange of the national currency to any international currency mostly used in international transactions. This reduces substantially the financial costs for the companies.

Since the Currency Board rules are neutral, it could be claimed that its advantages and disadvantages affect to the same extent all economic agents in the country. However, most of the large companies are big exporters and under the flexible exchange rate they were in a position to reap profits on exchange rate differentials (especially when the lag between production and sales is big). The fixing of the foreign exchange rates eliminated the opportunity for such profits, thus affecting the SMEs to a much lower extent.

### 2.1. Main characteristics of SMEs in the period 1996 – 1999

The analysis of small and medium-sized enterprises' place and sector contribution to Bulgaria's economy draws on the aggregated data from balance sheets and profit and loss accounts of 178 000 firms for year 1996, 189 367 firms for year 1997 and 205 643 firms for year 1998. This lot of firms does not extensively represent the single-person farmers actively producing, part of the financial institutions (commercial banks, insurance companies, etc.) and the budget sector organisations.<sup>2</sup>

Firm distributions by size remain more or less constant in the period from 1996 to 1998. Micro-firm share is some 92.5% and the share of small firms oscillates within the range of 5% and 5.5%. Thus the microfirms and the small firms make up a share of a little below 98%. On the other hand, in the period under consideration the share of big firms goes gradually from 1.5% for year 1996 down to 1.1% for 1998 of the total number of firms. Assuming that the medium-sized and big firms really operating in the economy come better represented in the sample, we can infer that in the period from 1996 to 1998 the really operative small and medium-sized firms have constituted over 99% of all the country's active firms.

#### Survey distribution of firms by size (%)

Firm size	1996	1997	1998
Micro-firms	92.19	92.47	92.40
Small firms	5.12	5.19	5.41
Medium-sized firms	1.17	1.08	1.05
Firms with staff from 101 to 250	1.00	0.86	0.76
Big firms	0.53	0.41	0.39

Table 1

Source: NSI and our calculations

<sup>2</sup> The budget sector represents predominantly centrally and municipally run organizations, as well as companies providing services financed mainly through budget subsidizing like those in education and health care (schools, hospitals, etc.).

SMEs portion is most significant in the service sphere. The industries where SMEs predominate in total analysed sample are hotels and catering, trade, financial services (excluding banks, insurance companies and some other financial institutions), education (excluding the budget educational establishments) and health care. The industries where the medium-sized and big firms take up the prevailing share of the total number of sample firms are exclusively in basic industry like the production and distribution of electricity, gas and water, as well as in the mining industry, where one out of three firms falls under the big firms group. Relatively high is the portion of the medium-sized and big firms in the branches of farming and forestry, also construction. Yet it should be noted that the analysed sample does not include the single-person farmers, hence the agricultural sector in reality comes much more fragmented than what the firm sample of this analysis demonstrates.

#### Firm distributions by aggregated industry branches and by size (%)

Industry	Micro-firms	Small firms	Medium-sized firms	Firms with staff from 101 to 250	Big firms
Total	92.40	5.41	1.05	0.76	0.39
Farming, forestry, hunting, fishery	64.84	25.67	5.74	3.36	0.39
Mining industry	41.61	19.88	6.83	11.18	20.50
Processing industry	79.71	12.17	3.27	2.79	2.06
Electricity, gas, water	41.91	15.44	8.09	8.82	25.74
Construction	80.13	13.89	3.09	2.27	0.62
Trade and repair	96.60	2.96	0.29	0.13	0.02
Hotels and catering	97.53	1.94	0.26	0.20	0.08
Transport and communications	95.60	2.78	0.71	0.60	0.31
Finance, credit, insurance	92.16	7.21	0.36	0.09	0.18
Real estate operations and business	94.78	4.06	0.64	0.37	0.15
Education	96.51	2.92	0.32	0.16	0.08
Health care	97.52	2.38	0.00	0.10	0.00
Other services	92.33	5.40	0.92	1.22	0.12

Table 2

Source: NSI and own calculations

Everywhere around the country SMEs prevail (over 98%). The relative portion of big firms is within the range from 0.7% to 1.5%. Greatest concentration of small and medium-sized firms is again observable in the city areas of Sofia, Plovdiv, Varna, Bourgas, Stara Zagora and Blagoevgrad. Along similar lines have been the regional distributions for the previous two years.

#### 2.1.1. Demography of SMEs

Data on SME company age, survival rates, birth rates have been extracted from sample studies popular under the titles PECO PANEL and DoSME (Demography of Small and Medium-Sized Enterprises) where Bulgaria participates and which are carried out jointly by Eurostat and eleven countries from Central and Eastern Europe (CEE). Initially the official UCEOI register was used, later the BULSTAT register. Typically these surveys sample the entities registered at a certain point in time which can be of various degree of activity.



First survey supplies data<sup>3</sup> on the private enterprises carrying out commercial and non-farming activities, that had been registered in the business registers of the eleven countries before 01.01.1995. In Bulgaria such were the enterprises registered under UCEOI. This survey highlights certain characteristic aspects of Bulgarian enterprises holding true also for the group of small and medium-sized enterprises as long as they predominate.

Enterprise age.<sup>4</sup> Bulgarian enterprises registered before 1 January, 1995 were relatively young since scarcely 4.2% of them had started operation before 1990, while in Slovenia, Hungary and Poland the percentages were 26%, 21% and 20% respectively of enterprises over 5 years of age.

#### Percentage distributions of enterprises by age as of 1 January 1995 \*

Country	Enterprise age					%
	1 yr	2-3 yrs	4-5 yrs	6-10 yrs	>10 yrs	
Albania	37.9	52.2	9.9	0.0	0.0	100
Bulgaria	20.4	42.5	32.9	2.7	1.5	100
The Czech Republik	18.9	44.6	33.7	2.0	0.7	100
Estonia	30.3	50.8	15.5	2.9	0.5	100
Hungary	21.0	33.4	24.7	12.1	8.7	100
Latvia	37.7	45.6	14.1	1.5	1.2	100
Lithuania	38.9	34.6	20.4	3.9	2.2	100
Poland	17.3	33.4	29.0	10.9	9.4	100
Romania	32.6	48.7	17.5	0.4	0.7	100
Slovakia	18.9	44.0	34.5	2.2	0.4	100
Slovenia	18.2	31.9	23.8	11.1	15.0	100
Total	21.1	39.2	28.0	6.6	5.2	100

Table 3

\* Enterprises registered in 1995 were not included in the group of one year of age.

#### 2.1.2. SME input in the gross added value

In year 1996 the SME sector was the source of 27.3% of the total gross added value in Bulgaria.<sup>5</sup> In 1997 this portion is reduced to 22.4%, while in 1998 certain recuperation took place of up to 25.4%. Yet the SME share of gross added value was still lower than in 1996.

The drop of SME input in the newly created income in 1997 is exclusively attributable to the acute financial and economic crisis of the second half of 1996 and early 1997. It had its most negative impacts on the sphere of services (excluding transport and communications) and especially trade, where small companies are extremely numerous.

<sup>3</sup> Panorama of Enterprises in the Central and Eastern European Countries in 1995, Eurostat, Phare.

<sup>4</sup> Quoted survey measures the enterprise age from the start of actual operation, not the entry in the business register of the statistical institution. Usually registration date precedes by several months, even several years the operation, still can happen later, as a result of improved coverage of the business register and entering enterprises already in existence yet so far left outside the observation scope of statistics.

<sup>5</sup> The indicator here accounts for the sum total of firms' pretax and preinterest operative profit (that is the actual difference between incoming and outgoing operation funds), labor expenses (including the payroll costs, social security costs, professional qualification and unemployment funds and any other due related to the payment of salaries) and the depreciation costs. The firms belonging to the financial services branch have something more here -- the difference between profits and losses from financial operations. We believe it all comes close to the concept of gross added value in terms of the national accounts system

Due to frustrated investment activity the decline was also considerable in the construction industry, an area where many small and medium-sized private companies had rapidly emerged and developed in the early and mid-nineties.

#### Gross added value shares by firm size and sector (%)

Size of firm/sector	1996	1997	1998
Total	100	100	100
Micro-firms	9.81	6.44	9.08
Small firms	11.37	9.56	9.94
Medium-sized firms	6.11	6.40	6.36
Firms with staff from 101 to 250	11.04	12.26	12.20
Big firms	61.67	65.34	62.43

Table 4

Source: NSI and own calculations

In 1998, after the stabilization of the macro-economic environment, the small and medium firms once again contributed relatively more to the gross added value with all the micro- and small firms whose shares grew respectively from 6.4% in 1997 up to 9.1% in 1998 and from 9.6% in 1997 up to 9.9% in 1998. Medium-sized companies maintain their share position while big firms decreased their portion of added value. This is a proof that small companies are highly sensitive to changes in the macro-economic environment and too quick to respond. This can be due to the relatively thin investment in long-term fixed assets in these firms; and on the other hand the entrepreneurs can be more flexible employing varying numbers of people depending on the changes in the economic conditions. Thus the micro-firms and the small firms can serve as a very good indicator for the current condition of the economy.

If the so called grey economy sector be taken into account the share of small and medium-sized enterprises sector could be re-estimated to some 35 - 38% when calculating the gross added value - somewhat different from the now accounted 23 - 27%.

The distributions of Bulgarian firms and their potential to generate added value allow for two conclusions to be drawn:

- Small firms have limited potential to generate added value. Newly constituted firms in the period of restructuring of the economy emerge most often in industries with lower than country's average efficiency of utilization of production resources like agriculture, trade, etc. This was probably preconditioned by the difficult entrepreneurial access to credit funds on which they could finance relatively larger investment projects which in turn could have generated relatively more income. It should also be taken into account that in crisis periods business undertakes rapid turnover activities.
- On the other hand this cannot but suggest the vast potential of Bulgarian economy that can be realized in the periods to come in case investment activity of Bulgarian entrepreneurs grows, as well as there is inflow of direct foreign investment. This could both boost overall employment in Bulgaria and help the more efficient re-structuring of present job opportunities from less productive economic sectors to such of higher productivity.

The potential for small and medium-sized firms sector development actually lies in their more massive invasion of the processing industry area, where they could undertake small but highly competitive projects to considerably expand the average gross added value generated in this sector of the economy.

### 2.1.3. SME contribution to export and import<sup>6</sup>

SME-s' economic performance varies with respect to Bulgarian exporting and importing. Their role in Bulgarian exporting is comparatively moderate. Over 80% of country's export is taken up by the two subgroups of the largest firms. Bulgarian importing, on the other hand, is not exclusively dominated by a single group of firms. Micro- and small firms in Bulgaria used to hold 34.5% of the total import to go down to 25.4% in 1997. In 1998 they gained back on their relative share in the country's import up to 32.8%. The other group playing crucial part in the dynamics of Bulgarian import is the one of the largest companies holding between 50% and 60% of country's total import in the period from 1996 till 1998.

#### Firm foreign trade participation by size and sector (%)

Sector	Micro-firms	Small firms	Medium-sized firms	Firms with staff from 101 to 250	Big firms
<b>Import share</b>					
<b>1996</b>					
The Economy - Total	21.98	12.52	3.45	6.76	55.29
Public sector	15.57	0.36	0.92	3.38	79.77
Private sector	33.09	33.58	7.82	12.61	12.89
<b>1997</b>					
The Economy - Total	11.37	13.96	3.34	10.86	60.47
Public sector	0.43	7.84	0.50	1.98	89.26
Private sector	23.46	20.73	6.48	20.68	28.65
<b>1998</b>					
The Economy - Total	15.13	17.70	5.69	11.36	50.12
Public sector	0.40	7.95	1.21	1.73	88.71
Private sector	23.30	23.10	8.17	16.70	28.72
<b>Export share</b>					
<b>1996</b>					
The Economy - Total	10.60	7.65	3.22	7.44	71.09
Public sector	0.08	1.09	1.09	6.07	91.67
Private sector	37.08	24.17	8.60	10.89	19.26
<b>1997</b>					
The Economy - Total	8.82	6.50	3.34	8.52	72.82
Public sector	0.09	1.60	0.69	5.00	92.62
Private sector	19.58	12.56	6.60	12.87	48.39
<b>1998</b>					
The Economy - Total	9.53	7.85	4.74	11.03	66.85
Public sector	0.05	1.05	2.80	3.92	92.18
Private sector	16.14	12.59	6.09	15.98	49.20

Table 6

Source: NSI and own calculations

<sup>6</sup> NSI data derived from customs declarations.

Extremely important in Bulgarian exporting are the processing industry firms who realized 78.4% of 1998 export. Comparatively, a lot of country's export is carried out by the firms involved in trade (17.5% in 1998). The ones exporting industrial and agricultural products are mainly micro- and small firms and probably firms specialising in foreign trade.

Thus the two major groups of players in Bulgarian foreign trade can be delineated. The first one is mainly constituted by coming predominantly from the private sector micro- and small firms. Their principal activity is importing goods to meet domestic demands with some of them also intermediating in the export of Bulgarian industrial products. The activity of this group depends largely on the structure and dynamics of domestic demand and particularly so on the end consumption. Hence the dynamics of their importing relates with the dynamics of real incomes in the country.

#### 2.1.4. Labour productivity<sup>7</sup>

Data analysis proves that labour productivity in the private sector grows with company size. Biggest private sector firms manifest in the course of the years, labour productivity from two to three times higher than in micro-firms. Here, again, largest companies have highest labour productivity, followed, though, by small companies showing more labour productivity than the medium-sized and big firms employing between 101 and 250. Large firms' labour productivity is determined by their industry, as well as by the technologies they are employing. The shortage of financial means typical for micro- and small companies does not only limit the entrepreneurs there in their choice of type of business to start, but also the equipment and technology to be used in their operation.

This may have been the reason why labour productivity was higher for most groups of firms in the public sector as compared to that in the private sector. In recent years, though, the difference between labour productivity in the public and private sectors gradually diminishes as far as almost disappearing in three of the groups of firms in 1998. It is also possible lower labour productivity to be attributable to another factor - namely the fact that some of the gross added value has not been accounted in certain firms, a factor that cannot be easily estimated.

The crisis in 1996 had extremely detrimental effects on labour productivity in industries like trade, financial services, education and health care (the two latter include enterprises other than those financed on the budget - national or municipal, also some public sector firms). Dominant in all these branches is the private sector, which caused the dynamics of labour productivity to dwindle for the whole sector. Productivity in construction has remained more or less stable all through the period, even marking certain increase in 1998, which might be an indicator for reviving investment activity of firms and population. The branch of transport, communications and tourism attained its 1996 labour productivity value and stands out as one of the industries with highest values on that. It can be anticipated that the Kosovo crisis of the first half of year 1999 took its adverse effects on this dynamic industry of Bulgarian economy where the private sector is successfully developing.

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<sup>7</sup> Labour productivity can be measured by means of various indicators. It has been assessed here in terms of the gross added value per employee.

**Labour productivity by groups of firms according to size and sector  
(BGL thousand, 1996 prices)**

Sector	Micro-firms	Micro-firms	Small firms	Medium-sized firms	Firms with staff from 101 to 250	Big firms
<b>Export share</b>						
<b>1996</b>						
The Economy – Total	490.7	295.5	470.7	351.8	338.2	639.5
Public sector	601.2	7096.1	630.4	322.0	318.6	670.8
Private sector	328.7	218.7	429.9	377.3	380.0	391.0
<b>1997</b>						
The Economy – Total	406.1	137.6	294.4	296.3	328.2	605.2
Public sector	580.1	324.3	386.9	276.1	311.7	685.6
Private sector	270.5	135.4	276.0	304.6	342.2	404.7
<b>1998</b>						
The Economy - Total	354.8	157.5	243.7	248.7	305.2	529.7
Public sector	522.4	391.9	276.6	267.0	286.9	608.8
Private sector	260.0	155.3	239.2	241.7	315.3	391.6

Table 9

Source: NSI and own calculations

**Labour productivity by industry branches (BGL thousand, 1996 prices)**

Industry	1996	1997	1998
Farming, forestry, hunting, fishery	339	361	208
Mining industry	709	576	462
Processing industry	534	451	339
Electricity, gas, water	1059	1185	1334
Construction	281	277	341
Trade and repair	540	309	241
Hotels and catering	254	200	246
Transport and communications	499	407	503
Finance, credit, insurance	-478	184	891
Real estate operations and business services	251	150	208
Education	499	112	182
Health care	553	69	143
Other services	266	159	250

Table 10

Source: NSI and own calculations

### **3. Major aspects of the national policies on SME promotion**

#### **3.1. Government policy with respect to SME**

In the first years of transition to market economy Bulgaria did not practically have any government policy for the promotion of SME development. With the years isolated activity took place, failing though to follow one common strategy and with very little efficiency. As concrete example here may serve the missing normative system to regulate SME activity, or the inefficiency of the "Small Enterprises" Fund. In reality consistent government policy for the promotion of SME became an issue as late as in 1997. Apart from the introduction of regulatory framework for SME sector the period saw the establishment of the institutional setting to formulate and pursue government policy with regard to SME, also National Strategy for the Development of SME was adopted in 1998. Our country joined in EU programmes for the promotion of SME, the process of harmonisation of our legislation with the Acquis Communautaire was initiated.

An SME Agency under the Ministry of Industry was established in 1997 as a state body, which supports the development and implementation of state policies on SME promotion. An SME Act was adopted in September 1999. Its enactment changed the statute of the SME Agency, which was transformed into a body under the Council of Ministers.

An Advisory Board for SMEs was established by virtue of the SME Act as a consultative body, comprising state and non-governmental organisations. The Advisory Board includes representatives of ministries, chambers of commerce, unions and branch associations with SME promotion as their main task. Its main objective is to contribute to the elaboration of the SME policy, development of SME support measures and business impact assessment.

ASME co-ordinates the establishment of a partnership network of state, governmental and non-governmental institutions and economic organisations, aimed at the achievement of a synergy effect in SME promotion. This network involves business centres, technological parks, business incubators and innovation centres. It facilitates the dissemination of data and information, related to tenders, programmes, projects, training and external financing opportunities. The SME Agency, jointly with the National Statistical Institute, has been preparing a preliminary study and analysis of the SME sector.

#### **3.2. National Strategy for Promotion of SME Development and Work Programme for its Implementation**

The main purpose of the National Strategy is to establish a favourable institutional, regulatory, administrative, financial and competitive environment enhancing the development of SMEs in Bulgaria. Its implementation is anticipated to result in:

- Development of private ownership, free competition and entrepreneurship;
- Job creation through relatively low capital investments;
- Development of managerial skills of entrepreneurs;
- Improvement of the export potential of SMEs;
- Introduction of high-tech sectors;
- Investment promotion in the SME sector;
- Europeanisation and internationalisation of the SME sector.

The National Strategy includes a set of specific measures for promotion of the small business, aiming at the following priority objectives: facilitation of the **administrative and legal framework on SMEs**; improvement of **financial services** rendered to SMEs; improved **competitive environment and competitiveness** of SMEs; **Europeanisation and internationalisation** of the sector. The Strategy outlines the role of legislative and executive authorities, as well as their co-ordinated actions towards its implementation. The key role is assigned to the SME Agency, which is charged with the drafting, regular updating and implementing of the Strategy. An integral part of the National Strategy is the Work Programme for its implementation. The Work Programme, defining the approaches for attaining the objectives of the National Strategy on SME development, provides measures for establishing an SME favourable environment, along with a series of programmes with specific short-term and mid-term (1999-2001) initiatives in the following areas:

- Improvement of the legal environment for SMEs;
- Provision of access for SMEs to financial sources and venture capital;
- Diversification of the services designated for SMEs;
- Dissemination of information on development programmes, existing and newly emerging partnership networks, R&D study reports, innovations and opportunities for technology transfer;
- Support to the existing and establishment of new training centres;
- Regional and branch programmes for existing and newly emerging SMEs, taking into consideration their specific characteristics;
- Programme for micro crediting and collaboration with donor organisations.

### 3.3. Major SME support policies

#### 3.3.1. Improvement of the regulatory and administrative environment

The legislation in force so far, as well as the new laws enacted recently, have produced twofold effects on SMEs – while the legislation certainly makes considerable steps forward in many regulatory areas, it at the same time sometimes introduces new administrative burdens for SMEs. The experience of the EU Member States shows that the task for improving the regulatory and administrative environment is a continuous and a long process in which there has to be consistency and perseverance. Thus, the current legal framework in Bulgaria needs to be reviewed, and impact assessment has to be carried out of the legislation in force as well as of drafts, and amendments have to be introduced in order to create an overall environment favourable for the business development

The measures, which the government has already taken to achieve this aim are as follows. Public procurement procedures have been streamlined by the new Public Procurement Act /1999/. The new Statistics Act /1999/, envisages the introduction of a unified identification number for the registration of the economic and other legal entities in Bulgaria. The Currency Act /1999/, changed the payment regime and abolished some restrictions on the export and import of foreign currency in cash.

The National Standardisation Act entirely repealed the mandatory statute of the Bulgarian Standards (approximately 13,000) and thus, SMEs in general, have been relieved from the obligation to observe rules, some of which have not been adjusted for decades.

The Government launched last year the process of review and consequently of simplification or abrogation of the various license and permission regimes. 93 such regimes with direct impact on entrepreneurship have already been abolished or simplified. The Government also suggested a detailed analysis of the acts on the local governance, in view of the fact that small and medium-sized businesses often meet with local bureaucracy.

ASME has initiated a review and simplification of the administrative procedures for obtaining licences, permissions, registrations and other forms for authorisation for carrying out business activity. The introduction of "one-stop-shop" system will considerably reduce the cost and time of entrepreneurs and therefore ASME is working on a pilot project for its implementation.

### 3.3.2. Employment Policy

The Ministry of Labour and Social Policy and the National Employment Service managed to establish a countrywide institutional network of Regional Employment and Labour offices, supported also by Regional Employment Councils consisting of state and civil organisations. Through this network the Government implements national projects and regional employment programmes with the support of national and international funding. Under the agenda of the forthcoming update of the Government's Programme 2001, the National Council of Tripartite Co-operation shall discuss measures and initiatives related to the problems of unemployment, poverty and children.

### 3.3.3. Financing Policy

External financing is crucial for the development of SMEs, but the access to such financing is strongly restricted by the stringent bank legislation. Regardless of whether the credit resource in question is part of the bank's own cash assets or is provided under credit lines and programmes through intermediary banks – agents, the major barriers for the access of SMEs to credits are the complicated banking procedures and the inability of SMEs to provide the collateral required by the Act on Banks, as well as the regulations of the Bulgarian National Bank. (For instance a mortgage on real estate, adequate pledges on fixed assets or state securities, etc.)

The end of 1998 and the early 1999 marked the start of the first consistent actions towards alleviating the procedures for improving the access of the small and medium-sized businesses to credit resources. They created opportunities for applying new financial instruments, including micro crediting programmes.

The main factors influencing the process of crediting SMEs include:

- Restrictive acts and regulations related to the Currency Board agreements;
- Discrepancy between official accounting reports of SMEs submitted to the tax authorities and the actual financing position of SMEs;
- The absence of skills and experience of the entrepreneurs to manage investment projects;
- The attitude of bank officers towards SMEs is an additional obstacle to crediting;
- Credits are solely short-term and are guaranteed by highly liquid assets (securities, bonds, etc).

A Promotional Bank was established upon initiative of the Bulgarian Council of Ministers in the beginning of 1999 as a state-owned bank. The priority target group of the bank are the medium-sized enterprises and in particular the production and export oriented ones. The Promotional Bank operates strictly on a commercial basis. Like the existing Micro-Credit Scheme (financed by KfW), the advantage for the entrepreneur of a medium-sized business is not necessarily a low interest rate, but the opportunity to work together with a bank that is committed to SME. The Promotional Bank provides long-term credits, a product that is rarely offered to SME in Bulgaria.



### 3.3.4. Financing through investment funds

Investments through venture funds in Bulgaria are made via the acquisition of shares of company against the investment made. The financing institution obtains the right to participate in the company management with the objective to minimize the risk. Most often the investment is made for a period of 5 to 10 years, after which the investors sell their shares to the major shareholders or on the stock exchange.

A guarantee scheme of the United Bulgarian Bank /UBB/ is under preparation in accordance with an agreement between the USAID and the Bank. The Agency for Small and Medium-Sized Enterprises, the State Agency for Energy Efficiency and UBB signed a cooperation agreement for the implementation of the scheme. The amount of the guarantee provided is 6 mln. USD for credits to SMEs for the period until 2004 and respectively 6 mln. USD for credits for energy saving projects for the period until 2006.

### 3.3.5. Participation in the privatisation process

The Privatisation Programme for the year 2000 takes into account that the process of privatisation and economic decentralisation is an integral part of the strategy for development and enhancement of SMEs' competitiveness. The SME Act provides for preferential participation of SMEs in the privatisation of separate parts of state-owned and municipal enterprises and unfinished construction sites. The preferential terms and conditions involve a rescheduled payment of the price within a period of either 3 or 5 years, with an initial instalment of respectively 50% or 30% on the price at the contract's conclusion. In case that an SME is the only potential buyer of shares and stakes of state or municipal ownership, it is entitled to the same incentives provided by the management buy-out procedure: an initial installment of 10% of the price, a 10-year rescheduled payment of the balance and an one-year grace period.

### 3.3.6. Regional Policy

In the context of regional development policy, SMEs are considered mainly as an instrument for the accomplishment of its particular goals.

The result of the regional development legislation (in particular the Regional Development Act and the Regulations on the Organisation and the Activities of the Regional Development Council with the Council of Ministers and the District Development Councils), has been the improvement of the institutional framework for regional development policies' implementation and the creation of better conditions for co-ordination and partnership, along with the greater opportunity for consideration and protection of SMEs' interests in the preparation and implementation of regional development plans. SMEs organisations have been offered the possibility to be represented in regional development councils. Besides the newly established councils, the responsibilities for the preparation and implementation of the National Plan for Regional Development (NPRD) are shared among institutions and units on national (the Council of Ministers, the Ministry of Regional Development and Public Works, other ministries and agencies), district and local levels.

The key instrument for the implementation of the regional development policies pursuant to the Regional Development Act, is the National Plan for Regional Development over a 7-year period. The first National Plan for Regional Development (2000-2006) was adopted by virtue of Decree of the Council of Ministers (DCM) No.208 of 1999.

The National Plan for Regional Development outlines three objectives further elaborated by the district development plans: the creation of conditions for a sustainable and balanced development of the individual regions; mitigation of regional disparities in the spheres of unemployment, income and the opportunities for development and opening to international and cross-border co-operation as a means to solve regional and local development problems.

Strong emphasis has been attached to the role and mechanisms to co-ordinate sector policies in view of resolving regional problems. The NPRD is being perceived as an aggregate on three levels of elaboration, co-ordination, adoption, implementation, control and updating of development plans, respectively of particular projects and programmes incorporating SME development programmes, the set-up of entrepreneurship promotion centres, etc. The plan proposes standard measures differentiated by regions of target intervention, covering also SME promotion, especially in the regions in need of diversification in the economic structure (less developed rural regions and regions in industrial decline).

### **3.3.7. Provision of information and consulting services**

The SME Agency developed its Information Strategy in 1999 with the major objective to establish an information system providing timely and reliable information about the standing and problems of the SMEs. This system encourages the process of alignment of SMEs with European and international business practices, and facilitates their access to information on international training programmes, international markets and foreign partners. It is the catalyst in establishing partnership networks and in the exchange of experience. The system is the necessary medium for discussions and information exchange. The consulting assistance for the SMEs focuses mainly on their access to credit resources from credit lines, banks, specialised financial institutions and funds; the SMEs are provided with timely information about the financing terms and conditions of the specific programme, credit line or loan.

### **3.3.8. Policies on enhancing SMEs' competitiveness**

In 1998, the Parliament passed the Export Insurance Act. The Act regulates the statute of the Bulgarian Agency for Export Insurance, Inc.. The Bulgarian trade offices abroad facilitate the exports of SMEs and assist them to establish contacts. Regular initiatives and presentation events are organised there, thus promoting and facilitating the export of Bulgarian goods and services to foreign markets.

A series of measures for the enhancement of SMEs' competitiveness has already started. They involve: incentives to the introduction of quality assurance systems (applying the procedures of the ISO 9000 series of standards); recognition of European rules of business culture and ethics; encouragement of environmentally friendly production (ISO 14000); access to modern technologies and R&D achievements.

### **3.3.9. Tax policies in the SME sector**

The tax policies implemented aim at maintaining the country's financial stability. Positive examples of changes in the tax regime are the decreased tax rates, the depreciation deductions, etc. As of 1 January 1999 the rate of the corporate income tax was decreased from 30% to 27%, while the VAT rate went down from 22% to 20%. The Government plans to reduce from the beginning of 2001 the corporate income tax further to 20% for big companies and to 15% for small companies.

Small companies with a turnover up to 35 000 euro are entitled to pay a patent /flat rate/ tax in three installments per year being relieved from double entry book-keeping.

#### 4. Conclusions

The general opinion about state policies on SMEs is moderately positive and supportive. The predominant opinion is that the weakest aspect of the policy is SME financing, basically due to the restrictive credit policies of the commercial banks, i.e. not directly related to state policies. The estimates of the policies on information and consulting services for SMEs are often controversial – they vary from “good” to “unsatisfactory”. The criticism is mainly directed to the lack of easily accessible and reliable information about the general economic and market environment.

We should note that the problem is of national significance not solely for SMEs, but for all businesses. Concerning sector policy, the priority sectors need to be identified and particular measures for the development of SMEs in these specific sectors should be undertaken.

A controversial question, having initiated many debates recently, is whether SMEs should enjoy any preferences and if so, what will they be. Some have no definite opinion on the matter, others consider that preferences should not exist and the principle of equality has to be retained, while favourable macroeconomic environment for the business in general, needs to be created. However, some people consider preferences as essential, especially in crediting; in taxation (even a tax holiday for SMEs has been suggested), especially for high-tech companies and technological parks.

It should be pointed out again that for the transition countries it is little so important than the development of the SME sector. The SME development can be achieved only by making our countries more entrepreneurial and innovative.

Major elements of the future SME support strategy should include the following key issues:

- the creation and strengthening of financial intermediaries /banks, equity or risk capital funds, seed capital funds, etc./ to better support SMEs;
- broadening of the technical assistance aimed at covering the needs of SMEs;
- strengthening the links between governmental officials, SME organisations and donors in favour of result-oriented policy;
- business impact assessment.

Having in mind the **globalisation of the market and the emerging new information society** there is a need for speedy diffusion of new technologies, the latter can be provoked by:

- support and better use of innovation by creation of new managerial skills and improvement of the attitude towards creativity, by marketing new products with the help of SMEs and improving the knowledge and competence of the people, by better financing of innovation – seed capital, reduction of taxes, development of more effective business plans;
- Government efforts to liberalize and de-regulate markets for products and services and the most important – to simplify procedures for licensing. Introducing the “one-stop-shop” system for registering new companies /reducing time and cost/;
- Consistency in legislation.

**Improvement of knowledge /science and technology/** can be accomplished through:

- better education;
- establishment of research centres with the universities in close cooperation with SMEs as way to commercialise new ideas;

In order to create a workforce capable to meet the challenges of the future in the field of **education** there is a need to make available the use of computers in schools and to provide daily access to internet.

**Easier access to financing** can be assured through:

- seed capital for start-ups especially for high –tech companies;
- business angels;
- venture capital funds;
- reduction of the tax burden in case of R&D;
- acceleration of the tax depreciation and investments in case of R&D.

The current state policies on SMEs certainly need further improvement, particularly in certain aspects like financing, crediting and taxation, as well as in the simplification of administrative procedures. It is critical to ensure good co-ordination, when formulating specific targets, objectives and priorities for their realisation in line with the changes of the economic environment. Another key to the success of SME policies is their timely implementation. Thus, the flexibility needed will be achieved; the tendency for fragmentary and contradicting measures in some areas will be eliminated, hence a better ultimate effect will be attained.

## Romanian SMEs

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Director of International Comparative Management Center  
President of National Council of Romanian  
Private Small and Medium Enterprises

### 1. Introduction

In this paper we focus on three objectives :

- 1) To present the Romanian SMEs situation in the framework of the transition to the market economy
- 2) To reveal the main characteristics of the Romanian entrepreneurs
- 3) To outline the possible actions to enhance the competitiveness of Romanian SMEs through innovation in the context of the evolution to the knowledge based economy

In order to obtain this objective we have structured the paper in three parts :

#### a) **Situation of Romanian SMEs regarding :**

- the evolution of the SMEs number during 1991 – 1999
- the distribution of the SMEs by sectors
- the comparative situation of SMEs registered and, respectively, SMEs worked
- the structure of SMEs turnover and employees by branches
- the main negative factors and threads for SMEs
- the main SMEs resources and opportunities for SMEs

b) **Characteristics of the Romanian entrepreneurs**, based on the empirical investigations, did by us together with Cambridge University and DePaul University Chicago, from the following point of view :

- age
- sex
- education
- experience
- motivation
- working time
- priorities for the next 2 years

c) **Ways to enhance the competitiveness of Romanian SMEs** through innovation based on the holistic approach. The main aspects are the following :

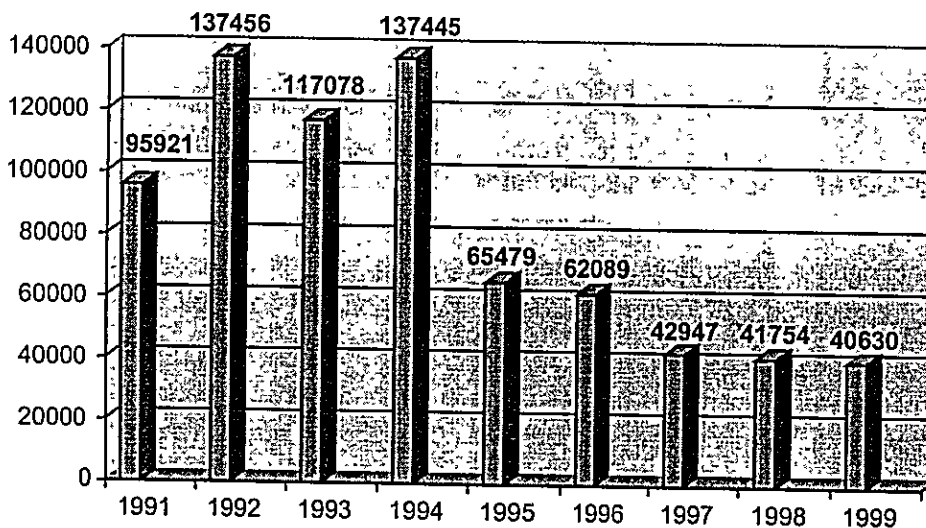
- the necessity of the SMEs holistic approach

- the Romanian priorities for SMEs
- the relation between global and economic national strategy – national strategy for SMEs development – specific policies for enhancing the innovation in the SMEs
- the strategic objective for SMEs development
- the concrete actions for enhancing competitiveness of SMEs through innovation
- the suggestions for Japanese involvement in Southern Eastern Europe in the SMEs sector
- the strategic recommendations for SMEs development in Romania

The last part reflects the main elements included in the Romanian strategy for EU integration

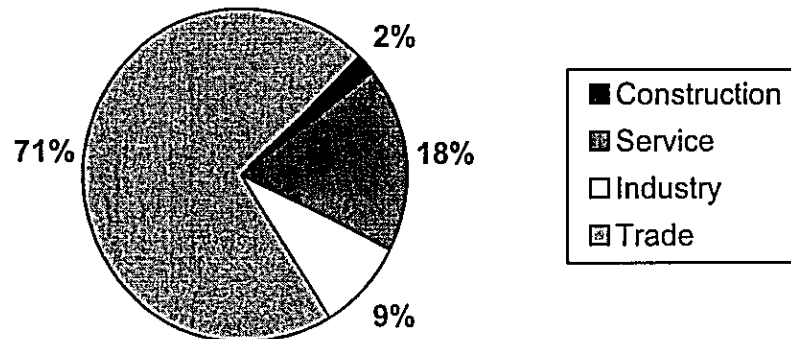
## 2. Situation of Romanian SMEs

### Number of the new SMEs



Graph 1

## Distribution of SMEs by sectors



## ROMANIAN SMEs SITUATION

SMEs – REGISTERED	760,600
SMEs – WORKED	401,326

## SMEs by sector

Sector	SMEs	
	Turnover (%)	Employees (%)
Industry	34.9	63
Agriculture	97.4	97
Constructions	94	86
Trade	62.9	90.1
Tourism	99.5	99.6
Services	94.5	90.7

### 2.1. Main negative factors and threads

- Difficult SMEs access to the unused spaces and equipment in state companies
- Difficult SMEs access to the credits and, mainly to the development (investment) credits
- Relatively high level of the fiscality
- Absence of the investment, development and export incentives for SMEs
- Private SMEs discrimination against state and public companies
- "hard" bureaucracy regarding the SMEs foundation and the "liquidation"
- Very low level of the SMEs guarantee fond
- Occasionally business contracts for the romanian entrepreneurs with foreign businessment
- Negative impact of the "certain" government and local administration decisions and actions on the SMEs
- Difficult SMEs access to the internal and foreign business information
- Partially lack on the managerial and business training for the entrepreneurs
- Excessive controll on the SMEs activities
- Incomplete and fluid contradictory legislation regarding SMEs activities
- Economic culture of the population not enough favorable to the SMEs and the entrepreneurs
- SMEs non-governmental not enough strong to promote and project specific entrepreneurs interests

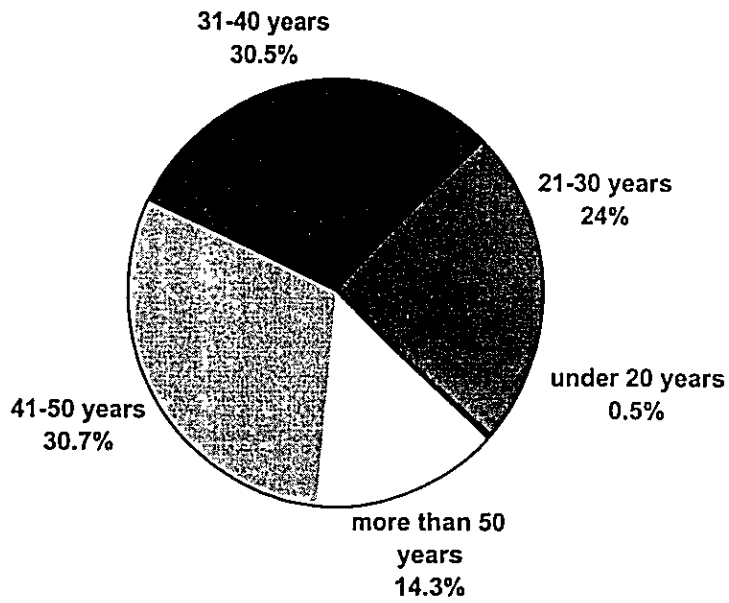
### 2.2. Main ressources and opportunities

- About 40% of the state companies spaces and equipment are not used
- The most part of the romanian entrepreneurs are hard working persons and available for large efforts
- Good education level of the romanian population
- Important indigenus natural resources oil, gas, coal, forest, water, sulfa a.s.o.
- Outstanding natural conditions for the agriculture and tourism
- Relatively large internal market – 23 millions inhabitants
- "interesting" geo-political position of the romania – placed at the crossroads of the european communications ways
- Good level of the educational and training system
- Numerous R&D institutions and centers
- Credits lines offered – especially for the import-export activities – by the international banks (BERD, World Bank a.s.o.)
- Low interest credits for the companies which hire jobless persons
- New created financial institutions (American-Romanian Fond a.s.o.)
- EU assistance programs for SMEs



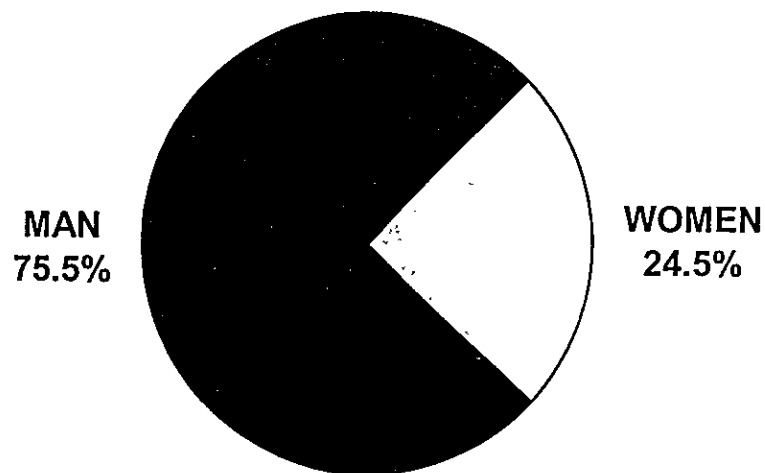
### 3. Main Characteristics of the Romanian Entrepreneurs – Results of Empirical Investigations

#### AGE



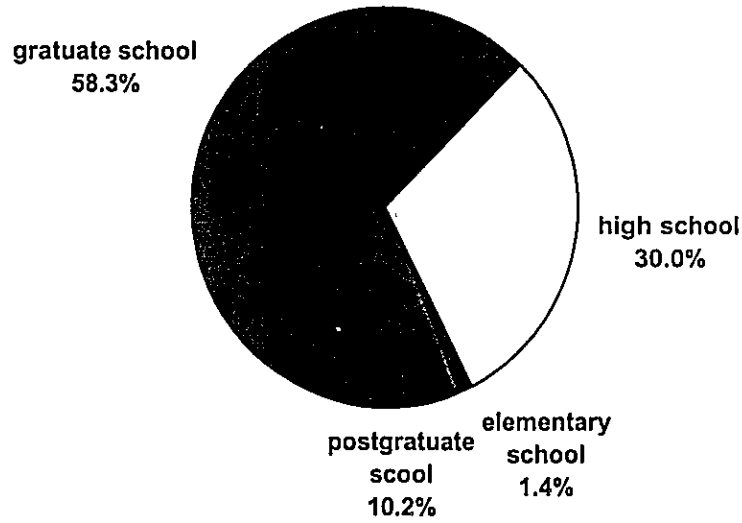
Graph 1

#### SEX



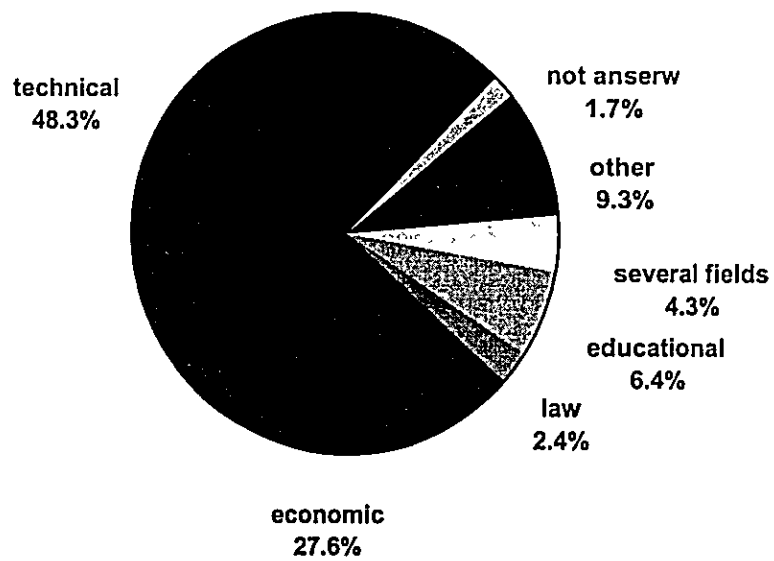
Graph 2

### TRAINING



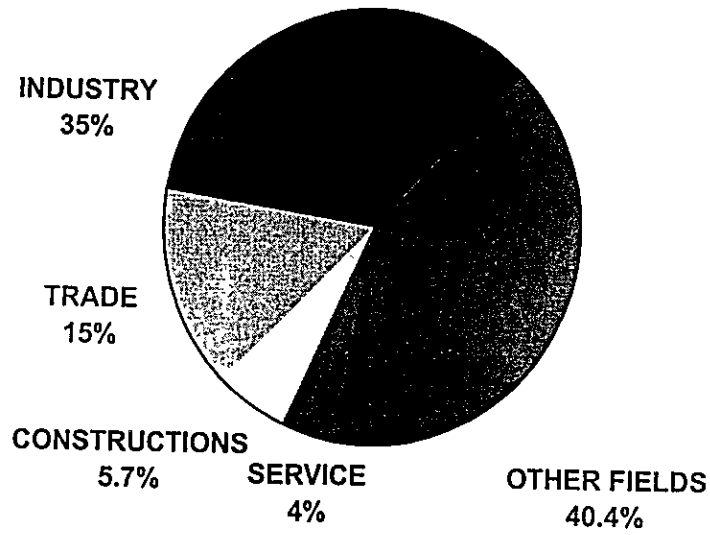
Graph 3

### EDUCATIONAL FIELDS



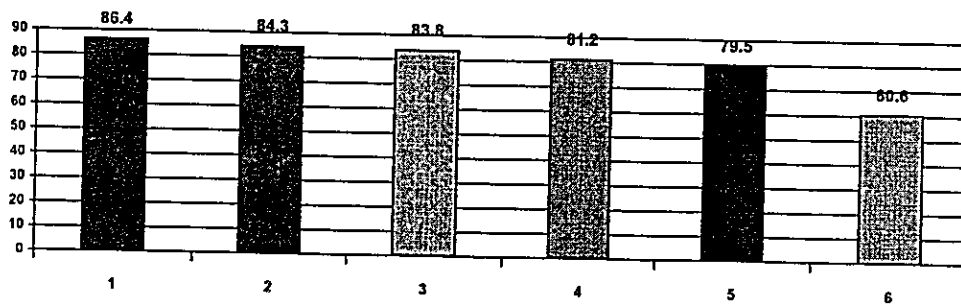
Graph 4

### FIELD PRIOR TO THE PRESENT BUSINESS



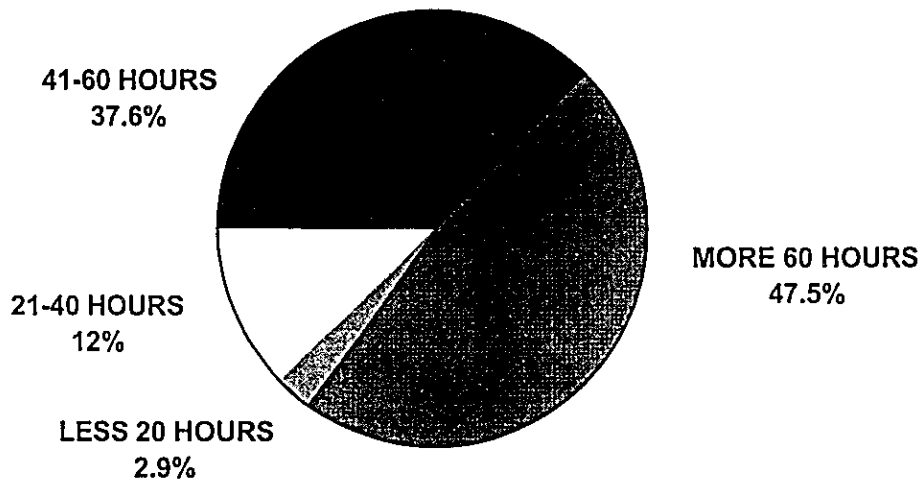
Graph 5

### Motivation for becoming and entrepreneur



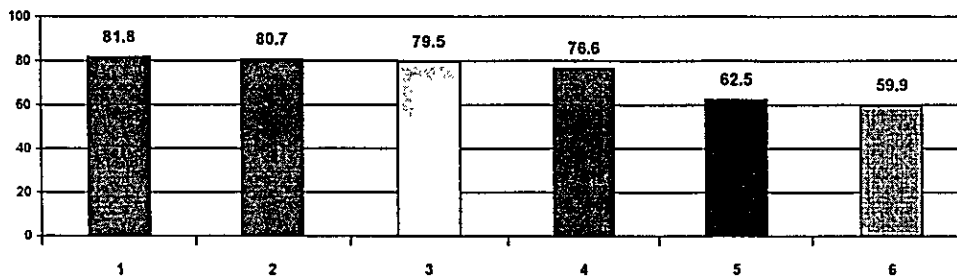
- 1) Development and application of an idea, a product, or a business
- 2) Work with selected persons
- 3) Personal and family security
- 4) Self-achievement
- 5) Better earnings
- 6) Contribution to the welfare of the community

### AVERAGE WEEKLY WORKING TIME



Graph 6

### Priority directions of action in the next 2 years



- 1) Adding a new product, service
- 2) Selling in a new market
- 3) Hiring of specialists
- 4) Acquisition of a new equipment
- 5) Development of MIS
- 6) Using of professional consultants

**"Robot" portrait of the Romanian exporter entrepreneur**

- Married man
- Engineer
- 46 years
- Long work experience (26.5 years)
- Foreign language speaking - average 2
- Development oriented – average 2 postgraduate courses
- Large foreign experience – average 16 foreign professional and private trips

**4. Enhancing the Competitiveness of Romanian SMEs through Innovation based on the Holistic Approach****4.1. Premises**

SMEs problems are very

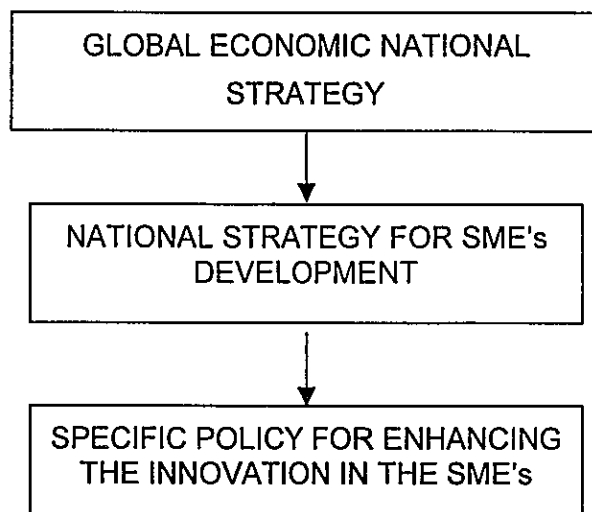
- heterogeneous
- complexes
- dynamic
- intercorrelated

SMEs problems needs a **holistic (systemic) approach** in each country based on:

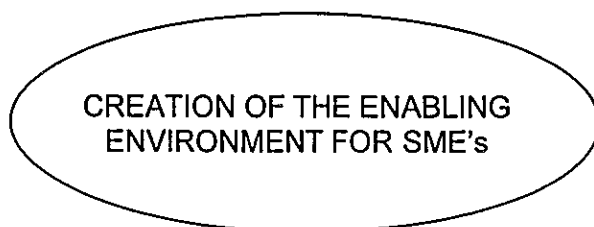
- Specific conditions on every country
- Implications of the internationalization and globalization
- Requirements of the next knowledge based economy

#### 4.2. Big danger in CEE

TO FOCUS ON THE PRIVATIZATION AND RESTRUCTURATION, NEGLECTING  
SME's DEVELOPMENT



#### 4.3. Strategic objective



#### 4.4. Concrete actions for enhancing competitiveness of the SMEs through innovation

Improvement of the **SMEs management** through:

- Management consulting centers
- Management training programs for entrepreneurs
- Incubators

Increasement of the **financial stimulents** for innovative SMEs:

- Seed capital
- Special credits
- Taxes reduction

Development of the **intrapreneurship** within large enterprises:

- Juridical aspects
- Economical aspects
- Managerial aspects

Achievement of the effective **information network** for SMEs:

- Regional level
- National level
- International level

Development of the **intrepreneurial culture**, especially for the young generation:

- High school special intrepreneurial courses
- University special intrepreneurial courses
- Mass media intrepreneurial actions financed by state

Assistance to the **SMEs organizations** for developing:

- SMEs networking
- Intrepreneurial services
- Enabling environment

Involvement of the SMEs representants in all major **governmental economic bodies**:

- National level
- Regional level
- Local level (Social dialogue it is not enough)

Transfer of the **aquis communitaire** to the CEE SMEs:

- Legislation
- Institutions
- Business approach and methods
- Specific measurement for stimulating SMEs

#### 4.5. Suggestions for Japanese involvement in southeastern Europe

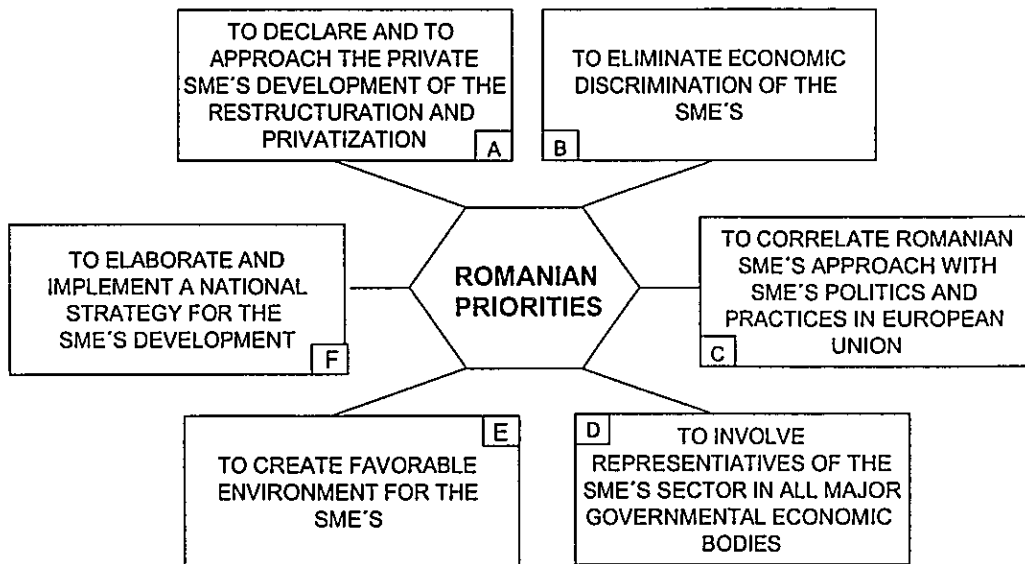
- Southeastern Japanese revolving fund to promote Japanese technology in the SMEs from this area
- Japanese center for the promotion of the Japanese investment in southeastern Europe countries
- Project to realize a system to interconnect the business information banks from southeastern Europe countries and Japan
- Project to develop constanza port area as a regional port to develop southeastern Europe business

#### 4.6. Strategic Recommendations

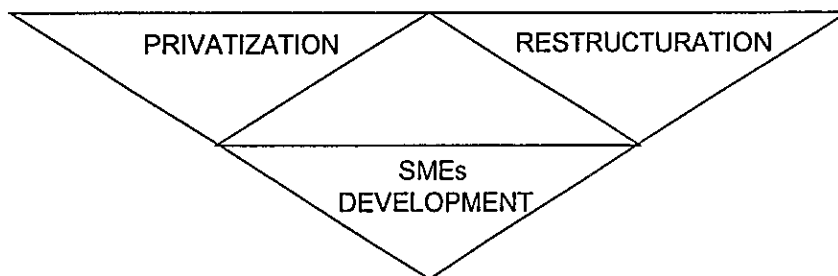
- Access of the private SMEs by leasing, renting, buying the state companies spaces and equipment
- Differentiation of the profit taxes, according to the SMEs branch, age and profit size
- Reduction of the profit taxes on the profit reinvested
- Financial assistance for the SMEs which are exporters of local products and services
- Fiscal facilities for the SMEs which invest in the unfavorable areas
- Conversion of the One State Bank in the Investmentbank for SMEs
- Creation of the Guarantee Fond for SMEs
- Involvement of the entrepreneurs and SMEs
- Foundation of the specialized information bank for SMEs
- Organization of the comprehensive and permanent training programs for entrepreneurs and SMEs managers and specialists
- Introduction in the high schools and universities of the entrepreneurial management course
- Development of the powerful national R&D centers and training network for SMEs
- Allocation of the semnificative R&D state budget for the SMEs major problems
- Development of the incubators and industrial districts network
- Involvement of the SMEs representatives in the managerial bodies of the national and local administration
- Development of the intensive national program in mass-media focused on the improvement of the entrepreneurs image (as one of the main "actors" of the market economy) and status and for its perception
- Assistance to the SMEs non-governmental organizations development
- Improvement of the Romanian legislation regarding the SMEs activities, eliminating the present necorrelations and contradictions



### ROMANIAN PRIORITIES



### TRIANGLE OF MARKET ECONOMIC DEVELOPMENT



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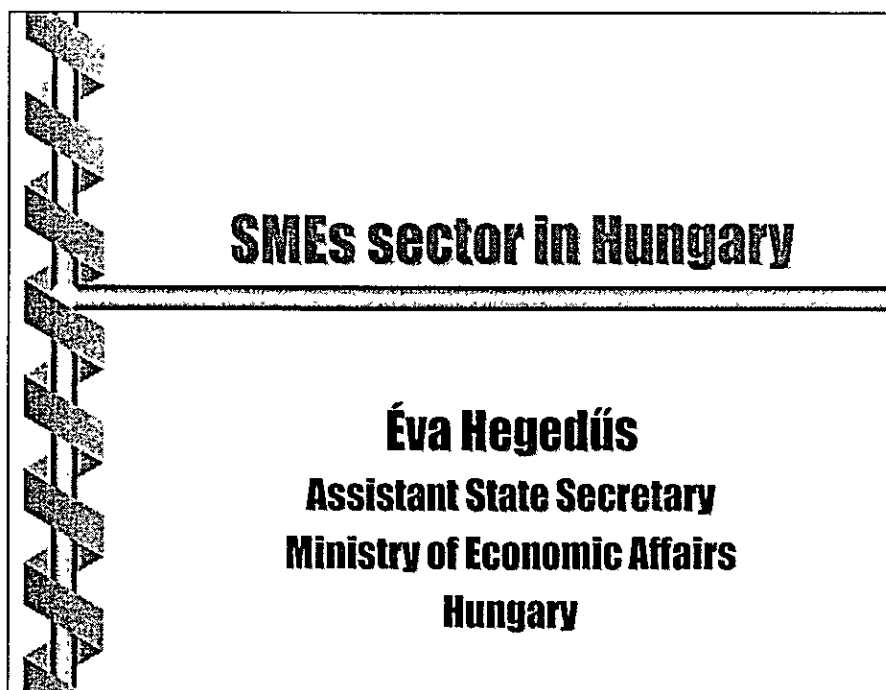
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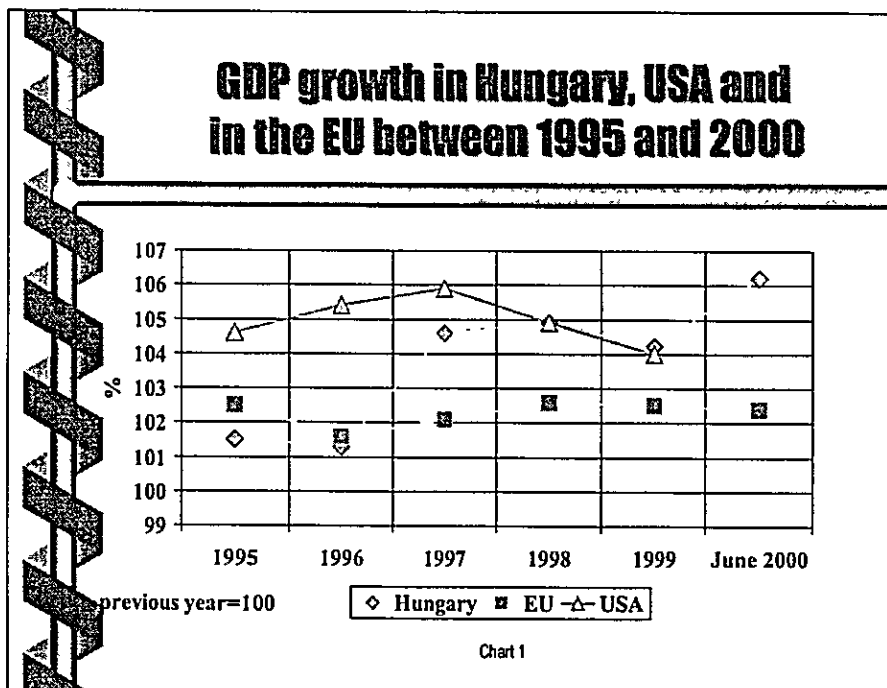
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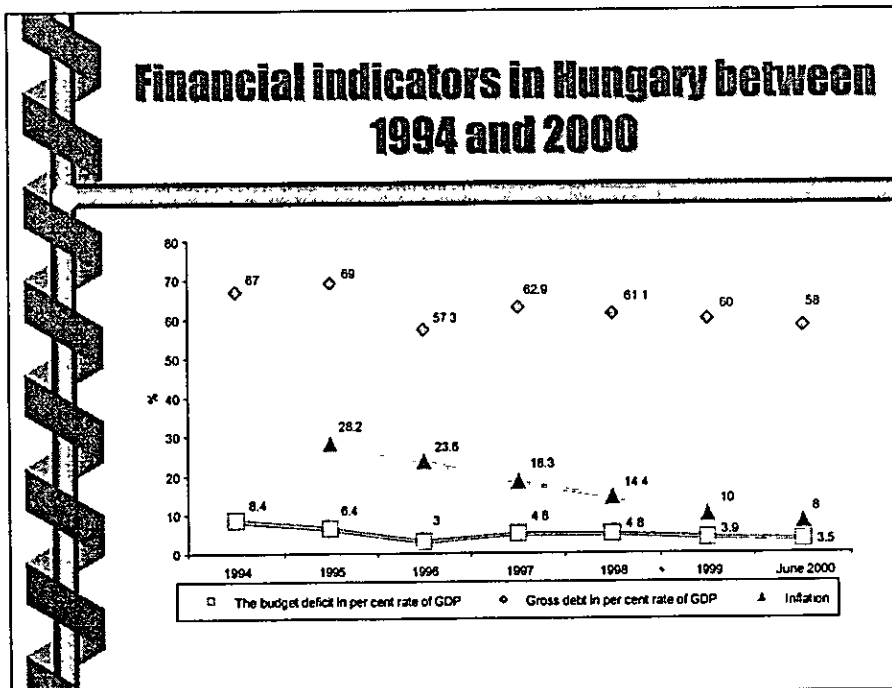
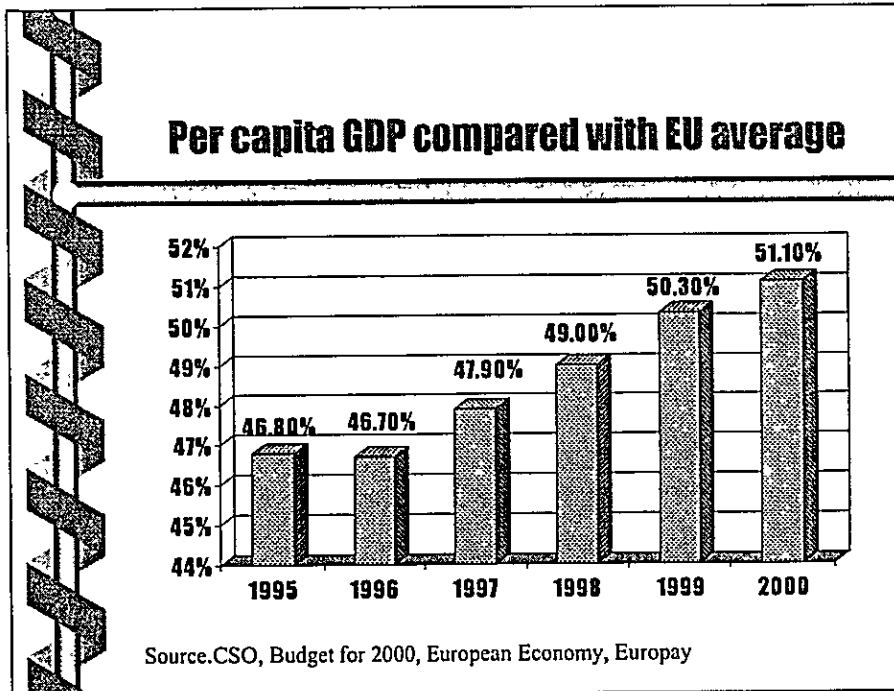
## **SMEs Sector in Hungary**

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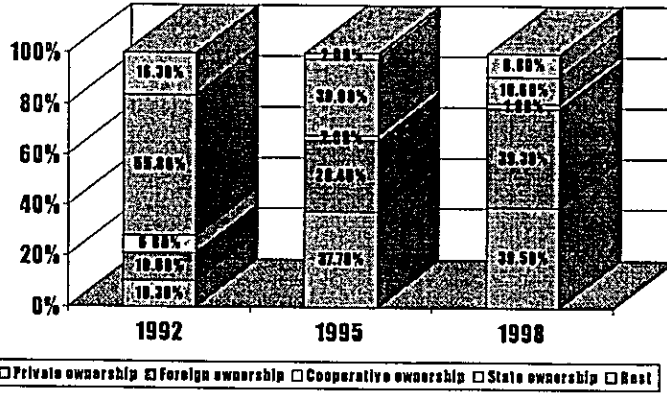
Ms. Eva Hegedus, Hungary  
Assistant State Secretary  
Ministry of Economic Affairs





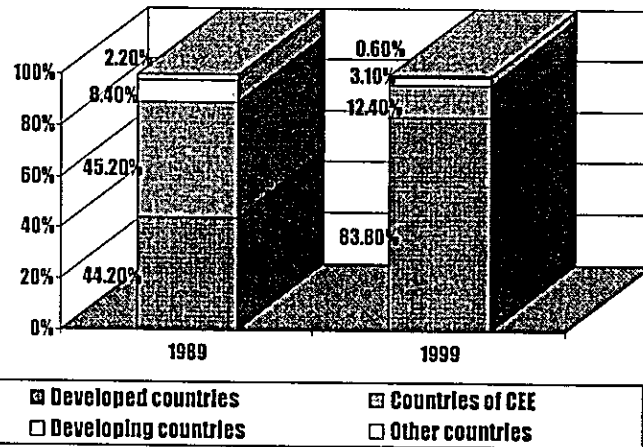


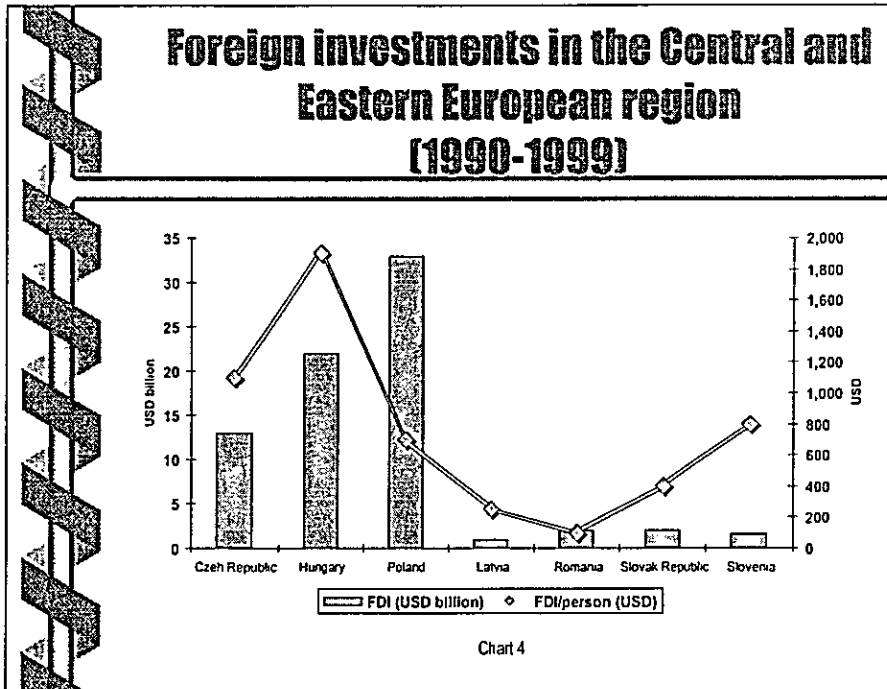
### Changes in ownership structure in the Hungarian economy



Source: Tax declarations

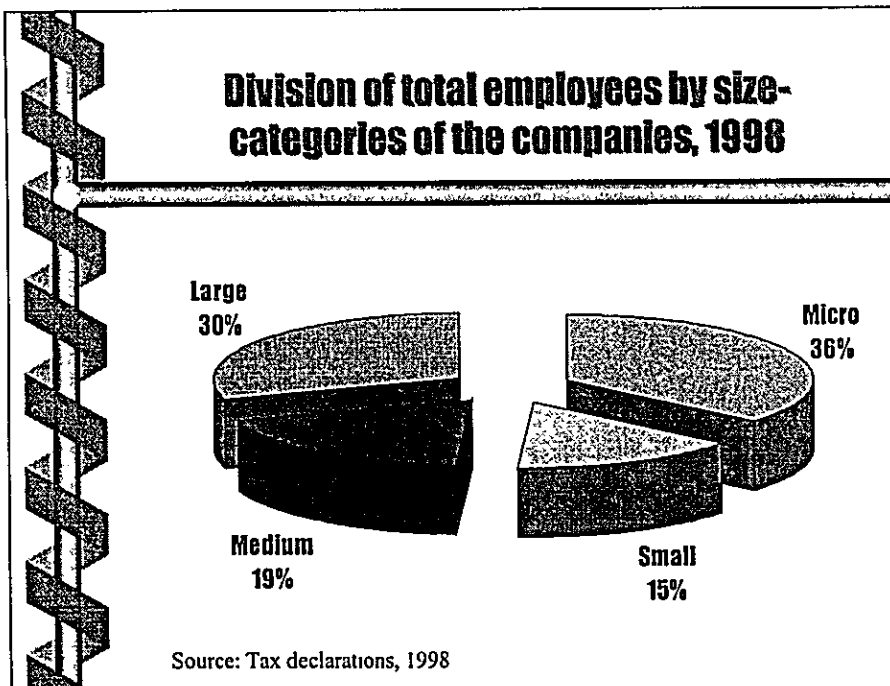
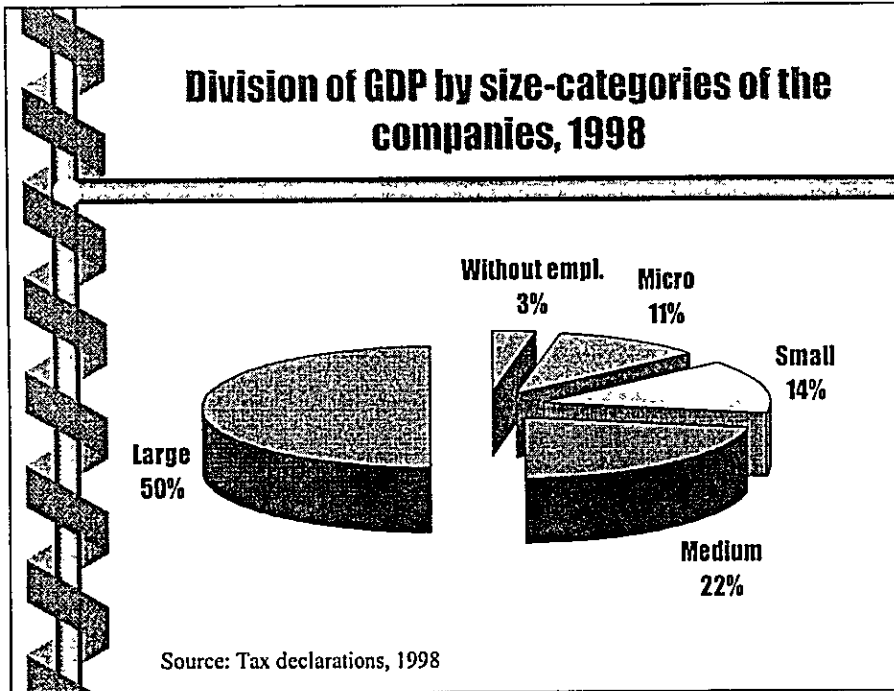
### Hungarian Export Structure



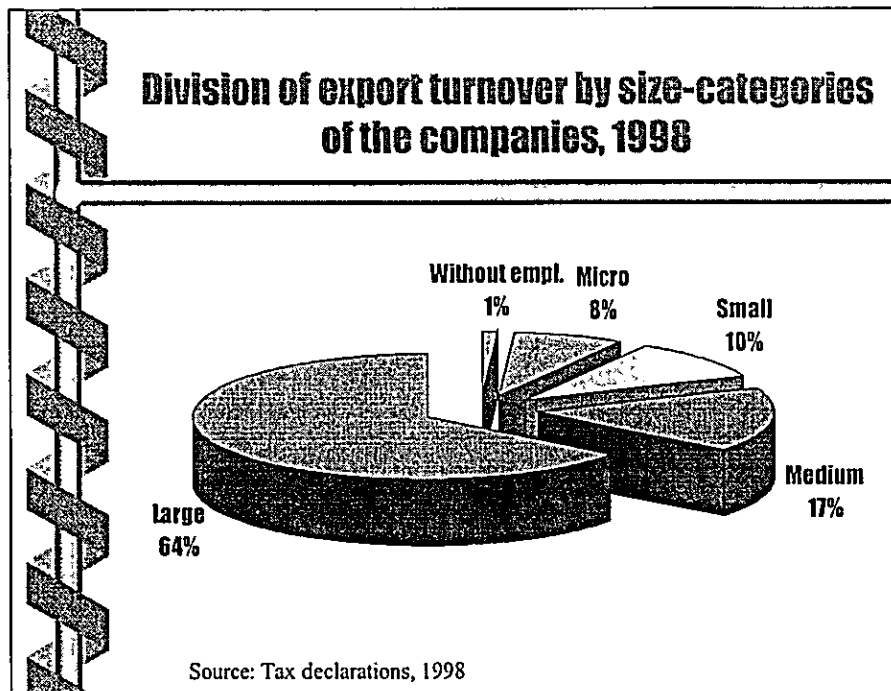


### Definition of small business

- **SME: total staff below 250 and net annual turnover max. HUF 4000 M or balance sheet total max. HUF 2700 M.**
- **Small enterprise: total staff below 50 and net annual turnover max. HUF 700 M or balance sheet total max. HUF 500 M.**
- **Micro enterprise: staff below 10.**







- ### Importance of SMEs
- **Employing the majority of workforce**
  - **Meet specific market needs**
  - **Innovative potential**



## **Typical problems of SMEs**

- **Weak own financial resources**
- **Low amount of assets**
- **Imperfect managerial skills**



## **Institutions providing financial support for SMEs**

- **Hungarian Foundation for Enterprise Promotion**
- **Credit Guarantee Co.**
- **Rural Credit Guarantee Foundation**
- **Hungarian Export and Import Bank**
- **Hungarian Export Credit Insurance Co.**
- **Hungarian Development Bank Co.**

## **Hungarian Foundation for Enterprise Promotion**

### **• Micro Credit:**

- staff less than 10 and turnover below 100M**
- max. HUF 3 M**
- NBH base interest rate**
- 0.5-3 years**
- min. 20% own source**

## **Credit Guarantee Co.**

- Supports mainly small enterprises**
- New guarantee exposure: HUF 30 bn in 1999**
- 90% guarantee if loan size below HUF 10 M**
- Fast process**
- Reduced fee (0.5%)**

## **Rural Credit Guarantee Foundation**

- **Created with PHARE aid in 1991**
- **Loans for agricultural activities**
- **70% budget guarantee**
- **Loans of HUF 16 bn guaranteed in 1999**
- **Max. HUF 8 M**
- **Total staff max. 25**

## **Hungarian Export and Import Bank Co.**

- **Refinancing credit extended to commercial banks for export promotion**
- **Customer credit to foreign banks with clients intending to purchase Hungarian goods**
- **Export financing credit extended directly to the clients**



## **Hungarian Development Bank Co.**

- **Loans for SMEs to create jobs (refinanced by EC Social Foundation)**
- **Loans for industrial and touristic investments (refinanced by EIB)**



## **Small Enterprise Credit Program**

- **Micro Credit (3 M) plus:**

**bank loan up to HUF 7 M  
guaranteed by Credit Guarantee Co.  
interest: max. 150% of NBH base rate  
interest subsidy (50% of NBH base rate).**



## Problems of Development of the SME Sector in Poland during the 1990s

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### 1. Development trends of the SME sector in the years 1990-1997

When observing the development trends of the Polish economy in the years 1990-1997 one can clearly distinguish two subperiods. The first one encompasses the years 1990-1994, when after the introduction of the principles of market economy industrial production in the state-owned enterprises started to abruptly decrease. The ineffective state-owned industry, producing in the era of the centrally managed economy the technologically outdated products, was no longer capable of responding to the competitive challenge after the opening up of the economy and the introduction of the internal convertibility of the domestic currency. There existed yet two other additional factors, which were decisive for the downfall of the state-owned enterprises. The first of these factors was the loss of the traditional sales markets,<sup>8</sup> primarily the eastern ones, where a number of products turned out in Poland had been sold before, like textiles, clothes, or shoes. The loss of these markets was related to the economic difficulties developing in the USSR, and, following the collapse of the USSR – in the Commonwealth of the Independent States (CIS). The second factor was the radical drop of the volume of governmental orders for the products of arms industry, in connection with the political transformations in the Central-Eastern Europe, leading to dissolution of the Warsaw Pact in 1991. The complete liquidation of a large number of the state enterprises and the decrease of production in the other ones entailed an increase in the unemployment rate from 6.5% in 1990 up to 16.4% in 1993 (16% in 1994). The unemployment rate would certainly have been higher were it not for the fact that a certain group of people having lost their jobs in the public sector acquired in the years 1991-1992 the right to earlier retirement pays, which, in turn, along with the necessity of paying unemployment benefits, was one of the major causes of the state budget deficit in the 1990s.

The sales of the state-owned and the co-operative enterprises, measured in comparable prices, decreased in 1990 by approximately 15% in relation to the preceding year, and by further 17% between the years 1990 and 1993. Yet, in spite of this decrease of sales of the state-owned and co-operative enterprises, manufacturing production remained in 1993 at more or less the same level as in 1990. This occurred owing to the activity of the small and medium sized private companies,<sup>9</sup> whose sales value in the period 1990-1993 almost doubled. Thus, countering of recession in manufacturing within the other divisions of economy is to a large extent the feat of the private small and medium enterprises (SMEs). It was just mainly owing to the activity of the SMEs that the gross domestic product (GDP), which decreased in 1991 considerably in comparison with the preceding year, increased in 1993 again to the level of 1990, and then exceeded in 1994 this level by 4%.

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<sup>8</sup> The economic difficulties caused by the severing of the former co-operation links were strongly felt not only by all the European COMECON countries, but also by, for instance, Finland, closely associated with the Soviet economy.

<sup>9</sup> For purposes of the present report the small firms will be understood to employ at most 50 persons (excluding owners and members of their families), while the medium-sized enterprise would be the one which employs between 51 and 250 persons.

The early stage of transformation,<sup>10</sup> taking place in the years 1990-1994, was characterised by the rapid growth of the number and significance of the SMEs, primarily in three domains: trade, construction, and manufacturing. In manufacturing, this growth was limited to a couple of rather more traditional branches, like food processing, garment, wood (especially furniture), printing (package and advertising leaflet printing), and construction materials industries. Of the more technologically advanced domains an exception was constituted by the precision industry, primarily owing to the companies assembling microcomputing equipment from the imported components and subassemblies. The directions of development of the SME sector in the early years of transformation are, of course, not a surprise. The period of real socialist economy left in our country an unfulfilled demand for quite elementary products and services, which started to be first of all satisfied by the private SMEs, more flexible than the large enterprises, which were, at that time, anyway, still largely state-owned. The SMEs searched for and occupied the appropriate market niches, especially there, where the technological processes were not too complicated, the capital necessary for establishment of an enterprise was not high, and the possibility of satisfying local demand made small-scale production profitable.

The early stage of transformation of Polish economy ended more or less in 1994. Starting with this year Polish economy began to grow at a rapid pace. Investment outlays of the private sector outside of agriculture<sup>11</sup> increased from approximately 4.8 billion US dollars in 1994 to 12 billion USD in 1997, namely by the factor of 2.5. The investment outlays borne by the SMEs rose from 3.3 billion USD to almost 7.5 billion USD, which was caused, in particular, by the intensive inflow of foreign capital. In the new economic conditions the role of the SME sector changed somewhat in comparison with the preceding period. This, however, did not slow down the development of the SME sector, but rather contributed to the change in the directions of expansion of the small and medium enterprises.

The number of the actually functioning, i.e. the so-called active<sup>12</sup>, SMEs increased in the years 1994-1997 by slightly more than 42%. Yet, in particular domains of economic activity the rate of increase of the number of active SMEs differed significantly. It can be generally stated that in the years 1994-1997 the rate of increase of the number of SMEs in the traditional domains of economy was significantly lower, while it was much higher – in relative terms – in the areas with domination of service. Thus, in the period between the years 1994 and 1997 the number of SMEs in manufacturing increased by 23%, and in trade – by slightly more than 31%. These two domains – side by side with construction – were in the period 1990-1993 among the most rapidly developing sectors in Poland as to the number of active SMEs. In distinction from manufacturing and trade, the SMEs in construction have been still developing dynamically after 1994. Their number in the three-year period analysed increased by as much as somewhat more than 70%.

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<sup>10</sup> The statistical data characterising the development of the SME sector in the years 1990-1993 are, regretfully, quite limited, for two reasons. First, the more systematic and methodologically correct study of the SME sector, carried out, in particular, with the representative method, were initiated by the Central Statistical Office (GUS) only in 1993. Second, the classification of the national economy, applied by GUS until 1993 was essentially different from the one introduced at the beginning of 1994, corresponding to the European standards. That is why the statistical data from before 1994 are to an extent incomparable with the ones from the later years.

<sup>11</sup> The data presented in this paper, concerning the SME sector in the years 1994-1998, were elaborated by GUS at the order from the Polish Foundation for Small and Medium Enterprises Promotion and Development, which finances its activity from the funds made available by the European Union (EU). These data were published before in the annual *Reports* of the Foundation concerning the state of the SME sector, and in four publications of RECESS, where they were considered in greater detail than in the Reports mentioned. All the information on the SMEs provided in the present paper will not account for the enterprises active in agriculture, forestry, fishing and fishery, and in case of data concerning the functioning SMEs – also in financial intermediation

<sup>12</sup> The notion of „active SMEs“ is used in order to make distinction with the SMEs registered in the enterprise register maintained by GUS. A part of the registered enterprises (approximately one third) do namely not conduct any proper activity (either ended their activity altogether or never started it after having registered) and have not informed GUS of this fact. That is why the numbers of active and registered enterprises differ considerably, and the rate of increase of the number of registered enterprises does not have to correspond to the real processes taking place in the economy.



The primary cause for this rapid growth was the increasing demand for the construction service consisting in repairs and overhauling of various facilities, both meant for economic activity and for housing, which was on the one hand the result of the enormous repair needs inherited from the period of real socialism, and on the other hand – the effect of a good economic situation starting from 1995, with the related increase of the incomes of the society. In the years 1994-1997 the number of active SMEs in two typically service-oriented sections of the economy, namely in the so-called remaining service activity (the increase of the number of SMEs by approximately 56%), and in the estate and business service (increase by 65%) was growing fast. The development of the latter of the two domains should in particular be emphasised, as it encompasses the firms that provide service to other firms in such areas as technical and legal counselling, marketing, management, and computer service. As it is commonly pointed out by the specialists dealing with the role and significance of the SMEs in the economy, a long-term development – especially of the small enterprises – and a modernisation of their way of functioning are not possible without a strong sector of firms providing service to the other ones.

As mentioned already before, the number of the SMEs in manufacturing increased between 1994 and 1997 by 23%, while the number of all the active SMEs in the economy grew at the rate almost twice as high – by 42%. Yet, not all the domains of manufacturing were developing at such a relatively slower rate. And so, for instance, the number of manufacturing enterprises of medium size increased<sup>13</sup> in the period 1994-1997 by approximately 30%, while the number of all the medium-sized firms in the economy increased only by a little more than 20%. This rapid growth took place, in particular, owing to the inflow of foreign capital to industry. In the group of the smallest industrial enterprises, employing up to five persons, whose number increased in the period analysed by roughly 21%, a relatively low rate of growth – or even an absolute decrease – of the number of firms was observed in the traditional domains of production, like food and beverages, textiles, garments, leather and shoes, wood products (except for furniture), as well as in production of goods of rubber and plastics, and of construction materials. These traditional branches of industry flourished in the initial phase of economic transformation of Polish economy, that is – before the year 1994. Then, on the other hand, in the years 1994-1997 there was a dramatic increase of the number of enterprises being the part suppliers for the automotive and machine-building industries, co-operating with the large companies, mainly those with foreign capital. And so, for instance, the number of enterprises producing parts for mechanical vehicles increased by 135%, and those supplying parts for machines and appliances – by almost 60%. Of the domains classified as high-technology the number of the smallest firms producing medical instruments increased by close to 68%, and of the ones producing microcomputer equipment – by 48%. Regarding other domains of industry, which feature a rapid increase of the number of the smallest enterprises one should mention printing and publishing, as well as the previously very much neglected waste processing, where the number of the smallest firms increased in the period analysed, 1994-1997, by approximately 74%.

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<sup>13</sup> One should add at this point, though, that a part of these „new“ medium-sized enterprises had been before the large enterprises, which moved over to the medium-sized class by reducing their employment to below 250 persons.

The significance of the SME sector for the Polish economy can be easily assessed on the basis of the data concerning employment. The total number of persons employed in the enterprise sector increased in the years 1994-1997 by 5.7%. Yet, while the number of persons employed in large enterprises decreased in this period by 7.2%, it increased in the SMEs by 15.1%. With respect to the latter, the increase of employment in the small firms amounted to 12.1%, in the smallest ones, employing up to 5 persons it was equal 18.4%, and in the medium ones – 23.6%. In terms of sections of economy the increase was the quickest in financial intermediation (by more than 88%), this being due, in particular, to the fact that starting with the middle of the 1990s foreign banks and other financial institutions started to set up their branches and offices in Poland on quite a large scale. The increase of employment in the SMEs was also relatively rapid in the sections of transport and communications (more than 24% of increase), estate and business service (more than 23%), and manufacturing (approximately 16.5%). There was, on the other hand, a rather slow increase of employment between the end of 1994 and 1997 in two domains, in which the numbers of SMEs grew dynamically, namely in construction and in the so-called remaining service activity. It must be remembered, though, that construction and services employ a large proportion of seasonal workforce and of part-timers, who are not accounted for in the total number of persons employed as of the end of the year, mentioned before. Besides, construction and service, as well as trade, employ a significant number of persons without any registering (the grey zone of the economy), of whom many are the citizens of other countries, primarily of Ukraine, Belarus', and Russia.

As can be concluded from the data here presented, concerning employment numbers, the SMEs not only secured in the years 1994-1997 the workplaces for those who lost their jobs due to restructuring or liquidation of the large state-owned enterprises, but also created new jobs for the young, entering the productive age. Due to this, the unemployment rate, amounting in 1993 to as much as 16.4%, dropped by 1997 down to 10.3%. Simultaneously, in the same period, the contribution of the SMEs to the GDP value has been increasing, reaching in 1997 the level of 45.3%. Hence, the gross value added (GVA) produced by the SMEs has been increasing quicker than that produced by other economic agents, including large enterprises. It was exactly owing to the activity of the SMEs that the value of the GDP, calculated in constant prices, was in 1997 higher by more than 26% than in 1990, and was even higher than in 1988, considered to be the best with this respect in the period of real socialist economy.

## 2. The state of the SME sector in 1998

In 1998 the economic situation in Poland worsened somewhat in comparison with the three preceding years. The GDP in constant prices increased in 1998 by 4.8%, while in 1995 it increased by 7%, and in the years 1996-1997 by, respectively, 6% and 6.8%. The primary cause of this worsening of the economic situation<sup>14</sup> was undoubtedly the financial crisis in Russia, which took place in August 1998. As a consequence of this crisis, the official export of goods from Poland to Russia decreased by at least 450 million USD in comparison with the preceding year. The losses, however, were much bigger in the so-called unregistered trade with Russia. The issue is in the purchases of goods in Poland for convertible currencies, made by the citizens of Russia. The producers and sellers of these goods (food products, beverages, garments, shoes, and furniture) were primarily the small and medium enterprises.

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<sup>14</sup> There are, however, the economists who put the blame with this respect on the government, conducting in 1998 the policy of cooling down of the economy by limiting the supply of money, which was meant, in particular, to counter the foreign trade deficit. One of the methods of decreasing the supply of money was to be the curbing of the budget deficit. Yet, this policy did not bring the results expected, due, among other, to the volume of credits and loans granted by banks in 1998 the businesses and the private persons.

At the end of 1998 the number of active enterprises was equal at least 1,726,073. The number of the small active enterprises was equal 1,709,294, i.e. slightly more than 99% of all the functioning enterprises. There were 13,322 enterprises of medium size (less than 0.8% of the total), and 3,457 large enterprises. Of the total number of active enterprises only 5,781 belonged to the public sector, while 1,720,292 – to the private sector. The public sector encompassed in 1998 2,219 small enterprises, 2,284 medium-sized ones, and 1,278 large ones.

The number of active SMEs increased in 1998 by 9%. The rate of increase was the same for the entire population of the active enterprises, which is, however, quite obvious, given the vastly dominating share of the SMEs in the set of all the active enterprises (99.8%). This rate of growth, though, also with respect to the private SMEs, was in 1998 twice lower than in the preceding years, 1996 and 1997, when it amounted to approximately 18%. The number of small active firms increased in 1998 by 9.1%. Here, of course, the rate of growth was as well at half of that from the years 1996 and 1997. Essential decreases of the rate of growth of the numbers of small firms were observed in the majority of domains of economy. Thus, for instance, in trade, the number of small enterprises was increasing in the years 1996-1997 at the rate of approximately 15% a year, while in 1998 this rate dropped to roughly 5%. The number of small construction enterprises increased in 1997 by 38%, while in 1998 – only by approximately 10%. There were only two domains of economy, namely manufacturing and communications, where the rate of growth of the number of small firms remained in 1997 and 1998 at similar levels, namely at 10% and 15%, respectively. In the group of the smallest manufacturing firms, employing up to five persons, the tendency observed already before persisted, that is – the one of a quicker increase of the number of businesses in the technologically more advanced branches than in the traditional ones.

The rate of growth of the number of medium sized enterprises decreased almost twice, as well, between 1997 and 1998. In 1997 it was at 8.1%, while in 1998 at the mere 4.3%. Similar regularity was observed in the majority of sections of the economy. Thus, for instance, in manufacturing the rate of growth of the number of medium sized firms decreased between 1997 and 1998 from 10% to 4.7%, in construction – from 4.5% to 1.5%, in trade – from 5.6% to 2.4%, and in transport – from 7.3% to 4.3%.

In 1998 as many as 39.6% of all the small enterprises were trade enterprises, although this share had been systematically decreasing since 1994. The small manufacturing enterprises constituted 13.4% of all the small enterprises, while the third and fourth ranks were occupied by the construction and the estate and business service sections, with similar shares somewhat exceeding 10.5%. In the group of medium sized enterprises the largest share (47.4%) was taken by the manufacturing firms, followed by trade (19.9%), and construction (14%) firms.

At the end of 1998 the enterprise sector employed altogether approximately 9,108,000 persons, of whom roughly 4,270,000 (46.9%) in small enterprises (2,385,000, i.e. 26.2% in the smallest enterprises, employing up to five persons), approximately 1,619,000 (17.8%) in the medium sized enterprises, and approximately 3,219,000 (35.3%) in the large ones. Thus, at the end of 1998 the SMEs secured jobs for 64.7% of all the employees of the enterprises. The analogous share for the end of the preceding year, 1997, was equal 63%, that is – by 1.7 percentage point less. The share of the small enterprises increased between the ends of Decembers of the two years compared by 1.2 percentage point, and of the medium sized firms – by 0.5 point. Private enterprises employed in 1998 approximately 75% of all those working in the enterprises, and if 100% denotes the total number of persons working in the SMEs, private enterprises accounted for more than 91% of it.

At the end of 1998 the number of persons working in the enterprises was by 0.4% lower than on December 31<sup>st</sup>, 1997. This breakdown in the upward trend of employment in the enterprises, observed since 1994, was brought about by the decrease of the number of persons working in the group of large firms – by 4.7%, which was not quite compensated by the increase of the number of persons employed in the SMEs, amounting to 2.1%. The year 1998 was the first one since a relatively long time, when the rate of growth of employment in the small enterprises exceeded the same rate observed in the medium sized firms. Yet, in both these groups of firms the rate of growth of employment was clearly lower than in 1997. In the group of small enterprises it dropped from 6.3% in 1997 to 2.7% in 1998 (in the smallest enterprises – from 14% to 1.8%), while in the medium sized firms – from 7.2% to 2.1%. Hence, a similar tendency to a decrease in the rate of growth could be observed here as in the case of the number of active SMEs.

In the group of small enterprises the rate of growth of the employment number in 1998 was lower than the respective average (the previously mentioned 2.7%) in manufacturing (2.2%), construction (1.9%), and trade (2%), that is – in the three basic sections providing jobs for roughly 75% of the total number of persons working in small enterprises. In these three sections it is only the lower rate of growth of employment in the small manufacturing firms that can be associated directly with the Russian crisis (the total number of persons employed in the section fell in this case by 3.6%). Regarding trade, the low rate of increase of employment in small firms can also be explained by the development of the supermarket network (employment in the large enterprises of this section increased in 1998 by 10%), established from scratch with an essential contribution of the foreign – especially French and German – capital. A particularly high rate of increase of the number of persons employed in small enterprises in 1998 was observed in financial intermediation (18.4% of increase), owing to the development of the banking and insurance sectors, largely due to the activity of foreign investors.

As far as the medium sized enterprises are concerned, the increase of employment in such sections as manufacturing (by 2.9%), construction (by 2.7%), as well as transport and communications (by 0.8%), was most probably caused by the transfer of some large firms to the class of the medium sized ones, as they reduced their employment to below 250 persons. In all these domains of economy, namely, an essential drop of employment in the group of large enterprises was observed (the biggest one in manufacturing, by 8.5%, owing, in particular, to the restructuring of the collieries). The situation was different in the case of such sections as trade (increase of the number of persons employed in the medium sized firms by 1.7%), financial intermediation (increase by 12.7%), and the estate and business service (increase by 0.7%), where employment was growing not only in the medium, but also in the large firms. Here, beyond any doubt, the increase of the number of persons employed in the medium sized enterprises did not occur owing to the mass migration of the firms, having employed before more than 250 persons, down to this magnitude class.

The data concerning employment numbers, commented upon before, do not account for the unregistered employment, that is – the persons employed in the grey zone of the economy. The respective analyses carried out by GUS indicate that the situation in terms of the share of illegally employed persons in total employment of the small enterprises is the best in transport and manufacturing, where this share was around 5%. In other words, in these domains only every twentieth employee of a small enterprise, including the single-person firms, was in 1998 employed illegally. In construction - every eighth, and in trade - every tenth employee was on the average employed illegally. A much more serious situation existed in the broadly conceived service sphere, except for the financial intermediation. Here, in 1998, every fourth employee of a small enterprise worked illegally, although in this domain, as well, the situation improved in comparison with the year 1995, when every third person working there was employed illegally.

The value added produced by the SMEs in 1997, calculated with due account of the hidden economy, equalled 45.3% of the GDP. In 1998 the share of the SMEs in the GDP was 48.1%. Thus, the contribution of the SMEs to the value of the GDP increased in 1998 relatively significantly, namely by 2.8 percentage points. This occurred mainly owing to the small enterprises, since in 1998 the rate of growth of the GVA produced by the small enterprises was, for the first time since many years, higher than the rate of growth of the value added produced by the medium sized enterprises. The share of the small enterprises in formation of the GDP amounted in 1997 to 36.2% and increased to 38.5% by 1998, that is – by as much as 2.3 percentage points. The contribution from the medium sized enterprises increased, on the other hand, from 9.1% in 1997 to 9.6% a year later, that is – by 0.5 percentage point.

The financial condition of the enterprises belonging to different magnitude classes is analysed in two different ways, depending upon the legal status of the enterprise, i.e., most generally – whether a firm has a legal identity, or is a firm of a natural person.<sup>15</sup> In case of the enterprises without a legal identity (natural persons conducting economic activity and civil partnerships) employing up to five persons,<sup>16</sup> a good measure of their financial standing is the income (sales minus costs) per firm. In 1998 this category, calculated for the entire group of the smallest firms<sup>17</sup> was equal 19,300 Polish zlotys (PLN), meaning a decrease by almost 25% in comparison with the year 1997, when this average income equalled 25,600 PLN. The incomes per firm dropped primarily in the traditional domains of economy. The most pronounced decrease – by approximately 44% - was noted in trade, followed by construction (decrease by more than 16%), and manufacturing (by roughly 14%). Incomes rose, though, in all the service sections – most rapidly in the estate and business service (by almost 36%). Incomes per the smallest firm had been in trade until as late as 1997 the highest among all the sections of economy. High incomes earned in trade attracted to this sphere free capital and the enterprising individuals, with the effect of a gradual decrease of the absolute magnitude of incomes between the year 1995 and 1997. The abrupt breakdown, which took place in 1998 was caused, on the one hand, by the Russian crisis, and on the other hand – by the development of the network of large and medium supermarkets, constructed mainly owing to the inflow of foreign capital. The Russian crisis had the decisive influence upon the drop of incomes achieved in manufacturing. The drop observed in construction was, in turn, the consequence of the decrease of incomes per firm in the category of the smallest enterprises in the two domains of economy, mentioned before, that is – manufacturing and trade, and therefore – the decrease of the investment outlays. The highest incomes per firm in the group of the smallest enterprises were observed in 1998 in the section of estate and business service. This fact can be explained by the relatively high skills of an important part of persons employed there, providing service in, for instance, counselling, marketing, promotion, computer applications, and accounting.

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<sup>15</sup> Enterprises not having legal identity (natural persons' businesses and civil partnerships) are allowed to conduct a simplified bookkeeping, and supply GUS with the information on the general magnitude of their revenues and costs only. On the other hand, enterprises endowed with legal identity (state-owned and municipal enterprises, co-operatives, and companies, except for civil partnerships), put together annual balance sheets (not necessarily for the calendar year), and send to GUS, side by side with the balance, the information on the basic revenue and cost items, as well as the so called financial effect (loss or profit).

<sup>16</sup> These enterprises accounted in 1998 for as much as 94.8% of the total population of small enterprises.

<sup>17</sup> The respective calculations relied upon the results of the representative studies of the smallest enterprises, published by GUS, contained in the series of reports bearing the title *Działalność gospodarcza małych przedsiębiorstw* (*Economic activity of the small enterprises*), plus the year for which a particular study was conducted.

The fundamental information on the financial situation of the enterprises endowed with legal identity<sup>18</sup> is provided by the so-called gross return on sales indicator<sup>19</sup>. In 1998 gross return on sales of these enterprises was 1.9%. Thus, it was lower by more than the factor of two in comparison with the year 1995, the best with this respect, and lower by one third than in 1997. The decrease of the gross return between 1997 and 1998 was the effect of the worsening financial situation of the medium-sized and large enterprises, both private and public, while the small firms belonging to both these sectors somewhat improved their gross return indicator. This indicator increased for the small enterprises between 1997 and 1998 from 2.5% to 2.6%. The return indicator in the medium sized enterprises decreased, on the other hand, from 3.4% to 2.5%, while in the large enterprises – from 3.5% to 1.2%.

The year 1998 was the first one in the five-year history of systematic analyses of the SME sector, carried out in Poland, in which the small enterprises turned out better than the two other magnitude categories in terms of gross return. In the private sector, though, the medium enterprises, in spite of having suffered a decrease of the return indicator, retained the first rank they occupied in 1997, staying ahead of the small and large companies with respect to the gross return indicator. Still, the differences of values of the gross return indicator between the particular magnitude classes of enterprises in the private sector were relatively small, which seems to indicate the existence of the tendency toward equalisation of profitability in various magnitude classes of firms.

The rate of increase of investment outlays in the enterprises slowed down somewhat in 1998 in comparison with 1997. In accordance with the simplified estimates, whose results should be treated with care, investment outlays of the enterprises, expressed in constant prices, increased in 1998 by approximately 19%, while in 1997 they increased by 23%. A decline in the dynamics of growth of investment outlays was observed in all the magnitude classes of enterprises, but the decline was most pronounced in the small firms, since the rate dropped there by half (from approximately 31% in 1997 to roughly 15% in 1998). The decline was moderate in the medium-sized enterprises (from approximately 47% to 39%), and almost insignificant in the large enterprises (from 15% of growth to 14%). A similar trend was observed within the private sector, where the rate of growth of the investment outlays decreased in all the magnitude classes of enterprises, by one third on the average. This decline amounted in the medium private enterprises to one fifth, while in the small and large private enterprises – to almost half of the previous growth rate.

Yet, in spite of this growth decline, the rate of expansion of the investment outlays, estimated in constant prices to be approximately equal 28-29%, remained in 1998 very high. Thus, in the group of medium-sized private enterprises this rate exceeded 43%, in the large private enterprises it attained approximately 32%, and in the small private firms, which definitely lagged behind the medium-sized and large ones in terms of intensity of investing, it was at around 14%. The thus high rate of growth of investment outlays, especially in the case of medium and large firms, would, of course, not be attainable without the inflow of foreign capital.

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<sup>18</sup> All of the large enterprises had legal identity, along with 97.3% of the medium-sized ones, but only 3.7% of the small ones.

<sup>19</sup> The gross return on sales indicator is the ratio of gross financial effect to total revenue from the entire activity of the enterprise, expressed in percent. In the enterprises endowed with legal identity the difference between the revenues and costs on the entire activity of the enterprise is called the effect on economic activity. This difference, corrected with the balance of extraordinary losses and benefits, is referred to as the gross financial effect.

### 3. The SMEs in the regional setting

The SMEs concentrate primarily within the large urban agglomerations, and in the areas with well-developed and differentiated industry. The reasons for the concentration of a large number of the SMEs on such areas are quite obvious. The share of the skilled and enterprising persons is much higher there than in the other regions of the country, and, also, the potential demand for goods and services supplied by the SMEs is higher there in view of, in particular, higher incomes of the population in large towns. Thus, in 1998, 29% of all the economically active SMEs functioned in the Masovian province, whose capital is Warsaw, and the Silesian province (with capital in Katowice). A relatively small share of the SMEs – the estimated 15% of the entire population – were located in rural areas. Within these areas the basic economic units were very small enterprises, single person or family firms. The development of the SMEs located in rural areas is limited primarily by the low incomes of the population inhabiting these areas. The problem of creation of new jobs outside of agriculture in the countryside is essential in view of the very small average acreage of Polish farms, and the resulting necessity of concentrating agricultural production, along with elimination of the hidden joblessness in the countryside.

The potential of the SME sector in particular provinces is well characterised by the number of the SMEs per 1,000 inhabitants. It can on a very high level of generalisation be said that the value of this indicator decreases towards the East, with the line of the river Vistula being the limit, which clearly discriminates with respect to the number of the SMEs per 1,000 inhabitants. Thus, to the East of this divide there are a number of voivodships, like, for instance, the Lublin voivodship, the Subcarpathian voivodship (with capital in Rzeszów), the Warmian-Masurian voivodship (with capital in Olsztyn), or the Podlasie voivodship (Białystok), where the number of the SMEs per 1,000 inhabitants ranged between 33 and 36. At the same time, in the Masovian province, leading with this respect, the indicator value was 56 per 1,000 inhabitants (while the country-wide average was 45).

In 1998 the SMEs functioning in just two provinces – Masovian and Silesian – accounted for as much as 29% of the total employment in the SME sector, that is – the share was exactly the same as in the number of the SMEs. These two provinces were followed – in terms of the share of employment in the SMEs – by the Greater Polish province (with the capital in Poznań), and the Little Polish province (capital: Cracow). The SMEs located in the four voivodships mentioned (out of the total of 16) provided jobs to almost half of all those working in the SMEs. In spite of the significant percentage share of the persons working in the SMEs in the Masovian or Silesian provinces (56.6% and 53.4%, respectively), the significance of this category of enterprises on the local labour markets of these provinces is far smaller than, for instance, on the labour markets of the Warmian-Masurian, Western Pomeranian (capital: Szczecin), or Pomeranian (Gdańsk) provinces. In these voivodships more than 70% working persons are employed in the SMEs, which is to an important extent due to the functioning of a relatively small number of large enterprises in these provinces and the taking over of their role by the medium-sized ones.

In 1998 the biggest increase of the number of persons employed took place in these voivodships, in which the highest number of the SMEs functioned, that is – in the Silesian and Masovian voivodships. This was beyond doubt closely linked with another phenomenon, namely with the concentration of investment outlays in a couple of most economically developed provinces.<sup>20</sup> The SMEs from the area of the Masovian, Silesian, and Greater Polish voivodships spent in 1998 altogether 52% of the total investment value of this group of enterprises. Thus, the division into the better economically developed western Poland and the less developed eastern part is deepening, alas. The too weak institutional support and the limited means disbursed for promotion of small business cause that the number of the SMEs is increasing at a declining rate, especially there, where the population has lower professional skills, where there is shortage of capital, and the infrastructure is below the national average.

#### 4. Barriers to the development of the SME sector

In spite of the high rate of growth of the number of SMEs in the years 1990-1997 the SME sector is in fact encountering several obstacles and limitations to its development. They were being overcome due to the advantageous – especially in the years 1995-1997 – economic situation. Yet, as mentioned already, the economic situation worsened somewhat in 1998 and there is nothing that would indicate a perspective of immediate improvement. Hence, the barriers and the obstacles encountered by the entrepreneurs, and first of all by the owners of the SMEs, limit now much more strongly the rate of growth of Polish economy and are harder to overcome than in the period 1995-1997.

The numerous survey studies conducted recently<sup>21</sup> indicate the existence of multiple barriers hampering the development of the SME sector. The entrepreneurs mention usually at the first place, as a main obstacle<sup>22</sup>, high taxes, followed by low demand, complicated financial and legal regulations concerning the principles of conduct of business, and lack of cheap credit. The fifth rank is occupied by the disadvantageous policy, conducted by the government with respect to the SMEs, and lack of support from the local authorities. The subsequent obstacles mentioned by almost exactly half of the entrepreneurs are: the unfair – in the opinion of the respondents – competition from the side of the large domestic and foreign firms, lack of information on the influence exerted by the integration of Poland with the EU on the situation of the SMEs, and the difficulties in acquiring valuable, skilled employees.

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<sup>20</sup> When analysing the data on the investment outlays for particular provinces one should not forget, though, that an amplifying influence on the degree of differentiation in these outlays is exerted by the assignment of the outlays to the locations of headquarters of the enterprises, and not to the actual locations at which they were spent. It is namely so that numerous enterprises have their official seats in large towns, while production plants, and trade or service outlets, are located in other parts of the country.

<sup>21</sup> See, e.g. the results of the survey study conducted by the Institute of Public Affairs, commissioned by the Polish Foundation for SMEs Promotion and Development, described in the report of W. Kozarek and P. Mielczarek, entitled *Opinie przedsiębiorców sektora MSP o prowadzeniu działalności gospodarczej* (Opinions of the entrepreneurs from the SME sector on the conduct of business, in Polish), Warsaw, 2000. When writing on the barriers to the development of the SME sector, the authors of the previously mentioned *Report on the state of the SMEs in Poland in the years 1998-1999* (as well as of the preceding issue concerning the years 1997-1998), published by the same Foundation, refer to the survey studies carried out, in particular, by the Ministry of Economy, the World Bank, and by the public opinion study centres, Demoskop and CEBOS.

<sup>22</sup> See the report by W. Kozarek and P. Mielczarek, referred to in the preceding footnote, pp. 43 ff.



The barriers mentioned here require a few words of comment, especially as they are essentially mutually interrelated. First, one should pay attention to the connection between such obstacles, listed by the entrepreneurs, as high taxes, complicated regulations, difficulties in acquiring good employees, and the disadvantageous policy of the government. In general, these responses are related to the conviction common among the entrepreneurs, that the rightist coalition government, ruling since the fall of 1997 is under a too strong influence from the trade union "Solidarity", and is guided in its decisions much more by the interest of the blue collar workers employed in the large state-owned enterprises than by the interest of the so-called middle class, to which the owners of the SME belong as well<sup>23</sup>. Consequently, in spite of the efforts undertaken, the scale of the personal income tax (PIT) paid by the natural persons conducting business, has not decreased since 1997, just like the insurance premiums paid by the employers on hired labour, although the scale of corporate tax (CIT) – paid by the enterprises endowed with legal identity – decreased.

The complicated tax regulations did not change, neither, and the regulations concerning social insurance have become – after the introduction of the social security reform at the beginning of 1999 – even more cumbersome than before. On the top of this, the community of entrepreneurs has been very much stirred recently by the issue of the potential changes in the Labour Code. In the framework of struggle with the increasing unemployment the trade unions aim at a shortening of the legally prescribed working time (down to 40 hours per week), like it happened, for instance, in France. The employers, to the contrary, maintain that such changes will contribute to increased unemployment, and their aim is to establish a Labour Code modelled after that of the United States. They primarily mean the weakening of the Labour Code restrictions concerning the procedures of layoff and employment (the questions of the length of notice, compensation value, etc.). Employers, alas, can count in their efforts only on the centrist Union of Freedom party, whose influence is quite limited. The very strong – now in opposition – Alliance of the Democratic Left (SLD), differing entirely in many basic questions from the ruling rightist coalition, supports the governing coalition, dominated by the trade union "Solidarity", on the issue of taxes<sup>24</sup> and the shortening of the working time.

When speaking of such barriers to the development of the SME sector as low demand or the unfair domestic and foreign competition, the entrepreneurs often refer to the situation existing in trade, where, starting with the middle of the 1990s, an expansion of the supermarkets is observed, established in a vast majority of cases with foreign capital. The assessment of this whole process by the entrepreneurs appears, however, to be highly subjective. Introduction of economic reforms in 1990 entailed the emergence of an enormous number of private shops, most often managed by entire families, rarely hiring outside labour, which led to an extreme dispersion of trade in Poland. This corresponded roughly to the situation existing in the West in the 1950s or 1960s. The margins appropriated by the small firms were, however, high, and the product range narrow, and so the customers positively reacted to the possibility of making their purchases in the newly established supermarkets, offering lower prices and a broader assortment of goods. The owners of the small shops – just like their Western counterparts two decades earlier – try to fight the idea of establishment of the supermarket networks with all the means available, including the administrative interdiction of constructing new large shops in some quarters of towns.

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<sup>23</sup> A kind of test on the popularity of the politicians of various orientations was constituted by the recent presidential elections, which took place on 8 October 2000. The leader of the "Solidarity" trade union, M Krzaklewski got not quite 16% of vote, while A. Olechowski, perceived as the representative of the middle class – more than 17% of vote.

<sup>24</sup> More precisely, the SLD proposes, rather than to just lower the taxes, to introduce various kinds of exemptions for the employers, including investment-related tax reliefs, which, however, would make the entire tax system yet less legible than today.

In view, though, of lack of social support such initiatives do not bring the effects that would satisfy the petty shopkeepers. The complaints of the entrepreneurs about the unfair competition, on the other hand, have certain rational foundations in case of foreign companies, which make construction of a new factory or purchase of a state enterprise dependent upon obtaining of various privileges, including tax exemptions and reliefs. Yet, the actual facts of granting such privileges become increasingly rare, also in view of the obligations of Poland related to our access to the EU, according to which all the economic agents ought to be treated equally (thus, in particular, no new so-called special economic zones can be established). Besides, the inflow of foreign capital – even at the cost of tax reliefs – is beneficial for Poland, since it activates definite areas, creates jobs there, and expands demand, thereby forming additional opportunities for the domestic enterprises, including also the small trade firms.

The here presented list of barriers to the development of the SME sector seems to contain yet two rationally justified items, not yet commented upon in more detail. The first one is the lack of information on the consequences brought for the SME sector by the expected integration of Poland with the EU. Politicians mention various dates of the accession of Poland to the EU, ranging between the beginning of the year 2003 and the year 2005, or even later. Yet, a responsible owner, who plans the development of her/his firm over a longer time period, must have a better knowledge of the conditions, in which the enterprise owned will be functioning in the coming years. The knowledge, however, in this particular domain is very limited and accessible only to a narrow group of economists<sup>25</sup> who work actively on the integration of Poland with the EU. The second of the barriers to the development of the SME sector, mentioned before, and actually existing, is constituted by the difficult access to credit. This particular obstacle became even more hampering in Fall 2000 in connection with the raising of the interest rates, which was a response to the increase of the inflation rate, although the latter had been caused primarily by the external reasons, such as the oil price increase on the world market, and the persisting high exchange rate of the US dollar. It is estimated that owing, in particular, to the elevated interest rates, only 15% of the Polish SMEs do regularly make use of credits<sup>26</sup>. It is exactly the lack of access to inexpensive credits that appears nowadays – side by side with the high taxes and the Labour Code stipulations, disadvantageous for the employers – to be the main obstacle limiting the development of the SME sector under the circumstances of a not too good general economic situation.

The entrepreneurs, who responded to the questions contained in the survey questionnaires, perceived the sources of their difficulties and failures primarily in terms of the external conditions. Yet, a number of reservations can as well be addressed at the entrepreneurs as an entire social group. The fundamental one of those reservations concerns the relatively low level of technical and economic knowledge, characteristic for the typical representatives of the class of entrepreneurs. The consequence is constituted by the relatively low innovativeness, especially of the small enterprises, which is apparent from the results of various studies. At the same time, the number of the so-called business support units, being the non-commercial institutions specialising in provision of service for the SMEs (like business incubators, centres of economic information, of innovation promotion and of technology transfer, as well as counselling) increases more and more slowly<sup>27</sup>, starting with 1996. In 1998 there were approximately 350 such units, that is – by 1.7% more than a year before.

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<sup>25</sup> An effort aimed at bridging this information gap resulted in the publication by B. Piasecki, A. Rogut, and D. Smallbone, *Wpływ integracji Polski z Unią Europejską na sektor MŚP (The influence of integration of Poland with the EU on the SME sector, in Polish)*, Polish Foundation for SMEs Promotion and Development, Warsaw, 2000.

<sup>26</sup> See *Raport o stanie sektora MŚP w Polsce w latach 1998-1999 (Report on the state of the SME sector in Poland in the years 1998-1999)*, Warsaw, 2000, p.238.

<sup>27</sup> See *Raport o stanie sektora MŚP w Polsce w latach 1998-1999 (Report on the state of the SME sector in Poland in the years 1998-1999)*, Warsaw, 2000, pp.210-213.

The cause for such a low rate of expansion of the network of such units was lack of means, as well as a marginal interest in their activity from the side of the local authorities. In 1998, similarly as in the initial stage of transformation of Polish economy, the primary source of financing of the business support units was constituted by the funds originating from the foreign assistance programmes, primarily coming from the European Union. Side by side with the relatively low level of technical knowledge, yet another reproach can be formulated with respect to the group of entrepreneurs in Poland. It is namely the defensive attitude vis à vis reality, reflected through the incapacity, aversion, or apprehension of the entrepreneurs as to the perspective of expanding the scale of their activity.

This is confirmed by the average number of persons employed per one SME, which has been persisting at a similar level for many years<sup>28</sup>. In other words, the development of the SME sector in Poland has a somewhat extensive nature and is expressed through the increase of the number of enterprises, with the new ones being characterised by similar features as those existing before, rather than through the development of the enterprises themselves, meaning their technical restructuring linked with expansion of employment. Such a situation gives rise to the apprehension that in case of a further worsening of the general economic situation many of such businesses would not be able to face the challenge.

## 5. Conclusions

Polish society took during the 1990s a crash course in economy. The various processes and trends, which appeared in the West over the last 20-30 years, visited Poland over just one decade. Still in the middle of 1989 Polish economy was a strictly rationed real socialist economy with the functioning system of rationing stamps for purchasing the basic consumption goods. Half a year later the society faced all the good and bad sides of the market economy, with the difficulties in selling the outdated products turned out by the large state-owned firms, followed by the collapse of many such firms, increasing unemployment, and at the same time – a perspective for forging one's fate opening before the enterprising and the independent. A dramatic surge in the number of the SMEs in the initial period of transformation constitutes the proof of the fact that many persons made use of this opportunity. Already by the middle of the 1990s, though, the demand for traditional goods was to a large extent satisfied. This brought a quicker growth of the number of enterprises providing service (including business service) and producing more technologically advanced goods than those supplied by the firms producing traditional commodities. In addition, the process of concentration in trade started, positively assessed by the customers, but bringing the threat of disappearance for many small trade firms of family nature. The tendencies appearing since the middle of the 1990s in industry and trade were initiated and maintained to a large extent owing to the inflow of the foreign capital. Finally, at the end of the 1990s the Russian crisis, and recently also the high prices of oil, caused a worsening of the general economic situation, and therefore also an additional threat to the SMEs, especially those economically weaker and producing outdated goods.

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<sup>28</sup> See J. Chmiel, *Problemy statystycznego pomiaru i analiza tendencji rozwojowych sektora prywatnych przedsiębiorstw w Polsce w latach 1990-1998* (The problems of statistical measurement and the analysis of development trends of the sector of private enterprises in Poland in the years 1990-1998, in Polish). Raporty CASE, Warsaw, 1999, p.42.

Simultaneously, Polish economy faces at the doorstep of the new century two great challenges. The first of these is to respond to the competition within the uniting Europe in connection with the expected access of Poland to the EU. The second challenge is related to the necessity of securing jobs, especially for the young from the demographic boom of the beginning of the 1980s, entering now the labour market. The experiences from Poland and from other countries demonstrate that the new jobs can virtually solely be created now in the SME sector. Hence, the question arises, whether the Polish SMEs will be able to cope with this task in the conditions of a generally not too good economic situation and under the competitive pressure from the SMEs of the EU countries, which are, in addition, strongly supported by the governments of the EU member countries, respective local authorities, and other institutions established exactly for this purpose. It must be feared that the Polish SMEs might not be able to stand up to the challenge without a much bigger support from the side of the Polish government and the local authorities than that extended until today.

In fact, the support from the Polish central administrations has been until today more of a declarative than real nature. In June 1995 the then leftist government adopted the document expressing the intentions of the state administration with respect to the SME sector. The intentions, though, were never put into practice<sup>29</sup>. The development of the so-called business support units, referred to here before, which was envisaged in the document, along with the formation of the system of SME monitoring, took place independently of the governmental initiatives, almost uniquely owing to the assistance funds offered by the EU. The subsequent programme of support for the SMEs, until the year 2002, was adopted by the government, this time of a rightist character, in May 1999. This new programme assumes three primary goals<sup>30</sup>: increase of innovativeness and technological advancement of the SMEs, increase of exports, and increase of the investment outlays of the SME sector. Still, the means allotted for the three-year implementation of this programme, which was positively assessed by the entrepreneurs, amount to quite a symbolic sum of approximately 60 million US dollars, according to the exchange rate as of the middle of 1999, that is – not quite two times the expected volume of assistance funds in the same period only. Given the enormous scale of problems to be tackled, these means seem to be far too scarce.

When assessing the scale and scope of the governmental support for the SME sector one should, of course, take into account other tasks related to the restructuring of the economy, which are resolved currently. We mean here, in particular, the necessary decrease of employment in coal mining, steel industry, and railways, which is associated with the resulting requirement of paying high compensations to the employees laid off, these compensations meant also to constitute the initial capital for setting up own small firms. Yet, even if we account for these facts, it still appears that the means allotted to the development of the SMEs, disbursed from the state budget, are definitely too small. The high rate of growth of the numbers of the SMEs in the 1990s, which occurred practically without any intervention from the side of the government, had a clearly demobilising influence on the activity of the central and local authorities.

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<sup>29</sup> See J. Chmiel, *Małe i średnie przedsiębiorstwa a rozwój regionów* (Small and medium enterprises and the development of regions, in Polish), ZBSE (RECESS), Warsaw, 1997, pp. 206 ff.

<sup>30</sup> See *Raport o stanie sektora MŚP w Polsce w latach 1998-1999* (Report on the state of the SME sector in Poland in the years 1998-1999), Warsaw, 2000, pp.113-115.

It was evidently concluded that a similar autonomous development of the SME sector would also continue in the future. The present problems of the development of the SME sector, though, are qualitatively different than before. Suffice to compare the possibilities open for the SMEs in conditions of unfulfilled demand at the beginning of the 1990s, inherited from the period of real socialism, and the present necessity of competing with the Western companies, in conditions of a market practically not protected against foreign competitors by custom duties nor import quota. The increase of the rate of unemployment, observed in Poland since 1998, despite the relatively high growth of industrial production and the GDP, appears as a warning that the question of a more resolute support for the development of the SMEs cannot be neglected any more.



## Session 5

### Roles of Government and Private Sector

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## The Selection by Market and the Role of Government

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### 1. Introduction

I spent 3 years in Poland from March, 1997 to March, 2000 as an advisor for Minister of Economy. My task was to advise the Minister on the industrial policy making. During my stay in Poland the attitude to industrial policy was not favorable for us under the Polish macro economic framework. Even this difficult period for my job, I have to confess that I enjoyed my job in Poland very much because I could reconfirm a certain positive role of government for the transitional economic countries.

I worked for many years in Japanese government and was involved in making and implementing industrial policies. The period of stay in Poland gave me a great chance to reexamine the role of government in the free market economy. My conclusion is that government has an important role for the national economy and has to take initiatives sometime, when the private sector has not developed strong enough. At that time government has to have a clear future vision for her state's economy and to keep a strong will to realize the vision. When the private sector is not strong enough, government should supplement the role of the private sector in the economy and cover the weakness of it. We should not wholly depend or rely on the choice of market.

The environment for industrial policy is not favorable now-a-days. Developed countries including EU member countries gradually came to avoid the governmental intervention on the economic activities and this is the time when the Central and Eastern European countries are trying to join the EU.

In the early 90's, Polish government drew up restructuring plans for main industries but the government did not support the implementation of these plans and left it to the self effort of each company and the selection by market mechanism.

Polish government signed the Association agreement with EU in 1992 and under the agreement Polish government lost main policy measures to support the restructuring plans of the selected important industries. Because the Agreement prohibited state aids which are thought to have a possibility of distorting market mechanism and free competition. Poland also joined GATT ( and WTO) and OECD. This movement also makes Poland to give up governmental direct support to specific industrial sectors.

The article in EU Association Agreement, which prohibits state aids to specific industrial sectors, has been introduced to the newly established Polish domestic law in 2000. This means that Poland officially abandoned the policy measures to support restructuring and modernizing specific industrial sectors. We can recall policy support to specific industrial sectors had been common even in the Western European countries in the 1970's and 1980's and it is still common among the South East Asian countries.

As for the restructuring plans for steel and coal industry in Poland, the target of them is obviously to strengthen their international competitiveness and to make them self sustainable. However, the policy which has been taken by the government so far is to accelerate reducing the production capacity, closing inefficient factories and coal mines and reducing redundancy of employment. On the contrary it does not include promoting positive investment for modernization and rationalization of production facility for their future development .

This is very different from the Japanese policies which were taken in 1950's and 1960's. Japanese industrial policies on coal and steel industry were always to stimulate modernization of the industry and to make them competitive in the world market.

As for the coal industry, Japanese government took a so-called "Scrap and Build" policy under which inefficient mines were closed and modernizing investment was focused on potential mines. After 70's, the policy was changed to reduce gradually production of coal and then to take a phasing out policy on coal industry . Now we maintain only two coal mines. The policy on the coal industry has been criticized time to time because government failed to keep the industry competitive and just prolonged its life with a huge public support. But on the other hand we can say Japanese inefficient coal industry is now almost diminished without any social problems and some areas where coal mines once located could transformed their economic structure to a good direction during the long transitional period.

As for the steel industry, Japanese government strongly supported their rationalization and modernization programs during 1950's and 1960's and thanks for them, Japanese steel industry could become the most modernized and advanced one in the world market in the second half of 1960's.

In Poland there has been only the policy for phasing out old industries, but no positive and supportive policy for transforming the old industrial structure to modern one.

After the economic reformation in 1990, the Polish government has adopted a typical classical free market system as its economic framework. Role of government on the micro economic activities was reduced drastically. The market environment surrounding state companies was changed from monopolistic, non-competitive one to free competition one. They had not been ready to the new circumstances. What happened in Poland after the new liberalizing policy started ? What is the result of the market selection and is it desirable one which the Poles had expected before?

I would like to discuss the changes of Polish economic structure under the free market economic system for these 10 years from the view point of industrial policy.

## 2. Change of Industrial Structure

First of all, the Polish macro industrial structure has changed since 1990. Shrinking of the share of manufacturing industry and development of trade, finance & insurance and service industries for individuals and businesses have been observed. This change would be natural under the new economic circumstances. The new economy needed development of these industries and there were a lot of business chances in this field. The development of these industries could become good absorbers for unemployed people and also gave a flexibility to the Polish economic structure.

Secondly, in the structure of manufacturing industry, we can see a reshape of the old structure which had been biased on the heavy industry. Namely capital goods industries especially industrial machinery industry were almost collapsed. At the same time, the light industry also shrunk greatly due to the liberalization of foreign trade.

In the first two or three years from the reformation, food processing industry and basic material industry such as steel industry and energy and power industry which were still protected from outside market, could maintain their position, and then daily necessity goods and durable consumer goods industries began to recover their production because of investment of foreign firms in the Polish market. The change of the industrial structure could be said a result of adjustment to the new circumstances of Poland.

Then I want to show another type of structural change in the textile industry. Before the economic reformation, Polish textile industry had a full self-supply structure. They imported cotton and wool as raw materials and spun them to thread, weaved cloth and made clothes and other final textile products. Poland also had textile machinery industry which could supply the necessary machinery for domestic needs. But now, the fully sustained structure changed. They import thread and cloth and concentrate their activity on knitting and sewing. But the domestic market for clothes has been taken over by the cheap imported goods. So Polish apparel manufacturers have to export their products to EU market. Unfortunately brand names of Polish apparel manufacturers are not established in the market and they do not have strong sales channels and networks in the market either. This means that they have to depend on OEM system under foreign famous apparel companies. As for the textile machinery industry, they lost their domestic market for spinning and weaving machinery because of reducing activity of them and as for sewing and knitting machinery they can not compete against imported ones and are giving up the domestic market too. This means that Polish textile machinery industry has almost collapsed in these 10 years.

This structural change in the textile industry can be said the result of liberalization of foreign trade. This policy forced Polish textile industry to find their new position in the liberalized market.

When we remember about the objectives of Japanese industrial policy in the post war period, we can say it was perpetual efforts for making advanced industrial structure, that is a shift from consumer goods dominated industrial structure to capital goods oriented industrial structure. We also focused our efforts to foster strong supporting industries such as metal processing industry, parts and components industry for machinery industry. Through this efforts we could build up today's well-balanced industrial structure. On the contrary, Poland abandoned the well established self-supply system and took only knitting and sewing part out of whole textile related industrial activities. This is the new division of labor for the Polish textile industry under the free market system. Is this structural change an advancement or a retrograde for the Polish industry?

### **3. Industrial Organization**

The industrial organization has also changed greatly.

Monopolistic supply system had to be changed and competition policy was introduced. Before the reformation, competition in the market had been deliberately avoided. Foreign trade was strictly controlled and it was common that manufacturing companies did not produce the same products which other companies produce. This kind of non-competitive condition had been gradually changed during the reforming period in 1980's. Industrial Associations were dissolved and member firms got their independence from the Association's control. Moreover each factory under the same company also became independent company. So the market was divided into small pieces and the companies could not gain the scale merit from integration of the market share.

Polish government introduced Anti-monopoly Law in February 1990 and established Office of Competition under the law. It is said that Polish competition Law is the most advanced one among the EU countries.

Now, some people point out one of the most urgent problems which should be solved is the fragmented industrial organization. They are wondering how the fragmented power companies, sugar factories, construction firms could be consolidated for surviving in the future?

Ministry of Economy tried to accelerate integration of the fragmented industries such as electric power industry but the attempt was refused in the Ministerial Committee and the future structure of the industry left to the market choice. As we can easily expect, the new industrial organization has been formed by initiatives of foreign companies. Foreign companies started buying the Polish fragmented power companies and are targeting to get some dominant market share in the Polish market.

How to form the desirable industrial organization is one of the most important subjects for industrial policy in order to strengthen international competitive power in the world market. In the case of Poland, government did not take initiatives for it and depended on the market choice. It means that foreign companies will decide the future Polish industrial organization. In the case of Poland Government could not establish a clear vision for the future industrial organization could not be established and their policy seemed floating back and forth. So they could not utilize its privatization process of state companies as a policy measure either.

On the other hand foreign investors have their clear strategy to gain a substantial market share in Poland. Some domestic capitals now are moving to establish industrial consortia or group holding companies to maintain some market share but the markets of cement, beer, sugar, pharmaceuticals and some chemical products, are already divided and controlled by foreign investors

#### **4. Selected industry by FDI**

The macro economic figures in Poland shows expenditure for consumption is in the very high level and investment expenditure does not seem to be big enough to modernize the nation's economy. Japanese economic reconstruction in the post war period was carried out through active modernization investment on industries and the fund for investment was procured through domestic financial market. In the case of Poland, domestic private financial system is still weak for supporting domestic industry's rationalization plan. More over Polish government has maintained strict fiscal policy with high interest rate.

Under the policy, many companies had to procure the money for the modernization by self-finance. This is one of the main reasons of delay of the modernization plans. The government did not support the modernizing efforts of individual industries and did not put strong policy priority for supporting them.

Today it is thought that FDI is the best way to solve the economic problems such as lack of capital for modernization, obsolete technologies, weakness of marketing activity, old management system so on. FDI can offer all of the necessary resources for modern management in a package. And Polish economy came to depend on the FDI for their economic modernization. Since 1994, FDI in Poland has been grown gradually and for these two or three years, Poland has attracted largest foreign investment among Central European countries.

During the early 90's, FDI in Poland was dominated by small and medium size companies from neighboring EU countries. But as the economy was stabilized successfully, in order to grasp the domestic market foreign large companies began to invest, at first in the field of daily necessary products such as beer, tobacco, first food, detergent, confectionary so on and then diversified their investment priority to durable consumer products such as automobiles, electronics products.

Foreign investors decided their investment fields through their world wide management strategy. Usually foreign investors did not show their interest in capital goods industry like machinery industries. They are not willing to make efforts to foster parts and components industries. They apt to import components and parts from their mother factories or their own long related companies. Capital goods industries will be left without outside support.

After the change of the administration in 1997, the policy of privatization changed and the process was accelerated in order to fill up the budgetary deficit. Polish government strongly needed new source of income. Since then, Poland has gotten a great amount of foreign capital by inviting foreign investors to large privatization projects. They included telecommunication, large retail banks, national airline, power sector and so on.

The government has been trying to privatize the second largest oil refinery, large steel mills, power companies. However, we have to remember again the foreign investors' preferential sector is not always the same of Polish desire. The oil refinery has not been able to find out appropriate investors so far. In the case of Huta Katowice steel mill, foreign investors required to divide the largest steel mill in Poland into three parts and it seems to be difficult to find out an investor for the main part of the company, the steel production division.

Polish government asked a Canadian consultant to make a modernization plan for the steel industry in 1992 but the implementation of the plan left to the hand of each company's self efforts. Without governmental supports, their modernization plans for gaining international competitiveness had to be delayed. I think Poland missed the chance to foster the internationally competitive steel industry and missed to strengthen their negotiation power against foreign investors. When we decide to entrust the future of nation's industry with hands of foreign investors, we should assess their managerial strategy in the global market and seek the effective negotiation way against them. □ At the same time we should improve the market position of Polish companies. This is the way to increase negotiation power against the foreign investors.

## **5. Fostering Small and Medium Size Enterprises**

Fostering SMEs is now one of the most important policy objectives for almost all countries. In the Central European countries, the role of SMEs is thought as an important measure for creating new employment, filling the gap which could not be covered by large enterprises and improving the industrial structure which should be more flexible to the change of economic environment. More over, it is also thought that supportive policy for SMEs can be the only industrial policy which will be allowed even under the IMF conditionality.

In Poland we could see an emergence of huge number of SMEs after the end of the planned economic system. It is known that majority of newly borne SMEs during the early stage of transition are trade and service companies which had not developed under the former economic system. As for the manufacturing industries, entry barrier to the market is higher than that for trade and service industries. They need a large initial investment and sophisticated technological and managerial skills. The emergence of SMEs had a significant meaning for modernizing the Polish economy and stabilizing the society by giving chances of new jobs to many people. The phenomena of the high rate of emergence of SMEs can be compared with the situation of Japan in the post-war period. A drastic social and economic structural change gives great chances for people to start something new.

Under the planned economy, technologically specialized SMEs was difficult to exist because of in-house manufacturing system which was prevailing and adopted by large state companies. State manufacturing companies were apt to produce not only final assembled products but also the parts and components by themselves. More over they usually had maintenance and repair factories under them. It means that free accessible market, which is essential for existence of independent SMEs, had not been developed. Even now casting products of parts and components for machinery still are produced mainly by in-house factories of large machinery companies. This market situation is one of the largest barriers for development of technologically specialized SMEs in Poland. If we want to promote development of SMEs in the field of manufacturing sector, we have to change this enclaved market condition first.

I can also point out another specific market condition for SMEs in Poland. Sometimes, SMEs can be born and grow in a protected local market. Local market sometimes has special character and preference of taste for selection of goods. Some products can not be distributed in far distance and will be consumed in the local market. These naturally protected local markets could be a cradle for local SMEs. After accumulation of power in the market some SMEs can expand their activities to nation wide market place. However, this growing process of enterprises could not be applicable in the planned economy. The domestic market had been highly standardized and become very equal and common. The government had deliberately eliminated specialities of local markets for these 40 years. Polish government also adopted very rapid liberalization policy for international trade and very low tariff rates on components and parts were applied.

I think Polish government has not offered favorable market conditions for SM manufactures to grow. SMEs in Poland was not given a time to prepare and improve their competitiveness to cope with the large foreign companies and imported goods.

Market conditions are varied by each industry, so we have to think about the characteristic of market condition of each industry and to prepare the most appropriate policy for them. I am regretted that the current SMEs policy is very horizontal and missed differences of the characteristics of each industry. I don't deny the importance of horizontal approach for SMEs promotion policy, but I think we can not succeed to foster, for example a desired supporting industry without more specific sector approach. I want to stress that the Central European countries have very different market conditions for SMEs from the Western countries and it has to be changed.

## 6. R&D and Innovation Policy

We saw the drastic shrink of R&D expenditure in the Central European countries after the reformation. It is understandable that policy priority of supporting R&D activity is not high when the society and economy is under a turmoil.

But, I have to point out another problem. After the adoption of free market system for their basic economic framework, governments in many Central European countries thought applied research should be carried out by the private sector and only basic research should be supported by government. Then, almost all national research institutes which had devoted mainly to applied research and transferring the result of the research work to state companies, have faced critical financial problems. In the case of Hungary and Czech, many national applied research institutes have been bankrupted and survived institutes had to change their activities from research to giving certifications and technological analysis services.

I think there is a serious misunderstanding about the role of government in the R&D activity. If private sector has not developed strong enough in the country, we can not depend on the private sector for applied research. The role of government is to supplement the weakness of private sectors and if so, government should support R&D activities of private sector or conduct applied research by themselves.

There exists a very wide technological gap between Central European countries and Western Advanced countries. The most urgent technology policy is how to fill this gap. Introduction of foreign advanced technology is needed and at that time national research institutes could and should become technology transfer centers for domestic private industries. For this purpose they have to keep their technological level high enough to select and digest foreign advanced technologies for domestic private sector. This is because applied research activities in national research institutes are needed. At the same time we should stimulate and promote private companies' R&D activities but we have to wait a little while till the private sector become to be able to afford to start R&D efforts.

## 7. Conclusion

In early 1990's, it was said that "No policy is the Best industrial policy." After that, some policy revision was made and several sectoral industrial policy programs were prepared. But basically governmental direct initiatives on specific economic activities has been avoided till now. Free market system are thought as the most efficient economic system and believed to bring us the most preferable result for the national economy in the Central European countries. But I think we have to think about the different development stage of economy and industry in each country. Ministry of Economy in Poland defined the industrial policy as follows; "The industrial policy is to promote economic development by not denying market mechanism but by utilizing it in an effective way." This approach is really right. We can not get the desirable goal against the market mechanism in the current economic system. However, I think we can guide and lead the national economy to the desirable direction under the effective governmental influence. I know that the environment for governmental initiatives on economic activities has changed compared with the one in 1950's and 1960's, when Japan could recover and develop our national economy under the strong influence of the government industrial policy, but I think we have still some room to allow the government to act more actively.

The main players are obviously private companies in the market mechanism framework. So we should prepare a good facility for them to act freely. But if we understand the real condition of private sector in the Central European countries, should we force them to compete with western large companies in the same play ground at this moment ? The fair competition which the Western advanced countries say is not always fair for the companies in the Central European countries. Many Central European countries already expressed their hope to join the EU and accepted the conditions which EU required for the member countries. This policy choice by the Central European countries is very different from that of the East Asian countries. The East Asian countries still try to keep the important role of government in the field of economy and industrial development. They have a future vision of industrial development and making efforts to realize the goal. And more importantly they recognize their private sector is not strong enough to compete with foreign large companies on the same ground.

I know that the social and historical background can not be comparable between Asia and the Central Europe. Asian countries seem to try to keep the varieties but European countries, on the contrary, try to get unity among them. Eventhough, I can just say if we decide to entrust every thing to the choice of market, we have to be very careful of the result and make efforts to get a good result as much as possible. Through this efforts we can rediscover the real role of government under the transitional period.



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## Role of government, private sector and private organizations

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### 1. Introduction

The government provides many economic functions that affect the way in which exchange and resources allocation are carried out in the economy. Basically, government can provide a legal structure that encourages or discourages economic activities. The government attempts to stabilize the economy by smoothing out the ups and downs in business activity.

During the post-war period the developed capitalist countries started from the mechanism of free market that prevailing functioned spontaneously to a mechanism which functions in a mainly organized manner. Developed capitalist countries achieved an intensive scientific and technical progress with important positive effects on economic efficiency, incomes, and population consumption.

In comparison with good evolution of the developed countries, the European socialist countries experienced economic decline due to the economic system characterized by super-centralized and bureaucratic planning.

After the removal of the monopoly of communist parties' power in European socialist countries, the option of new political forces in these states for their orientation to market economy has been justified also by the necessity of replacing the economic system. This mechanism was almost blocked with a mechanism similar to the one used by the developed capitalist countries.

Many people believe that the only way to attain economic efficiency is through competition. One of the roles of government is to serve as the protector of a competitive economic system.

Through privatization and creation of new enterprises it tends to remove the monopoly of state property and to assure the predominance of private property in all economic branches. The post-socialist transition period is defined as a mixed economic system where the elements of centralized management by the state are mixed with elements of the market economy. Consequently, the functioning mechanism of the economic and social life is much more complex than both the economic system that existed in socialist countries and the economic system existent in developed capitalist countries. In most European ex-socialist countries this situation was not taken into account. It was considered that the transition from planned to market economy should occur through a total liberalization of prices, wages, profits, currency, and external relations. As a result, financial blockage severely influences almost all enterprises in these countries. The way out of this impasse is not possible without reconsideration of the economic system used in the course of transition. It is necessary that such economic system centered upon the market and the economic rules should occur not as a spontaneous process, but as a process with the involvement of the state, economic agents, and all citizens.

## **2. Property rights and entrepreneurship**

If you were in a country where bank accounts and businesses were periodically expropriated by the government, how willing would you be to leave your money in a savings account or to invest in a business? Certainly you would be less willing than if such things never occurred. Therefore, the more certain private property rights are the more capital accumulation there will be. The property rights and the legal structure in a nation are closely tied to the degree with which individuals use their entrepreneurial skills. Entrepreneurs are the risk takers who seek new ways to do things and create new products.

In ex-socialist countries, privatization is often considered as a fundamental premise for the establishment of a democratic political regime and for the transition to market economy. Privatization cannot be limited only to this role since this process has many implications in the restructuring of the entire economic and social life in each country. Privatization holds the main role in the restructuring of the property system on which socialism was based. The monopoly of state property was set up as a basis of a political system of the proletarian dictatorship. However, this monopoly produced inefficiency in economy, since the enterprises and the citizens themselves have been frustrated by the attribute of property, a fact that made the state or the entire people's property be considered as no one's property. Through privatization process, the transfer of the largest part of state property into private property of citizens is assured, either free of charge or for a payment pursuing that the private property should become predominant in each country's economy.

On one hand, it is necessary to avoid crumbling the object of property among a large number of small enterprises since they cannot carry out an efficient activity and, therefore, cannot be viable. On the other hand, it is necessary that the new subjects of property that came out after privatization should adopt the organizing forms able to favor the extension of economic activities and the achievement of performances.

State property monopoly in ex-socialist countries considerably limited the individual and group economic interests, suppressed personal initiative and responsibility due to the super-centralized management of economic life; it severely influenced the possibilities to satisfy the needs of each individual and of the whole society. By privatization, a favorable ground for individual and group interests is created. These interests strongly stimulate citizens' initiative for successful economic activities they are involved into. However, at the same time, it determines them to assume the responsibility for the effects produced by the respective activities.

In modern market economy the activity is adjusted predominantly consciously by an adequate use of the objective laws by both economic agents and the state. The combination within the economic system of the market with the state's economic role explains, at large extent, the successes recorded by the developed capitalist countries during the post war period.

It has been argued that one way to improve economic growth in any nation is to improve its infrastructure. Each economy's infrastructure consists of its roads, communication system, financial system, and educational and training institutions.

## **3. The increase of the role of the market and the underestimation of the state's role**

The most important way in which a government influences the economy is through the governing plan. We are living now times when free market economy, globalization, deregulation are words on everyone's lips. The concept of no government intervention is more and more obsolete.

Consider a hypothetical world where there is no government regulation against pollution. You are living in a town that so far has clean air. A steel plant moves into your town. It has paid for the inputs of producing the steel: land, labor, capital, and entrepreneurship. The price it charges for the steel reflects, in this example, only the costs that the steel plant incurred. In the course of production, however, the plant gets one part of an input – smoke dispersal – free by simply taking it. The steel plant does not have to pay the cost of cleaning up smoke; rather, it is the people in the community who pay that cost in the form of dirtier clothes, dirtier cars and houses, and even more respiratory illnesses.

Developed countries such as Japan, United States, Great Britain, France, etc., are adepts of free market economy with some level of government intervention. Even Adam Smith promoted the idea of British float protection and nowadays governments cannot ignore the necessity of their intervention in economy to protect emerging and strategic industries and lead to economic growth. The government should facilitate conditions in which competition is most efficient and help where is not so efficient. To be efficient a system based on competition needs a well-developed legal system. This legal system must be periodically updated to reality and latest events. The state decision-making persons must have a high morality and implicate themselves in issues regarding the national state interest.

The functioning mechanism of socialist economy was centered on a super-centralized and bureaucratic plan. Within this system, the role of the market and the objective economic laws was considerably limited, in spite of the existent production commodities. Consequently, this economic system led to a deeper blockage, a fact that contributed to the fall of the Soviet type of socialism.

The transition in ex-socialist countries situated on the foreground of replacing the economic system based on the super-centralized plan with an economic system centered on market, which would be similar to the economic system in developed capitalist countries. As a consequence, important steps were achieved in the organization and functioning of other market categories: the labor force market, the capital market, and the monetary market. Along with citizens' assimilation of the necessary knowledge and an adequate conduct for their participation at all markets the increase of the market role in the functioning of our economic life is to be expected.

The markets secure a direct connection between the solicitants of products, services, labor forces, capital, and currency, and those supplying these elements. Each market is in a permanent interaction between demand and supply, favoring their reciprocal adoption. The disequilibrium between demand and supply, revealed by the market determines the economic agents to act for surpassing it. Markets substantially contribute to the allotment and efficient use of the available economic resources from the national economy. In this case, the economic agents are continuously preoccupied with increasing the efficiency of economic activities they are involved into.

Parallel with the positive effects the functioning of markets also produce some negative effects: speculation, the tendency of some economic agents to domination, breaking of the legal and moral norms within the relationships between citizens.

Taking into account that the main role of the market within the economic system in developed capitalist countries, I can say that the state's role substantially increased. It tended to amplify both the positive effects of the market and the limitation of the negative ones.

The democratic state should play an active and positive economic role in the conditions of modern market economy.

I consider that the state's role should confine to:

- 1) The adjustments of the frame of the economic activities
- 2) State's intervention to fix the situations of failure of markets
- 3) Redistribution of incomes

Many laws were elaborated and a series of adequate institutions were founded for functioning of the market economy, assuring thus the possibility that should more and more satisfy their individual and group interests in various economic activities.

In the modern world it is impossible that the state does not make decisions regarding the way in which competition must be organized within the market. At the same time, the state institutions should focus their attention on the elaboration of certain rules regarding the economic competition according to the total purposes of the society. If in the countries with a market economy consolidated long ago, the state plays an important role in competition, such role is also necessary in the course of transition in ex-socialist countries.

It is necessary a sustained preoccupation of the state to stop the decline of production, so that it may balance the ratio between demand and supply. It still does not exist the necessary ground for competition between economic agents that activate in each branch and the consumers are constrained to accept almost any commodities. That is why, it is necessary that the state should involve more substantially by both its economic possibilities and certain programs not only for the increase of production, but also for its restructuring according to the needs and real possibilities of the country. The state should provided a general climate for an economic activity able to determine companies to continuously deal with improving quality and reducing costs. Without perseverance in this direction products will not become competitive and there is also the risk to lose even important segments of the internal market in favor to foreign commodities.

It is necessary that the state should organize the process of privatization in such a way that its process should lead to both the increase of private sector in the total national economy, and the formation of competitive viable companies. This would secure a favorable ground for the competition in each branch and increase initiative and responsibility of all economic agents.

On one hand, an intensive competition on a healthy economic base on inner market that would allow an increasing number of economic agents to become competitive on the external market. On the other hand, the protection of the branches with strategic importance given by the state (which is accomplished in the developed countries such as Japan, United States, France, etc.) in order to avoid an increasing economic dependence of the country along with integration into the world economic circuit.

#### **4. Romania**

Since December 1989, Romania has undertaken an ambitious program of transition to a market economy based on private ownership and free competition.

The adoption of a new constitution in 1991, the free parliamentary and presidential elections in 1990, 1992, and 1996 as well as local government elections in 1992 and 1996 have all contributed to an irreversible break from the past. Today, the country is firmly moving towards a fully market economy.

After December 1989 in Romania it was estimated that an economic system based on the market should be secured without any gross intervention of the state in the evolution of national economy. The underestimation of the role played by the state in the modern market economy had negative effects on our transition towards such economy.

The main elements of the reform process have included: prices and foreign trade liberalization, privatization of state-owned properties, development of a free trade and healthy financial system (including banking activities, insurance companies, capital market).

The inadequate involvement of the state favored the perpetuation and even deepening several disorders within our national economy, the extension of anarchy, and the multiplication of the anti-social facts in all fields of the economy.

The state may – and should – determine the extension of competition of Romanian economy by adopting and using the legislative and institutional frame. It is necessary that through the entire economic legislation and economic institutions, the state should determine all economic agents to deal with the extension of their activity and increase their profits on a healthy base: the increase of labor efficiency and cost reduction, qualitative and sorts commodities structure improvement.

The government has encouraged the development of the private sector. In fact, more than 500,000 private companies have been set up, which now provide about 45% of the gross domestic product (GDP) and employ more than one-third of the active labor force.

Moreover, the private sector accounts for more than 40% of exports, 70% of consumption work, and 45% of services.

Imports and exports were also liberalized and new fiscal and monetary policies were promoted to control the budget deficit and inflation.

Confidence in the national currency – leu, has increased due to the positive real interest rates offered by banks and stabilized exchange rates on the domestic hard currency market.

Romania is also aiming to attract major inputs of foreign capital, technology, and managerial expertise, so as to redefine and improve its competitive advantages. To increase foreign investment, the Romanian government has promoted an active policy of attracting capital through setting up favorable institutional framework and adequate legislation. This legislation provides free access to markets and offers tax incentives in the case of substantial investments in the field of production.

The consolidation of the domestic investment environment is an absolute priority in our policy to attract foreign capital. To this end, it will be important to further liberalize economic activities and remove the obstacles and bureaucratic hurdles that foreign investors still need to overcome when negotiating and operating on the Romanian market.

In this context, essential changes were made so as to comply with the requirements of the Romanian economy's integration into European and Euro-Atlantic political, strategic, and economic institutions.

The state may – and should – provide the necessary connection between the competition in the inner market, and the degree of the competitiveness with which Romania participates at international economic relations.

Acting along the above-mentioned directions, the state might provide a predominantly organized competition for the Romanian economy. It would have favorable effects for both the economic agents with an efficient activity and meeting the demand of population's consumption and the demand of productions means for the economic activity. Without competition we can not get to a modern market economy able to provide an increasing evaluation of the available economic resources and the raising of the population's life standards.

In Romania, the national economy suffers because the state did not get involved as much as needed. Therefore, weak industries were almost killed by the outside competition without some sort of protection, by a controversial privatization of state owned enterprises, and by the lack of legal activity to prevent frauds, bribes, and corruption.

Besides privatization, the restructuring of unprofitable companies is an important task. To this end, the government has issued new regulations aimed at generating a positive cash flow in such companies, reducing and finally eliminating inter-company arrears and developing profitable economic activities without state support.

The main objectives of privatization as part of the overall economic reform program are:

- to create profitable private companies;
- to raise funds for restructuring and rehabilitating commercial companies;
- to establish the commercial and entrepreneurial management practices to be followed by those companies;
- to provide the background of an efficient capital market; and
- to educate the Romanian public as to the operations of a capital market in a market economy.

Privatization of farming land and other assets in agriculture is an essential element on the general reform program because agriculture has always been regarded as one of the main sectors of the Romanian economy. In Romania, more than 70% of farmland is now private property. The technical equipment of private farms has also expanded. For instance, they own nearly 50% of the total tractor fleet, up from 4.8% in 1990.

Under a 1990 Land Law, Romanians received the right to claim up to 10 hectares each from land that the communist had confiscated from private owners. However, land restitution has so far been slow.

The government ignored the national interest by borrowing money from international organizations at high interest rates and just waited for foreign investors to come without creating a safe and attractive field for investments.

Even the capital market did not received proper attention. After having been closed by the former regime for more than five decades, the Bucharest Stock Exchange officially reopened on June 1995.

Although, Bucharest Stock Exchange, a self-financing institution, posses modern trading and clearing – settlement systems can be compared with other prestigious stock exchanges from around the world, it struggles with a low capitalization and daily turnover. Big and attractive companies from industries such as banking, telecommunications, airlines, petroleum can not be found between the companies listed at Bucharest Stock Exchange. Moreover, government securities, here including government bonds, T-bills are not traded on this market. Instead of using this safe and cheap market to raise its capital, the government continues to ignore it presence.

Restructuring of companies was given high priority in the government program. In implementing this objective, the government worked closely with international financial institutions and the European Union to achieve progress in this area:

- the International Monetary Fund (IMF) program includes, among others, the restructuring objectives of enterprises;
- the World Bank has established upfront conditions regarding enterprise restructuring in order to proceed with its Financial and Enterprise Adjustment Loan (FESAL);
- PHARE has insisted on restructuring. During several months, an institutional framework has been created for to facilitate implementation of a restructuring program

In order to stimulate enterprise reform, in 1996 the Parliament endorsed the competition law, a law meant to protect, maintain, and stimulate competition, in the context of promoting consumers' interests. The Ministry of Finance is responsible for administration of state monopolies. The prices and tariffs for the products and services of state monopolies are to be supervised by the government and approved by the Office of Competition.

## 5. Conclusions

Starting after 1990, the privatization program of the Romanian economy has led to an increase in companies' capabilities to meet market economy requirements and adjust their behavior to the rules of competition.

The Romanian policy-makers and legislators have tried to keep a strict balance between the domestic reality and international practice, the international pressure of the workers and the interests of the foreign business community and the potential strategic investors and, last but not least, between the great variety of privatization techniques and theoretical approaches and the spirit of consistency and continuity.

