

# "MITTELSTAND" AND TRADE IN SOUTH EASTERN EUROPE

- Social market economy as a  
compass of development -

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# Preface

South Eastern Europe and especially the countries of former Yugoslavia are often regarded as a synonym for political, social as well as economical instability with future prospects that are more than complicated. However, the celebrations on the occasion of Bulgaria's and Romania's accession to the European Union (EU) on 1 January 2007 pointed the way forward to a peaceful stabilisation of the region. They raised the hope of the so called Western Balkan countries to move into the same direction as soon as possible. Once more the enlargement process of the EU has thereby proved its capacity to help applicant countries transform into functioning democracies and free market economies.

Promoting democracy, civil society and social market economy worldwide is one of the most important tasks of the Konrad Adenauer Foundation. Focused on the fundamental principles as freedom, social justice and individual responsibility, we have been involved in the transformation process in South Eastern Europe for many years.

We are convinced that "Mittelstand"<sup>1</sup> and trade are the driving forces behind economic prosperity. Therefore, the contributions that follow are supposed to provide a theoretical basis for further economic progress and stabilisation of the young democracies in the region. "Mittelstand" and trade - as the backbone of the European economy - represent today 99,8% of all enterprises. They employ about two thirds of the workforce, generate more than half of its value added and thus play the crucial role in creating economic development. Furthermore, they have, in the context of their underlying values, a special influence in backing up basic ideas such as individual and social responsibility.

The purpose of this publication is to encourage the creation of a stable and socially responsible entrepreneurship, as well as the establishment of social market economies in South Eastern Europe. The nine country reports from Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Montenegro, Romania and Serbia make concrete and practical recommendations to move in this direction.

To raise awareness of the special significance of "Mittelstand" and trade in wide parts of the local population, we attached great importance to the involvement of the academic environment - already during the writing of these reports. Through close cooperation among universities, entrepreneurs and politicians we strive for the improvement of the legal framework, the strengthening of self-administrative institutions and hence for the further development of "Mittelstand" and trade themselves.

With assistance of our local offices in the region it is also intended to create a platform for constructive discussions between local politicians, international stakeholders and possible investors, as well as bringing about intensified cross-border cooperation between the countries of South Eastern Europe.

Bearing in mind that "Mittelstand" and social market economy draw upon European and Christian values in general it is necessary not only to underline the economic factors but also to pursue an interdisciplinary approach. Therefore the different country reports embark on a brief historical introduction, followed by a general overview of the legal framework and a description of the institutions of self-administration.

For a better understanding of the specific position of "Mittelstand" and trade in the countries in South Eastern Europe the authors, first of all, point out their particular problems and requirements. Additionally, they identify the difficulties resulting from the socialist past and underscore the opportunities which could arise from the reform of the legal framework and from more efficient cooperation between local self-administrative institutions.

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<sup>1</sup> *In the international usage one can observe that the German term „Mittelstand“ has been increasingly adopted without any translation.*

The final chapter of each report makes concrete recommendations to political decision makers on how to initiate a fruitful process of developing the "Mittelstand" and trade. Such a process is supposed to contribute to the strengthening of "Small and Medium sized Enterprises" (SMEs) in the region and to support a productive collaboration between all actors.

As the political heir of the fundamental ideas of the first German chancellor Konrad Adenauer and his successor Ludwig Erhard, who substantially coined the German economic system, the Konrad Adenauer Foundation has committed itself to the promotion of social market economy principles worldwide. The creation of a socially responsible entrepreneurship ought to be the cornerstone of a successful economic upswing and is supposed to provide the population in South Eastern Europe with its social benefits. The following country reports emphasise the opportunities and benefits to establish the basic values of social market economy in the region.

I would like to thank Dr. h.c. mult. Karl-Jürgen Wilbert, Hauptgeschäftsführer of the Handwerkskammer Koblenz, and his assistant, Dr. Evelina Parvanova, for the good cooperation in the realisation of this project.

*Dr. Gerhard Wahlers  
Deputy Secretary General  
Head of Department of International Cooperation  
Konrad Adenauer Foundation*

# 1. Albania

by Denalda Kuzumi

## 1.1. Historical terminology background and terms of reference for the study

This paper is an attempt to measure the middle class in Albania, its components, characteristics, cultural and historical imprint, and progress in recent years. The reason for this lies in the importance that the term "middle class" has according to many sociologists. The stability perception that the existence of a middle class gives to a social structure or society is related to its position and function as described by Weber: "A class that does not have the possibly explosive tendencies of the lower class nor the absolutist tendencies of the upper class: a unit of professionals and business owners, with a certain level of security against social crisis because of their skill or wealth". (from Tilkidjiev: online)

As regards the means of production (Marxism), the middle class has more access to them than the lower class because of its skills and the power given it by the upper class, although the middle class remains in the service of the upper class and the assets, power etc. that the latter represents. Sociologists like Bourdieu, Goldthrope, or Tilkidjiev of the Sociology Institute of Bulgaria, or Denis Gilbert, who work on middle-class reality, have developed modern definitions that reflect this reality in their respective countries.

According to Tilkidjiev "the middle class is essentially a macro-social group, embracing individuals or rather categories of individuals, marked by a unique general attitude towards life. They are persons who owe everything to their own efforts, resources, qualification, education etc. Self-made as they are, middle-class people are also self-employed and relatively free and autonomous in their work. Their knowledge and qualifications, property and managerial skills are intentionally acquired, and so is their social status (...) and the status of the middle class within the hierarchy is clearly unique - in between the "upper-class" elite and the "lower-class" workers, in between the envy of the world and the pitied ones; hence the ability to adapt oneself quickly to different conditions and situations. Hence the stability effect that this group has in society". (Tilkidjiev: online)

In this paper, I rely on Tilkidjiev's definition **for my qualitative classification** of the middle class since the author has a post-communist national background and refers to the classifications of modern sociologists like Goldthrope, Evans, Bourdieu and Savage. He distributes the middle class in three strata: SMEs, public servants and the intelligentsia.

## 1.2. Historical background<sup>1</sup>

### 1.2.1. Middle class and trade in Albania during the medieval period

The historical path leads us back to the first signs of structured artisan production: the guilds system. The first signs of guilds in Albania are found in the 13<sup>th</sup> and 14<sup>th</sup> century in Durres and other areas. These guilds were established under Venetian

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<sup>1</sup> The data were taken from Mr. Zija Shkodra, *Esnaftet Shqipetare*, Chapter 2, Tirane 1973.

influence and ceased their activity during the war against the Ottoman invasion. During the Ottoman invasion from the 15th to the 20th century, Albania embraced the Muslim guilds system like the other SEE countries.

They were the only organisations recognised by the empire and the local authorities in the Albanian cities that were able to control activities (shoemaking, tailoring etc.) with a restricted and legally enforced access to professional knowledge, material, and production. Only the guild members had the right to practice the respective profession and run a business on their own, once they had become masters. Guilds represented the only structures that could engage in specific trade and crafts activities in town: handicraft workers were forbidden by law to run any business if they were not members of a guild, and only masters were allowed to be members of a guild.

The masters or guild members, besides representing their craft during the medieval period, show many features attributed to modern middle class representatives: **Education as part of the cultural capital**: only guild members had the right to become skilled in a certain profession. The businesses run by guilds are very similar to what we today would call **a family-run micro-enterprise**, which is often referred to as one of the components of the middle class. **High access to production**: because of knowhow and the regulatory framework.

## 1.2.2 The middle class after independence: 1912-1945<sup>2</sup>

During this period, Albania went through several stages of economic development which were mirrored in the production methods, the production activities, and the trade and social structures of the time.

At the beginning of the 20<sup>th</sup> century, Albania had implemented methods of capitalist production which, however, were not yet widely spread because of the feudal military system of the Ottoman Empire. The period between 1912 and 1924 was characterised by a lack of political stability and, consequently, slow economic growth. According to Ruli, "by 1920 the period of elementary capitalist accumulation is over (...) and therefore the period from 1920 to 1938 is seen as a period of stabilisation of the capitalist economy or industrial development" (Ruli 2000: 208).

Some trends of change:

The average number of workers per industrial production unit grew from 2-3 in 1912 to 15.7 in 1928 and to 30.5 in 1938.

The shift in importance from trade to industrial production. 1912 was characterised by a wide range of industrial goods being supplied by the trades. Only 10 Cities contained 4,600 shops of all kinds (Fishta). By 1936, industrial production accounted for 53.5% of non-agricultural products, while trade produced 46.5%. This shift in importance from trade to industrial production was backed up by the entry of foreign capital and the world economic crisis that struck Albania in 1934.

According to Fishta, the economy was divided into four sectors and accordingly into 4 classes: **the landowners, the bourgeoisie, the peasantry, and the tradesmen**.

Apart from industrial development in this period – from 1924 to 1929 according to Fishta or 1920 to 1938 according to Ruli - Albania remained an agricultural country since agricultural production accounted for 90% of the total domestic output, although attempts were made to modernise agricultural production by introducing modern methods of capitalist production.

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<sup>2</sup> *Fact and values from I. Fishta & V.Toci, Gjendja ekonomike e Shqiperise ne vitet 1912-1944, prapambetja e saj shkaqet dhe pasojat, p.10,14,57-99,148,188.*



*There are no studies or attempts to measure the middle class during these years or during the following period but there are statistical and narrative hints that make us come to the hypothesis that this class was mainly represented by medium-sized household agriculture economies and craft production units. These last were severely struck by the industrialisation movement, the world economic crisis, and a lack of regulatory framework or protection policies.*

### 1.2.3 The middle class under the communist regime; 1945-1990<sup>3</sup>

Under the communist regime, the country underwent a range of political, economic, and social changes. The industrialisation of the country was followed by a constant growth in the urban population (from 15.3% in 1938 to 33.5% in 1969) and the workforce.

Due to the egalitarian political concepts of the regime, the division into strata or classes almost lost its meaning. There is no information about per-capita incomes and their breakdown by profession or activity, although the statistics of that period give some hints that can be decoded. Even though the communist states proclaimed their lack of classes, this could not be implemented totally. As Tilkidjiev states, "positions related to power and authority or (...) can have a central role. The former socialist society is a good example of the predominance of power and authority over economics, culture, and prestige" (Tilkidjiev: online). Power was the most important form of capital that divided people into classes. For one, there was a leading and powerful political class (high political power and a form of cultural capital – education) that I would designate the upper class.

What about the middle class?<sup>4</sup> If we take education as well as power as a classification factor, and state assignments at different levels as a positioning indicator related to power, we can form a vague idea about the middle class as defined by sociologists during that regime.

In 1969, public servants (engaged in state administration) accounted for 21.6% of the workforce. 3% had a university education (intelligentsia and professionals) and 9% were specialists with secondary education, the components of what today is usually referred to as a professional middle class (belonging to the upper-middle, middle-middle, or lower-middle stratum). These "upper-middle class" professionals and intelligentsia (academics, doctors, lawyers etc.) played an important role for the political shift of the 1990s, showing once again the driving force and coordinative values of the middle class.

### 1.2.4. Conclusion:

**Trades in Albania** flourished during the medieval period under the guilds system. This form of production was maintained until the beginning of the 20<sup>th</sup> century. Some of the most common craft activities were leather and textiles processing, artisan work (national costumes, decorative weapons, silver and gold work), and building. Trade disappeared during the stabilisation period of capitalist production and in socialism because of the focus on industrialisation and the lack of protection policies.

The economic-activity structure after democracy (mostly SMEs) could make us hope for a tradition revival. Is it really so?

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<sup>3</sup> Data from Z.Fishta, *Historia e ekonomise se Shqiperise 1944-1960*, Tirane, 2004.

<sup>4</sup> Data from *The Statistical Yearbook 1969-1970*, Tirane, 1970 .

The social structure during the different periods - the medieval period, that from independence to the end of second world war (stabilisation and consolidation of capitalist production in Albania), and the period under the communist regime - show traces of a middle class as a social stratum. Since the middle class concept is related to capitalist societies, the weak presence of this structure (only during the first half of the 20<sup>th</sup> century) explains why the middle class was almost non-existent in the usual meaning of the term. Nevertheless, the characteristics of the middle class can be detected and decoded in these periods, showing how little the educational, professional, and power related social differences among Albanians were during the medieval period, the consolidation of capitalism, and the communist regime.

## 1.3. The legal framework in Albania

### 1.3.1. The legal framework after the establishment of the market economy and the change of the political regime

Political change was followed by an economic reform that started in 1992. According to Ruli, "the initial impact of the change caused several problems. In 1991/92, the GDP decreased by 40% and inflation reached 226%, while unemployment was estimated at 27.9%. The economic reform had three components: macro-economic stabilisation, restructuring the state-owned sector, and the privatisation of the economy, including industry, agriculture, and public services". (Ruli 2004: 217)

The first measures of the reform attempted to bring Albania back on track and tried to build a functioning structure for the market economy. Attempts during the first 10 years of the reform were more economic than anything else. This is due to the difficult path of transition, which was made even harder by the political, economic, and social crisis of 1997. The first attempts addressing the socio-economic structure of the country were made in the I-PRSP (Interim Poverty Reduction Strategy Paper) that was introduced in 1999. This was an IMF incentive, aiming to focus more clearly on growth and poverty reduction, envisaging a higher integration of the poverty-reduction and macro-economic elements of the programme and greater degrees of participation by civil society and national ownership.

The Albanian I-PRSP came into being in 2000, to be followed by the GPRS (Growth and Poverty Reduction Strategy) in 2001. The GPRS focus, as the name shows, still remains on poverty reduction, but it offers a convincing analysis of the transition period, its threats and opportunities, a mid term action plan of public measures, and a tentative long-term development vision. This strategy was replaced by the NSSD (National Strategy for the Social and Economic Development of the country). The NSSD was a dynamic document, subject to change, that addressed public measures, their realisation under the GPRS, public measures to promote social and economic development in 2003/04, and basic objectives of economic growth in the long term 2004-2015.

The NSSD has now been replaced by the National Strategy for Development and Integration (NSDI). "A single national strategy, the NSDI, will build on a comprehensive set of sector strategies and will be guided by a selective set of cross-cutting strategies. The national strategy will emerge as a synthesis of sector strategy documents developed for all sectors. The European-integration and NATO-membership planning processes will be fully incorporated in the national strategy." (Council of Ministers 2006, online)

Under this umbrella, an economic sector strategy, a social services strategy, and an education strategy are to be launched soon as important pillars. This institutional

framework has been mirrored over the years in the legislative framework which addresses social welfare directly and indirectly but the middle class less directly. The middle class is addressed more from an economic point of view in the legislative framework and related strategies (economic sector strategy etc.) that focus on a better business climate especially for SMEs. A series of fiscal laws positively influence SME development and the business climate:

- Reduction of the corporate profit tax from 23% to 20%
- Reduction by 50% of the profit tax for small businesses, from 3% to 1,5%
- Reduction of the employers' social-security burden by 9%, from 29% to 20%
- Reduction of the electricity price for businesses by 30%
- Tax exemption of dividends to be re-invested
- Release from the obligatory annual re-registration of businesses
- More transparent VAT reimbursement procedures

The Albanian SME definition is laid down in law 8597 of 17-02-2002 on small and medium-sized enterprises, a law focusing on political and state measures to classify, provide incentives for, and promote the development of SMEs and a direct legislative contribution to the SME sector.

### 1.3.2. Business registration procedures and the process of reducing the informal economy

Law 9536 of 15-05-2006 to amend law 7667 of 28-11-1993 on trade registration, procedures, and formalities applying to trade associations has shortened the registration process in court from 30 to 8 days. Another task is the IT adaptation of the trade register, the creation of an electronic database, and the improvement of business procedures. The improvement of this service is also expected to help reduce corruption in registration.

The task of reducing the informal economy is another important pillar of the improvement of the business climate. Reducing the informal economy will move a wide range of small businesses and self-employed persons from the illegal fringes to the healthy and legal side of business. Legality, an important feature of the middle class, is a characteristic that businesses which, according to INSTAT, account for 28 to 30% of the GDP do not have. VKM 246 of 21-04-2005 on the reduction of the informal economy, which has been revised and substituted with VKM 430 of 28-06-2006 on the approval of the mid-term plan for the reduction of informal economy 2006-2009 serves this purpose.

SME development is one of the components of the economic sector strategy. SME development policies will be designed in line with the SAA and the European Charter for SMEs. The SME development strategies have been in the focus of the responsible line ministry since 2001 and will continue to be (a national strategy paper for the development of the SMEs is to be drafted by the Ministry of Economics and approved by the government of Albania (government decision 57 of 02-02-2001). Here are some of the direct measures that are expected to be included in this new SME strategy being prepared by the Ministry of Economics with a wide participation by SME consultant companies, business representatives, etc, and to exert a direct influence on the further development of SMEs:

Improving the business climate for SMEs through policies similar to the fiscal policies mentioned above but focusing on SMEs; harmonisation of the SME law with BE; harmonising the trade associations law with EU law; tax deductions especially for SMEs; creating an one-stop shop National Centre and with branches in the cities, etc. Special focus on competitiveness and technology transfer through the innovation and technology transfer strategy, the R&D incentive programme of the University of Tirana, the creation of the Euro Info Correspondence Centre, etc.

Financial improvements for SMEs through donor programmes or other financial instruments like leasing, factoring, guarantee schemes, etc. The legislative impact of the SME development strategy and its implementation is in an early stage but expected to become reality during 2007-2013. Another important law for all components of the middle class; intelligentsia, public servants, and SMEs is law 9380 of 28-4-2005 on rights of authorship and other related rights which is slowly echoing through the Albanian society.

### 1.3.3. Conclusions

Under the socialist regime, the legal framework had a tendency to eradicate the social groups that rose during the capitalist consolidation period, especially the middle and upper class.

After the system change, the focus has been on economic reform and related laws to ensure the system change and the implementation of a market economy. Actions that address social and economic development are taken first through institutional frameworks such as strategies and studies focusing on the matter: PRSP, GRSP, NSSD, and NSDI, then find their implementation in the legislative framework. Many actions like the harmonisation of the SME law with the EC definition or the endorsement of the European Charter for Small Enterprises show guidance by the best practices and legislative framework of the European Union.

The legislation framework shows a tendency to concentrate on the economic aspect of regulations relating mostly to SMEs as such, without distinguishing between their economic activity. Possibly, greater attention should be paid to production-oriented SMEs (trade, etc.) in the legislative framework and in the respective strategies. The middle class as such is not addressed in this context. Trade are also not directly addressed or taken in consideration. No further comments can be made at this point, since using these terms without deeper reflection and including them in the policy and legal framework could destroy its possible positive effects in embryo. After this initiatory phase, a legislative framework specifically for the middle class might follow.

## 1.4. Institutions of self-administration

### 1.4.1 SME Institutions

**Governmental representation:** Albinvest is the governmental agency assigned to assisting and accelerating the inflow of foreign investment, improving the competitiveness of Albanian exporters, and providing assistance and professional support for the Albanian SMEs. Their homepage: [www.albinvest.gov.al](http://www.albinvest.gov.al)

Another important governmental unit is the Business Advisory Council. It is chaired by the Ministry of Economics and composed of representatives of different public authorities, private sector organisations, NGOs, and donor organisations/programmes.

**Business Associations:** (*the common and only form of self-administration*) In Albania, business associations in the normal meaning of the term are associations of

businesspeople with common interests related to production or any other business reasons. In the following, I am going to list the most important representatives or branches to the best of my knowledge:

Konfindustria is a voluntary alliance of businesses in Albania. Its model of governance resembles that of the Italian Konfindustria. Its objective is the protection of its members' interests by offering specialised services or different other operations within its scope. Their homepage: [www.konfindustria.com](http://www.konfindustria.com)

**Agro businesses associations** are gatherings of producers with the same production profile.

**Other associations** are similar to the agribusiness associations; they represent gatherings of businesses of the same field of activity. Being private initiatives today, these associations are growing in number in the market economy.

**Chambers of commerce** function as *independent, non-profit* institutions of *public law in many cities* in the territory of Albania. The Ministry of Economics, Trade and Energy monitors the legitimacy of their activity. The chambers are engaged in representing the business community in different cities in their relations and dialogue with the state as well as in various structures and activities at the national and international level. Membership may be either compulsory (for registered tradesmen and state enterprises) or voluntary (for representations and branches of foreign commercial companies registered in the commercial register in Albania).

**Regional development agencies** or RDAs are important because their role in regional development often focuses on SMEs, like the Korca Regional Development Agency. The services offered comprise counselling, training, information, and studies to the benefit of the business community, NGOs, and central and local government. They operate in 9 regions of the country.

**Other consulting companies** like ACIT (Albanian Centre for International Trade), a multi-functional research centre with a specific focus on international trade, and other organisations also contribute towards better governance and further development of the SMEs at the strategic and operational level, although they are not institutions of self-governance of this middle class segment.

**Financing and support programmes** are highlighted as important in various regional and governmental strategies as well as in many papers focusing on SME development. At this point, they are important for the survival of some of the above-mentioned structures.

## 1.4.2 Intelligentsia institutions

**The Academy of Sciences of Albania** was founded in 1972. It is the most eminent and important scientific institution in the Republic of Albania. It is an independent institution that unites the most prominent scientists of the country, that is, those who bear the title of "Academician". It includes other scientific institutions, centres, and organisms in its system. The new legislation on the Academy of Sciences lays down its position as an independent institution. The Government finances it.

This is a structure that used to be very much alive under the communist regime. Now, it seems to have gained structural without financial independence. Still funded by the state, it faces the same problem that most of the Albanian intelligentsia is facing at the moment; a lack of economic power and backup by proper policies, as in the case of the SMEs.

Their homepage: <http://www.academyofsciences.net/>

**Private research institutes** are mostly non-profit organisations and mostly concentrated in Tirana. They are listed among the self-governance institutions of the intelligentsia because this is where these people are represented. Their non-profit

status is also due to their inability to find a demand-driven market in Albania. The WCI Executive Opinion Survey of 2005 and 2006 shows that R&D activity in Albania is slow, whether in terms of collaboration with universities or in terms of expenditures on R&D (66% of respondents have no collaboration with universities and give an average rating of 1.6 out of 7 to collaboration on R&D with universities, while the average rating for expenditures on R&D is 2.2 out of 7). Although these are not institutions representing the intelligentsia, these organisations “manage the brain power” that is so important for a society. To the best of my knowledge, currently active “elite” organisations include the ICS (Institute of Contemporary Studies), the IDRA (Institute for Development and Research Alternatives), the Agenda Institute, the ACIT (Albanian Centre for International Trade), etc.

**The state also needs** highly educated, highly efficient, and professional people which fall under the third middle-class segment, but even though I tried I could not identify any self-governance institution for public servants.

**To conclude:** Currently, it appears that the SMEs are represented best. The lack of a legislative and regulatory framework to control and regulate the operation of other middle-class segments than the SMEs as well as the uncommon and unusual cultural, historic, and legal features involved leave their imprint in the lack of representative institutions. There are institutions addressing segments but not the stratum or structure as a whole.

## 1.5. The role of SMEs and trade in the economy of Albania

The role of the SMEs in the economy is measured by their share in production and economic activity, whereas the role of the intelligentsia and the public servants cannot so easily be measured in figures and statistics. We will try to combine their economic power with their social and cultural power, their education capital, and the typical characteristics of the middle-class segments and attempt to transform it into economic power.

### 1.5.1. General Developments<sup>5</sup>.

Albania has experienced an average economic growth of approx 6% p.a. during the last 3 years, accompanied by stable unemployment (approx 13% in 2005) and inflation rates (3.5% in 2005), with decreasing tendencies. Its GNI per capita has grown from 1,180 US\$ in 2000 to 2,090US\$ in 2004 and 2,580US \$ in 2005 according to the World Bank, which makes it a lower middle income country like all the other countries in the region except Croatia, which is a upper middle income country. In 2002, consumption-based inequality was moderate compared to other countries in the region, judging by the Gini coefficient<sup>6</sup> of 0.28. Nevertheless, income-based inequality tends to be high at 0.58. In terms of income inequality Albania holds a moderate position which, combined with the low GNI per capita of the Albanian population, shows that while differences between levels of income are moderate, income values by comparison on the international plane (GNI country value).

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<sup>5</sup> Data from World Bank Data and Research, Online.

<sup>6</sup> Albania Poverty Assessment, p. 14 , 2003.

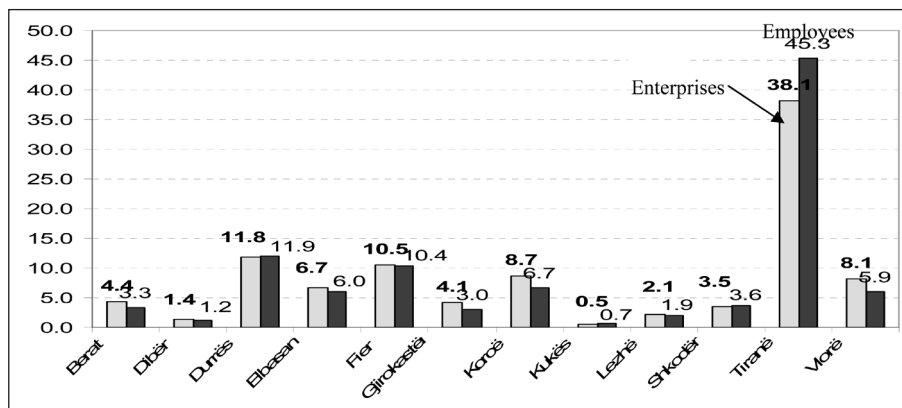
## 1.5.2. SMEs<sup>7</sup>.

Small and medium-sized enterprises are considered engines for the transition to a market economy. They underpin economic growth, employment, and other factors related to the living standard of society. The SME sector has played an important role in, and made a visible contribution to, the period of transition to a market economy. SMEs accounted for 64% of the GDP and for 66% of the employment in 2006, according to INSTAT (Instat: Albania in Figures 1995-2004 software). Their development and growth has been constant during the transition period. According to INSTAT, the number of private activities reached 64,710 during 2005, growing by 15% compared to 2004.

From the Albanian law on SMEs and the employment figures given by INSTAT, 99% of enterprises can be classified as SMEs. Only 423 companies have more than 80 employees, and only 40 companies (0.06%) have more than 250 employees, which means that according to the European SME definition, almost 100% of businesses are SMEs.

The graph representing the geographical distribution of businesses in Albania shows that almost 50% are concentrated in Tirana and Durres, where 57% of the business-sector workforce are employed. Foreign-capital enterprises (approx 69%) are also concentrated in Tirana.

*Geographical distribution of enterprises and employees during 2005*



*Source: Economic sector strategy draft*

A breakdown by the NACE code of activities shows that enterprises are mainly concentrated in trade (49%), services account for 24%, while industry and transport account for 11% and 10%, respectively. Trade and services, where **73.5%** of businesses operate, account for **45.2% of the employment in the private sector**. On the other hand, these two account for 63.8 % of the total turnover, while production and building account for 36.2%.

The concentration of SMEs in service and trade once again shows the low level of productivity of these enterprises. Only 17% of SMEs are engaged in activities that we would consider as productive.

Their revival did not mean a revival of trade or production operations, for production-oriented activities "make better use of the available factors and resources (...) are the driving force behind the rates of return investment(...)" (Global Competitiveness

<sup>7</sup> Data from the Statistical Yearbook 1995-2004, Software.

Report: 3). Our SMEs are trade-oriented and thus serve the Albanian market almost exclusively. This conclusion is based on the following facts:

Years Enterprise Classification	1999	2000	2001	2002	2004	2005*
Micro Enterprises	33,029	32,675	32,616	33,163	51693	58238
Small Enterprises	2,021	2,152	2,314	2,360	2063	
Medium (20-80 employs)	283	343	297	373	840	
Large Enterprises (80+)	346	307	294	352	313	423
Total number of enterprises	35,679	35,477	35,521	36,248	54909	64,710

- Trade is import-oriented, and the average ratio of imports to exports in 2003-2006 is 4.06 (Annual Foreign Trade Report 2005: 21).
- Export marketing is usually handled by the companies themselves. (Most respondents of the Executive Opinion Survey that is used as core data for the GCI among other factors awarded 5 out of 7 points in answer to the question whether international distribution and marketing is handled by international companies (1) or the local companies themselves (7), whereas the average mark is 4 out of 7. Albania has a ranking of 55 out of 125 (GCR: 528), which shows high grade of control being exercised by export companies over exports.

In other words: SME businesses, whose general productivity tends to be low because they are service- and trade-oriented, have the tendency to cover only the Albanian market.

It seems like the tendency has shifted again with the system change from (not well-functioning) large-scale production to small-scale production. Of course this change is basically due to the fact that transition period is not over yet. This has its effects on the economy in terms of underemployment, lack of development in rural or remote areas, etc. The lack of big industrial companies is addressed by the FDI element of the economic sector strategy by trying to stimulate the influx of FDI into Albania without neglecting business opportunities at home (it is important to show a profit on FDI, to show comparative advantages, and to match these with things we need. Combined, these three components form a win-win situation).

The strategy includes a choice of sectors for FDI inflow as well as state objectives and measures.

The strategy emphasises opportunities in the sectors of electric energy, fuels, mineral-processing, agro-industry, textiles, footwear, and business services.

Of course the bad image, the infrastructure, the energy supply, etc. are big challenges, but the objectives set forth in the strategy, such as creating industry parks, accelerating the FDI inflow by concessionary measures, intensifying strategy promotion structures, and measures such as the new law on concessions which is expected to facilitate access to public property, the cheap rental rates offered for public spaces etc. show that the merging of objectives and measures within the strategy could be seen as an attempt to relate FDI inflow to the basic infrastructure (energy, road construction etc) so as to enable further economic growth and development in Albania.

Thus, for example, electric energy is a promising sector now under state management which, combined with the objective of improving the law on concessions, the

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\* Data from the economic sector strategy draft, 2006.



Albania 1 Euro NISMA, and stronger promotion structures might serve to enhance the inflow of FDI.

Nevertheless, the SME's important role in the economy of Albania is clearly documented by economic facts and figures. Their value has been recognised by the government, and actions have been taken (the former SME agency now operates as an Albinvest sub-divisional objective) and will be taken on this account. The impact of these strategies (the NSDI economic sector strategy includes SME development and envisages a specific SME development strategy/programme) will be felt, and the SME development objectives of the strategy - such as improving the **enterprise culture, internationalising the better-developed SMEs, improving SME financing** - will be implemented in the period from 2007 to 2013.

Related recommendations include realising the law-enforcement and strategy tasks and shifting the focus to the SMEs' production activities, which could better addressed and supported by the state.

### 1.5.3. SMEs in the region; differences and consistencies<sup>8</sup>.

According to the conclusions of the Western Balkans study (studies on SMEs were conducted in all countries of the region in order to identify problems, opportunities, characteristics), small and medium-sized enterprises form an important sector in the economies of the Western Balkans whose potential for creating growth and employment is not fully exploited. They are the predominant form of business in all SEE countries, which is a factor of development and shows the entrepreneurial spirit of the population there. They are facing almost the same range of problems: regulatory, environmental, infrastructural, administrative barriers, and access to finance. The other barriers such as human resources, business software, and technology are somehow neglected even though innovation, technology, and employee education are very important for sustainable corporate growth.

According to the same study, differences can be found in the attitude towards entrepreneurship and also in the activities these enterprises are engaged in. In Albania, for instance, 74% of companies operate in the trade and services sector, in Serbia only c. 25%, and in Macedonia 50.6%.

In Albania, much is being done in this regard. The recommendations of the paper have already been adopted into the strategy and the SME assistance programme, and also implemented to a certain extent by the governmental agency Albinvest or other institutions that promote SME development.

Most probably, although the economic approach is well-considered at the strategic level, productivity increase (whether through strategies for the revival of trade or strategies that address productivity in other ways; e.g. services) should be stressed more at this point and combined with export-related or domestic coverage support for the companies.

These attempts should go hand in hand and should be better combined with other measures to improve social problems and mentalities in order to bring the sub-groups and segments of a possible middle class closer together and enable their cooperation.

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<sup>8</sup> Data from *Regional Review of SME Policy in the Western Balkans Countries, 2004*, S. Xhepa, M. Agolli, *Small and Medium-Sized Enterprises Development in Albania, 2004*.

## 1.6. The role of the public servants and the intelligentsia in the economy

### 1.6.1. In terms of income:

Income is an important factor of economic prosperity. Higher incomes may result in higher consumption and better living standards and signal economic development. By defining the statistical mean personal income and its relation to wages for each profession, we may gain an idea about their purchasing power and their role as consumers in society as well as a tool for cross-border comparisons of the middle class, while the percentage of this mean in quantitative or qualitative terms gives us a hypothetic percentual representation of these sub-strata.

According to the LSMS (Living Standards Measurement Survey) conducted in 2002, Albania has the highest LFP (Labour Force Participation) among the central and east European countries. This is partly due to the structure of the economy which, being largely agricultural, provides employment - even though part-time - to a considerable segment of the population. In Albania, 60% of the working-age population participate in the labour market (working age, for the purposes of the PRSP, includes persons aged 14 and above). 71% of working-age men and 51% of working-age women are active in the labour market.

### 1.6.2. Statistical mean:<sup>9</sup>

As the middle class is by definition pretty universal and goes beyond national perceptions of the statistical mean, which is expressed in figures, it may vary from country to country.

The statistical mean is usually calculated as a value that describes those at the center of the income strata in terms of household income or personal income. The statistical mean is calculated as the range between 80% and 120% of the median. The US Census Bureau also quotes an education and personal-income value which divides incomes by education level.

A personal-income sum including all earnings (full-time + part-time job, if any) of the respondents was derived from the Albania LSMS 2002 dataset. Figures between 80% and 120% of the median represent the statistical mean of the Albanians' personal income. GDP growth during the last years has been c. 6% p.a., or 30% in total during 2002-2006, a percentage that will be added to the range of values derived from the LSMS 2002. This is a projected statistical mean based on GDP growth. The other projection, calculated according to the growth of nominal wages, is c. 50% during the same period.

With assistance of these datas it can be shown that the statistical mean personal income in Albania varies between 15,600 lek, or 125 €, and 23,400 lek, or 188 €, per month.

### 1.6.3. Qualitative definition:

**The stratum of public servants:** Well-qualified employees of the state and local administrations as well as people with administrative and supervisory positions in the private sector.

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<sup>9</sup> Data for the statistical mean were extracted from the LSMS 2002 dataset, World Bank, online.

**Intelligentsia:** Their main resources are knowledge, culture, educational qualification, and intelligence. This stratum embraces various professionals and experts such as lawyers, doctors, architects, economists, artists, etc. Budgetary employees account for 20% of the total workforce. Employment categories that match the middle class definition account for 62% of the budgetary and 12% of the total workforce. We have reason to believe that most of the intelligentsia and public servants are concentrated in the public sector. This is a hypothesis that needs to be proven, but the reasons for it are:

99% of the economic activity is directly contributed by SMEs, a large number (94%) of which are micro-enterprises. Middle-class representatives defined by their education (tertiary education) who operate in the private sector can be identified in the SME sector (one-man enterprises, business managers, etc). This hypothesis is also enforced by the statistical data, showing labour-force status versus education level in Albania. Only 13% of Albanian men of the LSMS sample aged between 34 and 64 have any higher education, compared to only 5% of Albanian men aged between 15 and 35.

**Education and reform under the institutional framework:** The education reform as currently represented by the overall education strategy, where tertiary education is one of three components, gains in importance with regard to the prosperity and development of the middle class in the coming years. Some of the objectives included in this strategy aim to:

Enhance and improve the skills of the future workforce through more efficient, up-to-date, and modern teaching at universities. "Decentralisation" of universities and coverage of the regional demand for specialised workers by local branches of universities. Enlargement in terms of numbers. Improvement of research units within Universities. Combined work at these levels and intelligent implementation of these visionary ideas, which are expected to be realised by 2016, will result in more graduates better equipped with skills, ready to jump into the workforce. The strategy, if implemented as such, will have a positive effect on the share of the middle class in the coming years.

## 1.6.4. Mean income by profession

According to the LSMS 2002 data set, the correlation between wages and profession is such that you cannot see a direct profit from the respondents' education investment. Many respondents whose income falls within the statistical mean are classified as middle class by definition, but other respondents who do not belong to the middle class by definition also fall within this range of values. In prosperous industries, the pay of workers or unskilled labour may equal that of middle-class representatives; thus, for example, a guard's payment equals that of a teacher. Many workers, economists, teachers, and salespersons in shops have a monthly income of 120 € according to the LSMS dataset of 2002. This conclusion does not include pay differences due to geographical position, which can also be a differentiation factor. This cannot be considered an excuse, though, for the equal wages paid to middle-class segments and workers. Teachers, for instance, have a lower minimum and maximum wage than construction workers.

**Differentiation between the statistical mean (approx 40% of respondents) and the middle class by definition or educational level (approx 13%) shows that income does not reflect differences in professional attributes.**

## 1.6.5. Conclusion

I think that the middle class in the countries that have undergone the transition from state economy to open market, from communist or socialist philosophy and guidance to democracy, are facing more or less the same problems because of a common reason that conditioned their strata formation: the system change. They face the same problems also in addressing the question of what a middle class should represent. Can a taxi driver who earns as much as a professor be middle class? What about an SME that is not registered in court? The problems of the SEE states tend to be the same, as are their solutions. Nevertheless, they are faced with the fact that sub-groups are forming, as in every other open market-economy or democratic system.

They all have an important middle-class component, the SMEs, and all are struggling to have these business units survive the tough competition and find their place in the global market/arena. In Albania, there have been several attempts to enforce and enhance the role of SMEs in the country's economy by improvement their business performance and the respective regulatory and institutional framework. They already play an important role in the Albanian economy, contributing 99% to the economic activity. Their support at different levels, mostly represented in the economic sector strategy in bold print for the time being but to be elaborated in further detail during the period 2007-2013, has been confirmed by studies and investigations by state institutions (the former SME Agency, now Albinvest; the State BSO Agency; the Ministry of Economics; etc.) and other non-profit organisations such as ISB-ACIT, the European Institute in Bulgaria, etc.

About the other middle-class segments, namely the intelligentsia and the public servants, we must say that they are present but few in numbers. If we define them by qualitative criteria (education, profession), they approximate 12%, while if we refer to the LSMS dataset and the statistical mean, the middle class represents c. 40% of the workforce. The social and cultural power of the middle class is not reflected by its economic power.

**The difference between the statistical mean (approx 40% of respondents) and the middle class by definition or educational level (approx 13%) shows that income does not reflect differences in professional attributes. The gap between the education models of the two systems, one guided by socialist societal values, the other by market and democratic values, has most probably reduced the role of the middle class (education being important for its representatives) as an agent of collective action and coordination in society.**

The term middle class does not exist as a term of reference, at least in Albania. Strata formation has been indirectly addressed in economic terms in different papers (PRPS, NSSD, LSMS) based on income distribution, income distribution inequality, the Gini coefficient, consumption patterns) or in the political debate (e.g. the charges levelled at various politicians because of their income sources; projects and strategies against corruption; etc.). Attempts at concentrating on focal points issues which, like income inequality and corruption, entail costs for fragile communities after a system change are also attempts which indirectly affect the development of the middle class as a large and stable social class that contributes towards stabilising economic growth beyond the transition period.

The formation of a middle class is a perspective that, being naturally opposed to all the phenomena of transition we want to get rid of, can surely be adopted, included, taken into account, and referred to in the country's policies as a term that goes beyond and beneath, wins character and force as its specific importance increases, and lands and finds its way into the SEE communities as an international comparative term, as a factor of development, and as a factor of sustainability. Differences between middle-class representatives in different countries are there, but they are not many. Studies will make us understand more.

## 1.7. Reflection on the term social market economy and its implementation in Albania

The term market economy in itself is now almost two decades old in Albania, since the country left behind 50 years' experience of state-planned economy in 1990. The shift in the system and the economic reforms that were implemented immediately afterwards were totally market-oriented, aiming to reduce the role of state in the economy and consolidate free competition; they were followed and/or accompanied by macro-economic stabilisation measures aimed at controlling inflation, reducing the budget deficit, and liberalising prices. Shock therapy, a neo-liberal method which was also applied in other ex-communist regimes like Poland, was practiced in Albania and other eastern European countries. According to Prof. Jeffery Sachs, it was also implemented in post-war Germany between 1947 and 1948. Its kick-start effects were then replaced by the successful introduction of social market economy in Germany by one of its fathers, Ludwig Erhard. (I may say that it did not work quite as well in Albania since we are not done with the transition period yet.)

It would be premature to say that social market economy is being implemented in Albania, since the whole transition period was guided by neo-liberal principles: free trade, market regulation of the economy, private initiative, etc. Still, the lessons of 1997, many other transition problems like corruption in the state administration and elsewhere as proven by various studies and indexes, unfair competition, the possible existence of monopolies or oligopolies in Albania, crime levels, etc. have been taken into consideration, and the government has intensified its regulatory role in the last few years.

The institutional framework that addresses social and economic development, like the NSSD and the NDDI, political movements like the anti-corruption campaign during the last elections, the legislative framework such as the laws for a better business climate with a focus on SMEs, the consumer protection law or the law on the protection of authorship rights, the subsidies programme for businesses implemented for the first time by the government, as well as other fiscal policies show that the focus has shifted towards a more social state.

**Another possible choice** would be to try for a tailor-made social market economy featuring neo-liberal market openness, intensified competition, and economic growth which nevertheless combines this enterprise-oriented system, which according to Prof. Ulrich of St. Gallen University does not necessarily serve everyone, with a re-oriented social policy. A healthy middle class, sustainable growth and a modern civilized (social) market economy<sup>10</sup> are the three components that may/should influence policy-making in the future.

The middle class is considered a group of people who owe everything to their own efforts (resources, education, etc). This characteristic and their entrepreneurial spirit, education level, and autonomy at work make them more flexible and adaptable in situations of uncertainty. Their ability to fit in different situations can bring a stabilising effect to society.

For this reason, the middle-class concept should be developed further in Albania, which means building up a prosperous middle class, rich in numbers and abilities. This skilled, educated group of entrepreneurs can do much for a healthy, civilised market economy. In other words, this might become a two sided reaction, where the establishment of a healthy middle class positively influences the development of a modern civilised market economy, and vice versa. To replace the struggle between the two economic philosophies, which may be described in a nutshell as market freedom versus equality (social market economy) which, according to Ulrich, often

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<sup>10</sup> *The concept takes into consideration the ideas of Peter Ulrich, The civilized market economy, 2004.*

means "more freedom and less state", a new form might be taken into consideration. Social market economy principles and market-oriented economy could and should be combined, since competition in the globalized economy is becoming more and more sophisticated.

Is it possible to strike a balance between economic and civil rights in the framework of a more social market economy?

Probably this equilibrium would make market economy as it currently exists in Albania more social in modern terms, but more reflection on this is needed, and policies, regulations, etc. should shift their focus (slowly) from market economy to a modern social/civilised market economy. I do not dare to use the term social market economy on the German model to describe the way in which it is implemented in Albania, because we seem far away from that. Therefore, the vision of a tailor-made third way should be developed further.

### **A quick concrete review of the Albanian social/civilized market economy and the importance of the middle class for this model.**

Moving towards social market economy means a lot of personal and corporate responsibility towards society. This would be possible, given successful actors who are able to understand and implement this responsibility. Albanian SMEs or other middle-class representatives are not playing their role in this context at the moment. This is proven by the lack of a CSR (Corporate Social Responsibility) strategy as well as by the inadequate knowledge about and awareness of quality management, occupational safety measures, environmental matters, etc. Another piece of evidence is that the intelligentsia and the public servants are few in numbers, often lack or have little economic power (low income, pay, etc), and are not as active as they should be. A healthy middle class would be able to shoulder its responsibilities towards society and the planet. So the task at the moment would be to build up a healthy middle class. What does this mean? In terms of economic, cultural, and social capital, it would mean increasing these resources for each middle-class segment.

- Increase the productivity and market efficiency of SMEs (increased economic power).
- Increase the cultural and social capital of those belonging to the middle class so that they can assume an active coordinating role in society (upper middle class) and initiate interaction between sub-groups.
- Increase the technical skills and vocational training of the existing working class to give them a chance to move from ordinary to skilled workers, thus increasing their economic wealth (more efficient work, better position, better pay). This would expand the middle stratum.
- Improve communication between the segments.

How can we achieve this?

The following policies, measures, and strategies that take these facts into consideration might enable the two-side reaction to function:

A healthy middle class that contributes towards economic growth but pays attention to its social responsibilities within the framework of a modern social/civilised market economy, where improvements in specific directions are fostered by different means (institutional, legal, technical, financial support).

Activities mounted with the help of international knowhow that concentrate on these components - healthy middle class, economic growth, modern civilised/social market economy - as well as on their combination and relation, including brainstorming by local (to ensure tailor-made solutions) representatives such as university students, professors, research institutes, and members of the business community. A pilot

project with students, professors of different faculties, and professionals to explore further the meaning of middle class, both by itself and in relation to a modern civilised/social market economy, in statistical, economic, legislative terms, the characteristics of each current component, and what they should be in the future. At present, more thinking, further study, and brainstorming by think-tanks and by different actors in the public debate is needed to create an awareness of the definitions involved and their application in reality before any new terms are included in any political party programme, state policy, or sector strategy. All this could be promoted by creating an institute or centre with a special focus on the middle class and its role in society that would provide the institutional framework for coordinating all of the above, promoting the concept of middle class, and forge a link between research, reality, and policy-makers.

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## 2. Bosnia and Herzegovina (BiH)

*by Dr. Duljko Hasić*

### 2.1. Introduction

Generally, we may say that the development of small and medium-sized enterprises (SMEs) and trade in BiH is falling behind for historical reasons. It began with a very slow recognition of the role and importance of small businesses in the economy of this country. The reason for that lies in the fact that before the war, the economic structure of the country was based on large companies and complex, integrated economic systems.

The socialist model of the economy denied private ownership, business, and free entrepreneurship. In that context, not only was that sector not supported by systemic measures, but was limited by those same measures. After the war, however, there was a long conflict among professional and political groups over whether they should insist on the pre-war economic structure and thus give priority to big economic systems, or respect the role and importance of small and medium-sized enterprises and implement processes to support their development under the models recognised in the developed countries.

In this regard, we can say that BiH is not a typical example of the development of trade as well as small and medium-sized enterprises in a country which is going through a post-socialist economic transition. The absence of a clear choice lasted for too long, while small and medium-sized enterprises, as a factor of a country's development, began to grow in importance thanks to the positive influence of the international community, the positive experiences of the neighbouring countries, and a number of experts and politicians. We may say that both economists and politicians now agree that supporting small and medium-sized enterprises in all segments is a desirable direction for the future economic development of BiH in general and a prospect of employment for the middle class in particular.

Another unavoidable fact - which had a negative impact on the development of small and medium-sized enterprises - is the slow process of privatisation and market-economy transition in BiH. As the transition puts entrepreneurship and self-employment first under the rules of the market economy, it is obvious that the results of transition will have a positive, direct impact on the development of small and medium-sized enterprises.

A third important factor is the inconsistency of the economic policy and legislation at the national level, as strategic approaches, legal frameworks, and other tools of the development of small and medium-sized enterprises have so far been established solely at the entity level, without an adequate coordination or harmonisation at the state level, which prevented the creation of a middle class in society.

### 2.2. Methodology

For the purpose of this analysis, we used a combination of a research and interviews. In order to identify the shortcomings or gaps between international standards and reality regarding the emergence of the middle class, trade, and small and medium-sized enterprises in Bosnia and Herzegovina, we used two standards: 1) an assessment of the lack of development of small and medium-sized enterprises that was focused only on the future needs of SMEs; 2) any encouragement of the future development of small and medium-sized enterprises in Bosnia and Herzegovina has to be market-oriented to initiate the creation of a middle class.

The purpose of the analysis is to identify shortcomings, i.e. disparities between international standards and the SME reality in BiH, to analyse them, and to set priorities in addressing those shortcomings.

To collect the data required for measuring the time required for and cost of launching enterprises, interviews were conducted with 20 government officials, civil servants, judges, and businessmen. Questionnaires were sent to government officials (at different levels) as well as company owners and businessmen who live and work in Sarajevo, Mostar, Banja Luka, Zenica, Tuzla, and Bihac. Interviews were conducted with investors in Sarajevo and Banja Luka. Also, a broad analysis of available statistics was carried out.

The interviews and research provided an important insight into the existence of the middle class, and reasons for the need to create SMEs were discovered. Comments given by the small and medium-sized enterprises provided the foundation for setting a scale of priorities based on their requirements and for analysing the perception and understanding of the problems which SMEs are facing in Bosnia and Herzegovina, with a view to creating the tradition of the middle class and stimulating its emergence.

While collecting the data, we encountered some problems and sometimes difficulties. Systems of registration vary significantly from one place to another, also in terms of quality.

Copies of questionnaires, notes/minutes of interviews, and the data collected from the documentation are kept at the Macro-Economic System Division, Foreign Trade Chamber of Bosnia and Herzegovina.

## 2.3. Legal requirements for SMEs and trade in Bosnia and Herzegovina

There are many weaknesses in BiH, most of them related to the legal environment, the institutional framework, or other issues which hamper both the development of the middle class, the trade, and the SMEs and the chances of obtaining the required statistical data about them in Bosnia and Herzegovina.

### 2.3.1. External barriers:

- The existing legal framework is not favourable to the development of SMEs, trade, and the middle class.
- There is no consistent legal framework at the level of BiH.
- Currently, there is no definition of SMEs recognised in a legal framework in BiH.
- Information technology is not applied in administrative procedures.
- Government institutions at the level of BiH do not have a clearly-identified or defined role in craft and SME development, and no role in the provision and manner of support to trade and SMEs at the national, entity, and regional levels with a view to creating a socially-oriented market economy in BiH.
- Monetary, credit, and fiscal policies have not yet been developed or reached the phase of developing strategies for meeting needs and promoting economic operators.
- At the level of BiH, there is no institutional framework for supporting trade and SMEs, while the existing institutions at the entity level and in

the Brčko District do not meet the needs and expectations in this area. The consequence of this fact is a situation in which there are no programmes or measures specifically supporting the development of trade and SMEs.

The rigidity of the legal environment is reflected particularly well in the following:

- An oversized and bureaucratic administration which has counter-productive effects on launching businesses and the efficiency of the business process in firms.
- Legal frameworks are not developed and have not advanced in the phase of improving and harmonizing with the legal frameworks applicable in the European Union.
- The system of protection for private ownership, rights, and claims in commercial judicial procedures is not developed and is developing contrary to the nature of the market economy.
- Widespread corruption and economic crime, which are not addressed or punished effectively.

On the basis of information (SWOT analysis) derived from various regional<sup>1</sup> and other strategies<sup>2</sup> as well as available analyses of trade and SMEs in BiH<sup>3</sup> in the current situation in BiH, we can add the following external obstacles or weaknesses:

- A high level of bureaucracy,
- a poor focus on socially responsible entrepreneurship,
- no developed industries which SMEs and trade could rely on to create a middle class,
- lack of vocational training and an underdeveloped adult-education system, and
- insufficient investments in promising, long-term knowledge-based sectors.

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1 EURED – European Union Regional Economic Development Project in BiH. 2004:

*Regional Economic Development Strategy of the Sarajevo macro-economic region, socio-economic audit of the Sarajevo macro-region;*

*Regional Economic Development Strategy of the northwest BiH economic region, socio-economic analysis of the northwest BiH economic region;*

*Regional Economic Development Strategy of the Herzegovina economic region, indicators, trends, SWOT elements, and SWOT analysis of the Herzegovina economic region;*

*Regional Economic Development Strategy of the central BiH economic region, socio-economic audit and SWOT analysis of the central BiH economic region;*

*Socio-economic audit and SWOT analysis of the northeast BiH economic region.*

2 *Poverty Reduction Strategy Paper (PRSP) – BiH Medium-term Development Strategy 2004-2007.*

3 *Dostić, Milenko, 2004: "Ima li šanse za mala i srednja poduzeća u FBiH/Is there any chance for small and medium-sized enterprises in FBiH?"*

## 2.3.2. Internal barriers:

- A low level of knowledge and skills in new technologies, ICT, management, etc.,
- outdated technology in the majority of the existing trade and SMEs,
- a strong orientation of small and medium-sized enterprises on traditional production with a very low productivity and a low, level technology, and
- the SMEs' orientation on the local markets.

However, despite all the above-mentioned obstacles and barriers, a relatively high number of new businesses is established every year.

## 2.3.3. Characteristics of the business environment in Bosnia and Herzegovina:

- The supremacy of politics over economy continues.
- Delays in all aspects of transition (privatisation, denationalisation etc.) with a real risk of seeing the first decade of the 21<sup>st</sup> century pass in addressing economic problems which should have been solved in the early 1990s.
- The size of the internal market is too small and continues to be divided along entity lines. The Federation of BiH is further divided by the areas of influence of national parties, the boundaries of which the goods – unlike capital and the labour force – manage somehow to penetrate, which is the reason why it is still not possible to talk about a single market of around 4 million people in BiH.
- An unfavourable industrial structure, designed to be a source of raw materials and primary and semi-finished products for industries in other republics.
- Emigration of highly-educated manpower caused by the war.
- The banking system does not offer long-term financial services, especially those which support exports.
- Strong reservations on the part of foreign investors and their banks about Foreign Direct Investments (FDI), the reasons being political instability, the weak rule of law, and the miniature size of the internal market (the latter often being the first criterion in decision-making).
- A negligible part of foreign investments is directed to the revival of production, investments having been made mostly in reconstructing the infrastructure which, although necessary indeed, does not produce a significant surplus for exports in the first place, nor does it create job opportunities.
- The new industrial structure has no aspirations to high technological levels.

## 2.4. The structure of SMEs in Bosnia and Herzegovina

Because of the absence of consistent sources of data, we used different sources on the number of SMEs. It is obvious that there are close to 60,000 registered companies in Bosnia and Herzegovina, and that there is an unknown number of businesses – crafts and trade – operating in the shadow economy. Most of those companies in BiH are small and medium-sized enterprises, according to the EU definition of SME.

Table 1: Structure of SME in BiH:

Number of employees	Total number of legal entities and entrepreneurs	% of the total
1 – 5	88,508	85.4 %
6 – 10	5,815	5.6 %
11 – 50	6,927	6.7 %
51 - 250	2,394	2.3 %
TOTAL	103,644	100 %

Source: Foreign Trade Chamber of BiH, Journal No. 12, 2006

The above data show that so-called micro-companies (employing up to and including 10 persons) form the majority of all companies in BiH, accounting for 85.4% of SMEs. This is also the most sensitive group which requires all-round support in all areas and at all levels.

The extent of the shadow economy is a special problem. According to assessments by the EC and the World Bank, the shadow economy accounts for around 36% of the economy of the country. In view of the size of the population and the towns, there are more café bars and small grocery stores than in most other places elsewhere in the world. These activities are facing tough competition and profit margins so low they can hardly survive, some existing for a few months only. From the sectoral perspective<sup>4</sup>, the trade sector (both wholesale and retail) is dominating. In addition to trade, the processing industry (especially the food- and wood-processing industries) and also the mining industry are considered to be strong. We assume that the vast majority of SMEs operate in the trade sector.

Preference is given to trade and to some services in the process of establishing a company for several reasons, such as: less capital is needed to launch a business, the need for strict business standards and procedures is not as present as it is in production, business risks are lower, and shadow-economy opportunities are much greater. On the other hand, production requires more highly-qualified staff, an appropriate and competitive level of technology and equipment and, consequently, greater investments. In view of the lack of capital and its high price, it is only logical that the number of registered production companies is smaller than the number of registered companies involved in other sectors.

This problem will be addressed in a more effective way only once the state introduces a strategy to encourage the intensive use of the complementary advantages of the resources available in BiH, such as, for instance, energy, agriculture, forests, tour-

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<sup>4</sup> Approved – based on the socio-economic studies of the regional development strategies of EURED.

ism potential, etc. Such a strategy would also stimulate an increase in the number of businesses and SMEs in the sector of production.

There is a huge difference in Bosnia and Herzegovina between registered and active SMEs. Accurate data are not available due to the above-mentioned statistical weaknesses, although we know that the expansion of the number of registered companies in certain periods was unsuccessful because many of them did not become self-sustaining in the market or simply collapsed because of their bad corporate performance.

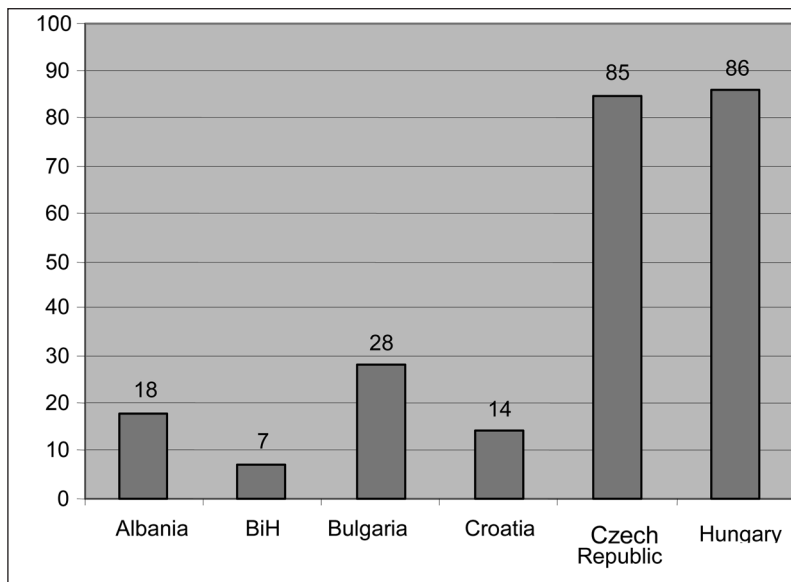
The results of this analysis show that the major causes for the collapse of small and medium-sized companies in BiH include an underdeveloped business environment, the absence of legal frameworks, the lack of real support by the state, the lack of capital at realistic prices, and unfair competition. However, another reason why newly-established companies are collapsing is the fact that they were established by insufficiently competent operators or managers who were not sufficiently prepared for their own business management. Entrepreneurship education, both within mainstream education and in additional training at seminars or other courses, has been so slow that it failed to catch up with the needs in the field.

The consequence of that is a huge number of informal and shadow-economy businesses and illicit employment. A strategic approach and legislation in the future will facilitate and encourage those businesses to go from the informal to the formal economy as they acquire business experience and initial capital.

Although reforms in many of those areas are under way, it will be necessary to invest more effort if we are to see real improvements which will contribute to the creation of a positive climate conducive to trade and SMEs.

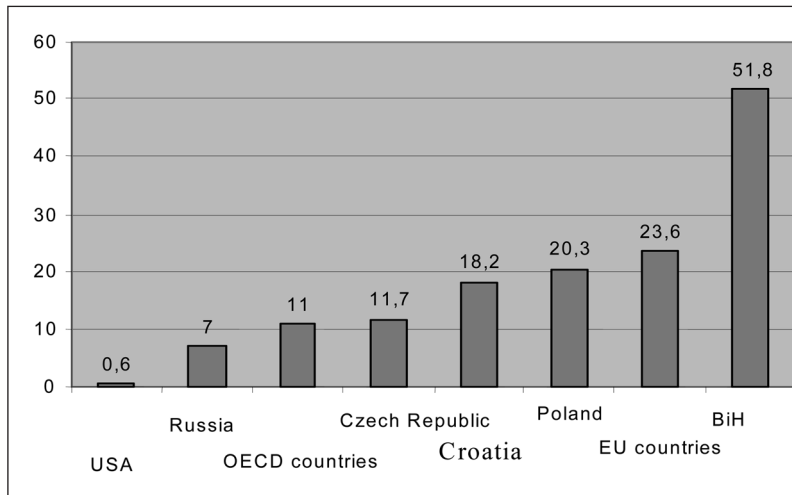
The graphs below show the most important indicators of development of the SME environment in comparison to other countries in the region.

*Graph 1: Number of companies in southeast Europe (per 1,000 citizens)*



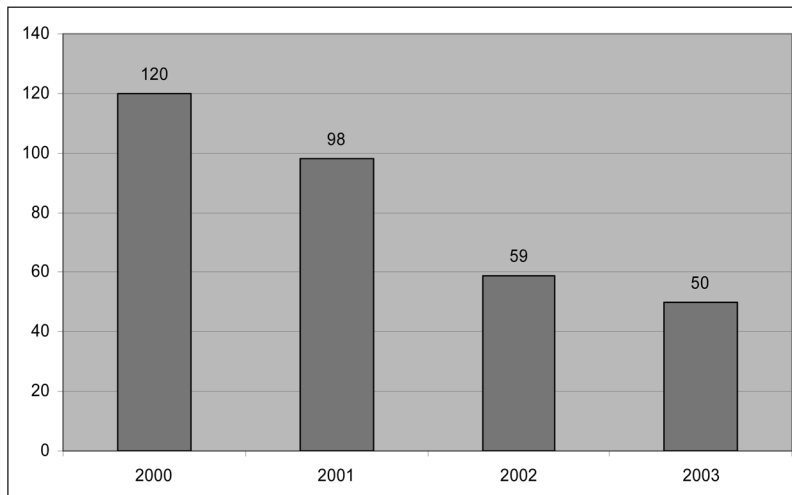
Source: EBRD Transition Report, 2004

Graph 2: Costs of establishing a company (in % of income per capita)



Source: World Bank ,Doing Business in BiH', Country Profile, 2006

Graph 3: Time needed to register a company



Source: World Bank ,Doing Business in BiH', Country Profile, 2006

The number of companies per one thousand citizens is the lowest in BiH, the costs of establishing a company are the highest among all countries analyzed, and the period needed for registration of ownership is the longest. What is more, BiH is falling behind other countries in the region in a broad array of other indicators.

There are several issues which require more attention, and whose implementation is recommended:

- Legal and regulatory changes are necessary, especially passing a company law, simplifying the process of registering companies, and passing a law on SME promotion and access to finances. In view of the complexity of these issues, it is necessary to examine in detail the legal and regulatory changes at all levels and in all sectors.
- Together with institution-building and improvement, this should be given priority. Strategies for national trade and SMEs will be needed in the coming period, forming a prerequisite for the creation of a middle class as a basis for ownership transformation.
- An institutional framework should be developed and managed so as to ensure a shared platform for public service providers and companies.
- Developing a suitable information system is of key importance. It is necessary to create an entrepreneurship portal from both the external and internal point of view.
- Developing important strategies, such as a strategy for innovations and a strategy for SME networking especially with the west European developed countries, would help ensure a more focused foreign assistance and a more strategic approach to issues which are extremely important for SME competitiveness in the long run.
- A common characteristic of all factors of competitiveness lies in the fact that their development is conditioned by training programmes and awareness-raising campaigns across the country.

It is proposed to create an institutional framework as a flexible, virtual platform which will enable members to communicate and exchange best practices and know-how so as to improve business services for trade and SMEs and make them more transparent and effective.

A faster development of the trade and SME sector will enable BiH to boost its economy and policy internationally, with the aim to speed up the EU accession process, to attract foreign direct investments, and to improve its negotiating position and the focus of its proposals with regard to foreign assistance. However, foreign assistance will be shrinking in the future – which is to be expected – while BiH will be gaining access to the EU programmes gradually and under conditions related to the success of the reforms in BiH and the ability of BiH to manage properly and co-fund individual projects. This is why it is imperative that governments in BiH pool their efforts, financial and human resources to provide support to small and medium-sized enterprises and successfully attract strategic investors, especially from the Federal Republic of Germany.

## 2.5. What restricts the creation of SMEs and social prospects in Bosnia and Herzegovina?

The results of this analysis show that in the post-war period, BiH, largely supported by abundant international financial and technical assistance, made significant progress. However, that progress has been slower than in most of the other countries in the region. This is why the following questions seem legitimate: Why has BiH failed to achieve better results in the economic and social spheres, especially in view of the fact that it has been privileged – unlike most of the countries in the region – to receive significant international economic assistance? It is possible to identify many factors which have contributed to that situation. Here, they will be explained in two different groups: (a) legacy-related factors, (2) inefficiency-related factors.



## a) Legacy factors

The economic structure is shaped by bureaucratic, not by market-related methods. Traces of its bureaucratic and voluntaristic origins are visible in the economic structure of BiH far more than in other countries of former Yugoslavia. That process lasted for almost half a century and covered the majority of resources in BiH. The process of using those resources on the market cannot be easily introduced even in much more developed and politically stable countries, let alone in BiH, where the war ended not so long ago which impoverished, devastated, and politically divided the country.

The consequences of the war are far more serious than one might guess. The conditions surrounding resources and the capability of using them in the market in BiH are much worse than it was believed immediately after the war. Human and material resources suffered many immeasurable and invisible damages. Figures cannot reflect the reality. A large number of people lived through different traumas, so that their abilities cannot be compared to the situation before the war. Also, a great number of educated people left the country and resettled elsewhere in the world, and the return process, envisaged under the Peace Agreement, failed to ensure the desired "quality" of the human resources that was required for development. Likewise, due to the establishment of a new political structure in BiH, the pre-war organization and management of many companies lack the necessary quality, which did exist during the years preceding the war.

BiH is not fully stable in political terms. Although the Peace Agreement was effective in putting the war to an end, many people are not satisfied with it, primarily because of the nationalist structures which guided the people and promoted ethnic interests in the past war. They continue to be active in the politics of BiH and appear as a legitimate representation of ethnic interests in the implementation of the Peace Agreement. In order to justify their existence, nationalist structures often tell stories about threats to ethnic interests, the unequal position of the nations in BiH, the injustice done in the Peace Agreement, etc. All this destabilises political relations in BiH and slows down the development of democratic institutions. That situation has caused great damage to the economy.

Insufficiently reformed society: There is a broad range of reforms going on in BiH. Unfortunately, the initiators and proponents of the reforms have often been the international institutions which became an important factor of the BiH post-war development. Another important factor in the reform implementation are the conditions imposed by the High Representative of the international community in BiH. Under such circumstances, national institutions often embarked on reforms only formally, with a shallow approach. In most cases, they reformed the system only to the extent defined by the international community in strict requirements. Too often, by reason of such an approach, the system continues to function as before in numerous fields.

## b) Inefficiency factors

Post-war recovery and development are not proceeding at the pace envisaged. Except for some important results achieved so far in recovery and development, BiH has not yet achieved economic stability. The present relative stability, and the comments saying that the balance-of-payments deficit is not so important for socio-economic stability, should be ascribed primarily to the political circumstances in BiH. Around 22,000 internationals live and work in BiH. Foreign missions have created around 10,000 jobs for the local population. According to some estimates, they spend around KM 1.4 billion per year in BiH, 13.1% of the BiH GDP in 2006. Also, transfers of money from abroad (foreign pensions, remittances from workers abroad, etc.) account for 11.9% of the GDP, or 1.3 billion KM. Of course, we should not forget international assistance. In 2005, it accounted for 6,9% of the BiH GDP (around 1 billion

KM). And of course, we should not forget that a significant amount of money flows in the shadow economy, i.e. as an unregistered demand. The aggregate sum of these amounts gives a clearer picture of "permanent sustainability" of the trade deficit of BiH. However, all these sources of foreign money will not exist for ever.

The authorities at all levels in BiH have failed to assume full responsibility for the social and economic situation. The strong role of the international community in the post-war development of BiH made things relatively easy for the national government. The national authorities are "hiding" behind international institutions and the High Representative, justifying their own failures by pointing at their powerlessness against the "will" of the international community. This is one of the reasons why democratic and effective institutions are being formed so slowly, regardless of elections in BiH, and nationalist policies continue to be powerful in one part of the political public in BiH.

Widespread corruption in society: During and immediately after the war, BiH became a centre of illegal trafficking in a whole range of goods, even human beings. The war in BiH, in which ethnic armies blocked supplies to the towns and territories and barred the passage even of staple foods, led to the formation of layers of "ethnic businessmen" who came to be a kind of "heroes" because they managed to provide goods. Of course, the prices were several times higher than the usual market prices. This was how different privileged "suppliers" amassed their wealth. At a very difficult time, they had money, which also meant power. After the war, they became sponsors, donors, and benefactors to many institutions, including political parties. With trade liberalisation after the war came the reduction of war-time price for a series of goods. In parallel, various cartels and lobbies got involved in trading in some important goods. Corrupt structures of government came to the surface. High profits were made thanks not to high productivity but to the evasion of customs, excise, and other taxes. The users of the budget and domestic production suffered. Of course, governments proved to be corrupt in the privatisation process, in public procurement, and in the implementation of the law. At this moment, there is almost no middle class in BiH.

Widespread shadow economy: Low living standards, a corrupt government, and a high unemployment rate supported the creation of a strong shadow economy. Because of the lack of development and the low economic efficiency, the shadow economy became a kind of a "social-welfare programme". Shunning responsibility for the social and economic situation and the absence of development, the authorities accepted the shadow economy as a necessity and came to tolerate its expansion. Of course, the shadow economy is a very "effective" link between poverty, corruption, and crime, discouraging legal business.

Ineffective macro-economic policy: There is no single coordinated macro-economic policy in BiH. Some international institutions, like the IMF, are exerting greater influence on macro-economic policy than the national governments. One part of the macro-economic policy is implemented by the entity authorities, albeit without sufficient and effective coordination. Also, international institutions often initiate and implement the required coordination of the government entity policies.

## c) "Forbidden resources" – free-entrepreneurship constraints preventing the creation of a middle class

"Employment" and "entrepreneurship" have become magic words and an answer to all socio-economic problems in the country. They are lavishly used even by those who have no idea whatsoever about the macro-economic determinants of employment, while their entrepreneurial efforts are much closer to the shadow economy than to any

of the important resources. We should not forget either that many statements about an easy solution to unemployment were contrived in the spirit of the finest socialist doctrine about full maturity, which sounds nice even today and gives unrealistic hopes to the socially vulnerable groups. It is true that free entrepreneurship may help reduce the unemployment rate and poverty. It is also true that the developed countries were becoming richer with every new step taken towards liberating entrepreneurship. However, we should keep in mind that this was happening in countries which already had, at that stage, a system of market economy, and had resource markets already established. In short, their experiences and results were achieved under conditions of free entrepreneurial approach to resources, in accordance with market principles. On the other hand, we in BiH are talking about free entrepreneurship, while of all markets we have only the market for goods, often criss-crossed by diverse criminal trends. Unfortunately, the vast majority of resources (labour, land, and capital) falls outside free-market flows. Under such conditions, we can talk about "free entrepreneurship", the market, and its integration only as a face-saving formula.

A major portion of resources of this country is "hostage" to diverse formalisms dating back to the socialist era, to barriers created during the war, to fears of an even worse socio-economic situation, and to the indecisiveness and non-creativity of the political actors.

Although BiH's unemployment rate is among the highest in Europe and its fictitious employment rate is probably among the highest, too, the labour market is not established yet. Competition for jobs is not open in most cases. Labour mobility is poor even between municipalities and cantons, let alone between the two entities. The value of the marginal product of the labour force has hardly any influence on the employment rate. Thus, companies which are operating at a loss, "eating up" their substance, can survive for years. This would not be possible under market conditions.

When privatised, companies often become burdened with old liabilities to the workers, the state, and their suppliers. In many companies, part of the capital continued to be controlled by the state (from 40%). These are the reasons why foreign investors are few (the list of all reasons is much longer), and why even domestic banks avoid granting loans to companies for restructuring. Banks rather choose to invest capital abroad. Citizens often keep their savings in the branch offices of foreign banks. This means that money exists – but there is no money in the economy. The reason is simple: The resources of a great many companies are "taken captive" by liabilities, interferences by the state, inconsistent privatisation, socio-economic problems, and technological underdevelopment. Such resources cannot produce profit, and - naturally - the banks are unwilling to take the risk of being "captivated".

Although we have a more than 50 percent rural population and vast areas of arable land, many pastures, forests, and waters, the impression is that "it is not possible to live on the land" (wood-cutting and exporting lumber seem to be the only exception). Many countries with fewer natural resources and a more unfavourable climate are using their land and producing crops better than we are, while we are buying their fruits and vegetables on our local markets. This means that the way in which we are using land as a resource is bad. We do not have the agricultural and economic policies to encourage the nationwide development of agriculture, cattle raising, fishing, forestry, and the related branches of the processing industry. The land is taken "captive" by old socialist forms of organisation and a semi-feudal usage in the vast majority of rural households. The abolition of the ceiling on landholdings was not followed by an appropriate agricultural policy, price policy, or tax policy. Politicisation of the agricultural policy and land management led to the collapse of agricultural production.

Entrepreneurs need the market of resources. An integral part of that market is the process of establishing (demand, absorption of resources) and closing companies (supply of free resources). These processes are at present linked to the resources controlled by private entrepreneurs, while the majority of resources is still "forbidden". This means that if free entrepreneurship is to create new jobs and contribute to

poverty reduction, it is necessary to make the resources of this country accessible to entrepreneurs under equal market conditions. The government will not be in favour of this liberation of resources (loss of material power). It will not be favoured by parasite companies, either, which are maintaining a privileged trade through various forms of corruption, such as companies keeping resources "captive" (under the "the profit goes to me and the cost to you" principle), non-competitive domestic companies, and others burdened with different ideological prejudices. But regardless of that, this country may develop and address socio-economic problems only with the resources which it has. For the state to use them, it should free them first of all from all forms of irrational use. If this is to happen, reforms are needed to discourage "or prevent irrational use of resources". Once the resources are freed, and once their market has been established, a true entrepreneurial middle class of people who will be using those resources effectively will be created.

## d) Inefficient privatisation – an obstacle to foreign investors

Bosnia and Herzegovina entered a "post-socialist" phase of development with the process of privatisation under the law on social capital of ex-Yugoslavia. Although the law had many imperfections, it should be said that its purpose was privatisation and the encouragement of market-economy development. However, the new authorities in Bosnia and Herzegovina (1990) quickly chose to review and suspend the privatisation process. Their major objection did not concern the efficiency of privatisation or its damaging effects on the efficiency of business. It sounds incredible, but it is true: The new, post-communist government resisted the sale of socially owned properties for very small amounts of money, although it was not clear how they came to the conclusion that something was devalued when no market for it existed (capital market). This means that the new government applied the same value judgment to capital as the old communist government. Without entering into a discussion about whether it was a justified or unjustified action, it should be noted, however, that the government's reaction caused a strong mistrust towards privatisation among the citizens. The peak of that mistrust was the moment the authorities of what is now the entities nationalised ("giving support to") socially-owned properties, ignoring a whole series of rules made during the implementation of the law on social capital. If we add to that the brutality of the war, which led to thousands and thousands of deaths, the devastation of nearly all resources, and the violation of many rights which are – in ethical terms – far above the right to property, it becomes clear that ownership in Bosnia and Herzegovina still does not have that form of economic motivation which is important for an effective economic development. Accordingly, the process of privatisation does not yet have the social and economic importance which it should have in a country in transition. This is also proven by the fact that in Bosnia and Herzegovina over the last several years, ownership has not been a source of security but rather, and too often, a cause of hardship. However, if they want to participate in the process of privatisation and to organise an efficient economy in this region, they will have to treat privatisation as a social priority. Of course, the problem of unfavourable conditions for consistent privatisation does not only stem from the past actions taken by the government in Bosnia and Herzegovina. The following does not contribute to successful privatisation, either: The powerful inertia of war-related contradictions, the strong inertia of socialist relations, undeveloped markets and market institutions, low efficiency, undefined prospects of development in a series of economic areas, a high level of corruption in institutions, the influence of criminal groups on economic processes, etc. However, all the above-mentioned problems may be solved if the government resolutely implements privatisation with the aim to establish market-oriented businesses and create a stable middle class.

## 2.6. Social and economic rights of citizens of BiH, necessary constitutional reforms

Over the last several years, trade and the crafts have seen a significant increase in their participation in the overall economic structure, primarily because of a pronounced complementarity with the development of the economy and the industry. Faster manufacturing and service trades serve the purpose of meeting numerous needs of both the economy and the citizens. Trade and crafts largely supplement the production programmes of industries, maintain their equipment, machinery, and vehicles, and offer a broad spectrum of services to the citizens. To intensify the development of trade, crafts, and private entrepreneurship, the economic-policy measures of Bosnia and Herzegovina should adjust legislation to modern needs in the next few years, especially from the aspect of consolidating a space for business, modes of funding, and tax policy.

In addition to private companies and private trade and service shops, the major providers of services in the towns across Bosnia and Herzegovina are companies which employ less than 100 people, and provide artisan and individual services and do repairs. The majority of such companies specialise in repairing certain types of vehicles, all sorts of household appliances, orthopaedic aids, optics, and certain medical aids, and in providing the whole range of hair-dressing and cosmetics services.

The number of private companies and private shops in the area of trade and crafts is increasing every year, thus opening new opportunities for increased employment. In the Sarajevo region, there are 202 private trade companies and 706 private trade shops.

**The social and economic rights** of citizens of BiH continue to be restricted by a poorly-developed economy. Officially, 40% of citizens are unemployed. Around 20% live below and 30% on the poverty line. This partly reflects the inability of what is indeed an undeveloped system of social security to meet the needs of the economically most vulnerable categories. The magnitude of the problem is such that it cannot be solved as a part of the normal social-welfare policy without constitutional changes. The issue of unemployment as well as protection from unemployment in the process of transition and restructuring of the overall economic structure must be treated as an integral part of the overall socio-economic restructuring.

From the perspective of the European integration, it would be difficult to establish that the present constitutional order is optimal. Such a state and constitutional structure prevents the implementation of reforms and thereby undermines the ability of BiH to make fast progress on the road to the EU. It is recognised, however, that some major reforms, despite important accomplishments in strengthening the state institutions, continue to be delayed because of differences between the positions of the state institutions and the entities. The lack of confidence in just any transfer of responsibility from the entities or cantons to the central institutions prevents the implementation of comprehensive and sustainable reforms of the institutions and the constitution. Only **radical changes** in the existing constitution of Bosnia and Herzegovina in this direction will contribute, among other things, to the development of the economy of Bosnia and Herzegovina. **A single economic space** of Bosnia and Herzegovina constitutes an interim precondition for all future integration processes. Strengthening the necessary **state institutions** represents a key factor for **the competitiveness of the economy and the products** of Bosnia and Herzegovina.

New constitutional arrangements in Bosnia and Herzegovina should, in the first place,

- establish a reintegrated Bosnia-Herzegovina nation with a feeling of a shared, common future. It has to be a nation at peace with itself, integrated territorially and ethnically, which lives in harmony, in full and

just partnership, committed to the whole country, all the people, and the economy.

- establish one psychologically free, safe, and developed Bosnia-Herzegovina society, self-confident, justifiably proud of itself, proud of its accomplishments, and strong enough to face all difficulties. Such a Bosnia-Herzegovina society will have to aspire to the maximum, fully aware of its potential, without being subordinate to anyone in psychological terms, and fully respected by other nations.
- strengthen a mature, democratic society which practices a form of consensual Bosnia-Herzegovina democracy oriented towards community, which may serve as a model to other developing countries.
- develop an academic and progressive society, a society which will be innovative and look to the future, which will not be just a consumer of technology but will contribute to the scientific and technological civilisation of the future.
- foster a society which will take care of its people and will have a culture of social-welfare, a social system in which the society will be put before the individual, in which social protection of the people will not address the state or an individual but a strong and firm family system.
- ensure an economically just society with full partnership in economic progress.
- establish a prosperous society with an economy that will be fully competitive and dynamic.
- establish a fully moral and ethical society, with the citizens resolved to foster religious and spiritual values and to respect fully the highest ethical standards. In the implementation of these activities, it would be important to strengthen the **decentralisation of the government in the entities and transfer economic and political sovereignty from the entities to the state of Bosnia and Herzegovina.**

All political parties in Bosnia and Herzegovina support **the European integration** and structural reforms, although they are not always willing to make the concessions necessary for real progress through constitutional reform. Delaying the passage of laws at the state level often reflects a lack of political will and different ethnic interests, but is also the result of some structural weaknesses, such as underdevelopment of the capacities necessary for promulgating laws and ineffective structures of support.

The stabilisation and association process requires from BiH **stable state institutions** which will ensure a functioning, efficient, and competitive market economy able to sustain the pressure in the single market of the European Union and assume the responsibilities of full membership, including implementing the goals and objectives of the political, economic, and monetary union. Bosnia and Herzegovina, its institutions, the executive and legislative branches of government, and its society will have to reach a consensus about the political, economic, and institutional development of the state. New constitutional arrangements will have to offer better economic and social security to the people of BiH.

The accession of Bosnia and Herzegovina to the European Union is one of its strategic priorities. The approval of the commencement of negotiations about a Stabilisation and Association Agreement is a first but important step on the long path towards the European Union.

The European integration process requires a comprehensive harmonisation of policies, an institutional framework, and a legal system geared to achieving European standards

in all areas. The prospect of membership in the EU is an extremely strong incentive to continue reforms in BiH, initiating the process which should enable the creation of an economic, legal, organisational, and social structure able to operate in accordance with EU rules. Its membership in the EU will help Bosnia and Herzegovina to open up its market to the EU member states, thus enlarging the EU internal market.

Accession to the EU is important also in terms of creating an institutional framework to strengthen the competitiveness of the BiH economy, integrating it into the EU single market, and increase the level of political stability, which will contribute to decreasing non-commercial risks for investments in BiH and to speeding up the economic growth and development of the country.

Progress on the road to the EU will also increase both the economic and the political attractiveness of BiH. So it may be expected that the signing of a Stabilisation and Association Agreement will be another incentive for investments in BiH.

It is important for BiH that today it is responding alone to the challenges of the global economy, naturally with the support provided by multilateral organisations in different areas. The concept of regional economic integration is not desirable for BiH because of the low level of convergence in the development of the countries in the region. If BiH starts moving forward to the EU faster, a new environment will be created in which Bosnia and Herzegovina's place in the global economy will be largely supported by the EU's policies and institutions, while the key responsibility for economic development and competitiveness continues to rest with the BiH institutions.

The signing of a Stabilisation and Association Agreement will be a test in which the economy of Bosnia and Herzegovina will have to make a stride into a sustainable and balanced economic system. This is a precondition for the BiH business community to move forward, based on its abilities, structure, and quality, to the standards required by the market of the European Union countries and the rest of the developed world.

The key factor in Bosnia and Herzegovina's readiness for negotiations about a Stabilisation and Association Agreement and for accession to the European Union in the foreseeable future will be the ability of its economy to join the European Union market.

Bosnia and Herzegovina and its business community should make preparations and assure the responsible bodies of the European Union that they are prepared for a successful implementation of the most important market reforms, for integration, i.e. for the establishment of a single economic space of Bosnia and Herzegovina, and for the application of quality standards as well as certification and other procedures necessary for a successful entry into the national and international markets, especially Europe's market. If it completes this phase successfully, i.e. if it passes the test, Bosnia and Herzegovina will be on the right path to full membership in the European Union.

*SWOT analysis of the development of trade, business, and the middle class in Bosnia and Herzegovina*

<p><b>STRENGTHS:</b>          Free access of BiH goods to the markets of more than 500 million people;          Liberal trade regime;          Economic growth in BiH;          Growth of demand in target markets;          High share of products with lower processing levels in the exports of BiH, based on natural resources and cheap labour force;          Tendency of exports to grow faster than imports;          Proximity of European markets;          Legislation in the area of foreign trade harmonised with international rules;</p>	<p><b>WEAKNESSES:</b>          Insufficient production in BiH;          Insufficient competitiveness of BiH goods in the international market;          High trade deficit;          High share of products with low processing levels in the exports of BiH;          Inadequate promotion in the international market;          Non-existence or inefficiency of institutions which support exports and control imports;          Insufficiently capable manpower in the state institutions and the economy;          Slow implementation of reforms and foreign-trade legislation;          Slow privatisation process;          Insufficient inflow of FDI;</p>
<p><b>OPPORTUNITIES:</b>          Reform implementation;          Gradual strengthening of the state;          Signing of an SAA with the EU;          Membership in WTO;          Implementation of an agriculture development strategy;          Institutionalisation of export promotion;          Establishment of domestic production support funds;          Completion of the privatisation and restructuring of BiH companies;</p>	<p><b>THREATS:</b>          Poor image of BiH in the world;          Invisible non-tariff barriers in BiH target markets;          Abolition of quotas for textiles and presence of Asian producers in target markets of BiH;</p>

## 2.7. Major macro-economic, legal, and infrastructural obstacles to the faster development of SMEs

The preservation of the stability of the national economy and the financial markets, a faster development of the capital market, a reform of the fiscal system and the labour market, the further liberalisation of foreign trade in the region, and other issues which are yet to be promoted in BiH will certainly encourage many foreign investors. The absence of a functioning single economic space in BiH forms a particular obstacle to creating an attractive business environment for both domestic and foreign investors, and for integration in the EU. Increased foreign direct investments and the creation of an open capital market (venture capital is particularly important for SME innovation) will be crucial for the long-term prosperity of the country.

Legal and administrative obstacles, expensive and time-consuming bureaucratic procedures for company registration, and the inappropriate fiscal and financial support given to companies are key obstacles to the faster growth of small and medium-sized enterprises.

There are also some other important obstacles to the operation of SMEs which are not based on macro-economic but rather on infrastructural constraints:



- a ten-minute telephone call is three to five times more expensive for a company in BiH than in the countries in the region or in the EU; and
- the percentage of Internet users in BiH is the lowest in the region (lower by 25% to 300% than in other countries).

Under such conditions, it is extremely expensive to work on the international plane or launch an initiative for partnership or networking. Both processes largely depend on the infrastructure and the supporting domestic and international communications which have to be far less expensive than they are in BiH.

## 2.8. Specific recommendations for the creation of socially-oriented market economy

It would be necessary for the new government agencies to specify in their proposals for social-welfare programmes that the state should ensure that a socially-oriented market economy is created by a combination of measures which provide a minimum living standard for all and permit all those to escape from poverty who want to improve their position in society. Such a programme would establish an efficient model which will clearly define who gets what, when, and how through the governmental social-welfare programmes, ensure that all poor citizens are treated equally, and contribute to the establishment of a social-welfare system which does not discriminate against its beneficiaries on any grounds and ensures the preconditions for mobilising all available resources necessary for the effort to combat poverty and social exclusion.

There is a need for the state to play a long-term role in conjunction with the development of society, the elimination of discrimination from present public policies, the establishment of minimum rights for all citizens, the creation of an opportunity for poverty elimination, the assurance of equal access to public services, the need to increase economic security of all employees, the need for clear positions of the political parties, the inefficiency of existing government policies, the fulfilment of the requirements of the parliamentary assembly of BiH, and the process of moving forward to the European Union.

A just, wise, efficient, and cost-effective state will ensure the fastest possible economic and social development, increased economic security, and the satisfaction and happiness of all citizens. These functions of the state are paid for by taxpayers' money, and if the citizens believe they are receiving more than they are paying in taxes, they will be pleased. Otherwise, they will not be pleased.

Nevertheless, the difference between a firm and a state is big. Everyone may boycott products or services, but they have to buy services from the state. For the majority of the citizens of BiH, tax is an "extreme necessity" which is paid in Bosnia and Herzegovina for very inferior and inappropriate public services that we receive in return. Most of the citizens are paying taxes only to avoid being punished, stigmatised, abused, imprisoned, and convicted. Also, most companies are not expecting any benefits from the state – only an obligation to be registered, to be counted, to pay taxes, or be punished if they fail to comply with state legislation.

Social-welfare programmes would greatly encourage the process of changing the role of the state in promoting economic and social-well-being through policies which encourage development and cooperation between the state, the private sector, and the citizens in efforts to eliminate poverty, inequality, and economic uncertainty. The implementation of such programmes would help citizens to notice for the first time the benefits of paying taxes and, more importantly, to see how the payment of taxes can reduce poverty and increase the economic security of all citizens, with a view to creating the prerequisites for as strong a middle class as possible.

With its social-welfare policy the state ensures increased economic and social-well-being for all citizens, regardless of their status in the society, for although its goal is to improve the position of the poor, those who are not poor will enjoy some benefits as well. The social-welfare policy's primary goal is to encourage the development of citizens who - because of economic, demographic, health, social, climate, and other characteristics - do not have equal opportunities to enjoy an equal status in society. Disabled people do not live in the same conditions as healthy people, life in rural areas is too different from life in urban areas, families with children live much more difficult lives than families without children, etc. If a social-welfare policy does not include all citizens in need of state aid, it will contribute to the growth of inequality and poverty and will become a tool of discrimination instead of fighting poverty and social exclusion.

We cannot say that there are public policies in Bosnia and Herzegovina that stimulate poverty alleviation or promote social inclusion with budget funds. So far, the only such public programme which is available to all citizens of BiH is the state fund for returnees who may, in a transparent process, apply for funds to solve any housing problems in case they want to return to their pre-war homes. However, those amounts are too small in comparison to the overall public expenditure and would be completely inefficient and ineffective without additional funds from loans and foreign assistance. Another and much more important problem is that of social exclusion in BiH.

In addition to ensuring a minimum of security, encouraging poverty elimination, and creating the preconditions for the development of the middle class, a social-welfare policy should also aim at ensuring equal conditions for greater well-being through cohesive access to private and public services. Once the state has ensured minimum living conditions and incentives for the poor to become non-poor citizens, we cannot be sure that every citizen will have equal opportunities to use his or her psychological, physical, and material potentials or equal opportunities vis-à-vis the state. For numerous reasons, citizens of one and the same state have different access to public and private services which are an important factor in their economic and social-well-being. The numerous opportunities in the community in which an individual lives permit them to use their economic potential and thereby reduces his or her chances of becoming poor.

The economic and social differences in Bosnia and Herzegovina cannot be ignored. In comparison to the citizens of Sarajevo, a citizen of any other part of BiH has far less opportunities to get a job, to be paid the same amount of money for the same job, to finish higher education, to work in profitable branches of the economy, to receive equal primary and secondary school education, to obtain equal primary health care, to use an equivalent public-utility infrastructure, to learn languages, acquire skills, get trained in information technology, access new scientific and technical knowledge, use information in a timely fashion, pay the same price for the same services, have access to the Internet, use soup kitchens and other charity services, have a variety of products available, etc. All these differences favour the citizens of Sarajevo, according to them better living standards and resulting in a smaller percentage of citizens living in poverty, unlike the situation in other, less developed areas in BiH. Apart from the fact that the citizens of Sarajevo live better lives than others on average, economic differences motivate many citizens from other parts of BiH to leave their homes and solve the problem of unequal opportunities by moving to Sarajevo.

Although in the last three years one of the key economic goals of BiH has been to create the conditions for self-sustaining and equal economic development, so far not a single action has been taken, no programme has been made, nor a law approved to promote economic and social development in the less developed areas of BiH, or to offer incentives.

A new proposal of a social-welfare programme must contain clearly defined actions which will ensure equal access to public services by encouraging their development

in undeveloped areas and encourage local economic development in the underdeveloped municipalities of BiH. In this way, the programme would avoid the risk of marginalising a very important cause of poverty in BiH – unequal access to public and private services by citizens who live in undeveloped areas of BiH.

The vast majority of citizens earn their income and provide for their families, ensuring them normal lives. In a market-oriented society you have to have money or be fully excluded from social life. You need to have money to buy food and clothing, to be warm, to have a social life and, ultimately, to be a member of society, without shame. Although the market in itself affords opportunities to work, it is not interested in the consequences for workers who lose jobs. Those who are employed may lose their jobs against their will, regardless of how important their employment is to them. The market may force a company to fire workers regardless of the fact that the workers may fall into extreme poverty.

Although the political parties at the BiH level and the entities put GDP growth, exports, production and employment, the implementation of a policy of sustainable development, the creation of conditions for increased investments etc. before anything else, it is almost impossible to see in the distribution of KM 9.23 billion of budgetary funds at all levels how, how much, or in which way the funds are used for the implementation of their goals. The only exception is agricultural policy which, thanks to the practice from before the war, ensures funds for increasing the revenues of farmers.

Although the majority of the citizens of BiH agree that it is necessary to make radical changes in order to improve the economic and social situation in the country, the citizens also agree on the manner in which those changes should be made. Regardless of the positions maintained by the political parties and the present government, the citizens of Bosnia and Herzegovina believe that the social-market model and accession to the European Union are the best way to improve the economic and social situation in the country. According to the results of a public opinion poll, if a referendum on Bosnia and Herzegovina's accession to the European Union were held, 85.2 percent of voters would support BiH's accession to the European Union.

In the EU accession process, Bosnia and Herzegovina will have to adjust its mechanisms so as to ensure higher and more stable levels of employment and its measures to promote access to employment, housing, training, education, culture, social welfare, and medical assistance to persons and their families who are already in – or are running the risk of – falling into social exclusion or poverty. The authorities will also have to modernise the system of social development radically to harmonise their policies with the key policies which form the foundation of the European Union. The European Union is continually modernising its social model, trying to increase the confidence of its citizens especially by encouraging employment and ensuring equal opportunities for all.

The proposed social-welfare programme will have to be based on the fundamental values of the European social model, the incentives of which ensure the elimination of poverty and social exclusion. The proposal for the social-welfare programme should include the establishment of mechanisms to ensure the functioning of social-welfare policy tools in a manner which is compatible with the social values of the European Union. The proposal for a social-welfare programme has to provide the foundations of a government mechanism for social development, without which BiH will not be able to expect the EU to provide financial assistance for the elimination of causes of poverty and social exclusion in the same way as in other EU countries.

## 2.9. Final Considerations

Unlike the previous years in Bosnia and Herzegovina, some noticeable improvements have been seen in the elimination of administrative obstacles to domestic and foreign investments. The pace of reform implementation in this area raises hopes that the

main administrative obstacles will have been removed by the end of 2005, that economic lawsuits will be addressed faster, and that better protection of creditors will be ensured. The focus in improving the business climate will shift from removing administrative barriers to creating conditions conducive to enhancing the competitiveness of the domestic economy, reducing tax rates, and strengthening economic management. These two factors are the key strategic instruments in the future development of small and medium-sized enterprises in Bosnia and Herzegovina.

In this small west Balkan country devastated by war, attracting more foreign investment represents an absolute priority which will – in view of the lack of domestic capital and the numerous positive effects of foreign direct investments – ensure, among other things, an increased employment rate, the development of new managerial skills, new technologies, new markets, and increased exports.

Strengthening entrepreneurship in BiH has already been defined as a precondition for the fast development of the private sector and especially for the growth of SMEs. In comparison to other countries in transition, BiH has the smallest number of companies per 1,000 citizens, the establishment of start-up companies is the most expensive in the region, more expensive than in any EU member state and much more expensive than in the U.S. or in Russia – a strong sign for the BiH government that it should speed up reforms with a view to creating a business environment which is more conducive to the development of SMEs. Still, despite all the above-mentioned obstacles, the number of newly-established companies is relatively high every year. According to the judicial statistics, 12,140 new companies were established in BiH in the course of the first 10 months of 2005. This shows that there is a certain interest in business, although it is still much lower than in other countries of the region and in the EU.

On the basis of the above assessments and evaluations, we can say that there is not sufficient evidence to indicate that small and medium-sized enterprises in Bosnia and Herzegovina are able accept the changes which are considered to be an important condition for overcoming the present climate in the economy of Bosnia and Herzegovina, which is insufficiently competitive under the conditions of globalisation. The following are the major concerns: administrative barriers, insufficient use of information technology services, and a lack of staff capable of keeping pace with modern managerial skills and technological innovations. The ongoing transition-related reforms in society, and especially in the economy, have a positive impact in allowing SMEs to penetrate gradually the regional market and also a wider market beyond the region. All this will strongly encourage the process of accession of Bosnia and Herzegovina to the European Union.

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## 3. Bulgaria

by Prof. Dr. Ivan Tchalakov

### 3.1. Historical introduction

By the mid-1980s, the Bulgarian economy was characterised by one of the lowest shares of private (or quasi-private) activities among the COMECON countries. From the 1950s to the early 1980s, the specifically socialist form of incorporation<sup>1</sup> was considered the main line of economic development. By the 1980s the Bulgarian economy was dominated by approximately 100 large vertically-integrated economic organisations, often comprising dozens of enterprises spread all over the country. Agriculture was collective on a scale similar to that of the former Soviet Union, and in the 1970s, the tendency towards unification led to the creation of so-called agro-industrial complexes, some of which managed the agriculture of entire regions. Commerce was 100% state-owned, while individual economic activity in services and trade was allowed only under the umbrella of so-called 'labour-productive cooperatives' and the economic units of the Central Cooperative Union.

In 1989, a team from the Institute of Sociology at the Bulgarian Academy of Sciences (BAS) carried out a national survey among industrial managers about the ecological situation in their plants.<sup>2</sup> Preparing the sample for the survey, we were given the following data by the National Statistical Institute about the number of economic enterprises in the thirteen main sectors of the Bulgarian industry.<sup>3</sup> It appeared that the total number of autonomous economic units in the industry was 3,055 in the spring of 1989, 18% of which were the enterprises in trade and other forms of small-scale production, registered under 'Others' (542 enterprises). Only one year later, after the radical political and economic changes of 1989, the National Statistics registered more than 400,000 newly-created firms! This trend continued in the years that followed, and although not all of them survived, in 2001 the total number of enterprises was 224,151, of which 91.9% (205,902) were micro-firms with fewer than 10 employees. Now, only 1% of the enterprises were owned by the state, the remaining 99% being in the private sector. So the structure of the Bulgarian economy radically changed in about 10 years.

During the decades before 1989, when the large state-owned forms of economic organisation predominated, the middle class in late-socialist Bulgaria took a rather specific shape. The Bulgarian sociologist Chavdar Kuranov pointed out that since the mid-1970s a relatively large 'middle class' layer emerged and developed in the country which, unlike those in the developed Western countries, was defined *according to its consumption and not its production of economic goods*. Those are people whose families owned fitted-out apartment or houses, mass-produced household appliances (TV sets, automatic washing machines, electric or gas ovens, etc.), cars (manufactured in the USSR, the Czech Republic, Poland, or the former GDR), and often also a summer house (villa). Typically, they spent a two or three weeks' summer holiday on the sea or at mountain resorts. The middle class thus defined comprised almost exclusively middle and upper-level employees in the state administration or industry,

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1 *Large state-owned vertically-integrated economic organisations with operational autonomy, but subordinated at the strategic level to departments of economic ministries and the top communist-party leadership.*

2 *Chalukov, I. T. et al. (1993): The Ecological Awareness of Bulgarian Industrial Managers. The Environmentalist, Vol.3.*

3 *Power generation, fuel extraction, ferrous metallurgy, mechanical engineering, electronics, chemicals, construction materials, wood-processing, paper and pulp, garments and textiles, fur and leather, food-processing.*



in services (medical doctors, tourism, etc.), or in the distribution of goods. Nikolai Tilkidjiev further developed these ideas, studying the transformation of this stratum during the period of transition since the 1990s.<sup>4</sup>

Hence, it appeared from the 'surface' of economic statistics and legal documents (see the following section) that a middle class and a social economy in the strict sense of the term (defined by its place in the *production* of economic goods and services) was missing in Bulgaria on the eve of the radical political and economic changes of 1989. Yet a closer look at the processes that took place in the economy since the late 1970s reveals a more complex picture. We should not forget that the trend towards over-corporatisation (economic dominance of large vertically-integrated companies) did not characterise only the socialist economy – the classical socialist model was born in the first half of the 20<sup>th</sup> century when corporations were predominant in the developed capitalist states. As Joseph Schumpeter wrote in 1942 in his last book, "socialism looks out at us from every window of contemporary capitalism". *The radical change in Western capitalism began in the 1960s, when radically new economic phenomena first emerged in the USA, such as risk (venture) capital and small high-tech firms that successfully competed with the large corporations and sharply increased the dynamism of the economy.* Since the end of the 1970s, the term 'small and medium-sized enterprises' with its new type of entrepreneurship gradually gained popularity both in economic theory and in the practical economic policy of the Western countries. It is hardly a coincidence that the serious attempts at reforming economic relationships in Bulgaria coincided with the incursion of these new Western ideas: about the limited capacities of corporations, about the role of autonomous small and medium-sized enterprises as subcontractors of the large state enterprises, about their role in testing new articles and forms of production at a much smaller economic cost, about the need for specific financing mechanisms, etc.

As we have pointed out in another publication, throughout the whole history of socialism economic reforms have always been the result of a change in the power ratio between the *economic* and the *political nomenklatura*.<sup>5</sup> The latter comprised members of the organisational and ideological departments of the communist party together with the secret services as their 'right hand' (including those monitoring foreign trade with the West). Its main asset (or 'capital') was steering every field of society – *control over the 'cadres'*, the appointment and promotion of relevant people in key positions. With the reforms that were gradually introduced in Bulgaria since late 1970s the dominant position of the political nomenklatura was challenged by the increasing power of the *economic nomenklatura*, i.e. the 'cadres' managing the economy – from the lowest directors of enterprises through the managers of the large vertically-integrated state 'combines' to the heads of economic ministries and their officers. They developed their own sense of unity, their own 'industrial ethic' and managed to establish themselves as a group opposed to the political nomenklatura. From this point of view, *the history of the higher echelons of the Bulgarian Communist Party was marked by several big clashes between these two wings, with the political nomenklatura winning every time.*<sup>6</sup>

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4 See Tilkidjiev, N.: *The middle class in Bulgaria*, Sofia 2003.

5 Tchakov I., (2006): *Socialism as Society of Networks and the Problem of Technological Innovations*, in: *Sociological Problems, Special Issue 2006*, BAS Academic Publishers, Sofia, pp.343-371.

6 *This happened first at the end of 1960s with the dismantling of legendary economic cartel "Bulgarian Sea Fleet" (former TEXIM), when the founder and chief manager of the cartel Georgy Naydenov was prosecuted and jailed under false accusations. The same happened in early 1975, when Prof. Ivan Popov – the man who initiated the successful development of the electronic industry and later became deputy Prime Minister and member of the Politburo – was dismissed from his positions. Their high esteem in Bulgarian society, especially among industrial managers, threatened the power of party's top leadership.*



By the end of the 1970s Bulgaria, and the former socialist countries in general, began to face competition from the newly-industrialised countries in the Far East (and even in Latin America), whose economies were operating under similarly authoritarian regimes but were not subjected to restrictions by Western countries (such as the CO-COM embargo). The cases of South Korea and Taiwan have demonstrated that countries with an economy based on private property and conducting political reforms aiming at democratisation are much more successful than socialist states in passing from the catching-up phase to innovative economic development. Conversely, the incapacity to carry out adequate political reforms in many of the Latin American countries has engendered an effect similar to the 'stagnation' in the socialist countries.<sup>7</sup> The socialist economies had to respond to these challenges. In this environment, the economic nomenclatura in Bulgaria managed, by the early 1980s, to create a special organisational structure, the Bulgarian Industrial Economic Association (BISA), which copied the structure of the Japanese confederation of industry. Initiated by Ognyan Doynov<sup>8</sup>, the BISA became very popular because of its initiatives aimed at optimising economic development. It backed the attempts to relax administrative controls, to allow small-scale private property in industry and agriculture, to enforce economic relationships with Western corporations, etc. One of these initiatives was to boost the development of small and medium-sized enterprises and to give them more autonomy than other socialist economic organisations. The Party allowed such firms only in the light industry: they obviously contained more capitalism than could be stomachied at that time. Yet as part of these reforms, the state-controlled printed media and TV stations made the first attempts at promoting entrepreneurship and personal economic initiative.

On the eve of the radical changes of November 1989, the economic nomenclatura was defeated again. In December 1988, Ognyan Doynov, the most popular economic leader who was highly respected among Bulgaria's Western economic partners, was dismissed, blamed by the pro-Soviet lobby at the Politburo for being a mouthpiece of Western influence in the economy. His removal was a sign for the same to happen to his followers in the economy and the state and party machine.

## 3.2. Legal framework for trade and entrepreneurial activities in Bulgaria

Using an untraditional approach, the Bulgarian sociologist Ivo Hristov argued that under socialism *some regulations that are traditionally extra-legal (from the viewpoint of Western legal traditions) were entrusted with legal functions*. He discerns an "immanent legal system of socialism" which "... should not be sought only in norms that bear the name of law. The leading criterion will not be formal appellation but the actual regulative functions and proper forms of regulation. Proceeding from such a

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7 See Gereff, G. and D. Wyman, (1990), *Manufacturing Miracles. Paths of Industrialization in Latin America and East Asia*, Princeton, Princeton University Press.

8 Ognyan Doynov obtained an engineering diploma at Sofia Polytechnics. After a few years of work as an engineer, he went on to the Ministry of Trade to become, at the age of 29, director general of the foreign trade corporation Koraboimpex. In the mid-1960s, he was sent to Japan, where he spent five years. At first his activity was closely connected with Koraboimpex's operations (purchase of ships for the Bulgarian merchant fleet, etc). Later he became co-president of the Bulgarian-Japanese mechanical-engineering and commercial association created by the Bulgarian fork-lift truck producer Balkancar. His company was exceptionally successful. Soon after his return to Bulgaria he was engaged as an expert in a working group attached to the Central Committee of the Bulgarian Communist Party. By the end of the 1970s he had established himself as a leading economic manager, and he was appointed member of the Communist Party Politburo and Vice Chairman of the Council of Ministers.

criterion, we will discover that the search ought to be expanded to include *regulative practices that do not formally pertain to law*, the so-called internal instructions, 'secret' decrees, etc. Legal regulation is realised not only by part of the norms that are a component of the formal body of laws, but likewise by departmental, interdepartmental, and Party regulations which, though not formally called legislative, perform legal functions and have their own specific legal nature". (Hristov 2004, p. 6)<sup>9</sup>

Until the early 1970s, the 'secret' legal regulation of economic practices contradictory to the ideological orthodoxy of communism predominated<sup>10</sup>, but after the mid-1970s, new *written documents* appeared. On June 14, 1974, *Edict no. 1196 on economic, manufacturing, and technical cooperation with foreign legal and physical persons* was enacted which for the first time regulated economic collaboration, financial and industrial cooperation, and the exchange of equipment and technologies with developed Western economies. Six years later, a 'legal breakthrough' came with the enactment of *Edict 535 on economic collaboration between Bulgaria and foreign legal and physical persons*. It was important that "... *the legal regime of economic associations [with foreign partners] was characterised by exceptionality*, i.e. they did not fall under the provisions of other legal regulations", and he concludes that "the legal provisions of Edict No. 535 can be considered the *initial test for a large number of economic, financial, and management techniques through which the gradual dismantling of the system would be carried out*. (my italics – I. Tch.)" (Hristov 2004, p. 14).

This is confirmed by the observations of the Bulgarian lawyer Emilia Petkova<sup>11</sup>. She claimed that, although the 1980s saw some attempts to engage the Bulgarian economic units and citizens in a different way, there was not separate arrangement for trade and small enterprises. (Petkova 2007) The main legal form for these activities remained *the law on cooperatives* from 1953, which was replaced in 1983 by the new law of cooperative organisations, which in turn was abolished in 1991. Both laws define cooperatives as social-economic socialist organisations, stipulating that private trade are regulated and controlled by Ministry of Communal Economy and Public Utilities. There were special rules defining who had the right to practice a craft, how trade and other small private shops were to be opened and closed, how craft shops were to interact with other socialist economic organisations, etc. The rules also provide sanctions against breaking the law, including the closing of illegal shops. (Articles 1, 15, and 16 of the *law on cooperatives* of 1953 as amended in 1956, 1958, 1968, and 1978). In 1983 a new *law on cooperative organisation* referred to 'labour-production cooperatives', including those relating to trade. Since the members of these cooperatives were to participate directly in the production of goods and services, the law required at least half of the founder-members of these cooperatives to have professional qualification in their specific fields of activity. (*law on cooperative organisation*, State Gazette No. 102/1983, No. 46/1989)

The policy of granting independence to economic subjects was further developed in the mid-1980s in a "... search for an effective way of separating ownership from control through *decentralisation of property rights*". (Peev 2002, p. 40). According to this author, the formula that "the state is the owner and the work collective is the manager" and its implementation in 'self-managing' work collectives marks the attainment of a certain degree of clarity about the problem of property rights under

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9 Hristov, I. (2004): *The Law and Transition*, in: *Sociological Problems*, vol. 3-4/2005 (in Bulgarian).

10 "... Together with the official line of reforms of the Bulgarian economy, there was another, bolder and realistic way of thinking... [Its] proponents were mostly foreign trade functionaries, who were closely acquainted with the regularities of the world market and had practical experience... The most significant experiment in seeking new roads for the economy was carried out in the 1960s by the free (!) enterprise TEXIM, which later grew into an economic corporation named Bulgarian Merchant Fleet". (Karamanev 2001, p. 56).

11 Petkova, E. (2007): *The Legal Framework for Crafts in Bulgaria after 1980*, unpublished expert analysis.

socialism. This principle was embedded in a series of normative acts such as *the rules of the economic mechanism* (REM) and its amendment, the *decree on specific rules of the economic mechanism in agriculture*, the *decree on contracts between socialist organisations*, etc." (Hristov 2004, p. 16)

At the beginning of January 1988, the famous *Decree 56* was enacted. Its provisions continued in force through most of the 1990s, regulating economic activity. It was abrogated only in 1996! Article 2 of Decree 56 declared the firm to be the main form of economic activity but granted citizens the right to carry out such activities without registration. It also allowed joint-stock companies. Article 57 of the Decree required those who registered a firm to work in it personally. The taxation of traders and collective firms was not based on profit but on the *income tax law*. Thus, the decree regulated "...simultaneously matters such as general organisation and principles of economic activity in general, the legal regulation of so-called 'firms'; the insolvency and liquidation of firms; the regulation of economic activity by the state; the economic activity of foreign firms within the country, the legal rules of profit and its transfer; real estate and related property rights, etc.... [It attempted] to encompass entirely and codify through its regulations a new economic and social world, the world of the market." (Hristov 2004, p. 18)

It is clear enough that, two years before the start of political changes in Bulgaria, 'the market world' had found a place in the articles and paragraphs of Decree 56. Researchers assert that Decree 56, just like the normative documents that preceded it, ended in failure, attempting to effect an impossible combination: "The state bureaucracy was to retain its economic power over nationalised capital while simultaneously creating market competition and, hence, higher effectiveness" (Peev 2002, p. 40). But, viewed from the perspective of the concrete economic agents, things seem different: in fact, *Decree 56 and its preceding documents created enclaves in which economic actors learned separate elements of market behaviour, acquired knowledge and attitudes, and mastered certain techniques and rules that would provide them with competitive advantages at the start of the real reforms several years later*. Some authors went even further, defining the processes prescribed by Decree 56 as 'spontaneous privatisation':

"... The government retains possession of the enterprise. But the use and management of the assets is private and, directly or indirectly, free. The ways of achieving this are infinitely many, ranging from hiring public space and offices at prices below the market to assuming the debts of an enterprise as state debts and remitting its obligations to other state enterprises. *The process began with the enactment of Decree 56 (January 1988) and the registering of firms with state assets*. On August 17, 1990, the Great National Assembly (on the proposal of a group of parliamentary representatives of the Union of Democratic Forces) attempted to stop this process and adopt a decision for imposing a moratorium on managing state and municipal property. This decision proved completely meaningless as Parliament was unable to make the government observe it." (Stanchev et al. 2004, p. 123)

In addition to these changes, the Council of Ministries passed the *rule for collective and personal labour activity of citizens in the production of additional goods and services* which remained in force until 1999. It replaced the previous *regulation for the practice of trade and commercial activities by citizens* (passed in 1980), according to which these activities were to be carried out only in cooperatives and other collective forms. The new rule permitted self-managed socialist economic organisations and citizens to increase their incomes by producing goods and supplying services. The state institutions were to encourage these activities. The *Rule* forbade, however, the use of paid labour (i.e. exploitation) and required that these activities be carried out only by collective and personal efforts on the part of the citizens. To this end, they were to sign a contract with an existing economic organisation, to organise themselves in small production collectives, to rent small production or service premises, or

register as tradesmen, traders, or service providers. Chapter V of the rule described in detail the meaning of 'practicing a craft', 'independent organisation of small productions and services', etc. The Rule was followed by two additional regulations of which one, *Regulation No.4*, remained valid till 1999.

It is clear from above that in practical terms, the laws and rules covering autonomous economic activities by citizens were largely introduced in the late 1980s. The political changes of November 1989 only raised the ideological barriers against paid labour, thus eventually opening the door to free entrepreneurial activities.

### 3.3. Hidden barriers obstructing autonomous entrepreneurship and trade during the 1990s

Unlike central European countries, the 'velvet revolution' in Bulgaria was actually used by the political wing of the communist party nomenklatura to transform its political into economic power. This wing retained control over practically all spheres of Bulgarian society until the late 1990s. One of the main features of this period was the suppression of the people's initiative and entrepreneurial spirit, explicit attacks against independent entrepreneurs, and the denigration of their public image. During the 1990s, the true entrepreneurs in Bulgaria were working in a hostile economic and political environment of rent-seeking and asset-scraping capitalism. As has become clear at the end of the first section, this specific form of capitalism stemmed from the events that took place in the last decade of socialism. *So, unlike Hungary, it was the political nomenklatura – whose representatives in their vast majority saw the economy through the optics of the old Marxist political economy and lacked specific industrial managerial skills – which was destined to carry out the post-socialist economic transformation of Bulgaria.*

Instead of opening the doors to the foreign investors, empowering the most talented industrial managers, and promoting the entrepreneurial spirit of an economically active population deprived for more than 50 years of the very conditions for becoming entrepreneurs (property rights and fair access to credit), the ruling elite did just the opposite. Seeking to preserve their dominance in society, the 'reformers' adopted a strategy of converting their political into economic capital. They successfully used the conservative neoclassical models the Western economic experts were selling after 1989 to push the economic nomenklatura out of any positions it still possessed and to impose their own rent-seeking and asset-scraping strategies. These strategies included number of interrelated measures, the most important of which were:

Gaining control over the country's financial system by appointing trusted people to the now-independent banking system; a special amendment to the law stipulated that bankers were not personally responsible for the loans granted by them(!).

Keeping the share of the state in industrial property large, while dismantling former vertically-integrated structures (state combines) and establishing stringent control over the industrial managers of independent enterprises (via the banking system, by appointing trusted people, by means of specially-created criminal groups, etc.).

Exploiting the state-owned plants by so-called 'input-output economics', i.e. by compelling their managers to buy raw materials at comparatively high prices from specific suppliers and to sell their products at comparatively low prices to specific distributors (usually both small trade firms privately owned by representatives of the political nomenklatura working in the sector).

Suppressing the emerging independent entrepreneurs by limiting their access to credit and forcefully pushing them out of the most profitable sectors. Controlling the legal system by appointing trusted people and introducing special legislation to remove the system from public control and accountability. The process of restitution launched in 1992, by which the property nationalised in 1947 was returned to the for-

mer owners was slow, incomplete, and successfully used as an ideological camouflage for the real economic processes that were taking place. Worst of all, the restitution mentality encouraged by this process was practically identical with the economic philosophy of the political nomenklatura. It also implied rent-seeking capitalism, focusing public attention on the possession of property (mostly outdated material assets) instead on the opportunities to make money in new ventures or on the emancipation of the credit system from the political system by creating conditions for fair access to credit. Maintaining its control over the new 'independent' public media, the ruling elite deliberately discredited the emerging patterns of entrepreneurial activity and independent trade. It continued to spread an atmosphere of distrust towards private initiative, reducing it to a type of semi-criminal activity. There were relatively few cases of successful entrepreneurs managing to creep into the media.

In comparison to 1990, which marks the beginning of the transition to market economy, the private sector had grown to more than 3.5 times its original size by 2000. During the three years from 1998 to 2000, the private sector accounted for over 60% of the service industry. As a result of the privatisation process, private service and industry firms increased their share the total value added from 53.3% in 1999 to 68.2% in 2000. The relative share of the private sector grew in employment grew from 5.9% (241.600) in 1990 to 70.1% (2.063.000) in 2000, or by a factor of 8.5 in absolute terms. By 2000, investments were made predominantly in the private sector which reached a relative share of 62.1% of the total investment activity... (Chobanova, R.-Innovation Policy Profile: Bulgaria, in: EC Enterprise Directorate General, Contract N°INNO-02-06, *Final Report*, Volume 2.1, 2003)

Hence the new Bulgarian state and its political institutions as they emerged after 1989 are something very different in their nature and functions from their Western analogues. They were not based on the principles of accountability and civil service or a clear identification of policy objectives and related public interests. Rather, the Bulgarian political system was used by the winners in the battle between the two wings of the communist nomenklatura as a shield that guaranteed the flawless application of their rent-seeking and asset-scraping strategies in order to gain economic superiority.<sup>12</sup>

The result of this type of economic management was hundreds of 'sucked-dry' state-owned firms – highly indebted, with outdated and badly maintained equipment, paying meagre salaries, and abandoned by their best workers and specialists. Combined with grain shortages and high inflation, this led to the mass unrest in the winter of 1997, preliminary elections, and a new democratic government. Within a few months, the new government closed 16 'drained' private banks, introduced a currency board, and launched a rapid privatisation programme. Three years later, the share of state ownership in the economy had fallen from over 70% to below 30%. The complete domination of the ex-communist political nomenklatura was finally broken. For a few years, however, it was replaced by a 'democratic domination' that was fairly similar in its effect, for the democratic government exercised strict control over the privatisation process and the economy as whole, favouring its own party machine. Paradoxically enough, by 2001 it had become clear that state and political institutions had been used again for the enrichment of yet another politically-linked group.

According to surveys in business circles, it was not until the government of the ex-monarch, Simeon of Saxe-Coburg-Gotha, came into power in 2001 that state institutions adopted relatively neutral attitudes towards private companies, both those

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12 *That is why the 'bandit model' of Mansur Olson for the role of governments in the east European economic transformation provides an appropriate framework for conceptualising of what was going on 'in the field' – the model defines the role of politicians and bureaucracies in post-socialist economies as 'bandits' attempting to extract maximum resources from the 'public' and introduces relevant variables, such as the ability of the 'public' to resist, the lifetime of the bandits' economic policy, and the level of their internal cohesion. (Olson 1995: 437-462)*

that belonged to the former ex-communist or ex-democratic nomenklatura and those owned by independent entrepreneurs. The invitation of Bulgaria to join the EU in 1998 and the negotiations with the EC that followed were another important reason why the Bulgarian post-socialist political system moved towards Western standards of behaviour, including changes in the relationships between the political and economic spheres.

The results of our research show that the 'conversion' strategy of the political nomenklatura did not succeed entirely. There were sectors which provided adequate conditions for true entrepreneurs and trade to emerge, develop and grow. Their representatives came from different backgrounds – skilled workers and talented engineers from the industry, industrial managers sacked by the ruling elite in the years before and after 1989, members of the former capitalist class that had their property restituted, or simply people of entrepreneurial spirit who seized the opportunity to do business under the new economic conditions, where private property was legally permitted.<sup>13</sup> Relatively invisible during the first years of transition and passing through many hardships, these entrepreneurs gradually increased their economic strength. By uniting their efforts in newly-emerging industry associations, craft unions, and chambers, they began to exert pressure on the political system at the end of the decade to abolish the dominant model of rent-seeking capitalism.

Which sectors of the economy favoured these developments most? – We might tentatively define two complementary principles which, taken together, help differentiate between the sectors 'conquered' by representatives of the post-communist political nomenklatura and those where true entrepreneurs had a better chance to develop.

The first principle is *the overall profitability of the sector*. The political nomenklatura as defined above focused on the most lucrative sectors, such as the mass production of consumer goods for the domestic market (tobacco, alcoholic beverages including wine, oil derivatives, pharmaceutical products, cosmetics, household chemicals, etc.), trade in such goods (especially imports), and sectors with remaining competitive advantages on the international markets – ferrous metals, wood and wood-processing, heavy chemistry, electric-power generation, etc. We should add to this group service sectors such as telecommunications and tourism, although their specific characteristics brought about some long-term constraints for purely rent-seeking strategies. Only few very strong multinational companies were able to penetrate into these sectors, often with the help of Western governments and after paying serious money for licences. However, a number of low-profit sectors – such as the production of manufactured goods and services with a relatively limited demand and/or a large share of skilled manual labour; with few prospects of exports, requiring significant investments and expensive maintenance, with long payback periods, etc. – remained relatively free for entrepreneurial initiative and small independent trade.

The second principle is *the sectors' inherent resistance* (or rather 'rigidity') *to rent-seeking and asset-scraping strategies*. Arguably a newcomer to the economy, the political nomenklatura might encounter *sectors with low and high entrance barriers*. The former either did not require specialised know-how, or it was similar to that possessed by the representatives of the political nomenklatura (for example trading in consumer goods or oil derivatives). In these sectors, its representatives easily took

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<sup>13</sup> *It is worth while to recall the definition from the 2003 Green Paper on Entrepreneurship in Europe: "Entrepreneurship is first and foremost a mindset. It covers an individual's motivation and capacity, independently or within an organisation, to identify an opportunity and to pursue it in order to produce new value or economic success. It takes creativity or innovation to enter and compete in an existing market, to change or even to create a new market. To turn a business idea into a success requires the ability to blend creativity or innovation with sound management and to adapt a business to optimise its development during all phases of its life cycle. This goes beyond daily management: it concerns a business' ambitions and strategy." (page 5)*



command positions and were able to manage their new business effectively. The traditional mass-production industries like ferrous metals, heavy chemicals, etc. should also be included in this group, where the ability to manage low-skilled employees (both in production and in distribution) was a key asset, and where it was relatively easy to sustain mass production at acceptable quality. In these sectors, the typical output consisted of low-tech products which did not require special maintenance or the development of special services for customers. Moreover, contravening existing regulations, industrial standards, intellectual property rights etc. went unpunished in these sectors because of the submissiveness of the government institutions and the weakness of the legal system.

Yet there were sectors with *high entrance barriers* - where the very production process and the specificity of the products presupposed specialised knowledge. Therefore, they needed skilled labour and management, and product maintenance, and trust between producers and customers (or between service providers and their clients) was crucial for the business. In the majority of such cases it was difficult for the political nomenclatura to develop a sustainable business, not only in most of the trades but also the in IT industry, where the most successful business of its representatives was to re-sell abroad sophisticated electronic equipment imported previously with the utmost effort through the Western embargo.

Therefore, the true entrepreneurs and trades were able to survive and develop in a number of economic fields with 'high entrance barriers' and relative low profit. Our studies of small and medium-sized businesses in sectors such as *information and communication technology, perfumery and cosmetics, fork- lift trucks, and some others* has led us to the following conclusions about the current situation:

- 1) Despite the hostile economic and political environment in Bulgaria during the years of economic transition after 1989, there emerged a substantial number of vibrant and developing trade and private SMEs, which sought to impose their own agenda on the political system and to improve its response to their specific needs and interests. The development of trade and SMEs in these sectors has reached the stage of differentiation and specialisation. Even small high-tech firms evolved that specialised in providing innovation and engineering services to others.
- 2) There is a clear regionalisation in certain types of business. New trade and SMEs in a given sector often emerge as clusters in certain regions because of industry-specific traditions (e.g. large enterprises from the socialist period), local traditions, a specific cultural or natural environment, the presence of a relevant research and education infrastructure, etc.
- 3) The innovative SMEs kept working on changing conditions on the internal and international markets, the unpredictable financial and legal environment, and the unstable political process. On the local markets, they compete with firms from the West and from other post-socialist countries. Often their competitors receive direct or indirect support from their governments, such as export subsidies, protective import tariffs, and recruitment subsidies. Until recently, when the country joined the EU, there was no such backing on the side of the Bulgarian government.
- 4) Working without assistance by government institutions (which, instead, were often a source of additional troubles), the entrepreneurs and tradesmen managed to cope with various obstacles and turn their failures into sources of experience and points of support for their development. They analysed and learned from their experience, investing continuously in new skills, new equipment and technologies, the design of new products and services, and the qualification of their employees. They are very flexible, often diversifying their activities and entering new markets.

5) The new true entrepreneurs and tradesmen developed a business ethic that deserves special admiration. Although it was developed in the hostile conditions of the Bulgarian rent-seeking capitalism of 1990s, it reproduces the classical entrepreneurial spirit of vigour, persistence, hard work, trust and correctness towards customers and business partners, etc.<sup>14</sup> We have found in number of firms and trade that the children of the entrepreneurs studied the same specialty at their vocational school or university, clearly intending to continue one day the business of their parents.

6) The majority of SMEs and tradesmen realise the necessity of collective action to defend their interests and those of the sector as whole. They are organised in associations and chambers which try to implement the rules of business ethics and to formulate collective positions towards those who violate these rules. The associations have developed a number of activities supporting the business of their members, such as transfers of experience from developed countries, training in good management practices, or establishing contacts with political parties and government institutions. The expansion of the activities and responsibilities of these associations poses serious challenges to their development – they often lack resources and administrative capacity, there are difficulties in hiring qualified staff, etc. These and other difficulties might result in serious crises in their development.

7) The innovative entrepreneurs are used to not relying on governmental and political institutions in their business; they prefer not to enter into a dialogue with them. However, this reduces their ability to define their problems and frame them appropriately, leading to a lack of lobbying and other skills. This turned out to be counter-productive during the period of the negotiations between the government and the European Commission about the economic and other conditions of the EU membership of Bulgaria, as well as during the initial period of full membership. Collaboration between entrepreneurs and government is urgently needed.

8) The situation becomes more complex since trade and entrepreneurial SMEs have specific needs and face different problems which vary not only between but also inside the sectors. This makes the dialogue with governmental and political institutions even more difficult. The traditional arrogance of state officials towards private businessmen<sup>15</sup> adds to this – they are not inclined to listen to the entrepreneurs and often offer standardised general solutions, irrelevant to the concrete problems of the firms. People of low qualification who are unable to understand the problems of entrepreneurs often hold key positions in government offices. Frequent staff changes because of political and other reasons are another barrier to collaboration.

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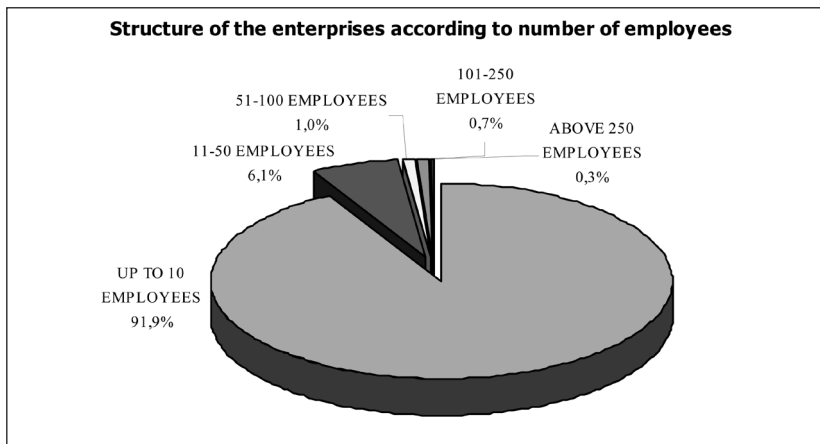
<sup>14</sup> *The experience of innovative entrepreneurs sharply differs from those of the representatives of rent-seeking capitalism who heavily relied on political and state backing of their activities and on the financial and legal 'perks' thus provided – the chance of not repaying loans, delaying social and health securities, paying reduced taxes and customs duties, breaking intellectual property rights, etc. That is why changes in political power often led to bankruptcy among the 'party' firms.*

<sup>15</sup> *This is a tradition rooted deep in the Bulgarian past, far beyond the communist period – to the times of state capitalism in the first half of the last century.*



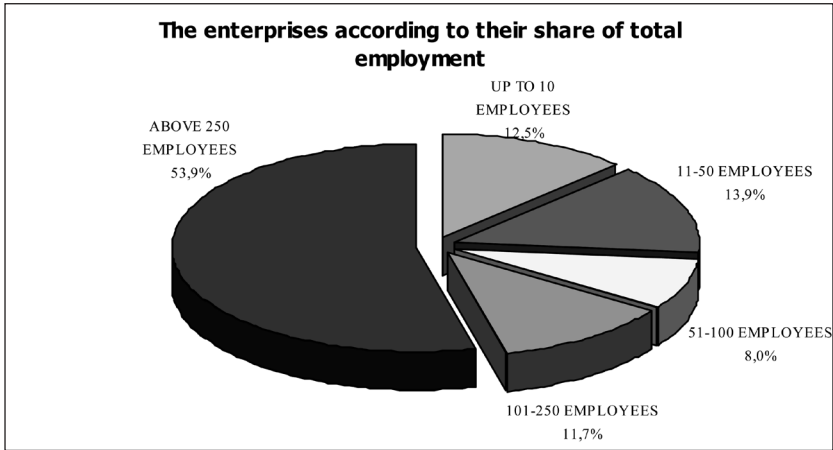
### 3.4. The role of SMEs and trade in the Bulgarian economy - Changes in regulations and practices that emerged in the process of accession to the EU

Bulgarian statistics do not list separate data about trade. However, it is possible to draw some conclusions about the role of the middle class, the trades, and small enterprises from data on the number of employees per enterprise. An extensive study of *Small and Medium-sized Enterprises in the Republic of Bulgaria*, carried out in 2004, reveals that private firms accounted for 99% of the total number of companies registered in Bulgaria. The vast majority of them – over 90% - were micro-firms with less than 10 employees (see the graph below). Our own studies have shown that most of these firms are operated by self-employed persons or families. Practically all tradestmen are registered in this category.



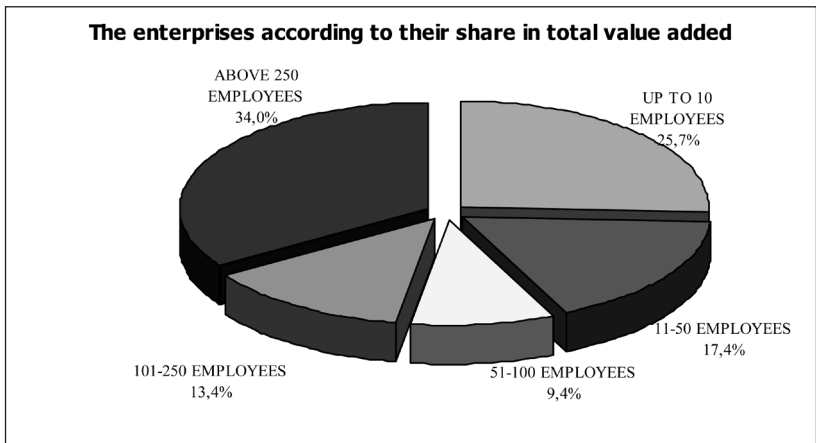
(Source: *Small and Medium-sized Enterprises in Bulgaria*, National Statistical Institute 2004, p.33)

The data reveals that micro-firms provide employment for about one eighth of the working population (12.5%). If we add small firms with 11 to 50 employees, the share increases to more than one quarter – 26.4% of the workforce.



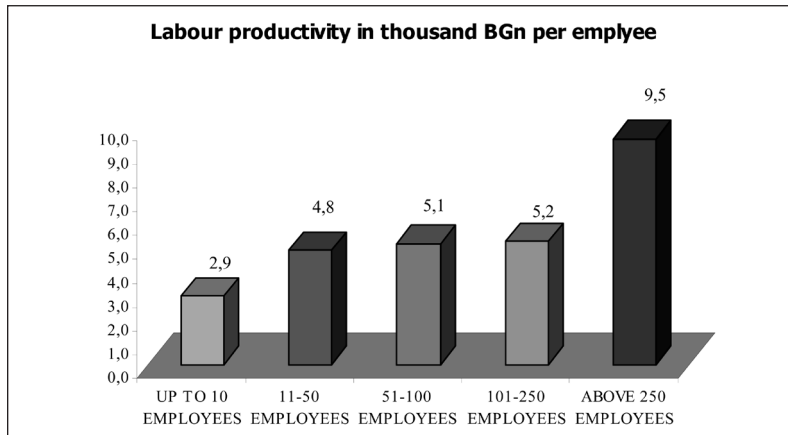
(Source: *Small and Medium-sized Enterprises in Bulgaria, National Statistical Institute 2004, p.44*)

Another important indicator of the role played by micro- and small enterprises is the value added they create for the economy. As the following graph shows, although micro-firms account for one eighth of the workforce they generate more than one quarter of the value added! Together with small firms, their share rises to above 40% of the total value added in the economy.



(Source: *Small and Medium-sized Enterprises in Bulgaria, National Statistical Institute 2004, p.67*)

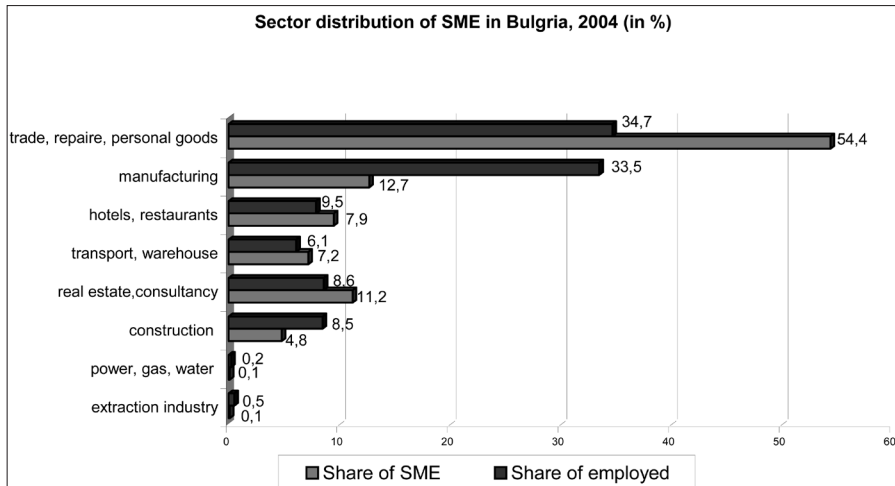
The data from the study of Bulgarian National Statistics of 2004 reveal one of the problems that tradesmen, micro-, and small firms have to cope with – relatively low per-capita productivity. As the above graph shows, productivity in micro-firms is more than 3 times lower than the average productivity in the biggest enterprises.



(Source: *Small and Medium-sized Enterprises in Bulgaria*, National Statistical Institute 2004, p.81)

This is not surprising as the traditions of trade and small business have begun to develop anew only a little more than 15 years ago. As the lawyer Emilia Petkova has pointed out, for more than 50 years the country lacked an autonomous and consistent legal basis. The *law on trade* was passed only in 2001 (State Gazette No.42/2001), while the law on SMEs, introduced a few years earlier (State Gazette 84/1999), did not mention trade at all! So it is only after 2001 that modern legislation in the field was introduced, creating national and regional chambers of various trades, introducing the system of craft education and licensing, etc. It is important to note that the law on trade expanded substantially the rights of the tradesmen's organisations, including the right to promote legislative changes, to adopt their own rules and regulations, etc. At the end of 2001, the law on SMES was changed to accommodate the definitions in the law on trade. In 2005, the corresponding amendments were made in other related laws, such as the *law on the taxation of physical persons*, which includes the tradesmen who are not registered as legal persons (small traders).

The *2006 Special Report on SMEs in Bulgaria* prepared by the Center for Economic Development, Sofia ([www.ced.bg](http://www.ced.bg)) provided interesting data about the sectoral distribution of SMEs (incl. trade) according to their shares in the value added and in employment. It shows that SMEs are concentrated in two main sectors – *trade, repair and personal goods* and *manufacturing*. Almost half of SMEs and trade are in trade, the repair of motorcars and home appliances, and the production of personal goods. These are predominantly micro-firms with less than 10 workers, or else self-employed, while the SMEs in manufacturing have more workers than the average (12.7% of firms account for 33.5% of the workforce). These two leading sectors are followed by four others, each accounting for about 10% of the firms and 8% of the workforce. Among them are the rapidly developing sector of *real estate and consultancy*, followed by *hotels and restaurants*, *transport services*, and *construction*.



(Source: *Special report on SMEs in Bulgaria, 2006, p.52*)

The 2006 report also provides comparative data about *women as SME entrepreneurs and managers* (page 35). Studies carried out between 1994 and 2006 reveal a slow but steady growth in the share of women entrepreneurs, whose firms now comprise about *one third of the total number of SMEs*. The trade-union statistics for 2006 also reveal a 37.7% share of women among the self-employed (<http://www.nsi.bg/>). These shares are compatible with those in other developed countries, such as Germany, where women are managing 42.8% of the country's SMEs. ([www.dw-world.de](http://www.dw-world.de)) According to the study, women entrepreneurs in Bulgaria are managing most of the micro- and small enterprises in trade and services. However, there is a growing number of women in the consultancy business and other sectors. The reports pointed out the problem that possibilities to work online from home are practically non-existent, while in the United States this widespread type of business, managed predominantly by women, provides employment for more than 14 million people.

Positive changes in the relationships between tradesmen, SME entrepreneurs, and government institutions are also worth mentioning. The 2006 report assesses the results of the 2002-2006 *Strategy for the Promotion of SMEs in Bulgaria* adopted by the government of the ex-premier Simeon Saxe-Coburg-Gotha (pp.20-22). It aimed at simplifying the administrative and legal environment for SMEs, improving their financial environment, supporting innovation and technology development, integrating SMEs into the European and international markets, improving their access to information and services, supporting regional collaboration, and promotion the entrepreneurial spirit among the younger generation. According to the report, *only part of the objectives has been achieved*, yet this was a significant step in the right direction. Among the successes, the report mentions the harmonisation of the Bulgarian legislation in the field of trade, entrepreneurship and SMEs with European law, which included changes in the *law on SMEs* and the introduction of a *new definition of 'micro-firm'*. The former Agency for SMEs was reorganised as the Executive Agency for the Promotion of SMEs ([www.sme.government.bg](http://www.sme.government.bg)) to respond better to the needs of small enterprises. Special measures improved the access to information about legal changes, the procedures to apply for funding in EC funds in support of SMEs and entrepreneurship, the access to new technologies, etc. The new *law on commercial registration*, which aims to create a unified electronic register of legal persons in Bulgaria, simplified the existing procedures and increased the transparency – and

improved the quality of – the services provided for SMEs. In 2003, a reform of the tax administration was launched, and the newly-created National Revenue Agency went into operation at the beginning of 2006. This also improved significantly the procedures and the level of services provided for businesses and citizens.

In 2002, the Bulgarian Parliament passed a special *law on limiting the administrative regulation and control of economic activities*. According to the 2006 Special Report on SMEs "...as the first law of this kind, it has number of drawbacks, but in general it created a good basis for the initiation of the process of deregulation in the economy. The most important achievements of the law were the introduction of two principles in the day-to-day operations of the administration: the 'single-desk principle' in serving entrepreneurs, and the 'principle of tacit agreement'. (p.89) Three years later, these principles have entered into the entrepreneurs' relationships with the administration – 12.4% have been using single-desk services, and 1.7% have applied the principle of tacit agreement. (source: *Vitosha Research* survey, cited in [rehttp://www.nsi.bg/](http://www.nsi.bg/) port). These are initial steps, however, and there is a lot more to be done in this direction.

### 3.5. The role of foreign assistance for trade and SMEs in Bulgaria - the German experience

During the process of economic transition, Bulgaria was supported by a number of international institutions and foreign countries. In this concluding paragraph, we should like to address some issues relating to foreign assistance and its correspondence with the specific post-socialist conditions in the country.

We have mentioned above that in the early stages of transition, the former political nomenclatura of the communist party willingly bought the advice of the International Monetary Fund, the World Bank, and other international organisations and actively used neo-liberal vocabulary in its efforts to transform its political into economic power. However, this was to a larger extent official rhetoric, while the initiative and entrepreneurial spirit of the ordinary people were actively suppressed at the same time. This was an especially efficient 'paralysing strategy' since at the surface, it reflected widespread (but not public!) attitudes about the former state dominance in the economy, relaxing governmental control of economic activities, and assuming responsibility for oneself. Here, the specific economic experience of continental Europe, with a business culture careful to strengthen social balances and adjustments in society and relying on a wider public involvement in the economy, was not dominant and even practically silent in comparison to the resounding neoconservative ideas.

Yet since the mid-1990s, some agencies from western continental Europe entered Bulgaria and initiated a number of small projects that differed significantly from the macro-economic recipes of the big international organisations. We would like to mention especially the Swiss Agency for Development and Cooperation and some regional Swiss funds which did an excellent job in the 1990s of helping municipalities and locally emerging business communities in several carefully selected regions of the country. The Regional Craft Office for Southeast Europe, established in Bulgaria by the Chamber of Crafts in Koblenz, Germany, played the same role<sup>16</sup>. They all focused on helping economic actors at the regional level, working both with local public

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16 To this we should add the activities of some venture-capital funds in Bulgaria (such as *Caresbac Bulgaria*, managed by the Washington-based *Small Enterprise Assistance Funds –SEAF*) and the *Job Opportunities through Business Support (JOBS) Project* supported by *United Nations Development Program (UNDP)*. Their activities had somewhat similar effects, supporting micro- and small businesses at local level and strengthening their social awareness.

authorities and the business community, promoting the value of social responsibility in business, and emphasising the role of public-private partnership and carefully-designed business rules. We believe that the persistent engagement of these institutions in the country and their long-term activities, although not too visible at the national scale, played an inestimable role in the economic development of Bulgaria - this also was capitalism, but one which differed significantly from that promoted by the public media and by mainstream international advisers.

Now, in 2007, one could say that Bulgaria and other countries in Eastern Europe were a terrain on which two versions of capitalism clashed – the neo-liberal, Anglo-Saxon model on the one hand and the 'social market economy' model on the other. Similar to what happened in the Western countries, the first became dominant in Bulgaria. We believe that this dominance brought some positive results, since it inspired – at least in the younger generation, but not only there – a feeling of self-reliance and promoted a risk-taking mentality, much needed after the decades of state control and state assistance in the economy. Although at a high social price, the practical implementation of the neo-liberal model in Bulgaria after 1997 helped to restructure the economy rapidly and clear off the huge outdated industrial assets inherited from the socialist period, paving the way for the rapid economic development which the country has been experiencing since 1998. The neo-liberal model implies flexibility and favours innovation, initiative, and the entrepreneurial spirit – and this was the painful lesson hundreds of thousands had to learn after working for decades as 'employees', as paid workers, leaving it to the 'others above' to think about long-term strategies, about markets, customers, competition, investments, etc.

Now, many people realise some of the drawbacks of neo-liberal model. In this process, the experience gained under the 'other capitalism', the social market economy version promoted by organisations like the Chamber of Crafts in Koblenz, Germany, the Swiss agencies, and others will be extremely important. Because it is thanks to their activities that there are now public servants trained on this model, a legal background has been established<sup>17</sup>, and there are hundreds and thousands of tradesmen and entrepreneurs who have adopted a business ethic which reflects the social needs of regions and local communities.

Which model is better and which will succeed – ten years ago the answer was almost clear. But today, as a recently-published conference announcement declared, "... the growing unreasonable social pressure in the labour markets, stagnating and partially even decreasing real wages and a new poverty right in the middle of the European welfare states are increasingly perceived to be unjust, and are therefore denounced. Not only in the population, but among politicians who do not wish to be confined any longer to the role of a service provider for deregulations and deeper tax cuts in the interest of the industry, critical voices are rising".<sup>18</sup> Should we agree with the conference organisers that the European business elites failed to overcome the challenges of globalisation and the simultaneous transformation of the command economies of state socialism? And why do they not mention entrepreneurs and SMEs?

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<sup>17</sup> *We should mention here the important role played by the Chamber of Crafts in Koblenz in providing expertise and demonstrating to the government institutions the importance of a modern legal basis for trade. It was the group of experts at the Chamber's regional office in Bulgaria who prepared and successfully lobbied at the 38th National Assembly (Bulgarian Parliament) for passing the law in 2001.*

<sup>18</sup> *European Business Elites between the Emergence of a "New Spirit of Capitalism" and the "Erosion of State Socialism", Potsdam, 1-2 November, 2007, Centre for the Study of Contemporary History, Potsdam and Chair for European Contemporary History, University of Salzburg.*

# 4. Croatia

by Vladimir Cvijanović<sup>1</sup>

As there is no exact definition of trade or small and medium-sized enterprises in literature, we will adopt EUROSTAT's definition<sup>2</sup>: By small and medium-sized enterprises we mean legal entities which employ less than 250 persons. In addition, the Act on the Promotion of the Development of Small Entrepreneurship<sup>3</sup> stipulates that this definition includes trade. The aforementioned organisations need to be independent in business, have a turnover that does not exceed 60m HRK (approximately 8m EUR), and have assets (when paying corporate tax) or long-term assets (when paying income tax) of not more than 30m HRK (approximately 4m EUR).

## 4.1. Brief historical introduction

From the end of the Second World War until 1991, the Republic of Croatia was part of the Socialist Federal Republic of Yugoslavia. Its development, therefore, was politically, legally, and socio-economically determined by the systemic specificities of that federal state. Although trade have existed since the middle ages on Croatian territory, the beginnings of a large-scale organisation of trade do not go back further than the mid-19<sup>th</sup> century. The socialist period marked a huge break with the previous economic organisation of the country. Hence, (private) trade and companies faced drastically different conditions after the Second World War. Private firms that existed in Croatia before socialist times were nationalised.

As far as SMEs are concerned, the Yugoslav economic system in the period after the Second World War until 1955 was characterised by central planning and state-owned enterprises. The new Yugoslav constitution of 1974 initiated changes that were formalised in 1976 in the Law on Associated Work (Ostojić 2001). These changes brought about clear cut with the past, introducing the famous principle of self-governance on a wider scale – a principle that became the distinctive feature of the Yugoslav economic model, together with social ownership<sup>4</sup>. As in other former socialist economies, vertically-integrated large enterprises predominated in monopolistic and oligopolistic market structures. These enterprises were *de-facto* strategic carriers of regional development, (infrastructural) investments, and employment (cf. Ostojić 2001). They were supported not only legally but also politically. On the other hand, this structure of the economy was not balanced by an appropriate number of SMEs<sup>5</sup>, a fact which was termed the 'socialist black hole'. In addition, trade and trademen in socialist times were quite isolated in their activities. That was to be expected, given the mainstream ideology at the time, the small size of craft operations, and the very restrictive and ever-changing legal regulation which caused many ups and downs in the development of the sector.

The socio-economic crisis which the socialist systems suffered as late as the 1980s provided a fertile ground for discussions on the sustainability of those countries and

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1 I would like to thank Zoran Aralica, Igor Medić and Radenko Milošević for helpful comments and suggestions on this topic.

2 Which is also embodied in Croatian law.

3 See Official Gazette No. 29 of 2002.

4 I.e. companies were owned by the collectivity of citizens.

5 In 1985, employees in Yugoslav enterprises employing 1 to 100 workers accounted for 8% of total workforce. That was more than in the other socialist countries (5%), but much less than in the West (Petrin and Vahčić 1987: 11, as cited in Zarić 1990: 159).

the necessity for market-based reforms (cf. Tomaš 1990). In the former SFR of Yugoslavia, entrepreneurship was emphasised as early as the 1980s as a sort of panacea for the economic problems the Yugoslav economy was facing (cf. Franičević 1990).

Legally, companies in the socialist period (until the late 1980s) were restricted to societal ownership, and trade were limited in scale and scope. Income equality was officially proclaimed. As private ownership prevailed in the trade sector, tradesmen were looked upon as strangers.

Table 1: Structure of the Croatian economy in 1990

Form of ownership	Firms		Labour employed		Capital	
	Number	Percentage	Number	Percentage	Million Euro	Percentage
Social (among which public service firms)	3.637 (98)	35,5 (2,7)	1.105.873 (123.097)	97,6 (11,1)	29.455,2 (9.248,9)	100 (31,4)
Private	6.785	62,5	19.602	1,7	-	-
Cooperative	284	2,6	5.290	0,5	-	-
Mixed	153	1,4	2.001	0,2	-	-
Total	10.859	100	1.132.766	100	29.455,2	100

Source: Croatian Agency for Restructuring and Development (1992) and Bendeković (2000: 56).

## 4.2. Legal framework for SMEs and trade in Croatia

It was not until the second half of the 1980s that plurality of ownership was introduced to provide an incentive for workers<sup>6</sup>. The processes of ownership transformation and privatisation<sup>7</sup> coincided with the beginning of the transition and the proclamation of independence of the Republic of Croatia in 1991. Regulation of trade was especially stringent between the end of the Second World War and the end of the 1950s. Due to this unfriendly environment, many trades became part of socially-owned enterprises. The decades that followed introduced much more favourable conditions for (private) trade, especially in terms of forming associations, obtaining funding for their activities, and acquiring the right to a pension (in 1970). Although the Social Contract on Small Businesses for the period from 1976 to 1980 explicitly foresaw a greater involvement of trade in economic growth and development, other legal regulations (most notably taxes and rates) negatively influenced the further development of this part of the economy. Trade received a fresh boost in the 1980s when their role in economic development of the country was recognised. This boost persisted into the transition period with the new Law on Trade of 1993 and the 'political' recognition of their activities (Kolar and Jovičić 2002).

The legal and political foundation for SMEs and trade is provided by the following documents:

<sup>6</sup> I.e. mixed ownership - employees were able to buy a share in the company they work for.

<sup>7</sup> For more on privatisation in Croatia see Račić, D. and V. Cvijanović (2005), "Privatization, Institution Building and Market Development: The Case of Croatia", Kušić, S. (ed.), *Path-Dependent Development in the Western Balkans. The Impact of Privatization*, Peter Lang, Frankfurt am Main: 43-77.



- Law on the Stimulation of Small Businesses<sup>8</sup>
- Strategic Development Framework 2006-2013<sup>9</sup>
- Other programmes for the development of trade and SMEs
- Trade and Crafts Business Act<sup>10</sup>

The law on the Stimulation of Small Businesses specifies the goals of SME development as well as measures to stimulate their growth and development. Furthermore, the Strategic Development Framework of 2006-2013 formulates targets for the stimulation of SMEs. Recently, things improved greatly when the procedures needed to register a craft or a company, originally promulgated by the central government<sup>11</sup>, were abbreviated and simplified. Furthermore, an initiative to cut down on redundant regulation is well under way. The Croatian Export Offensive (HIO) is a recent example of a comprehensive programme for the development of trade and SMEs. However, trade is barely mentioned in it. So far, the Trade and Crafts Business Act has been the regular backbone of trade in Croatia.

As far as the laws and policies for trade and SMEs are concerned, improvements have generally been noticeable since the coalition government came into power in 2000. These changes coincided with a clear political course and consensus targeting accession to the European Union. In 2003, Croatia adopted the European Charter for Small Enterprises. Government aims to further harmonise the legal framework and follow EU policy principles (cf. European Commission 2006).

Problems with the legal framework for trade and SMEs are many and could be divided into two main groups: 1) complicated and opaque regulation (NVK 2003); 2) regulation demanding lengthy and expensive procedures in various entrepreneurial activities, accompanied by judicial inefficiency (cf. World Bank and the International Finance Corporation 2006). Procedures tend to be especially expensive as the size of an enterprise gets smaller. Such regulation stimulates corruption, makes the public administration that sustains it more expensive (Singer and Lauc 2004), and is inherently time-consuming for entrepreneurs.

Notwithstanding the need for further simplification and for eliminating redundancies in legal regulation, most of the problems do not lie in the field of regulation *per se*. Much more needs to be done in terms of implementation and policy-making. While conditions for trade and SMEs have been improving by and large in recent years, some problems have a much longer-term character. Examples include judicial inefficiency<sup>12</sup> as well as communication problems among ministries and between ministries and entrepreneurs. The latter problem might be alleviated by establishing efficient regulatory assessment (cf. European Commission 2006). Croatia still lacks a concept and strategy of long-term socio-economic development, which would serve as a foundation from which regulation and policy could be derived. In this sense, the *acquis communautaire* as well as other recommendations and instruments of the EU serve as a lighthouse for Croatian policy-makers. However, translating EU legislation cannot solve the specific problems the country is facing in terms of inherited industrial structure<sup>13</sup> (both from socialist times and from the privatisation process).

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8 See the Official Gazette of Republic of Croatia, No. 29 of 2002.

9 Available at [www.nhs.hr/download/STRATESKI\\_OKVIR\\_ZA\\_RAZVOJ.pdf](http://www.nhs.hr/download/STRATESKI_OKVIR_ZA_RAZVOJ.pdf) (in Croatian).

10 See Official Gazette of the Republic of Croatia, revised text, No. 49 of 2003.

11 These measures were formally connected to a project of Croatian government called HITRO. HR, which literally translates as 'urgent.hr' (.hr being the internet domain of the Republic of Croatia).

12 Which translates into risks and uncertainties in transacting business.

13 EU regulations, directives, decisions, and case law represent only the legal framework, while specific policies should be formulated by the respective (candidate) country which has sovereign powers.

### 4.3. Institutions of self administration of SMEs and trade in Croatia

The main institution in charge of SMEs as well as trade is the Ministry of Economy, Labour and Entrepreneurship<sup>14</sup>. The institutions of self-administration of SMEs and trade in Croatia are the following:

The Croatian Employers' Association (HUP): the HUP was founded in 1993. It is an umbrella organisation comprising 23 sectoral associations including the small and medium-sized entrepreneurs' association (which represents the Croatian SMEs). The HUP principally represents employers' interests and as such is a social partner in the tripartite body which also includes representatives of the Government and the trade unions (Economic and Social Council). The HUP strongly favours the private sector, market economy, and reducing the role of the state in the economy. It strives to strengthen the competitiveness of the Croatian economy. It has its own journal (EU-konomist) as well as a programme for management education (PUMA).

The Croatian Chamber of Economy (HGK): The HGK is the 'official' chamber of the Republic of Croatia established by the Law on the Croatian Chamber of Economy of 1991, which gives it certain authorities. It was founded in 1852 and nowadays comprises many associations as well as 20 county chambers. It offers not only general and sectoral information on the Croatian economy but also operates a commodity exchange on its website.

The Croatian Chamber of Trade and Crafts (HOK): the HOK is a chamber with a long history behind it, whose origins date back to the second half of the 19<sup>th</sup> century. Officially, however, it was founded in 1994. Like the HGK (see above), the HOK has certain legal competences, and membership is mandatory for trade registered in the Republic of Croatia. It is organised in many smaller craft associations based in counties, towns, and municipalities, economic activity being another criterion. It endeavours to assist different trades in becoming competitive, especially by providing assistance for trade fairs. Like the HGK and the HUP, it provides contacts, and its website acts as an information desk for different projects offered (see HOK for details).

The Association of Croatian Institutions for Promoting Entrepreneurship (UHIPP): The UHIPP is an umbrella organisation promoting the interests of SMEs, especially in the market for consultancy services (Singer and Lauc 2004).

The SME and Entrepreneurship Policy Center (CEPOR): The CEPOR is the first think-tank focussing on the problems of SMEs and entrepreneurship that functions nation-wide. It was established in 2001 as a non-profit organisation co-founded by institutions from academic circles as well as various business associations, including entrepreneurship centres. Although the CEPOR is active in advisory activities as well as in lobbying, its value lies in the research it conducts. The Global Entrepreneurship Monitor (GEM) is its most famous research project (since 2002), an international undertaking that covers over 30 countries besides Croatia.

The Croatian Chamber of Economy is organised on the Austrian/German model, where membership is compulsory. The same can be said of the Croatian Chamber of Trade and Crafts, where membership is also compulsory. The Croatian Employers' Association is an NGO and the only one of the aforementioned associations represented on the Economic and Social Council. The CEPOR is a non-profit institution established by mutual agreement between the Open Society Institute Croatia and the Croatian Government.

In addition to the aforementioned institutions, which all cover the whole territory of

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<sup>14</sup> There are also other institutions in charge of crafts and SMEs organised by the central government. The most important (most active) ones are the Croatian Agency for Small Business (HAMAG) and the Croatian Bank for Reconstruction and Development (HBOR). Due to a lack of space we will not go into details about them here.

the Republic of Croatia, there are many regional institutions that support entrepreneurs in various ways, such as:

**Entrepreneurship Centres (EC):** they are active on the local or regional level, county or town. Currently (February 2007) there are 47 ECs (CEPOR 2007). Legally, they have many forms, as they may be organised not only as companies but also as associations, local-government departments, or self-management institutions. Consequently, the sources of funds for such centres vary from central or local governments to foreign governments and international institutions (Singer and Lauc 2004). They function as service centres for entrepreneurs, offering them legal advice, information, consultancy services, and education and organising promotion activities.

**Business incubators (EI):** situated mostly in towns, their goal is to help start-ups in obtaining access to different business facilities. Their legal forms vary, as do their initiators. The latter could be local governments (which is mostly the case – cf. BIOS and Audeo 2007), but there is also, as far as Croatia is concerned, a unique example of a student business incubator organised by the Faculty of Electrical Engineering and Computing, University of Zagreb.

**Technological Centres and Technological Parks (TC and TP):** The first TCs were founded in 1990, and the first TP in 1994. According to some sources (CEPOR 2007) the total number of TCs and TPs in Croatia is 7. Generally, we may say that their role is to support research and development activities as well as technology transfer from universities to the market, but they could also offer other services, functioning like business incubators<sup>15</sup>.

Both technological parks and business incubators were not established consistently according to a certain model. Rather, different foreign consultants assisted in founding various technological parks and/or business incubators.

As the above overview suggests, there are many organisations besides those of the central government that are active in the field of entrepreneurship. A general characteristic of both the former and the latter is their fragmentation, causing lack of communication and coordination between them (cf. Singer and Lauc 2004). Besides, our experience shows that the institutions of self-administration of SMEs and trade in Croatia have been doing part of the job the central government (or the ministries in charge) should be doing, like coordinating the different institutions as well as the 'basic' education of entrepreneurs. Thus, they have been losing action resources which could make a difference, like making use of the appropriate EU funds. In this sense, facilitation of the aforementioned activities by the central government (or a ministry) would be a welcome move to assist institutions supporting entrepreneurs.

## 4.4. The role of SMEs and trade in the Croatian economy

The perspectives that could open up for trade and SMEs are huge. However, they primarily depend on a concept and strategy of the Republic of Croatia<sup>16</sup> that will have to be adopted and followed. Secondly, they depend on a robust statistical foundation for making decisions. However, that foundation is mostly imprecise or nonexistent, especially on the regional level (Singer and Lauc 2004). Thirdly, one should not forget that the growth and development of trade and SMEs is inextricably connected with large enterprises. As, generally speaking, certain high-tech industries are missing in Croatia, the question remains how to make a quantum leap from a rather low-

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<sup>15</sup> Such is the case with Technological Park Zagreb, which was the first technological park in Croatia – founded in 1994.

<sup>16</sup> While number of strategies different governmental instances in Croatia have long passed one hundred, a concept of development is still missing.

tech industrial structure (see below) to a high-tech industrial structure. One obvious possibility would be to attract foreign direct investment in high-tech industries (cf. Račić et al 2005a)<sup>17</sup>, which would serve as a motor for trade and SMEs (cf. Kušić and Cvijanović 2003). Due to an increasing degree of integration into the EU<sup>18</sup>, policy-making (at country and enterprise level) is ever more determined by the EU guidelines. In addition, Croatian policy-makers and managers should make more use of available EU funds (i.e. increase Croatia's absorption capacity).

Table 2: Breakdown of the Croatian economy by enterprise size

SME	Number	Share	Employees	Share
Trade	100,532	61.8	241,714	23.7
Cooperatives	795	0.5	4,293	0.4
Micro	49,534	30.4	116,431	11.4
Small companies	9,561	5.8	140,602	13.8
Medium-sized companies	1,845	1.1	167,336	16.4
Total SME	162,267	99.6	670,376	65.7
Large companies	720	0.4	350,617	34.3
Total economy	162,987	100	1,020,993	100

Data refer to June 30, 2003 (sources: CBS, FINA, CCE, CHIF, Trade Register and MTSME), as quoted in: Government of the Republic of Croatia 2003: 17.

The data shown in the above table show the structure of the economy regarding the size of enterprises and the number of workers they employ. The importance of trade and SMEs for the Croatian economy is clearly visible: SMEs (which includes trade and cooperatives) account for 99.6% of all business entities in the country and employ almost 2/3 of the workforce.

Although SMEs and trade<sup>19</sup> account for the vast majority of business entities in Croatia, their competitiveness is not satisfactory. The structure of the Croatian exports is heavily biased towards raw materials and work-intensive products (cf. Kušić, Cvijanović and Stefanov 2003). Unfortunately, this does not change when we take a closer look at the SMEs, especially their exports. Manufacturing industries in which SMEs are widely represented are usually low-tech, with the exception of machines and appliances, where their share was 40.9% in 2004 (Aralica 2006). This problem is reflected in the growing trade deficit of the Croatian economy, and it is multi-faceted. The main reasons are summarised by Čengić (2006): incompetent management and a general lack of education in the business sector, poor economic diplomacy, and defects in the development-promotion function of the state (Čengić 2006).

The importance of SMEs for economic growth and development has been recognised<sup>20</sup> in Croatia since 1980s, when an attempt was made to reform (but not to transform!) the political and economic system, which had entered into a crisis. The rhetoric of the political circles of the 1980s and 2000s, when we look at key words such as entrepreneurship, SMEs, and innovation, is strikingly similar (cf. Franičević 1990). However,

<sup>17</sup> As the example of Ireland shows.

<sup>18</sup> This manifests itself in the harmonisation of legal regulations and increasing socio-economic as well as cultural ties with countries of the EU.

<sup>19</sup> There is a lack of statistics on exports by Croatian crafts.

<sup>20</sup> Primarily politically, as it has been incorporated in policy.

as in the last decade, we are today witnessing in Croatia a drastic socio-economic as well as cultural discontinuity in the form of 'the transition', exacerbated by the war of 1991-1995 and the break-up of the former Yugoslavia. Hence, the 1990s have seen less emphasis on 'fine-tuning' the economy (e.g. by stimulating pioneering SMEs) and on a new generation of (economic) policy-making (as regards innovation and the attraction of foreign direct investment)<sup>21</sup>. In line with the new course for the EU from 2000 onwards, the issues of liberalization and institution-building have been much more in focus.

Consequently, the challenges facing policy-makers, SMEs, academia, and supporting organisations have cleared up – competitiveness and growth of SMEs, innovativeness, increase of SME exports, access to finance, cluster formation. Policy-makers more or less accept these issues, although applied policies have been suboptimal. Some policies have either been missing (e.g. regional policy) or have only begun to develop (e.g. innovation policy). In addition, some issues, like that of reindustrialising the Republic of Croatia, are not properly understood by policy-makers. Furthermore, challenges lie not only in the adjustment of policies but also in their coordination. Moreover – and just as importantly – it is the quality of professionals that work for various governmental (or quasi-governmental) institutions that is crucial.

More specifically, another crucial issue is the stimulation of growth-oriented trade and SMEs. Growth, in the economic sense of the word, means an increase in total revenue and/or number of employees and/or profit. However, sources of growth can differ – they could be based on market position (e.g. monopoly), imitation (i.e. replication of other models), incremental innovation (e.g. small improvements of existing products/services), or radical innovation (i.e. products or services that are totally new on the local/international market). Although trade and SMEs that are based on radical innovations represent only a minority of the total, they have been recognised both in economic theory (from Schumpeter on; see also Singer et al. 2006) and in economic policy (e.g. in the EU) as entities that have a significant impact on economic growth. This should be acknowledged by Croatian policy-makers, too, and the relevant policies adjusted. However, trade and SMEs should be understood and analysed in terms of the industrial networks and clusters they are (or could be) part of.

Concrete measures for stimulating trade and SMEs may be divided into three basic categories: 1) macro-conditions, 2) sectoral conditions, and 3) conditions at the corporate level. Macro-conditions are conditions at the level of the national economy, primarily comprising social, cultural, and economic factors. While the first two have a rigid character, economic factors are more flexible. However, due to lack of space, macro-conditions will not be discussed here. Sectoral conditions and conditions at the corporate level may be divided into several fields, as indicated by two recent and very important research studies done for Croatia – Račić et al. 2005 and Singer et al. 2006<sup>22</sup>: 1) general preconditions, 2) education and quality of the human factor, 3) research and development, 4) development of financial markets, 5) innovation cooperation.

As general preconditions for stimulating entrepreneurship activities in trade and SMEs we can consider the following measures/activities. A development concept and strategy for the Republic of Croatia is a *sine qua non*. Furthermore, the government

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21 *Predominant concerns in the 1990 were macro-issues in the sense of establishing a functional state. Economic policy was largely macro-oriented following a top-down approach from the country's capital. Only one out of three pillars of the economic transition (macro-economic stabilisation, liberalisation, and institutional restructuring – see Balcerowicz 1995) could be considered completed in the 1990s, and that is macro-economic stabilisation. – with negative consequences for the economy, as some claim (most notably Zdunić, Kulić, Medić, and later Nikić). Privatisation (which is a precondition for liberalisation) and institution-building were significantly mismanaged (Račić and Cvijanović 2005).*

22 *The following recommendations for policy-makers are based on the two studies mentioned. The author participated in one of them (Račić et al. 2005).*

should insist on an educated and professional public administration for trade and SMEs, especially those with above-average growth potentials. The participation of women in entrepreneurial activities should be encouraged.

Regarding education and the quality of the human factor, the following measures are needed:

- Universities, colleges, schools and other institutions/forms of education should adopt programmes/subjects/competitions conducive to entrepreneurial thinking and acting.
- Different training programmes should be established based on cooperation between and co-funding by the public and private sectors.
- Education in "fields of the future", such as biological, medical, and various technical sciences should be fostered.
- As the complexity of innovation activities grows, interdisciplinary education should be stimulated.

In the field of research and development, emphasis should be placed on the following measures:

- Streamlining the system of research and development support (e.g. by introducing tax incentives).
- Closer cooperation between experts taking part in Master and Ph.D. studies and the business sector (e.g. on technological projects).
- Employment of persons with a doctoral degree should be stimulated.

Regarding the development of the financial markets, the following measures are desirable:

- State support should not be limited/restricted to subsidies and credit as financial instruments but equity investments should be encouraged as well.
- Remove obstacles to, and stimulate establishment of, venture capital funds (e.g. restrictions on investments in venture capital funds by pension funds should be abolished).
- Stimulate organisation of business angel networks.
- Public procurement should play a more active role in the stimulation of new technologies.

As for innovation cooperation, there are several solutions to be considered:

- Closer attention should be devoted to possibilities of cooperation between the business sector, academia and the government, such as collaborative projects of the academic community and the business sector.
- Stimulation of mobility of experts between the business sector and academic institutions.
- Incentives should be created to promote cooperation between innovative enterprises and scientific research institutions.
- Multinational enterprises should be stimulated to cooperate with domestic SMEs. Furthermore, as Croatia lacks certain high-tech industries, foreign direct investments could be directed to those sectors.
- Cluster formation.

## 4.5. SMEs and trade as motors in creating a social market economy

Social market economy is a well-known concept developed in Germany under Ludwig Erhard and Konrad Adenauer. It basically advocates a mixed economy with good public services and sustainable development with high economic growth rates and good working conditions in an eco-socially responsible business sector. However, as socio-economic conditions have changed (globally) since the concept was launched in 1960s it is questionable how to continue with its implementation, even in Germany, where the concept was born.

Croatia has embarked upon a transition fraught with huge problems and challenges (see above) from which it has not recovered fully. One of the most important questions was how to create a functioning market economy in which principles of social justice are respected. Although today's Croatia has definitely inherited certain traits of the socialist system, many more were lost in the past 16 years. The reason lay in the huge redistribution of assets in consequence of the problematic process of privatisation<sup>23</sup> (cf. Račić and Cvijanović 2005), in social exclusion, and a lack of social dialogue – especially in the 1990s (cf. Stubbs and Zrinščak 2005). Although conditions have been improving, there is no clear message from policy-makers as to what sort of capitalism Croatia will pursue (the individualistic Anglo-American type or the collective type of continental Europe). The prevailing neoliberal economic ideology sees the problems of the public administration (the state) on the one hand and business on the other as black and white, claiming that the public administration should be contracted and play a lesser role in the economy, and that the market should be left to its forces.

However, new initiatives have recently arisen that aim to promote social market economy from the SME's perspective. In December 2004, a conference ("Promotion of corporate social responsibility in Croatia: An agenda for 2005"<sup>24</sup>) co-organised by the Institute of Economics and the Konrad Adenauer Stiftung was held in Zagreb. The key objectives of the conference with regard to strengthening corporate social responsibility have been largely achieved, particularly increasing the awareness of the issue of corporate social responsibility and corporate governance; Best practices in corporate social responsibility have been promoted in the social reports of various companies' as well as in the media. However, some issues remain, such as:

Implementation of best practices of corporate social responsibility in trade and SMEs.

A code of business ethics has still not been widely accepted.

A corporate governance code, although specified in the law, is still missing.

The following steps to advance best practices of corporate social responsibility (and therefore social market economy itself) should be taken immediately (cf. Bagić et al. 2004): Education on multi-sectoral partnerships for NGOs, the public administration, and enterprises; education for journalists writing about corporate social responsibility, promotion of codes of business ethics and corporate governance.

The concept of social market economy has not been seriously considered by Croatian policy-makers (governments that have held power so far). After 15-16 years of transition during which we have (more or less) left some of the largest issues behind us (like war and problematic privatisation), the issue of social market economy should be high on the political agenda. However, none of the political parties has so far proved to be a credible agent of its introduction.

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<sup>23</sup> *Whereby certain social groups have not been allowed to participate.*

<sup>24</sup> *For more on the conference see [www.poslovniforum.hr/agenda](http://www.poslovniforum.hr/agenda) (the website is in Croatian only).*



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# 5. Macedonia

by Aleksandar Stojkov and Ivica Bocevski

## 5.1. Brief historical introduction

The Macedonian economic-development strategy during the socialist period was based on large-scale industries designed to satisfy the needs of the integral Yugoslav market.

The processes of privatisation, trade liberalisation, and fiscal consolidation during the transition had an immense impact on the Macedonian middle class. Thousands of persons were plunged into lower social strata by enterprise restructuring and large-scale labour-shedding programmes. Moreover, the rapid liberalisation of trade at the outset of the transition to a market economy led to the demise of a significant number of small and medium-sized enterprises previously sheltered by high tariff barriers. Lastly, the revenue-based fiscal adjustment in Macedonia involved a substantial increase in the indirect tax burden (mainly consumption taxes, which are known to be regressive) and a consequent deterioration in the disposable incomes of the intermediate and lower social strata.

In terms of size, the medium-sized enterprise (MSE) sector generates around 18-19% of the Macedonian GDP, absorbs a similar share of the total employment, and generates approx. 13% of the Macedonian exports of goods and services (Table 1).

Table 1 - The importance of medium-sized enterprises for the Macedonian business sector (2003)

	Number of enterprises	Shares in employment	Contribution to GDP	Export-oriented enterprises	Value of exports (in 000)	Contribution to exports
Small	55,267	58,4	50,7	1886	479,259	39,8
Medium-sized	475	18,2	18,4	195	156,546	13,0
Large	459	23,4	30,9	93	511,853	42,5
Undistributed	-	-	-	312	56,155	4,7
Total	56,201	100	100	2,486	1,203,813	100,0

Source: Author's calculations based on data from the State Statistical Office.

## 5.2. Legal framework for MSEs and trade in Macedonia

The period from 1971 to 1988, i.e. the contract-based phase of the Yugoslav model of socialism, saw the derogation of the legal concept of "enterprise" and, accompanied by open political and scientific euphoria, the inauguration of the notion of "organisation of associate labour". The creators of the "Bermuda triangle" legislative concept, the triangle of basic organisations of associated labour, workers' organisations, and complex organisations of associated labour, negated ownership rights and introduced the vague concept of "societal ownership", while officially proclaiming to favour a market-oriented socialism (Constitution of SFRY, 1974).<sup>1</sup> These organisa-

<sup>1</sup> Article 46, 47, 62, and 63 of the constitution explicitly mentioned the pro-market orientation of the socialist economy (Nedkov et al., 2003).

tions of associated labour were founded on the following principles: They (1) were socially-owned rather than state-owned; (2) lacked autonomy for their business decisions; (3) used non-market valuation of the factors of production; (4) counted on large-scale state-provided bailouts (or soft budget constraints); and (5) had no independent human-resource management and recruitment policy. The fact that entrepreneurial culture was suppressed during the socialist period, along with the very low rates of managerial turnover following the insider privatisation, explains in part the sluggish economic growth of Macedonia till 2000.<sup>2</sup> Professional organisations of the middle class in socialist Macedonia were regulated by the law on social organisations and civic associations and the law on citizens forming associations, social organisations, and political organisations on the territory of the SFRY.<sup>3</sup> These organisations were by no means precursors of the civil sector in the transition-economy context, since their primary objective was to provide support for the socialist regime.

At present, there are three relevant laws that define the legal framework for the medium-sized enterprises' (MSE) operations: The company law (Official Gazette No. 28/2004), the law on accounting (last revised in 2002), and the law on the establishment of an Entrepreneurship Support Agency (Official Gazette No. 60/2003). An important drawback in the legal system is the lack of a consistent definition of MSEs, since the accounting law and the newly adopted company law introduce different threshold criteria for delineating firm size.<sup>4</sup> Such discrepancy has caused slight disorientation in identifying the target groups of enterprises which genuinely need state support measures.

The Macedonian company law partly incorporates the Commission's recommendation (2003/361/EC) with respect to the size of medium-sized enterprises. For instance, it defines medium-sized enterprises as those that (1) employ less than 250 workers; (2) have an annual turnover below € 10m and (3) an average annual balance-sheet total (through the year) of less than € 11m. These figures are well below the newly-adopted EU thresholds for SME definition that took effect at the beginning of 2005. Even so, a recent analysis conducted by the Southeast Europe Enterprise Development (SEED, 2003) finds that 70.3% of small enterprises and 47% of medium-sized enterprises do not exceed the annual turnover threshold of 810,000 EUR. Hence, full compliance with the EU-recommended size delineation criteria in the enterprise sector is still pending on stronger productivity growth and further speedy reforms in the Macedonian economy.

A noteworthy aspect is that the existing legal framework regulating MSEs *per se* is not a major obstacle to the development of the Macedonian MSE sector; rather, it is the inadequate implementation of the legislation, the slow resolution of property and contract disputes, the heavy regulatory burden, limited access to financing, etc. We will go deeper into these aspects in the later sections.

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2 *Using enterprise-level data, Zalduendo (2003) empirically documents that new firms have outperformed the surviving old ones.*

3 *Published in "Official Bulletin of the Socialist Republic of Macedonia" No. 32/83 and 12/90 and the "Official Bulletin of the Socialist Federal Republic of Yugoslavia" No. 42/90, respectively.*

4 *The accounting law (Article 4) defines medium-sized enterprises as those which in the preceding two calendar years have satisfied at least two of the following criteria: (1) employed at most 250 employees (based on working hours), (2) generated an annual turnover of less than 40,000 average gross monthly salaries in Macedonia (approx. 15.4 million EUR), and (3) have an average annual balance-sheet total of less than 30,000 average gross monthly salaries (approx. 11.6 million EUR).*

### 5.3. Institutions of self-administration of MSEs and trade in Macedonia

The entrepreneurial middle class in Macedonia is mainly represented by the two chambers of commerce and its delegates in the National Entrepreneurship and Competitiveness Council set up in 2003. With its 15 regional chambers and 17 artisans' associations throughout the country, the formerly state-owned "Macedonian economic chamber" is still the largest business association. It encompasses 23 professional associations, while the artisan organisations operating under its umbrella have approximately 7000 members.<sup>5</sup>

With the liberalisation of the law on chambers of commerce in 2002, the *de novo* private sector was granted the right to establish its own chamber of commerce, the union of economic chambers in Macedonia, which by now covers five industry-related sectors. It constitutes an important platform for articulating its preferences as opposed to the representative organisation of the large and predominantly formerly state-owned enterprises.

Until recently, the international cooperation of the business associations has been following the traditional links with the former Yugoslav markets. Several government agencies have sporadically provided limited financial support for strengthening export orientation, product diversification, and international links in the Macedonian MSE sector. While initial transition experiences have been unsatisfactory, the recently-established agency for the promotion of entrepreneurship in the Republic of Macedonia has somewhat reversed this track record. For instance, its implementation of the cross-border "Development of SMEs and Entrepreneurship in Southeast Europe" project, supported by the Southeast Europe Stability Pact, the Central European Initiative, the Ministry of Economics of the Republic of Macedonia, encompassing three sub-projects on business cooperation networking, entrepreneurship training, and regional twinning, has been considered an example of successful regional cooperation. Seven centres for business cooperation have been established on the former Yugoslav market (Slovenia, Croatia, Bosnia and Herzegovina, Macedonia, Serbia-Montenegro, and Kosovo), ensuring the efficient flow of the supply of and demand for information in the region. By the end of 2005, partners had submitted over 2,000 entries, and supply and demand had been matched in over 3,000 instances.

Broader initiatives for the development of bilateral business links include Macedonian-German Business Association,<sup>6</sup> which is considered to be the largest bilateral non-profit business-related association, the American Chamber of Commerce in Macedonia, and the Macedonian Enterprise Development Foundation financed by the Kingdom of the Netherlands.

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5 *The new law on artisanship provides the option of transformation into artisans' chambers (regional or municipal) and establishing a joint chamber at the national level.*

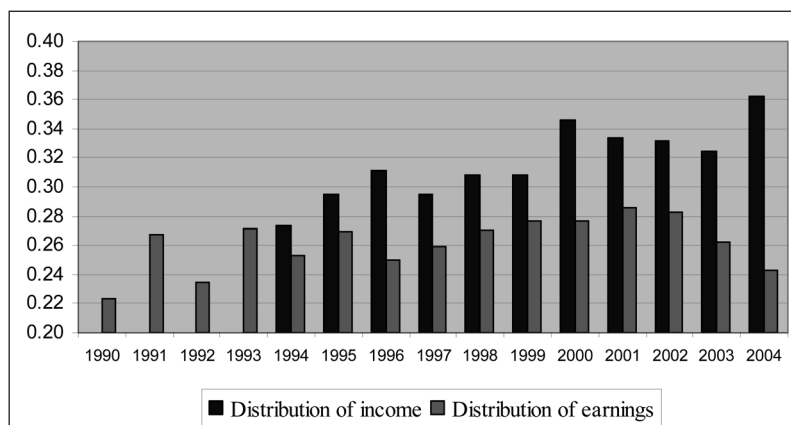
6 *The Deutsch-Mazedonische Wirtschaftsvereinigung (DMWV) was established in 2001 and had 130 members as of February 2007.*

## 5.4. The role of MSEs and trade in Macedonia

### 5.4.1. Towards an economic definition of the Macedonian middle class

As in most transition countries, there are methodological difficulties in defining the intermediate social class in Macedonia based on purely economic criteria. Such class differentiation, solely identified by income disparities, would face, *inter alia*, serious identification problems associated with the unreliability of personal-income data. In a country with a significant tax-evasion culture and informal economy accounting for around 40% of the GDP (Schneider, 2002), the under-reporting of personal incomes should not be surprising, particularly among the upper class, as documented by the extremely low collection of taxes at the higher marginal rates (18% and 24%) of the progressive three-bracket personal-income tax. Such practices, along with capital flight, partly explain the surprisingly low level of officially-measured inequality, expressed by the Gini coefficients of income and earnings inequality (Chart 1). In contrast, Macedonia saw a rapid rise in the imports of luxury goods and, at the same time, a constant increase in the percentage of households living below the poverty line, reaching 30.2% in 2003 (State Statistical Office of Macedonia, 2006).<sup>7</sup> Hence, the official income data do not reflect the melting middle class and the rapidly polarising income distribution during the transition.

Chart 1 - Gini coefficients of income vs. earnings inequality during the Macedonian Transition, 1990-2004



Source: TransMONEE database 2006, UNICEF Innocenti Research Centre, United Nations.

If occupational status is taken as a reliable indicator of the middle class in Macedonia, it seems that the intermediate social stratum is populated by entrepreneurs, mainly in the vibrant new small and medium-sized enterprises, middle- and high-ranking civil servants, well-educated professionals, managers of donor-supported non-governmental organisations, and qualified white-collar workers in companies of good standing, predominantly concentrated in the urban areas. There seems to be sufficient evidence for not including tradesmen in the entrepreneurial middle class because their incomes seriously deteriorated during the transition. Another notewor-

<sup>7</sup> The poverty line in Macedonia is 70% of the median expenditure, according to official statistical estimates.

thy aspect is that a large portion of the population belongs to the agricultural class, primarily engaged in subsistence production, and with dispersed political power. Only those farmers that have adopted modern capital-intensive forms of agricultural production can be considered as part of the middle class, as they have demonstrated entrepreneurial spirit.

Interestingly, in an ethnically divided society such as that of Macedonia, the middle class is not very diverse in its ethnic affiliation. Unemployment and non-activity rates among minorities are considerably higher, so that their share in the intermediate social stratum is relatively low (Table 2). An important factor for low diversification is the poor education background among certain ethnicities, associated with low access to education.

Table 2 - Selected labour market indicators by ethnic affiliation (2002 census)

	Total	Macedonians	Albanians	Turks	Roma	Vlachs	Serbs	Bosnians	Other
Employment rates	61,9	68,0	38,8	41,8	21,5	74,7	69,1	39,7	59,2
Unemployment rates	38,1	32,0	61,2	58,2	78,5	25,3	30,9	60,3	40,8
Non-activity rates	52,8	46,5	70,7	61,9	52,4	51,7	52,7	56,6	56,5
Share of unemployed in working age population	18,0	17,1	17,9	22,2	37,3	12,2	14,6	26,2	18,0

Source: State Statistical Office, 2002 Census.

Attempts to quantify the size of the middle class have been scarce and not up-to-date. For instance, a poll on subjective class differentiation conducted in 1998 revealed that 32% of the respondents considered themselves part of the working class, 30% declared themselves middle-class representatives. The lower upper class and the elite constituted 23% and 2%, respectively, while the remainder did not respond (Dimitrievska, 2002).

The middle income groups can only serve as a proxy for the middle class because it is its common cultural, social, and political values that define its place within the social taxonomy.

## 5.4.2. The local value of MSEs and trade in the Macedonian economy

To gain political support for the middle class, the election campaigns of most political parties contained promises of increased access to state funding. Yet only those who made explicit promises to eliminate red tape, corporate subsidies, and narrow-interest loopholes did win the middle-class votes.

The middle class has preserved its sympathies for state secondary schools and state-funded universities, mainly because of their relatively high knowledge standards (only compared to private ones), low tuition fees, and better employability prospects. Additionally, having recognised the challenges of globalisation, it invests heavily in extra-curricular forms of foreign-language and computer education for its children.

The middle class largely relies on the public health service, but it can also afford some services of private medical care. It only occasionally uses public transport because of the outdated vehicles and the availability of cheap cars, given the liberalised imports of second-hand cars (up to 7 years).

### 5.4.3. Supporting the MSEs and trade: Policy-relevant recommendations

With respect to the support of the middle class and the MSE sector, the government of Macedonia only formally adopted a holistic approach when it enacted the national strategy for small and medium-sized enterprises (2002-2012) and the ensuing operational programme for 2003-2007. However, the implementation efforts turned out to be far from satisfactory, due to the weak administrative capacity for developing and implementing government policies. Not only government institutions, but even more the local government units are in need of strong assistance in the development and implementation of a comprehensive MSE policy. Additionally, there have been ad-hoc initiatives to support MSE development, such as the introduction of a state-funded guarantee fund by channelling additional budgetary resources through the state-owned Macedonian Bank for Development Promotion, but without visible success.<sup>8</sup> Despite these initiatives, the overwhelming impression is that access to financing is still very difficult for most small and medium-sized enterprises. The main reasons for the low level of credit to the enterprise sector are: (i) credit rationing and the high collateral demanded by the bank-dominated financial system, and (ii) the low management culture in many small and medium-sized enterprises. The first problem has been partly mitigated by the establishment of a foreign-equity fund, the Small Enterprise Assistance Fund (SEAF),<sup>9</sup> the IFC-sponsored technical facility Southeast Europe Enterprise Development (SEED), and the inflow of foreign credit lines. The second problem requires more attention and underscores the urgent need for technical assistance in the preparation of viable MSE business plans and business skills training, in order to meet the requirements of the various credit lines and the recently-established equity funds in Macedonia.

To discourage the sizeable shadow economy and spur the development of the private and particularly the MSE sector, economic policy-makers substantially reduced the personal-income and corporate tax rates at the beginning of 2007, reducing corporate tax from 15% and replacing the progressive income-tax schedule of 15%, 18%, and 24% by a uniform tax rate of 12%. The adoption of a flat rate may generate growth-enhancing effects in the medium term, but the policy itself involves an important trade-off in terms of income redistribution and widening wage differentials in favour of the upper class. Therefore, while waiting for the initial economic surge, the authorities should implement a broad-based and politically neutral tax-collection policy to provide a level playing field for the business sector. Additionally, the fiscal system envisages relatively high statutory rates of social contributions, which along with the soft budget constraints (tolerance of inter-enterprise arrears and non-payment of taxes and utility bills) imposes a heavy burden on the official economy and weakens the growth prospects of the new private sector.

A particular effort is required on the part of the authorities to improve access to secondary and university education for minorities in order to promote greater ethnic

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<sup>8</sup> *The state-owned "Macedonian Bank for Development Promotion", which was established in 1998, lends funds (mostly donor-provided) through the commercial banks. Additionally, the bank provides export credit insurance for Macedonian companies.*

<sup>9</sup> *The SEAF was established by the European Bank for Reconstruction and Development (EBRD), the International Finance Corporation (IFC), and Germany's Deutsche Investitions- und Entwicklungsgesellschaft mbH (DEG).*



diversity in the middle class, which seems to be a key to unity and long-term political stability. Moreover, the government of Macedonia must ensure criteria-based and transparent allocation of the budgetary grants earmarked for civil-sector development. The existing system of grant allocation favours its political allies and encourages corruptibility, thereby undermining its crucial democratic role.

Along with the financial consolidation of health system financing, action is urgently needed to regain the citizens' confidence in the basic health institutions. The recent privatisation of some of the basic health services must be strongly supported by a targeted government assistance programme, given the stagnant real wages in the medical profession during the whole transition period. In a broader perspective, the widening discrepancy between public and private-sector wages must be addressed speedily. The initial efforts to apply the wage decompression policy originally designed by the World Bank in the public sector should be re-activated in order to prevent the drain of yet more staff to well-paying private companies and reduce widespread corruption. Moreover, the Macedonian government should conduct its own public expenditure review, reconsidering the magnitude and the composition of social-development outlays.

In the first stage of decentralisation, some social institutions were simply devolved to local governments without sufficient expenditure allocations. For instance, primary schools are now a municipal responsibility, but low central-budget grants undermined the existing quality of public services in primary education. Another argument that calls for much stronger political support for promoting decentralisation and democratic local governance is the geographically uneven distribution of the middle class, which is concentrated in 10-12 towns in Macedonia. Expanding the public functions of local governments is indispensable, given the present exceptionally low decentralisation level (local government expenditures amounted to around 2.7 percent of the GDP in 2005) and the need for support of the local development initiatives.

As antitrust policies are literally non-existent due to the extremely weak administrative capacity of the Competition Protection Commission, market imperfections are largely tolerated. Among the most critical areas we find the oligopolistic bank-dominated financial system in Macedonia, which has been shielded by significant controls on international capital mobility, and the telecommunications sector.

*Table 3- Selected transition indicators for the southeast European transition countries, 2006*

Indicator Country	Government and Enterprise Restructuring	Competition Policy	Banking Reform and Interest-rate Liberalisation	Infrastructure Reform
Albania	2+	2	3-	2
Bulgaria	3-	3-	4-	3
Croatia	3	4+	2+	3
Macedonia	3-	2	3-	2
Romania	3-	3-	3	3+

*Source: EBRD Transition Report, 2006.*

*Note: Transition indicators range from 1 to 4+, with 1 representing no change from a centrally-planned economy and 4+ representing the standards of a market economy.*

In the first area, the government should liberalise entry for foreign banks in order to revive the traditional middle-class respect for saving and investment and to re-build trust in the financial system. The issue of public trust is an important one, given the low institutional credibility and several episodes of financial instability at the begin-

ning of transition. In fact, financial statistics revealed only recently that from 2003 onwards, Macedonia witnessed a strong consumer-credit growth (including mortgage-financing), which eased the financial pressure on the middle class and enabled increased consumer spending on durables. The liberalisation of the telecommunications sector is expected to take place in 2007, after strong and persistent calls by the European Commission for allowing more competition in this area.

In addition, the government should grant the middle class improved access to the decision-making process. Important economic-policy moves have been based on political intuition, to the exclusion of concrete empirical analyses and a constructive public debate. Since most middle-class business associations have expressed their willingness to share ideas and participate in the policy and budget preparation process, it is a government responsibility to catalyse their constructive efforts.

Lastly, the promotion of foreign investment, given the relatively low level of incoming FDI stock in Macedonia, is expected to have strong spillover effects on domestic industries, job creation, and the further consolidation of the middle class.

## 5.5. Supporting MSEs and trade as a step to create a social market economy

### 5.5.1. On the relevance of the German concept of social market economy for Macedonia

During the transition period, Macedonia's economic policy was obviously based on neo-liberal foundations, given

- The large-scale privatisation of many public enterprises and segments of the health care system;
- The substantial trade liberalisation, both multilateral and bilateral;
- The impressively rapid and substantial reduction of budgetary subsidies; and
- The recent abandonment of the progressive income-tax system and the introduction of a flat rate that is the lowest in Europe, etc.

The penetration of neo-liberalism may have been facilitated by IMF-supported programmes and the World Bank development-policy loans, using the instruments of explicit and cross-conditionality policy. Since there has rarely been a decent dialogue on the main routes of the Macedonian economic policy during the transition, it would be premature to say that there has been a critical mass of proponents of viable policy alternatives.

The slow but sustained growth rates of the Macedonian economy from 2002 onwards enabled a gradual consolidation of the middle class and the re-emergence of considerations of social cohesion. The social-deficit debate has also benefited from the contributions of the middle-class intellectuals returning with their education completed at foreign universities. One of the important indicators is the growing public pressure to expand the social component accompanying the structural reforms and reduce the market imperfections arising in several crucial areas, such as competition policy, public expenditure management, and the observance of labour standards. The free and unchecked economy has spurred private-sector growth and raised the country's GDP per capita, but market distortions seem to impose constraints on development. *Lack of competition* in the infrastructural and financial sector (to note a few), along with the highly ineffective anti-trust policies, seriously attenuate the country's social welfare. Indeed, competition and deregulation issues absorbed a considerable part of

the economic agenda presented during the parliamentary elections in 2006, but the challenges remain. Additionally, *public-expenditure management* has been traditionally poor, witness the numerous state audit reports exposing serious budget execution irregularities. While such practices weaken the trust in the institutions, they also impair the cultivation of a positive taxpayers' attitude. Hence, the MSE sector should publicly support government efforts to tighten internal and external financial controls of budget expenditure. Lastly, the labour unions, weak in an environment of persistently high unemployment rates (35.9% according to the Labour Force Survey in the third quarter of 2006) have failed to check on the employers' observance of core labour standards. Part of the blame should be attached to the diverse Macedonian governments, which have treated the dialogue with the labour unions as important only in pre-election periods. Hence, employment protection and a transparent and regular social dialogue with labour unions and MSE representatives should rank relatively high on the reform agenda of the political parties in Macedonia, regardless of their affiliation.

The most important issue, particularly among the middle-class representatives, seems to be the concern that most policies were not debated publicly but simply implemented as a political survival strategy of the ruling coalitions. Surprisingly, even the European Commission's Analytical Report on Macedonia (EC, 2005, p. 40) complimented the broad consensus on national economic policy, despite the divergent policy proposals and the lack of a quality dialogue among the major stakeholders. These are strong arguments for reconsidering the need for a strategic discourse and the relevance of social market economy, not necessarily as a constitutional objective but merely as "a strategy in economic policy".<sup>10</sup>

Recent trends in the Macedonian economy and civil society point to a different interplay between the representatives of the public sector, private enterprises, labour and the civil society. The ossified corporate post-communist structure of the economic and social dialogue has gradually broken down (as mentioned above, the government of the Republic of Macedonia, the Economic Chamber of Macedonia, and the Federation of the Trade Unions of Macedonia formed the Economic-social Council in the past). In the last decade and a half, Macedonia has experienced pluralisation and diversification in the organisation of both the private and the labour sector. The newly-emerging alternative groups are slowly building their capacities, establishing their image in the wider Macedonian public, and voicing their opinions on various topics. The Confederation of the Trade Unions of Macedonia (CTUM) and the Union of Autonomous and Independent Trade Unions (UAITU) are seeking representation on the Economic-social Council. The CTUM even managed to legitimise itself as a representative of the public-sector workers and has recently begun negotiations for a new collective agreement between the government and the public-sector workers (the majority of the public-sector workers are members of CTUM).

Also, the agricultural sector is experiencing a renewal of the activities of several organisations, the largest one being the Federation of Farmers of Macedonia which serves as an umbrella platform for the various unions and organisations representing different agricultural sectors and regions in Macedonia.

Given the fact that Macedonia is gradually opening up to the regional, European, and global economy, there is a pressing need to establish social programmes and networks which will provide the necessary security and relief for the affected.

Social market economy is still the optimum alternative for the Macedonian society and economy if all these various groups are represented in the process of establishing the agenda and pursuing the social dialogue necessary for supporting the model of social market economy. Otherwise, the social dialogue may end up with the opposite effect of promoting special interests benefiting tiny groups, rather than providing the necessary platform for the reform and overhaul of society.

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<sup>10</sup> See more in: C. Joerges and F. Rödl (2004): "Social Market Economy" as Europe's Social Model? EIU Working Paper, law No. 2004/8, European University Institute, Florence.

## 5.5.2. MSEs and trade as promoter of social market economy

The Macedonian middle class should enhance the political visibility of its efforts to encourage the MSE sector to adopt corporate social responsibility (CSR), which presently is negligible by international standards. Integrating social and environmental concerns in the business strategy and operation of Macedonian companies would, *inter alia*, enhance social inclusion, demonstrate greater respect for environmental protection, and improve the observance of core labour standards. For instance, the latter should be tackled by expanding the scope and effectiveness of the government's labour inspection services in order to (1) discourage businesses from entering the shadow economy; (2) promote a level playing field for doing business in Macedonia, and (3) alleviate the deep mistrust between employers and employees. The list of potential public-private partnerships to stimulate CSR encompasses initiatives for spending more on worker retraining so as to compensate in part the losers of the transition, tax exemptions for eco-innovations, awareness-raising campaigns, etc., in line with the recently adopted EC Communication (2006). Indeed, the main pressure has to come from the civil sector and the business associations of the middle class. With the growing role of entrepreneurs in the policy-making process, one should expect that the voice of the middle class will increasingly be heard by top government officials and high-ranking civil servants.

Given the poor track record in environmental protection and the pressing need for compliance with the *acquis communautaire* in the medium term, Macedonia must put more emphasis on its environmental policies. The middle-class concerns over excessive pollution in certain towns (Veles, for instance) have triggered widespread public and political support for preserving the environment and human health, despite the sizeable economic and social costs.

The unfavourable business climate during the early transition and the substantial difference between expected real wages in Macedonia and the destination countries (adjusted for migration costs) has discouraged many business start-ups in the MSE sector. Additionally, the increasing proportion of educated migrants should be addressed, since the drain of young and skilled migrant workers seriously weakens the potential of the middle class and affects the quality of the human capital in Macedonia. The other side of the coin is that the sizeable emigration during the transition has resulted in large and persistent inflows of remittances, which have been reaching 5% of the GDP in some years. While they obviously ease the balance-of-payments difficulties, little attention has been paid to channelling these financial transfers into eradicating poverty and stimulating investment. Remittances can be used more productively in promoting human-capital formation and spurring physical investment, and these initiatives must be jointly promoted by the MSE associations and the central government.

The innovative capacity of the Macedonian MSEs needs systematic support accompanied by larger budget outlays, in addition to the annual prizes for original product developments. More precisely, the missing link between the entrepreneurial middle class and the academic community needs to be established. There have been some joint research efforts, but only sporadic ones, and that in response to donor-supported initiatives. The stimulation of the entrepreneurial spirit should also include developing the young people's interest in tradesmanship and professional trade, starting with spreading the idea of entrepreneurial education at all schools.<sup>11</sup> In the long term, a culture of nurturing may attract new businesses and activate the latent entrepreneurial characteristics of the Macedonian middle class.

Given the rapid production of new regulations pertinent to market economy as well as the prolonged use of pre-transition secondary legislation, the middle class has

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<sup>11</sup> *The experience of Bulgaria seems to be very instructive in this context.*

been praising the vigorous efforts of the government of Macedonia to streamline legislation. In the experience of other transition economies (for example, Moldova), the regulatory guillotine and regulatory impact assessment practices seem to have a beneficial impact on businesses as they simplify the legal and administrative environment and reduce red tape and needless bureaucracy. Prominent among the beneficiaries of relieving the regulatory and administrative burden will be the MSE sector, since these enterprises are particularly fragile when facing regulatory imperfections. Thus, the MSE sector must provide a visible contribution to the process of revising the existing body of regulations and creating a business-friendly environment, using to the full the government's commitment to ensure greater participation by relevant stakeholders.

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## ANNEX TABLES

*Table A1 - Economic indicators of the importance of the MSE sector in Macedonia (2000-2003, average)*

Industry	Contribution to GDP	Share in Total Employment	Share in Total Number of Enterprises
A Agriculture, hunting and forestry	0.3	9.6	4.8
B Fishing	0.0	25.5	5.4
C Mining and quarrying	0.1	14.5	8.0
D Manufacturing	3.2	22.5	2.0
E Electricity, gas and water supply	0.5	20.7	21.8
F Construction	1.2	28.9	1.6
G Trade	1.6	7.0	0.4
H Hotels and restaurants	0.2	12.0	0.6
I Transport and communications	1.4	11.9	0.3
J Financial brokerage	0.0	0.0	0.2
K Real estate, rentals, and business activities	0.3	10.1	0.5
L Public administration and defence, compulsory social security	0.6	9.6	0.6
M Education	0.4	6.6	1.8
N Health and social work	1.2	34.2	2.2
O Other community, social. and personal service activities	0.4	11.4	0.3
Total	11.4	15.9	0.9

*Source: Authors' calculations based on disaggregated data from the State Statistical Office, 2005.*

*Table A2 - Employment by industry and firm size in Macedonia in 2000-2003 (average shares, in percent)*

Industry	Small Enterprises	Medium-sized Enterprises	Large Enterprises
A Agriculture, hunting and forestry	78.1	9.6	12.2
B Fishing	74.5	25.5	0.0
C Mining and quarrying	20.1	14.5	65.5
D Manufacturing	41.7	22.5	35.8
E Electricity, gas and water supply	9.9	20.7	69.5
F Construction	39.5	28.9	31.6
G Trade	85.8	7.0	7.2
H Hotels and restaurants	82.0	12.0	5.9
I Transport and communications	43.3	11.9	44.8
J Financial brokerage	2.0	0.0	97.9
K Real estate, rentals, and business activities	72.6	10.1	17.3
L Public administration and defence, compulsory social security	10.4	9.6	80.0
M Education	93.4	6.6	0.0
N Health and social work	31.1	34.2	34.7
O Other community, social, and personal service activities	68.7	11.4	19.9
Total	53.7	15.8	30.5

*Source: Authors' calculations based on disaggregated data from the State Statistical Office, 2005.*





# 6. Moldova

by Eugen Roscovanu

## 6.1. General introduction

The Republic of Moldova ranks second in the world in terms of the **proportion** of remittances by Moldovan workers employed abroad in the country's gross domestic product, according to the UN Report to the 39<sup>th</sup> Session of the UN Commission on Population and Development. In this respect, as a proportion of GDP, remittances were most significant in Tonga (31 per cent), the **Republic of Moldova** (27 per cent), Lesotho (26 per cent), and Haiti (25 per cent). According to OECD data, the number of emigrants from the Republic of Moldova reaches approx. 660 thousand workers, and according to independent research data, there are one million foreign workers, i.e. one-third of the population. The total amount of actual remittances may be larger, since these estimates do not include transfers through informal channels, which in the Republic of Moldova are estimated to reach USD 1bn. As for the GDP per capita, it is four times lower than Romania's and six times lower than in Latvia. <http://www.cia.gov/cia/publications/factbook/fields/2004.html>

The number of SMEs has been increasing, and it has risen by 2,800 as against 2005. But as the chart below indicates, the number of employees increases at a small rate, although exaggerated percentages are indicated.

The first programme, however, was of particular importance in that it set certain priorities and established that small businesses needed direct support from the executive and legislative power. A major experience was the fiscal credit stipulated in the Small Business Act, granted for a five-year period. But because of the difficult procedures required for obtaining the fiscal credit and its inadequate promotion, only 168 business operators in the country benefited from the facility. Moreover, in 1998 the Small Business Act was amended, to the effect that the fiscal credit was cancelled. It was only due to strong protests by the Small Business Association that business operators having already signed fiscal credit contracts with the respective inspectorates were permitted to benefit from it for the initially stipulated five-year period. Legislative instability constantly threatened the first governmental programme on small business and entrepreneurship. While exact calculations are hard to make, the programme has not been very successful, although the intentions seemed very good. The experience had both positive and negative aspects, but continuity was not pursued and a thorough analysis was not carried out. While such flaws are common to other economic sectors as well, in the small-business field any error, any wrong step has a serious impact on the sector, which is highly sensitive. Small business is one of the key factors in increasing the citizens' well-being and raising revenues to the state budget and local budgets. There is no doubt that it is of particular political, social, and economic importance. Moreover, it is a good solution to assimilate and create jobs and to ease out crises. Hence the urgency of drawing up further programmes to support the small business sector and develop entrepreneurship. In 1999, a government Resolution<sup>1</sup> launched the governmental programme for small business support for 1999-2000. One can safely say that this was one of the least successful documents of this type, although the need for such a document is undeniable. Because of the political instability, the programme was only adopted in August 1999, although it had been designed for the entire year 1999. The legislation in force did not fully contribute to citizens exercising their right to economic initiative, while small-business taxation and reporting procedures needed immediate simplification, concurrently with

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<sup>1</sup> *Resolution by the government of the Republic of Moldova No. 750 of August 5, 1999. Official Journal of the Republic of Moldova, 1999, no. 87-89, art. 788.*

the extension of financial support, information, and consulting facilities. An equally inadequate development is noted with the small-business financial support-crediting mechanisms: The credit guarantee fund was not established, a number of measures aimed at optimising the small-business support and development infrastructure were not implemented. These aspects were identified upon assessing the results of the governmental programme for small-business support for 1999-2000. In view of stepping up the development of small businesses, the government of the Republic of Moldova decided to extend the scope of the programme for small-business support for 1999-2000 to the year 2001. The same document lays down a decision on the extensive development of the small-business infrastructure.

In 2000, attempts were also made to draw up local programmes. In Chisinau, a municipal small-business support programme for 1999-2000 was approved, which stipulated among other things the establishment of a municipal small-business support fund and an information centre for entrepreneurs as well as granting facilities to production companies. But both the national and the municipal programmes lacked adequate financial support. One may state that they were limited to noble intentions and failed to reach their goals. The efficiency of the measures laid down in the programmes is hard to assess, as the implementation period overlapped a crisis in the economy as a whole which reflected on all sectors of activity, and small businesses are sensitive to such phenomena.

It is particularly important to contrast this to the way small-business development is approached in the third public programme, which marks the start of a new strategic public management in the sector. We are thus witnessing the emergence of a new concept: The **strategic management of double standards** in the development of the SME sector in Moldova. All facts and figures support this assumption, and therefore we are entitled to put it forth, at least as a working hypothesis. But let us start by quoting several excerpts from the programme foreword:

"The governmental programme for small-business support for the years 2002-2005 (the Programme) is drawn up in accordance with the Republic's social-economic policy. The key objectives of this Programme are to use enterprises in the small-business sector as a key element of the market economy, as a tool to reduce unemployment rates and increase the citizens' living standards, by creating the necessary conditions for small businesses to move to a new qualitative level, by consolidating the domestic potential and capitalising on the facilities granted by the state. The small-business development level must contribute to forming a positive image of the Republic of Moldova and ensuring an efficient market economy, with a view to integrating it in the European and world economic system. The creation of a favourable environment for small businesses must become a real guarantee of the consolidation of our efforts to improve cooperation with donor organisations and participation in international projects. The governmental policy in this area is aimed at ensuring the access of the Republic of Moldova to international programmes and at signing bilateral, intergovernmental, and multilateral agreements supporting the small-business sector. *Small-business development in the Republic is not sustainable, and is often hindered by the following factors: The absence of a clear interpretation, through normative acts, of the governmental policy concerning small-business support; slow removal of administrative barriers (registration, certification, inspection systems, and authorisation procedures, regulation of lease mechanisms, etc.); the absence of concrete and efficient mechanisms of public crediting-financial support; excessive tax pressure and the onerous reporting system; the entrepreneurs' lack of confidence in the stability of the business environment, given the frequent modifications of economic legislation; the excessive involvement of the government in the activity of business operators.* (our emphasis)

In spite of the aforesaid, the results of the small-business sector in the Republic of Moldova prove the existence of a sufficient potential consistent with the strategic economic development objectives, which requires the promotion of a governmental small-business support policy."

Everything is clear, yet everything remains on paper. An important part of the action plan is not implemented. Government officials keep talking about the aforementioned problems, which are also referred to in the action plan. But the business environment does not change. Out of the total number of registered small enterprises, only 6.2 per cent are able to file financial reports, as the others have no operations. According to data made public by the Statistics and Sociology Department of the Republic of Moldova, on January 1, 2004, approx. 22,900 companies (as against 22,100 in 2002) operated in the SME sector.

Accounting for 89 per cent (90 per cent in 2002) of the total number of companies and for 27 per cent (26 per cent in 2002) of the total number of employees, small businesses contributed 22 per cent (23 per cent in 2002) to the total turnover (revenues from sales) in the Republic. Another point of relevance to the size of companies in this sector that is worth mentioning is that in the period under analysis, the average enterprise employed six persons (six employees in 2002), with a turnover – MDL 586,000 (MDL 489,000 in 2002) – 4.1 times lower than the national economy average. Small businesses are primarily represented by limited liability companies: 75 per cent of the total number, 81 per cent of the turnover, and 64 per cent of the number of employees in the SME sector. Joint-stock companies account for approx. 8 per cent of the number of SMEs, 10 per cent of the turnover, and 14 per cent of the workforce. In the structure of turnover by ownership forms, the major share (89 per cent) is accounted for by private ownership, followed by joint ventures (held by Republic of Moldova + foreign ownership) with at 5 per cent. In 2003, the total profits of business operators in the SME sector amounted to MDL 216m. Also, according to results reported for 2003, only 38 per cent of the SMEs made a profit (for the entire economy, profitable companies accounted for 41 per cent of the total). Also worth noting is that, while they accounted for 89 per cent of the total number of companies, small businesses only generated 11 per cent of the profits reported by companies in the national economy. Results by operation types indicate that small businesses primarily operate in construction, trade and real-estate transactions, rentals, and services to companies.

In Moldova, the absence of a clear economic outlook and a long-term economic programme leads to a focus on an aggressive fiscal policy, which is known to be ineffective in the long run. It may only benefit those who want to impoverish citizens and take control of the economy for oligarchic interests.

In fact, small-business support and encouragement is promoted in many states in the CIS space: Russia, Kazakhstan, and Ukraine. In Kazakhstan, for instance, the Department for SMEs is directly subordinated to the President of the Republic, who also appoints its staff. Important amounts for the support and development of entrepreneurship are earmarked in the state budget on an annual basis. Cities are authorised to finance SMEs from their own financial resources and from the state budget, which ensures concrete economic facilities. Micro-enterprises are inspected every three years. In order to check a small company, an inspector must be registered with the Prosecutor's Office. These are things that our entrepreneurs can only dream of.

In 2002, MDL 20m was allocated from the state Budget for financing unemployed persons able to prove their small-business management skills, to be selected through a business-plan contest. The result of these intentions laid down in the 2002 Budget Act was spectacular: The MDL 20m earmarked under the Budget Act were distributed as pension benefits!

The law was ignored. Millions of MDL were spent by certain circles of senior officials as they pleased, which fully confirms the author's hypothesis of the **reverse-effect syndrome** persisting in the economic policy on small-business support in the Republic of Moldova.

But the business environment is thus dealt heavy blows, and the consequences will be notable a long time. Naturally, in a healthy market economy several small enterprises can pool their capital in order to upgrade their technology, to cope with competition, and to meet consumers' needs. Small enterprises join forces in order

to rent large storage facilities, launch other operations, purchase high-performance equipment, and gain larger market shares. But such processes occur naturally, rather than being dictated by governmental resolutions. There is no doubt that under such circumstances any businessman will think twice before moving to expand operations, invest in the business, and create new jobs. In fact, small businesses are known around the world as a means to make a living not only for the more active and enterprising. There are even international organisations of retired professionals, e.g. the CESO in Canada, the SCOR in USA, etc., who are offered encouraging taxation terms and get involved in various small-business operations, where they provide consulting services on the basis of their lifelong experience and their multiple business connections. Our pensioners, which make up a vulnerable socio-professional category, could work in the most diverse fields, in micro-enterprises, entrepreneurship, and small enterprises, if they had the same conditions. But, of course, these services should be volunteered by those who want to obtain employment to the extent to which their physical and intellectual condition allows it. Both the new generation and the middle-aged have a lot to learn from experienced pensioners. The latter are forced by economic circumstances virtually to beg, as if doomed to be passive witnesses of a catastrophic situation; they are manipulated rather than involved in the real life of our society. Small businesses may be a solution for them, as it may for many others. Small businesses offer them at least a hope and opportunity to survive.

## 6.2. Definitions – micro-enterprises and SMEs

1. A micro-enterprise is a business operation which meets the following criteria: Average annual staff – max. 9 employees; annual turnover – max. MDL 3m; total assets in annual reports – max. MDL 3m.
2. A small-enterprise is a business operation which meets the following criteria: Average annual staff – max. 49 employees; annual turnover – max. MDL 25m; total assets in annual reports – max. MDL 25m.
3. A medium-enterprise is a business operation which meets the following criteria: Average annual staff – max. 249 employees; annual turnover – max. MDL 50m; total assets in annual reports – max. MDL 50m.

## 6.3. Legal Framework for SMEs and trade in the Republic of Moldova

For seven years, small businesses have had an average of 3-6 employees. Limited liability companies account for 74 per cent of the total number of small businesses, 83 per cent of the total turnover, and 64 per cent of the total workforce. Joint-stock companies: 9 per cent of the number of companies, 12 per cent of the turnover, and 16 per cent of the workforce. Of the total number of registered companies, 90 per cent are accounted for by micro- and small enterprises. Labour productivity in the SME sector is 11 per cent higher than the country average!

### 6.3.1. Considerations on the strategy paper on SME development support for 2006-2008

The strategy paper on the development of small and medium-sized enterprises lays down strategic lines of action and related measures, which will be implemented by

the government so as to facilitate the development of small and medium-sized enterprises. In drawing up the strategy, the following aspects were taken into account:

- The results and impact of the implementation of the governmental programme for small-business support for the years 2002-2005;
- Priorities and objectives of the Economic Growth and Poverty Reduction Strategy Paper (2004-2006);
- Priorities and goals stipulated in the European Charter for Small Enterprises, as well as the international experience in the support and development of the SME sector;
- Priorities laid down in the Partnership and Cooperation Agreement signed by the Republic of Moldova and the European Union and in the EU-Moldova Action Plan; and
- Analyses of current barriers and hindrances to the development of the SME sector carried out by the government, the donor community, and independent analysts.

## 6.4. The development of SMEs and trade and their role in the economy of the Republic of Moldova

The small and medium-sized enterprise sector may serve as a foundation for the building of a modern and dynamic knowledge-based economy. This sector of the national economy may contribute substantially to the gross domestic product, to increasing employment opportunities, and to encouraging exports. In a market with a sound competition, small and medium-sized enterprises are able to react flexibly and adjust rapidly to recurring and structural economic changes. In this regard, a well-developed SME sector may contribute towards strengthening stability and macroeconomic growth in the country.

The **goal** of the strategy is to create favourable circumstances for the development of the SME sector so as to increase its long-term contribution to sustainable economic growth and poverty reduction.

The **objectives** of the strategy are:

- To increase the gross value added produced in the sector;
- To increase the SME sector's contribution to reducing poverty by developing new employment opportunities to ensure citizens' incomes;
- and to develop more sustainable and competitive micro-, small, and medium-sized enterprises.

To reach the strategy's goal and strategic targets, the following strategic lines of action have been defined for 2006-2008:

- Promoting a policy favourable to the development of small and medium-sized enterprises by creating an encouraging legislative, regulatory, institutional, and fiscal framework;
- Facilitating access to funding;
- Developing the entrepreneurial culture and modern business consulting services;
- Strengthening the competitiveness of small and medium-sized enterprises; and

- Promoting the dialogue between the government and the private sector;

Since the late '90s, attempts have been made to implement a number of measures aimed at stepping up the development of the SME sector by creating an encouraging legislative, regulatory, and fiscal framework, granting financial support for the sustainable development of small businesses, enhancing SME competitiveness, and stimulating the development of an entrepreneurial culture. Such measures, however, did not have a significant impact on the development of the SME sector, and additional measures are to be taken to ensure the continuity of actions already implemented and the sustainable development of the sector.

The National Statistics Bureau collects quarterly / annual financial reports from approx. 30,000 business operators. Also, private persons and self-employed whose fixed assets exceed MDL 350,000 or whose turnover exceeds MDL 1m are obliged to report to the National Statistics Bureau. Of the total number, 28,000 businesses qualify as small and medium-sized enterprises.

An analysis of the dynamics in the SME sector, which currently accounts for approx. 92 per cent of the total number of companies in the country, also reflects a steady increase in the number of enterprises rather than quality in the sector. Current statistical data officially confirm the progress made by companies in the SME sector in terms of the number of people employed, the number of profitable companies, turnover, etc. In this context, it must be mentioned that in 2002-2004, the number of operators in the SME sector grew by over 5,700 as the number of small companies and micro-enterprises increased by 873 and approx. 4,800, respectively. The medium-sized enterprise sector totals approx. 1,440 companies.

A breakdown by type of operation shows trade as the primary activity in the SME sector (45 per cent), followed by the processing and extractive industry (13 per cent), and real-estate transactions (12 per cent). By ownership forms, 91 per cent of the companies in the SME sector are privately owned, 2 per cent run on public capital, 2 per cent on foreign capital, and 5 per cent are joint ventures.

In geographical terms, the cities of Chisinau and Balti rank first by enterprise headcount, turnover, and personnel employed. In terms of the sector's contribution to employment, an analysis of its dynamics indicates that in 2002-2004, the number of people employed in the sector increased by approx. 43,000 to more than 170,000 at present, which accounts for approx. 30 per cent of the total number of persons employed in the economy, indicating an inadequate use of the SME potential. According to various international surveys, including IMF reports, under encouraging development circumstances this figure should reach at least 40 per cent. But for the past five years the figure has not moved up, in spite of attempts at "raising" it by purely statistical means.

In 2002-2005, the SME sector made notable development efforts, as the turnover officially reported by the companies in question increased by approx. MDL 9bn. At present, its share in the total turnover is 26 per cent.

Thus, the conclusion has been reached that the SME sector has been profitable since 2003, with positive financial results totalling MDL 215m. The trend persisted in 2004, when financial results were reported to total MDL 356m.

In 2004, 11,000 companies reported profits (as against 8,000 in 2002). The same number of companies reported zero revenues; approx. 30 per cent reported losses or did not file official reports as they had not operated over the past 3-5 years.

It should be mentioned that the most profitable activities include constructions (approx. MDL 184,000 per company), real-estate transactions (approx. MDL 151,000 per company) and the processing industry (approx. MDL 100,000 per company). On the other hand, the most substantial losses per company, on average, were reported in the processing industry – approx. MDL 108,000, followed by agriculture at approx. MDL 54,000. The aforementioned results indicate the need for company modernisa-

tion, which requires major investments, as well as for a special approach by the state in the sector in question.

### 6.4.1. Hindrances to the development of SMEs

Since 1992, Moldova has seen a steady increase in the number of small and medium-sized enterprises. In 1998, a severe crisis occurred in the sector, which left small businesses in Moldova considerably behind many other states from the CIS space. Thus, the sector's small share in the number of people employed and the reported turnover reflects low entrepreneurial development skills as well as an inadequate business environment.

Furthermore, in analyses of the sector carried out by foreign experts and non-governmental organisations representing the interests of SMEs and entrepreneurs, the following aspects were identified as key hindrances to the operation of small and medium-sized enterprises:

- Inefficient regulatory framework;
- Limited access to financial and information resources;
- Low competitiveness of national enterprises in the international market; and
- Low levels of entrepreneurial skills and an underdeveloped business-support infrastructure.

To solve regulation issues, the reform of the regulatory framework was initiated under law No. 424-XV of December 16, 2004 on the revision and optimisation of the legislative framework of entrepreneurship. Its implementation is aimed at revising the structure of public institutions with regulatory duties and the legislative-normative framework of entrepreneurship. Related measures are necessary in order to simplify the structure and number of administrative procedures required to the entrepreneur at various stages of business development, to the effect of reducing "business operation costs."

In 2002-2005, the access to finances was also improved, although banking interests remained rather high. Over the past three years, an increase has been noted in the volume of loans granted by the banking sector, and interest rates have not yet decreased in real terms.

Also, the government took measures to give a fresh impetus to the Fund for Entrepreneurship Support and SME Sector Development. The European Bank for Reconstruction and Development and the International Finance Corporation offered local commercial banks credit lines addressing small and medium enterprises. A number of organisations, e.g. "ProCredit," "Corporatia de Finantare Rurala", and "Microinvest" grant credits to micro-enterprises and small enterprises. However, small enterprises have limited access to credit as they face common problems such as low capitalisation rates, lack of security, limited experience in credit spending, high interest rates, and limited access to financial consulting information.

Another aspect worth mentioning is the underdeveloped entrepreneurial culture, in spite of the considerable increase in the number of small enterprises. In most cases, entrepreneurs, particularly small-enterprise owners, who have urgent training needs are not aware of this; consequently, training and consulting centres cannot survive on account of the low demand for their products and services. Also, the competitiveness of small enterprises in Moldova remains inferior. Efforts have been made to strengthen ties between research and development and higher education institutions and the private sector. Steps have been taken to raise the entrepreneurs' awareness of procedures to secure the protection of and transfer intellectual property rights.



Another important aspect in SME development is the use of information and communication technologies. At present, although there are a number of broadband Internet service providers, the use of IT&C in small and medium-sized enterprises remains low. There are insufficient surveys on the involvement of Moldovan companies in e-commerce, while the implementation of a broader e-government service set is still at an early stage.

## 6.4.2. Creating a legislative and regulatory framework to encourage SMEs

To ensure the sustainable development of enterprises, particularly of small and medium-sized ones, clear and transparent laws and regulations are necessary and should be efficiently implemented. Entrepreneurship legislation and norms should provide a framework of common rules to ensure the open and free completion of transactions, while at the same time respecting the interests of enterprises, consumers, and society as a whole as well as the principles of free competition. The regulatory framework, however, is known to be a burden for small and medium-sized enterprises, generating barriers to trade, investment, and innovation, and reducing economic efficiency, as proven by the social problems experienced in 2006-2007: Numerous protests by entrepreneurs, lockouts in marketplaces, violent picketing of administrative offices.

According to "good governance" principles, as defined by the Organisation for Economic Cooperation and Development in its 1995 Council Recommendation on Improving the Quality of Government Regulation, the regulatory framework should serve a clearly identified political purpose, and should be fair, simple, accessible, and efficient. Over the past few years, entrepreneurship laws and regulations in European Union Member states have been improved on the basis of the OECD principles. The government has joined this endeavour and initiated the regulatory framework reform.

Several areas remain problematic:

- Bringing legislative reforms to the forefront of the government's agenda;
- Consulting the private sector in drawing up and endorsing legislation and normative acts;
- Regularly reviewing existing regulations to ensure constant effectiveness;
- Reforming public services to ensure their efficiency and high quality, including the extensive implementation of the "one-stop shop" principle in public services;
- Introducing the e-government service to allow for on-line interaction with authorities,; and
- Progressively introducing IT&C in regulatory systems.

One major issue is the distance between the executive and legislative power and civil society.

By embracing the "good governance" principles of the OECD while delaying the regulatory framework reform, the government carries on a non-transparent and monopolist policy, working on double-standard principles. Another important factor which impacts business operations is the fiscal system. No steps are taken to enhance the efficiency of the tax management system (e.g., optimisation of the number and frequency of declarations for tax purposes). The government does not implement transparent policies for small and medium-sized enterprises, in line with the principles laid



down in the European Charter for Small Enterprises. The quality of the information and services provided by public authorities to small and medium-sized enterprises is questionable.

### 6.4.3. SME access to funding

The prevailing financial resources for small business remain personal investments by the entrepreneurs. Thus, measures need to be taken so as to develop the financial infrastructure for small and medium-sized enterprises in Moldova in line with the highest international standards. In the period covered by this strategy, priorities in this respect are as follows:

1. To develop the legislative, regulatory, and institutional framework by introducing new financial instruments, adopt the legislation needed in order to encourage the introduction of new financial technologies, consolidate and professionalise citizens' savings and loans associations, as well as to facilitate the sustainable development of micro-financing bodies. Innovating activities should be aimed at encouraging emigrant labour to channel remittances into investments. A set of additional measures is needed in order to establish crediting offices and to ensure the management of a unified database on business operator's credit records, as well as to permit its free use by banks and non-bank crediting institutions.
2. To increase the financial resources earmarked for small and medium-sized enterprises. To facilitate the access of micro-, small, and medium-sized enterprises to credit, efforts must be made to attract international credit lines for national small and medium-sized enterprises and to create savings schemes so as to accumulate credit resources in the medium and long run. In order to ensure financial resources to encourage the export of domestic products and develop economic sectors with a significant growth potential, the role of the Fund for Entrepreneurship Support and SME Sector Development must be redefined. Protests followed the attempt to increase the statutory share capital of limited-liability companies to MDL 30,000, which will create barriers to the use of this organisational-judicial form. There are local experts who believe that this amount should be reduced to zero, and that business operators themselves should be allowed to decide on their share-capital value.

### 6.4.4. Enhancing SMEs competitiveness

At the 2000 Lisbon Summit, the European Union member states announced their intention to turn the European economy into the most competitive and dynamic knowledge-based economy in the world by the end of 2008, with a potential for sustainable economic growth and higher social cohesion. Also, upon adopting the European Charter for Small Enterprises, the heads of the European Union states recognised the key role of small and medium-sized enterprises in the transition to a competitive economy.

The Republic of Moldova and another thirty-four states undertook to implement the Charter principles in their economies, and the European Union accepted Moldova as part of this process in November 2004.

In this context, the government undertook to carry out a number of actions in the following directions:

1. Stimulating the development of an innovation culture, aimed at enhancing the efficiency of production and marketing, at improving product and

service quality, at launching new products and services, and at acquiring new production processes.

2. Promoting innovation, drawing up feasibility studies for the establishment of research centres and innovation parks, and introducing close cooperation schemes between university departments, research and development institutions, and enterprises. Further, the government undertook to provide support for cluster development in strategic sectors.
3. Consolidating the use of IT&C
4. In order to facilitate e-commerce operations, steps will be taken to improve knowledge about communication and information technologies. To facilitate access to such technologies for the rural population; marketing information centres will be established in order to promote SME products and services in local and foreign markets.
5. Facilitating access to international markets.
6. Sustainable development in the SME sector will largely depend on its ability to enter foreign markets. An adequate trade policy will be implemented by negotiating additional free-trade agreements, developing the Moldovan Export Promotion Organisation, and reducing administrative barriers in domestic and foreign trade now and in the future. The infrastructure for quality certification will be developed so as to meet European Union quality, testing, and certification norms.
7. One way to strengthen the competitiveness of small and medium-sized enterprises will be the identification and implementation of schemes able to stimulate contracting and subcontracting relations between small enterprises in strategic sectors with a growth potential and large enterprises.

### 6.4.5. Implementing and monitoring the strategy

The strategy implementation process will take place at a national and local level. At a national level, the responsibility for implementing strategy components will rest with the relevant ministries, bureaus, and services, while at the local level, local public authorities will be in charge of the implementation process. The coordination and monitoring of the process is a task assigned to the Ministry of Economics and Commerce.

Actions within the remit of central public institutions, including drawing up and endorsing the legislative and regulatory framework, are assumed to be directly carried out by such institutions, and to entail no additional costs to the state budget other than current expenses. As for those activities having a direct effect on small and medium-sized enterprises, or requiring implementation costs additional to current expenditures, these will be financed from foreign-donor resources. Related actions will be implemented by institutions which are partners with the government in the strategy implementation process:

- Organisations representing the interests of small and medium-sized enterprises (business associations);
- Business service providers; and
- International financial institutions and donor organisations.

The implementation of strategic actions by non-governmental organisations and the private sector, provided transparent methods are used to select the respective insti-

tutions, will contribute to the efficient management of the financial resources allotted and to maximising the targeted effects.

This strategy will be funded by budgetary allocations, foreign technical and financial assistance, and other resources which do not fall under the relevant legislation.

Ministries, other central authorities, local public authorities, the business support infrastructure, and foreign donor assistance represent the institutional framework for the implementation of the public policy supporting the SME sector in 2006/08. The core of the institutional and logistical framework for implementation will be public institutions in charge of supporting small and medium-sized enterprises, which will distribute the financial resources allotted for the implementation of strategy actions and collect information on the results and effects of its implementation.

All institutions and organisations involved within their remit in the implementation of actions and goals of this strategy will submit information on the strategy implementation process to the Ministry of Economics and Commerce, while the Ministry will centralise the respective data and forward them to the government for analysis and conclusions.

## 6.5. The action plan in the strategy paper on SME development support for 2006-2008

### 6.5.1. Consolidating the legislative and regulatory framework, implementing the regulatory framework reform

- Review legislation and regulations on small and medium-sized enterprises
- Modify the current legislation so as to harmonise it with the new law on small and medium-sized enterprises

**Comments:** Harmonisation of the Moldovan legislation on small and medium-sized enterprises with the European Union legislation

- Redefine the SME sector so as to distinguish more clearly between the various types of enterprises: micro, small, medium-sized, and large, as well as their respective rights and obligations
- Review all laws and regulations on the SME sector in order to ensure transparency in their enforcement and eliminate arbitrary interpretations
- Implement “good governance” principles as defined by the Organisation for Economic Cooperation and Development

**Comments:** Identification of the optimum number of reports and the optimum form of the reporting system for various categories of operators in the SME sector. Introduction of electronic report filing. Implementation of the “one-stop shop” principle in the reporting system

- **Optimising registration procedures:**
- Reduce the timeframes for enterprise and institution reorganisation and deregistration procedures;
- Reduce, from two to one, the number of notifications to be published in the Official Journal concerning reorganisation and deregistration from the state Registry Office;

- Eliminate from legislation (Art. 67 Civil Code) the obligation of legal entities to publish in the Official Journal notifications of registered-office changes. The respective information will be posted on the Ministry of Information Technology Development website, at [www.mdi.gov.md](http://www.mdi.gov.md);
- Reduce to a minimum (to complete elimination) the entrepreneurs' obligation to present certificates and other documents to public authorities. This will be replaced by posting and using such information on websites and in electronic registries operated by public authorities (state registration office, licensing office, National Migration Bureau, National Statistics Bureau, Central Fiscal Inspectorate, National Health Insurance, National Social Insurance Agency, state Agency for Intellectual Property, etc.)
- Optimise the licensing procedure by endorsing the normative framework and implementing the "one-stop" licensing office, among other things

### 6.5.2. Optimising the fiscal framework to stimulate SME development

- Improve tax management so as to reduce the administrative costs of SMEs and minimise fiscal-legislation violations.
- Improve the VAT refund mechanism by eliminating useless steps in the current procedure which generate difficulties in ensuring compliance with the refund deadlines laid down in the legislation, optimising the VAT refund mechanism

### 6.5.3. Facilitating SME access to funding

- Adopt the law on citizens' savings and loan associations in a new form
- Develop the venture capital system
- Draw up and adopt the law and regulations on venture capital, which will ensure the necessary framework for the introduction of venture capital schemes in Moldova, and harmonise with the existing financial legislation and relevant best practices
- Review banking legislation with a view to simplifying the SME-sector crediting process

### 6.5.4. Increasing the financial resources earmarked for SMEs

- Implement measures to consolidate SME capital
- Introduce credit guarantee schemes to encourage crediting, with a focus on:
  - Interest deductibility upon launch of operations
  - Financing lease operations
  - Financing export operations

Explore new ways of encouraging the banking sector to introduce long-term savings

schemes so as to generate the funds for long-term SME credits at accessible interest rates

### 6.5.5. Enhancing SME competitiveness

Improve the technical and innovation potential of SMEs.

Enhance the international competitiveness of the Republic of Moldova. Identify the preliminary ranking in the Global Competitiveness Index of the World Economic Forum as a benchmark in enhancing the international competitiveness of the Republic of Moldova, SME competitiveness included, and implement those actions which will cause the index to improve.

Draw up and implement a national strategy document on innovation whose objectives will be

- to define measures to ensure the fast and efficient transfer of new technologies, products, and ideas in production and services; and
- to define cooperation schemes involving universities, research and development institutes, and enterprises

Ensure SME access to national and international intellectual-property databases

Grant financial and logistical assistance to small and medium-sized enterprises in order to promote innovation

1. Extend assistance to small and medium enterprises which own assets subject to intellectual-property rules for their participation in domestic and international invention exhibitions and fairs
2. Organise conferences, symposiums, and round-tables on scientific subjects, adopt other technical/scientific measures dedicated to intellectual-property issues in the economy and the role and place of small and medium-sized enterprises in the innovation process

**Comments:** Harmonise the legislative framework and enforcement norms, support the steady development and adjustment of the national intellectual-property protection system to European standards, reinforce cooperation with the European Union and relevant international and regional institutions

Draw up programmes and an action plan for the development of industrial clusters and output chains in the national economy

**Comment:** Identify potential sectors for cluster creation and draw up national and regional plans and programmes on cluster and output-chain development. Emphasis will be placed on promoting the creation of SME production and cooperation networks with a view to developing products and improving production and marketing technologies.

Introduce an award scheme to encourage competitiveness in small and medium-sized enterprises in Moldova

### 6.5.6. Support for SME participation in representative structures and trans-European networks

1. Establish contacts with European business assistance networks and databases **Comments:** Establish relations with EURO INFO CORRESPONDENCE CENTRES; the European Association of Crafts; the Network of SME associations, innovation centres, etc.

2. Participate in international research and development programmes **Comments:** Assist participation in international research and development programmes, e.g. EUREKA, the Fifth European Community Framework Programme on research, technological development, and demonstration activities.

3. SME participation in activities related to the European Charter for Small Enterprises **Comments:** Encourage the involvement of national SME and entrepreneur associations in drawing up the annual report on the implementation of the European Charter in Moldova as well as in other activities related to its implementation.

4. Establish "Euro Info" centres attached to chambers of commerce and industry

Review the legislative and normative acts in force in the Republic of Moldova.

Departments will modify and amend legislation, on a regular basis, in conformity with provisions in WTO agreements in the following areas: Intellectual property; services; standardisation and certification; trade-related investment measures; customs valuation of goods; rules of origin; import licensing; application of safeguards, anti-dumping and countervailing measures.

## 6.6. Conclusions

A solution for the development of the SMEs would be an incentive system of taxation that would save resources for joint ventures and would enable SMEs to undergo permanent development. The fiscal burden remains not only an issue of raising money for the budget but also a matter for the development of micro-companies and SMEs. Improving the small-business regulatory system includes a set of economic mechanisms, organisational measures, and legal acts. The economic mechanisms would have to give attention to improving the taxation system and broadening the access of enterprises to financial resources.

The fiscal burden on small businesses is heavier than on other sectors of the economy in the Republic of Moldova. Taxation (the share of all taxes and revenues in the composition of the gross domestic product) accounts for 54 per cent in the small-business sector and for 46 per cent in the overall economy. The share held by small businesses and micro-businesses in the taxes applicable to all economic operators in Republic Moldova is at 20 per cent. That is above the share of the employees in the small-business sector (10 per cent) and more than the fixed funds used in the sector – 12 per cent. This confirms the need for rationalising the small-business taxation system. Reducing the tax rate would lead to a larger number of tax-paying enterprises. Surveys suggest that, should the revenue tax drop under 20 per cent, half of the owners/managers of small businesses would be ready to turn their operations legal and pay the taxes they owe. The corporate profit tax is 20 per cent, whereas the income tax levied on individuals varies according to the size of the income, from 10 per cent to 22 per cent. The standard VAT rate is 20 per cent; preferential VAT rates are 5 per cent and 8 per cent. Export VAT is 0 per cent. The fiscal burden in Moldova is 58 per cent for micro-enterprises and 52 per cent for small businesses. If the state cannot cut the tax rate for all the small businesses, it would nevertheless be reasonable to do that at least for the micro-enterprises. Another supporting argument is that research shows that certain micro-enterprises with no more than 5 employees (including the owners who are also employees, family enterprises, and so forth) tend to be faced with more serious issues than other kinds of companies at all stages in their development. Taxation conditions for authorisation holders could also be expanded to include micro-enterprises. To improve the situation of small businesses measures are needed in the entire system. Here are a few examples:

- Harmonise legislation
- Introduce a flat-rate tax applicable to small businesses
- Simplify accountancy
- Introduce a system of annual reporting
- Make registration as a VAT payer voluntary
- Create dedicated credit lines
- Actively finance the state programme for small businesses
- Grant authorisation holders the status of a small business
- Review tariff policies. Introduce zero customs duties for imports of raw materials that are not locally available
- Cut to 5-10 per cent the corporate profit tax to reduce the share of underground economy
- Unify or organise a reasonable information exchange scheme between government structures and economic operators. We suggest the establishment of a joint database to monitor all the paperwork submitted by economic operators to obviate the need for presenting the same document to several government agencies
- Recognise conformity certificates issued in other countries (EU), for example for imported equipment, so that a new certificate should not be required again in the Republic of Moldova. The Moldova standard functions should also be completed in order to prevent competing interests stemming from the double formal and implementation functions
- Complete the network of agreements on the avoidance of double taxation with countries in the region and with the EU
- Simplify customs clearance to a significant extent mainly by reducing the number of documents that are checked and by not having the same document checked twice or several times by various authorities
- Solve the VAT refund issue: Simplify the actual procedure, have fewer documents submitted, and comply with VAT refund deadlines
- Organise periodic meetings in the Republic of Moldova attended by investors, government officials, and international organisations to identify common problems in the private sector and to find solutions
- Smoothen the issuance of all the documents and certifications necessary to establish a business
- Significantly simplify work-permit awarding procedures to foreign specialists working in Moldova
- Continue to reduce the number of licences and extend their validity. Facilitate access to information regarding all particular aspects of a licence to improve transparency and deter bribery. Reduce the number of documents/authorisations needed to obtain a licence and limit the involvement of further ministries in the licensing process
- Abate bureaucracy and graft in government bodies (customs, tax inspection, business registration chambers, licensing authorities)
- Allocate own financial resources and international loans to infrastructure

development: National roads and railways, telecommunications, etc.

- Stimulate activity of the financial institutions to grant cheap loans to entrepreneurs
- Reduce the fee for obtaining a tourist visa to enter the Republic of Moldova from USD 360 per year to USD 50 and to USD 5 for a visa needed for a maximum of seven days

From the standpoint of an individual running a small business, the economic situation needs to be highly stable, and legislation should protect entrepreneurship. Economic, political, and financial stability are particularly important to small-business owners who represent the middle class that is now emerging in the Republic of Moldova. At the same time, small-business owners are aware of the precarious state of the economy, so they are now asking just to be left alone as long as they cannot hope for any kind of assistance from the government. Naturally, the current state of affairs requires a judicious regulatory policy to improve the business environment and foster entrepreneurship. The reality is, however, that entrepreneurs are about to be gradually put out of business by the cancellation of legal priorities and fiscal constraints, and small businesses tend to be more and more the subject of excessive and unjustified inspections, while enjoying incentives only on paper. The syndrome of the reverse effect and double-standard management still persist in the economic policy of this country.

### 6.6.1. Major issues

- Instability of legal and normative (regulatory) acts
- Excessive red tape
- Excessive controlling
- Fiscal pressure and ineffective tax administration
- Insufficient cash flow
- Limited access to funding
- Shortage of domestic and foreign investment
- Difficult access to markets, including foreign markets
- Persistent corruption
- Poor managerial skills and entrepreneurship culture
- Manifest aggressive monopolistic trends in the economy
- Faulty regulations
- Serious negative impact of legislation on the business environment

### 6.6.2. Imperative needs for the development of the SMEs

Improve the business environment by:

- Promoting a reform of the regulatory framework;
- Fostering and safeguarding competition;



- Optimising management and marketing;
- Supporting and helping SME growth;
- Promoting exports;
- Stimulating investment;
- Opening cheap subsidised credit lines;
- Granting freedom to businesses;
- Simplifying accountancy;
- Protecting lawful competition;
- Creating a free and consistent social and economic system, open to the business community and governed by objective market rules and the principle of personal responsibility;
- Shifting emphasis from excessive regulation to monitoring and assessing the actual impact of such regulations;
- Safeguarding the right of economic operators to lawful competition;
- Rejecting competition distortion and limitation and banning the abuse of dominant positions on the market;
- Helping growth and protecting competition through central and local public authorities;
- Developing a constructive dialogue between the government and the private sector;
- Facilitating access to financial sources;
- Improving the efficiency of SMEs by supporting the development of professional and managerial skills; and
- Creating a nationwide information and advisory network of resources for SMEs.

This is also verified by official statistics that, although they do not faithfully reproduce the genuine situation in the field, do nevertheless suggest a general deteriorating trend in the small-business sector.

The more elaborate the organisational and legal structure of small companies is, the more important the problems are. High percentages indicate that there are both initial and long-term problems that need solving. The first position is held by the limited-liability companies (31.6 per cent), the second by general partnerships (12.6 per cent), followed by limited partnerships (28.6 per cent) and holders of entrepreneur's authorisations (12.6 per cent). These indicators change when the legislation changes.

## 6.7. References

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3. Government Decision 850/27.06.2002 on the state programme for the support of small businesses for the period 2002-2005; Official Journal 96-99/954, 05.07.2002.
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# 7. Montenegro

by Ana Šebek

## 7.1. Brief historical introduction

The development of small and medium-sized enterprises represents the basic factor in every modern economy. Small and medium-sized enterprises stimulate private property and entrepreneurial capacities. They are flexible and can easily adjust to the change in supply and demand on the market. They create employment opportunities, promote the diversification of economic activity, support sustainable growth, and significantly contribute to exports and trade. The development of small and medium-sized enterprises is a complex challenge that involves several stakeholders with a direct interest in each sector of the state and economy.

The importance of small and medium-sized enterprises for the economy is beyond any doubt. All research shows that, globally speaking, over 90% of all jobs are performed in small and medium-sized enterprises. Small and medium-sized enterprises employ two thirds of the total labour force of the European Union.

Considering the fact that small and medium-sized enterprises represent an integral part of every country's economy, the undisturbed and fast development of this segment depends on the general social, political, and economic circumstances in each country.

The private SME sector in Montenegro has passed through two periods: The first embraces the whole post-war period until 1989, that is until the passing of the law on the performance of economic activities by personal work and means owned by citizens, the second following after the adoption of that law.

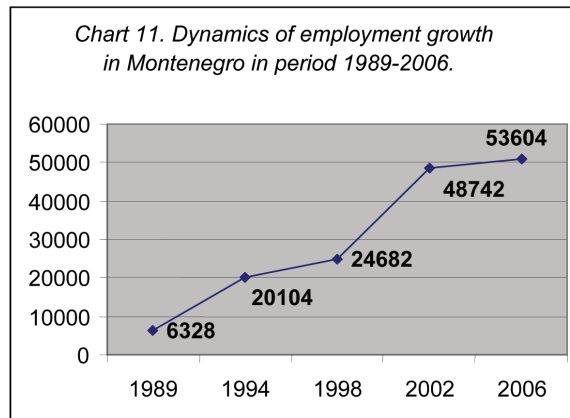
Until 1989, the period prior to the passing of the above-mentioned law, small and medium-sized enterprises in private ownership practically did not exist. This period was characterised overall by restrictive and unfavourable conditions for the development of SMEs. The following rule for the development of SMEs existed in this period: Only activities enumerated in the law were permitted. Besides that, in our economic theory, entrepreneurs and SMEs were treated as undesirable and not as one of the development factors. As a result of such an attitude, the law stipulated those activities where private initiative was permitted (catering, handicrafts, transport, and agriculture). The law also stipulated the limits up to which a private firm was permitted to grow (maximum of 5 employees, limited assets, limited arable area of 10 to 20 hectares). Not only was organised support lacking, but it was also attempted to limit the number of SME entities in various ways and restrict the development of the existing ones. Such a social status and regulation had consequences on the number and structure of SME units (the greatest part of SMEs were small handicraft shops and small catering units with not more than two employees).

After 1989 and the passing of the new law, the development of this sector started. The new law was very liberal regarding the list of activities permitted for entrepreneurs as well as costs and registration procedures. All of this, together with the growing economical crisis and the beginning of privatisation, increased the interest in private company registrations. From 1989 onwards, the number of SMEs increased rapidly from 36 units in 1989 to 769 units in 1990 (21 times more enterprises in just one year), going on to reach 5,328 in 1998 and 11,305 in 2006 (these figures only show the number of active enterprises, while the number of registered ones was more than double that). The number of sole-proprietorship units (entrepreneurs according to the law) increased in the same period (1989-1990) from 4,068 to 5,584, and to 5,514 in 1998 and 14,749 in 2006.

The data in following Table show the dynamics of SME growth.

Year	Number of active Enterprises	Entrepreneurs
1989	36	4,068
1990	769	5,584
1998	5,328	5,514
2006	11,305	14,749

The number of persons employed in the SME sector increased from 6,328 in 1989 to 24,682 in 1998 and to 53,604 in 2006.



In 2006, most SMEs existed in the trade and transportation sectors and in the processing industry.

## 7.2. Legal framework for SMEs and trade in Montenegro

The business environment in Montenegro has significantly improved over the past few years. Ninety-one laws have been adopted which, largely harmonised with EU standards, created a solid institutional set-up for encouraging investments and implementing the economic policy embodied in the strategic document of the government of the Republic of Montenegro, the Economic Reform Agenda. The most notable laws adopted in the past period are: The law on business organisations, the lien law, the law on business organisation insolvency, the law on the fiduciary transfer of property rights, the law on value-added tax, the law on accounting, the foreign-trade law, the customs law, the law on free zones, the competition protection law, etc.

Also, over the past few years Montenegro has implemented substantial institutional reforms in the key sectors, i.e. the fiscal system, the financial sectors, the payment system, the pension system, privatisation, the restructuring of enterprises, etc.

A large number of laws were adopted which aimed at contributing to a more transparent and efficient collection of budget revenues (excise tax law, law on tax on the profits of legal entities, real-estate tax law, law on value-added tax, law on withholding taxes due from natural persons, law on local-government financing, etc).

In mid-2004, the law on withholding tax due from natural persons underwent modifications (Official Gazette of the Republic of Montenegro, No. 37/04) whereby the rates of the withholding tax were reduced under the programme "Legalisation of existing and creation of new jobs". The reduction was carried out in two stages (from July 1 to December 1, 2004 by 5%, and from December 1 onwards by 10%). For entrepreneurs engaged in independent activity, additional tax breaks were introduced for investments (calculated taxes may be reduced by 50% of the investments made and up to 70% of the calculated taxes) and employment of additional workers.

The law to change and amend the law on retirement and disability insurance (Official Gazette of MN No. 39/04) and the law on health insurance (Official Gazette of MN No. 39/04) introduced cuts in the employers' contributions to retirement and disability insurance and to health insurance, which was realised in two stages (from July 1 to December 1, 2004 by 5%, and from December 1 onwards by 10%).

Towards the end of 2004, changes and amendments to the law on tax on the profits of legal entities were adopted (Official Gazette of MN No. 80/04), which included a reduction in the tax rate from 20% to 9% and extended the possibility of obtaining tax relief by investing in securities and employing new workers.

Towards the end of 2005, the law on value-added tax underwent modifications (Official Gazette of MN No. 76/05) whereby, in addition to the general rate of 17%, a reduced VAT rate of 7% was introduced for accommodation services in tourism.

The most significant reform in the financial sector has been the introduction of Euro, which resulted in inflation stabilisation. In the course of 2002 and 2003, a set of by-laws were adopted which enabled the enforcement of the above laws in practice. All the adopted laws and by-laws have been harmonised with EU legislation and internationally accepted standards. Privatisation is conducted in accordance with a privatisation plan adopted on an annual basis. The basic aim of privatisation is to enhance competitiveness and the functioning of society as a whole, to encourage foreign investments and entrepreneurship in all areas, and to increase employment and advance the standard of living.

### ***Laws and by-laws regulating the privatisation process***

Law on ownership and management transformation (Off. Gazette of MN No. 2/92 and 27/94)

Law on the privatisation of the economy (Off. Gazette of MN No. 23/96, 6/99 and 42/04)

Law on private-sector participation in the delivery of public services (Off. Gazette of MN No. 30/2002)

Decree on the privatisation plan for 2005 (Off. Gazette of MN No. 7/05)

Decree on the formation and composition of the Privatisation Council (Off. Gazette of MN No. 33/98, 24/99 and 48/03)

Order on the sale of stocks and property by public tender (Off. Gazette of MN No. 65/03)

Order on the sale of stocks and property by public auction (Off. Gazette of MN No. 20/04)

By 2005, around 80 % of the state property was privatised. Even though the business environment in Montenegro has significantly improved over the past few years, the environment entrepreneurs are operating in is still challenging, given the rather complicated legal and regulatory framework, the large and insufficiently transparent system of public administration, and the poor judiciary structure in Montenegro.

The lack of a balanced and predictable legal and regulatory framework for the establishment and operation of a company poses an obstacle to the development of

entrepreneurship in the relatively small market of Montenegro. Such complexity contributes to the challenges, risks, and growing operating costs in Montenegro. Therefore, some of the basic challenges Montenegro is faced with in the creation of an entrepreneurial society are harmonising the legal and regulatory framework for business operation, simplifying and reforming the procedures in all aspects of business operation, consistently implementing positive legal solutions, and providing a predictable business environment. Montenegrin small and medium-sized enterprises and entrepreneurs operate in an environment regulated by a unique legal framework for business operations which equally applies to other business entities. Thus, with the exception of the laws regulating the status of certain business entities treated as the SME sector, there is not a single systemic regulation referring specifically to SMEs. The specific nature of this sector is most frequently recognised by granting SMEs a more favourable position in certain areas of business operations, i.e. a milder treatment is applied to the SME sector. Entrepreneurs are generally poorly informed about the licensing procedure, and usually it is only after its initiation that they learn about the necessary documentation and fees payable for it. The licensing procedure is decentralised, rather complicated and leaves significant space for arbitrariness; approvals and orders are issued by a large number of bodies and institutions both at the local and the national level; the costs incurred for a license to operate are exceptionally high, and due to the above-mentioned reasons they may not even be precisely calculated in advance, i.e. they vary according to the type of activity and the documentation required for it; authority is given for numerous inspections by various regulations; finally, legal provisions referring to this area are found in a multitude of laws and by-laws and thus frequently overlap.

The number of taxes and other levies is still higher than the optimum. The deficiencies of the current state of affairs are particularly visible in the increasingly insignificant advantage of the low rate of the tax on profits of enterprises (9%), in the high rates of taxes imposed on employers, and in the wide range of fees and contributions that each business entity is faced with in its regular operation (mainly for services and infrastructure). The total burden of 1.05 Euro on each Euro paid in wages represents a powerful stimulus to the shadow economy. The figure includes contributions to the pension and disability insurance (PIO), the unemployment and health insurance, compulsory chamber of commerce and trade union dues, and withheld taxes. The employer pays contributions both on his own behalf and on behalf of the employee. There are also some additional payments stipulated in the General Collective Agreement.

However hard the state strives to regulate the performance of economic activities legally, place them on record, and levy taxes on them, there are always certain segments in which a larger or smaller volume of economic transactions dodges some of the regulations. This is particularly true of economies in transition. In Montenegro, too, the shadow economy appears in practically all the forms that are typical of economic systems in transition and underdeveloped economies. There are various forms of the shadow economy in Montenegro, the most frequent and widely present being the following: Illegal import and distribution of excise goods; circulation of transit goods on the domestic market; circulation of export goods on the domestic market; selling goods and services for cash without a record; high-interest money-lending beyond the legal framework (usury); withdrawing and keeping cash outside the regular payment system; privileged and illegal construction of buildings; non-registered employment; illegal timber felling; etc. Despite the evident novelties and positive solutions in labour market regulations, it is clear that this segment, in fact, represents a compromise between deregulation and repairing the damage inflicted on employees hit by the reforms.

Still, even if we disregard this compromise which is undoubtedly necessary in the current stage of transition, a set of elements remain which may be changed and which further complicate a market already burdened by procedures. (For example, when

the Employment Agency is involved as a mediator, the procedure itself is highly complicated and includes a whole set of forms, codes, and strict deadlines for announcing a vacancy. At the same time, there is no possibility of advertising online). Poor accessibility to loans granted by commercial banks substantially affects the development and growth of SMEs. High interest rates almost completely deny SMEs any periodical financial injections for advancing their business operations. In December 2005, loans granted to the private sector had a nominal interest rate of 10.24% to 12.68%.

In addition to this, the conditions a client of a bank needs to fulfil in order to receive a loan are highly demanding and vary from bank to bank. The set of documents (three as a minimum) which is necessary for an application requires much time and money, and what is particularly demanding in this respect is the preparation of a business plan and loan security, mainly in the form of fiduciary guarantees or mortgages.

What poses a special problem is the attitude of banks towards SMEs, which stems from the lack of a credit history (for new and relatively small enterprises), the lack of quality collateral (banks require collateral in urban areas at a value ratio of 2:1), and the lack of adequate financial reports – SME balance sheets chronically suffer from a capital deficit.

### 7.3. Institutions of self-administration of SMEs and trade in Montenegro

At the moment, several institutions are directly or indirectly involved in the development of SMEs. They are:

1. The Directorate for the Development of Small and Medium-sized Enterprises
2. The Development Fund
3. The Montenegrin Chamber of Commerce
4. The Employment Agency of Montenegro
5. Other institutions/organisations:
  - Union of Employers of Montenegro
  - Center for Entrepreneurship and Economic Development (CEED)
  - Montenegro Business Alliance (MBA)

#### **1 Directorate for the Development of Small and Medium-sized Enterprises**

The government of the Republic of Montenegro established the Directorate for the Development of Small and Medium-sized Enterprises on December 1, 2000.

The basic tasks performed by the Directorate for the Development of Small and Medium-sized Enterprises relate to several aspects of support for the development of entrepreneurship and SMEs:

- Defining a strategy of development for small and medium-sized enterprises;
- Preparing and realising programmes and projects for small and medium-sized enterprises;
- Coordinating programmes, measures, and activities related to the development of small and medium-sized enterprises;

- Monitoring the realisation of financial support programmes for the development of small and medium-sized enterprises, including foreign financial support allocated for their development;
- Providing expert assistance and participating in the preparation of regulations related to the development of small and medium-sized enterprises, particularly those aiming to achieve goals and standards set by the European Union for the development of small and medium-sized enterprises;
- Exploring the impact of legal and other regulations on the development of small and medium-sized enterprises;
- Preparing programmes for the education of entrepreneurs;
- Creating projects and managing the organisation of regional and local centres for the support of the development of small and medium-sized enterprises; and
- Proposing and ensuring the realisation of special programmes for encouraging the development of small and medium-sized enterprises (fostering the development of franchising, leasing, venture capital, techno-economic parks, incubators, etc).

The Directorate for the Development of Small and Medium-Sized Enterprises performs the institutional role in the support of small and medium-sized enterprises through a network of regional/local business centres.

The primary aim of this project is to support the development of small and medium-sized enterprises and entrepreneurship by creating an institutional network at the local and regional level. One of the objectives is to diminish regional differences by ensuring adequate support for the development of small and medium-sized enterprises at the local and regional level, as well as by providing the information necessary for refining the government's policy and strategy in this area.

The establishment of regional/local business centres offers citizens all necessary information about how to set up an enterprise, assistance in access to banks, assistance in the development of business plans and feasibility studies, and any other relevant and practical information and advice. In practice, this should be made a short-term goal of the centres. Providing support and assistance to small and medium-sized enterprises in their growth and development, transforming micro- into small and small into medium-sized enterprises, i.e. fostering their growth and development as a contribution to the overall economic development of the country, may be designated as long-term goals. Finally, what may certainly be designated as the strategic goal is to enhance the environment in which small and medium-sized enterprises operate, and to increase the level of their competitiveness.

In the period from 2002 to November 2006, the Directorate for the Development of Small and Medium-sized Enterprises provided, in cooperation with commercial banks, financial assistance to SMEs through the following development projects:

- "Increasing the competitive capacity of local enterprises"
- "Youth in business"
- "Incentives for entrepreneurship"

The above-mentioned projects were implemented in order to improve competitiveness and the use of local resources (natural, production, and human resources), promote entrepreneurship, create new employment, and stimulate exports.

Credit lines under the projects mentioned were implemented in cooperation with the commercial banks, and they made the final decisions about approving funds under favourable credit conditions (average interest rate of 5%, repayment period up to 5 years, and a grace period of 12-18 months).



The total number of projects supported was 138, with a total value of € 8,877,900. With the implementation of these credit lines, a total of 533 new jobs were created.

*Table: Overview of credit support by the Directorate for the Development of SMEs 2002 - November 2006*

Project	No of Projects	No of Emil. Persons	Project Value ( € )
Increasing the competitive capacity of local enterprises	54	267	6,201,000
Youth in business	2	2	50,000
Incentives for entrepreneurship	82	264	2,626,900
TOTAL*	138	533	8,877,900*

Source: Directorate for the Development of SMEs

\*Figure is not final – the project is still ongoing

## **2. Development Fund**

The Development Fund of the Republic of Montenegro was established in 1995 in the process of transforming ownership and management in Montenegro's economy.

The Mission of the Fund is to foster economic growth in the Republic of Montenegro through the development of private businesses and promotion of entrepreneurship; ownership and management restructuring of enterprises and the national economy in general; and the development of the capital market and a corporate culture.

The basic goals of the Fund are:

- The privatisation of Montenegro's economy;
- Greater efficiency in corporate dealings;
- The creation of a favourable environment for investments by local and foreign partners;
- Integration in international economic and financial institutions; and
- Increasing the national income and enhancing the living standard of Montenegro's citizens.

The results shown so far in the process of transforming ownership on the one hand and supporting investments in profitable projects on the other place the Development Fund of the Republic of Montenegro among those institutions that play a decisive role in the future sustainable development of the country.

In the period from 2002 to November 2006, a total of 301 SME projects were financed through the good offices of the Development Fund, with a projected value of € 118.4m in which the share of the Fund was € 21.46m. 2,254 new jobs were created under these projects. Loans were placed through the commercial banks at interest rates of 5-10% annually, with a repayment period of 4 years and a period of grace of 12-18 months.

Table: Overview of credit support provided by the Development Fund 2002 - November 2006

Year	No of Projects	Projected Value €	Share of the Development Fund €	No of Jobs
2002,	34	8,750,000	1,730,000	440
2003,	72	25,800,000	4,360,000	700
2004,	37	17,150,000	2,430,000	260
2005,	37	10,100,000	2,,340,000	159
No- vember 2006	121	56,600,000	10,600,000	695
TOTAL	301	118,400,000	21,460,000	2,254

Source: Development Fund of Montenegro

### 3. Montenegro Chamber of Commerce

The Montenegrin Chamber of Commerce is an independent, business, professional, and interest organisation of enterprises, banks and other financial organisations, insurance organisations, and entrepreneurs doing business in the territory of Montenegro. The Montenegrin Chamber of Commerce is a member of ABC (Association of Balkan Chambers) and the Association of Adriatic-Ionic Chambers of Commerce.

Within the Montenegrin Chamber of Commerce there are 11 associations including the Association of Small Enterprises and Entrepreneurs with the following tasks: Monitoring and analyzing economic trends and proposing measures to improve the operating conditions of members; considering and giving expert opinions on draft laws and bills and other regulations concerning the economic system, economic and monetary policies, and development about their impact on working conditions; cooperating in the preparation of measures of economic policy and development strategy related to the activity of the association; promoting the establishment of business connections between business entities, the development of cooperative relations, and specialisation in the country and abroad; keeping up with global achievements in the field of technical and technological development in certain economic sectors and applying them in the country; cooperating on standardisation with the competent state bodies; applying domestic and international technical standards and norms; taking part in the development of mechanisms to protect domestic production; mounting initiatives and proposing measures to eliminate monopolies on the domestic market and taking part in the development and application of relevant collective agreements.

Successful cooperation has been established and maintained with the competent state bodies, chambers, and associations concerned with the development of entrepreneurship on the whole. To assist in the development of small enterprises and entrepreneurs, the Montenegrin Chamber of Commerce concluded a cooperation agreement with the Crafts Chamber of Koblenz in the beginning of 2002.

In addition to this, the Montenegrin Chamber of Commerce actively participated in the organisation of seminars, conferences, round-tables, forums, etc. in the period from 2002 to June 2006 and organised public hearings on certain laws of interest to its members.

### 4. Employment Agency of Montenegro

The Employment Agency performs a public service aimed at satisfying the needs of employment in the territory of Montenegro. It is linked to the Ministry of Labour and Social Welfare and to the national fund of the retirement and disability insurance. The Employment Agency of Montenegro is a legal entity organised as a public service agency.

The Employment Agency of Montenegro influences the functioning of the labour market through the following activities:

- Researching the labour market;
- Acting as a mediator in the employment process;
- Counselling and informing employers and unemployed persons about employment possibilities;
- Keeping records in the field of employment;
- Ensuring insurance rights by virtue of unemployment;
- Organising the training and education of unemployed persons;
- Providing career orientation, information, and guidance to professional staff and developing methods for career orientation;
- Preparing the analytical, planning, and information basis for proposing and defining the employment policy;
- Preparing and implementing measures of active employment policy;
- Adjusting the information system to reflect changes on the labour market and ensuring public information; and
- Studying the development and nomenclature of professions.

The Employment Agency of Montenegro has been stimulating the development of small and medium-sized enterprises since the time when the importance of small and medium-sized enterprises for the development of the economy began to be understood. Its projects are:

1. Self-employment programme
2. 14 credit lines programme

The programme for a continuous encouragement of employment and entrepreneurship in Montenegro, better known as the self-employment programme, has been implemented by the Employment Agency of Montenegro since February 1999. The basic goal of the self-employment programme is to create a system for the continuous encouragement of employment and entrepreneurship in order to mitigate the unavoidable negative impact of the reform processes, enable the development of entrepreneurship and the establishment of new and the development of existing SMEs, thus supporting the reduction of unemployment, faster economic development, and the economic structure in the Republic. Through this programme, credits are given under favourable conditions (interest rate 3% annually, grace period of one year, repayment period of 3 years for individuals and 2 years for legal entities, loans to be repaid in semi-annual instalments).

From 2002 until the end of November 2006, there were 7,721 credit applications for the self-employment programme, permitting the projected creation of a total of 12,804 new jobs. The value of these projects is € 38,390,960. On January 28, 2004, the government of the Republic of Montenegro signed an agreement with six banks on the implementation of projects within the programme of 14 credit lines. The value of these credit lines is approximately € 13.2m. The project was implemented by the Employment Agency.

The credit lines represent incentives to employ unemployed persons, and there were a number of credit lines for specific activities. There were 659 projects approved in total, which provided employment for 1,472 workers. The total value of approved credit funds was € 10,090,945.

*Table: Overview of credit support through the self-employment programme and the 14 credit lines programme*

Programme	No of Projects/ Applications for Credit	Project Value	No of Jobs
Self-employment Programme	7,721	38,390,960	12,804
14 credit lines Programme	659	10,090,945	1,472
<b>TOTAL</b>	<b>8,380</b>	<b>48,481,905</b>	<b>14,276</b>

**Source: Employment Agency**

## **5. Other institutions/organisations**

### *Union of Employers of Montenegro*

The Union of Employers of Montenegro was founded on April 8, 2002. In December 2003, a professional department of the Union was established for the support of small and medium-sized enterprises, which provides:

- Free legal advice,
- Free creation of web presentations,
- Interconnection between SMEs,
- Discounts among SMEs, and
- Connections between SMEs and foreign partners.

The Union of Employers has signed 17 partnership and cooperation agreements with domestic and international institutions and formed the Association of Crafts and Small and Medium-sized Enterprises. It has also adopted the Declaration on the Competitiveness of the Montenegrin Economy. As regards legislation, the Union of Employers has participated in the development of a number of draft laws and in the work of a number of boards (board for monitoring and interpreting the collective agreement), working groups (for the development of the strategy of cooperation between NGOs and the government of Montenegro), and councils (Statistical System Council). The Union has also taken part in the realisation of several projects in cooperation with the government of Montenegro, the EAR, and the CRNVO.

In cooperation with the government of Montenegro and the EAR, the Employment Agency has organised a number of round-tables, seminars, workshops, and training courses for SMEs.

### *Center for Entrepreneurship and Economic Development (CEED)*

The Center for Entrepreneurship and Economic Development (CEED) is the first non-governmental, non-political, and non-partisan organisation in Montenegro. It was founded in 1993 within the Faculty of Economics as an incentive for young people to stay in Montenegro. In 1998, the CEED became independent of the Faculty but nonetheless maintained strong ties with academia. The CEED's strategic partner is the CIPE in Washington. The service activities of the CEED aim at supporting the development of small and medium-sized enterprises through research and analyses, recommendations for policy-making, publishing, and consultancy.

### *Montenegro Business Alliance – MBA*

The Montenegro Business Alliance is an organisation founded in September 2001 with the aim to develop the private sector and a free market in Montenegro. The Montenegro Business Alliance comprises nearly 500 members which employ over 15,000 workers and generate over 30% of the GDP of Montenegro. Within the activities aimed at changing the business environment, the Montenegro Business Alliance was the first organisation to publicise its business agenda in which it presented its efforts to alter the business environment and to represent the interests of the private sector in Montenegro as best it could. Also, the Montenegro Business Alliance participated in the development of a large number of laws and launched a large number of initiatives.

As an organisation, the MBA is recognised by the government of the Republic of Montenegro and its ministries as well as by the representatives of foreign organisations in Montenegro and abroad, such as the World Bank, the MMF, USAID, etc. Additionally, the Montenegro Business Alliance has signed a protocol of cooperation with the assembly of the Republic of Montenegro, and an MBA representative is a member of the Board of Economy, Finance and Environmental Protection.

## 7.4. The role of SMEs and trade in Montenegro

The importance of small and medium-sized enterprises for the economy is beyond any doubt. All research shows that, globally speaking, over 90% of all jobs are performed by small and medium-sized enterprises. Small and medium-sized enterprises employ two thirds of the total labour force of the European Union. Convergence with the European Union involves harmonising the system environment and improving the entrepreneurial climate, private initiative, and the development of small and medium-sized enterprises. This commitment is based on current global processes that support exactly the development of small and medium-sized enterprises because of their profitability and their proven adaptability to the dynamic changes in the economy.

Some general indicators may be quoted here to illustrate the development of SMEs in Montenegro.

There are several sources of data for monitoring the number of companies in Montenegro and in the SME sector as well as the number of persons employed by them:

1. The central register of the commercial court,
2. The Statistics Agency, Monstat,
3. The Fund for Health Insurance of the Republic of Montenegro,
4. The Tax Administration, and
5. The Pension and Disability Insurance Fund (Fund PIO).

These institutions use different criteria to monitor registered companies as well as the categories of SMEs and the number of their employees.

We will use only data from first three institutions.<sup>1</sup>

Table: Number of registered companies and entrepreneurs 2002-June 2006

Year	Registered Companies*	Entrepreneurs**
2002	13,401	11,020
2003	12,997	12,132
2004	14,761	13,152
2005	16,575	13,953
2006	17,793	14,749

From the data used, we may conclude that the number of registered companies has continuously increased in the period 2002- 2006. The number of registered companies has increased from 13,401 in 2002 to 17,793 in 2006, i.e. by 4,392 or 32.77%. In the same period, the number of entrepreneurs similarly increased by 33.83%, that is, from 11,020 in 2002 to 14,749 in September 2006.

Table: Number of active SMEs (entrepreneurs and MSME) 2005-September 2006<sup>2</sup>

Year	Entrepreneurs	%	Micro-enterprises	%	Small Enterpr.	%	Medium-sized Ent..	%	TOTAL
2005	4,668	42.83	1,526	14.01	2,108	19.34	2,597	23.83	10,887

1 Data from Monstat and the CRCC have been used in the overview of registered companies and entrepreneurs.

The central register of the commercial court monitors all registered companies in Montenegro from the aspect of their organisation but does not monitor specifically the category of SMEs.

Monstat monitors all registered companies categorised by form of organisation but not the category of SMEs as such.

The criterion for the definition and monitoring of SMEs that is used by the Health Fund is number of employees. Based on that criterion, this institution generates overviews of SMEs that include entrepreneurs and/or micro-, small, and medium-sized enterprises (MSMEs).

\* Monstat's register tracks economic entities (except for entrepreneurs), business associations, state authorities, political organisations, social organisations, institutions, cooperatives, and associations of citizens. However, Monstat has no record of entrepreneurs or employee numbers, so that the category of SMEs is not monitored.

The exclusion of certain sectors from the register (state authorities, judicial authorities, local self-government units, political organisations, social organisations, associations of citizens, and institutions) yields an overview of the number of registered companies.

\*\* The number of entrepreneurs in 2002 and 2003 is taken from the project "Information basis on SMEs in Montenegro" which is based on CRCC data. The project was implemented by the Directorate for the Development of SMEs, Monstat, and the Faculty of Economics. The number of entrepreneurs for 2004, 2005, and September 2006 was supplied by the CRCC.

2 The criterion for the definition and monitoring of SMEs that is used by the Health Fund is number of employees. Based on that criterion, this institution generates overviews of SMEs that include entrepreneurs and/or micro-, small, and medium-sized enterprises (MSMEs).

This involves active companies defined as companies that regularly pay contributions to health insurance and taxes (VAT, personal income tax, profit tax). As accounts do not contain a standard record of financial turnover, the criterion for the definition of active companies that was used is the regular payment of taxes and contributions.

IX 2006	4,771	42.20	1,574	13.92	2,220	19.64	2,740	24.24	11,305
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According to the data from the **Health Fund**, the total number of **active** SMEs (entrepreneurs and MSME) was **10,887** in **2005**.

In the SME structure, the highest percentage goes to entrepreneurs (4,668 or 42.83%) and medium-sized enterprises (2,597 or 23.83%). The total number of small enterprises is 2,108 (19.34%), while micro-enterprises have the smallest percentage in the structure (14.01% or 1,526).

In the first **nine months of 2006** there have been no significant changes. The total number of SMEs is **11,305**, and the structure is almost the same – entrepreneurs hold 42.20% (4,771), micro-enterprises 13.92% (1,574), and small and medium-sized enterprises 19.64% (2,220) and 24.24% (2,740), respectively.

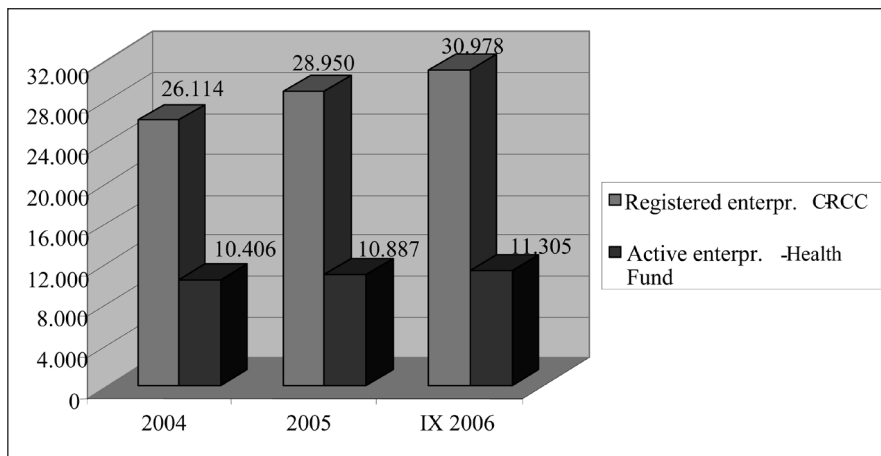
To compare the number of active SMEs with the number of registered enterprises, we have used data from the Health Fund for 2004, 2005, and September 2006 as well as CRCC data for the same period.

*Table: Share of active enterprises in the total number of registered ones 2004, 2005 and September 2006*

Year	Registered Enterprises	Active SMEs	Share of Active SMEs in the Total Number of Registered Enterprises
2004	26,114	10,406	39.84%
2005	28,950	10,887	37.60%
VI 2006	30,978	11,305	36.49%

It is obvious that the number of active enterprises increased in the observation period from 10,406 in 2004 to 11,305 in September 2006, which represents an increase of 8.63%. In the same period, the number of registered companies increased by 18.62%. However, the share of active registered enterprises in the total has gone down, which may be due to a higher rate of growth in the number of registered companies or the fact that the CRCC monitors all registered enterprises in Montenegro and does not delete the companies that are closed down, so that the figures used for comparison are relatively high.

*Graph: Share of active enterprises in the total number of registered ones 2004, 2005 and September 2006*



To monitor the structure of enterprises by type of activity, we used data from Monstat and the Health Fund. If we look at the structure of enterprises by type of activity, we may conclude that, according to the Monstat data for the period from 2002 to June 2006, most of the registered companies worked in trade (55%-51%), the processing industry (12%-13%), transport, warehousing, and communications (7%-8%), with the lowest number dealing in financial brokerage (0.5%-0.6%), mining and quarrying (0.35-0.34%), and energy and gas production (0.19%).

*Table: Number of registered enterprises by type of activity 2002-June 2006*

Year	Total	Agriculture, Forestry and Water Manag.	Fisheries	Mining and Quarrying	Processing Industry	Production of Electricity, Gas and Water	Civil works	Wholesale and Retail	Hotels and Restaurants	Transport, Warehousing and Communications	Brokerage	Real Estate, Rentals and similar	Health and Social Work	Other communal social & individual service activities
2002	13,401	270	44	47	1,672	26	573	7,395	909	986	68	893	218	300
2003	12,997	258	38	46	1,626	23	557	7,166	889	949	67	868	213	297
2004	14,761	293	48	50	1,846	28	637	7,924	1,125	1,090	67	1,058	249	346
2005	16,575	312	52	56	2,010	34	758	8,626	1,356	1,255	96	1,338	287	395
2006	17,793	331	56	56	2,094	34	874	9,020	1,496	1,364	109	1,661	291	407

According to the **Health Fund** data for **2005**, most of the active SMEs (entrepreneurs and MSMEs) work in wholesale and retail and repairs (4,144 or 38.06%), transport and warehousing (1,626 or 14.94 %), the processing industry (1,413 or 12.98%), while the lowest number of entrepreneurs and MSMEs work in brokerage (111 or 1.02%), mining and quarrying (34 or 0.31%), and fisheries (22 or 0.20%).

As compared to the end of 2005, the number of enterprises at the end of September 2006 was higher by 418.

As the enterprise structure by type of activity did not change, the highest number of active SMEs (entrepreneurs and MSMEs) still work in wholesale and retail and repairs



(4,311 or 38.13%), transport and warehousing (1,652 or 14.61 %), the processing industry (1,427 or 12.62%), hotels and restaurants (1,254 or 11.09%), while the lowest number of SMEs (entrepreneurs and MSMEs) work in electricity, gas and water generation and supply (42 Or 0.37%), mining and quarrying (33 or 0.29%), and fisheries (26 or 0.23%).

Table: Number of active SMEs (entrepreneurs and MSMEs) by type of activity 2005 & Sept.2006

Year	Total	No Activity	Agriculture, Forestry and Water management.	Fisheries	Mining and Quarrying	Processing Industry	Production of Electricity, Gas and Water	Civil Works	Wholesale and retail	Hotels and Restaurants	Transport, Warehousing and Communications	Brokerage	Real Estate, Rentals, and similar	Health and Social Work	Other Communal Social & Individual Services
2005	10,887	142	164	22	34	1,413	42	335	4,144	1,239	1,626	111	958	117	540
2006	11,305	149	164	26	33	1,427	42	368	4,311	1,254	1,652	117	1,072	123	567

The structure of enterprises by type of activity in both sources shows that the highest number of active SMEs work in trade, transport, and industry.

When analysing the current situation and the trends in the labour market, one should have in mind that existing records on employment and unemployment, official and unofficial, derived or defined in research, projected or assessed in Montenegro still vary significantly, depending on the source. So if the data on employed and unemployed persons in Montenegro provided by Monstat, the Health Fund, and the Employment Agency were corrected and objectively presented on the basis of the above-mentioned elements (illegal work, "uninsured" farmers, etc), the number of truly employed persons in Montenegro would be over 200,000, and the number of unemployed would be approximately 30,000.

Table: Number of persons employed by SMEs (entrepreneurs and MSMEs) in the period 2002 – August 2006

Year	Total	No of Persons Employed in SMEs (Entrepreneurs and MSMEs) <sup>3</sup>	Share of SMEs (Entrepreneurs and MSMEs) in the Total Number of Employed Persons in %
2002	113,827	30,861	27.11
2003	111,968	48,174	43.02
2004	143,479	52,600	36.66
2005	145,479	52,485	36.08
August 2006	154,699	53,604	34.65

Source: Monstat, "Enterprises in Montenegro by Size in 2003", Employment Agency, Health Fund

According to the **Monstat** data, the average number of persons employed in Montenegro in August 2006 was 154,699. The number of employed persons in the period

from 2002 to August 2006 shows a tendency to grow; it increased by 40,872 persons or 35.9%. The number of employees in SMEs (entrepreneurs and MSMEs) also increased significantly, from 30,861 in 2002 to 53,604 in 2006, which is a 73.7% increase. The share of SMEs (entrepreneurs and MSMEs) in the total number of employed persons in all these years similarly tended to grow, increasing from 27.11% in 2002 to 34.65% in August 2006. To analyse in greater detail the structure of employed persons in SMEs in 2005 and 2006, we have used the overviews prepared by the Health Fund.

In 2005, according to the data from the **Health Fund**, there were 52,485 persons employed by SMEs (entrepreneurs and MSMEs). In the first 9 months, of 2006 this number increased by 1,119 to 53,604 persons.

**Health Fund data suggest that in 2005**, out of the total number of 52,485 persons employed by SMEs (entrepreneurs and MSMEs), the highest number are employed by medium-sized (27,815 or 52.98%) and small enterprises (13,080 or 24.91%). Entrepreneurs employ 7,707 (14.68%), while the lowest number is employed by micro-companies (3,899 or 7.43%).

In the first **9 months of 2006**, most of the total of 53,604 persons employed in the SME sector were still employed by medium-sized (27,986 or 52.21%) and small enterprises (13,634 or 25.43%). Entrepreneurs employ 8,025 persons (14.97%), while the lowest number is employed by micro-enterprises (3,959 or 7.39%).

*Table: Number of persons employed by SMEs (entrepreneurs and MSMEs) 2005 and September 2006*

Year	Entrepreneurs	%	Micro-enterprises	%	Small Enterpr,	%	Medium-sized En,	%	TOTAL
2005	7,707	14.68	3,899	7.43	13,080	24.91	27,815	52.98	52,485
Sept. 2006	8,025	14.97	3,959	7.39	13,634	25.43	27,986	52.21	53,604

*Source: Health Fund*

The number of persons employed by SMEs (entrepreneurs and MSMEs) **by type of activity** is derived from the overview of the Health Fund.

Under that aspect, out of the total number of 52,485 persons employed by SMEs (entrepreneurs and MSMEs) in 2005, according to the data of the **Health Fund**, the greatest proportion works in wholesale and retail and repairs (14,498 or 27.62%), the processing industry (12,363 or 23.56%), transport, warehousing, and communication (6,036 or 11.50%), and hotels and restaurants (4,432 or 8.44%), while the smallest share is employed in health and social work (784 or 1.49%), mining and quarrying (311 or 0.59%), and fisheries (87 or 0.17%).

**In the first 9 months of 2006**, out of the total number of 53,604 persons employed by SMEs (entrepreneurs and MSMEs), the greatest proportion was similarly employed in wholesale and retail and repairs (15,718 or 28%), the processing industry (11,258 or 21.00%), transport, warehousing, and communication (6,017 or 11.22%), and hotels and restaurants (4,595 or 8.57%), while the smallest proportion worked in health and social work (816 or 1.52%), mining and quarrying (318 or 0.59%), and fisheries (180 or 0.34%).

Year	Total	No Activity	Agriculture, Forestry and Water Main.	Fisheries	Mining and Quarrying	Processing Industry	Production of Electricity, Gas and Water	Civil works	Wholesale and Retail	Hotels and Restaurants	Transport, Warehousing and Communication	Brokerage	Real Estate, Rentals and similar	Health Sector and Social Work	Other Communal Social & Individual Services
2005	52,485	1,031	1,902	87	311	12,363	2,459	2,145	14,498	4,432	6,036	1,139	3,793	784	1,505
2006	53,604	1,022	1,993	180	318	11,258	2,498	2,230	15,718	4,595	6,017	1,154	4,052	816	1,753

## 7.5. Supporting SMEs and trade in Montenegro as a step to create a social market economy

There is no doubt that small and medium-sized enterprises recently played a very important role in the overall societal and economic development of Montenegro, especially in solving the unemployment issue. However, that growth and development must not be exaggerated. Much of everything that happened in the SME sector is due to transfers from the public sector and other specific conditions and circumstances that stimulated this development, so we should not be too optimistic. The real picture of SME development appears if we drop these effects and take a look at the net effects of own resources. The government should do much more in the institutional, organisational, financial, and other fields, to improve results.

In view of the great importance of SMEs in the social and economic development of any country, the fact that the creation, management, and growth of firms represents a difficult and risky task, and that small firms (just because they are small, with limited personnel, funds, and knowledge) find themselves in an unfavourable position compared to large enterprises, all governments of developed market economies have an elaborate, special system of support by which they „polish“ general conditions on the market and bring SMEs approximately in the same line with large firms. These measures are undertaken from the national to the local level. In fact, the countries with the most developed SME sectors have the longest tradition, the most detailed system of support, and the most developed network of institutions supporting SMEs.

Because of this, this issue is now much more appreciated at the government level, so that organised measures, programmes, and support mechanisms were initiated at the national, local, and international level. SMEs support measures today are much wider and more sophisticated, in modern as well as in former socialist economies. But it is the market economies that have the most comprehensive support system and institutional network. As is well known, the SME sector consists of a large number of very different firms with very different growth potentials and different needs for support.

In the first stages of development, when SMEs operate on a local market and cover local needs, assistance with resources, information, personnel, and technology is needed much more than by those who are emerging on the international market. In that sense, constraints are more severe (resources, skilled labour, information) in the production and high-technology sectors than in the service sector and other traditional branches. Also, constraints will be more severe in a country at a lower stage of cultural and economic development.

Montenegro has significant resources for development of small and medium-sized enterprises (this report covers potentials without making recommendations for their development). By implementing adequate measures for each development potential, Montenegro, without exaggerating, could be one of the leading countries in the region. A brief description of the resources mentioned (natural, production, and human resources; market potential) will be given below.

### *Natural resources*

Natural resources represent a significant potential for the development of Montenegro. Even though these resources impact the creation and development of SMEs only indirectly, they are significant as general industrial resources and a basis for overall industrial development. The most important natural resources include agricultural resources, forest and water potentials, tourism potentials, and maritime activities.

### *Agriculture, forestry, water resources*

In addition to the basic preconditions for the development of agriculture (agricultural land), Montenegro has numerous comparative advantages:

- Favourable climatic conditions for specific crops ranging from olive and citrus-growing in the littoral through early vegetables and other cultivation-intensive crops in the central area (Zeta-Bjelopavlići valley) to animal husbandry in large mountain areas in the northern part of the Republic;
- Largely unpolluted land, water, and air, which enables Montenegro to promote organic agriculture more intensely;
- Significant unused terrains of cultivable land as well as terrains where it is possible to increase production per land unit significantly without endangering resources; and
- The existence of a market with local and tourist demand, while numerous specific Montenegrin products potentially have good placement possibilities on foreign markets.

The available agricultural resources permit producing high-quality, recognisably Montenegrin products, especially meat, milk, and dairy products, honey, fish, vegetables, fruits. Distinctive crops such as forest fruits (blueberry, edible fungi, etc.) as well as indigenous medicinal herbs (especially sage) grow on this terrain as well. The most important qualitative feature is naturally clean water (measured by the most severe global standards). The wealth of potable water is still poorly utilised, even though a couple of factories for the production of bottled water were founded in recent years. The freshwater lakes and rivers of Montenegro are rich in trout, carp, and bleak, while the sea has an enormous potential of blue fish (anchovies, sardines, and other species). Forests and forest land cover 720,000 hectares and occupy 54% of the territory of the Republic, mostly (572,000ha) in the northeast part. The total timber mass is estimated at 72m cubic meters, of which 29.5m (41%) are conifers and 42.5m (59%) are deciduous. The total increment is estimated at 1.42m cubic meters.

### *Tourism potential*

Montenegro is an ecological state. On the basis of that, it holds a top position on tourist maps. A large number of sunny days during the summer months and a large quantity of snow in winter determine the two forms of tourism in most represented Montenegro: Maritime – summer and winter – and recreational. The fact that in one day you can sunbathe on the beaches and ski on attractive ski slopes is what makes Montenegro an exceptional geographic region. The length of the seacoast is 294km, while the length of beaches is 73km.

Four national parks are located in Montenegro: Durmitor – 39,000 ha; Lovćen – 6,400 ha; Biogradska gora – 5,400 ha; and Skadar lake – 40,000 ha. Significant resources for the development of hunting, fishing, religious, and rural tourism exist as well. Specifically, there are attractive conditions for the development of agro-tourism and extreme tourism (extreme sports).

### *Maritime activities*

Due to its comparatively advantageous natural resources and well-developed material base as well as its overall effects, the maritime industry is significant for the development of the overall industry of Montenegro and represents one of the priori-

ties in this regard. The main entities of the maritime industry are: The ports of Bar, Kotor, Zelenika, and Risan, the Adriatic Shipyard of Bijela, the Ship Repair Institute (Remontni zavod), the Barska plovidba, Nimont, and various shipping companies.

#### *Production resources*

##### *Industry*

Industry is mostly based on existing resources, and the integrated mining-energy-smelting production chain has the largest share in it. Existing resources provide a basis for a much more developed processing industry than the existing one. The structure of the industry base also includes metalworking, mechanical engineering, wood processing, textiles and chemicals, leather and footwear, clothing, household appliances, construction and forest machinery, and significant construction capacities. Montenegro has significant industrial capacities for processing and finishing agricultural products: Butcheries, fish-processing factories, grain mills with silos, dairy plants, bakeries, beer and juice factories, fruit-processing factories, vineyards and wine cellars, medicinal herbs, factories for the production of cigarettes and confectionary products, coffee-processing, etc.

##### *Wood processing*

The volume and the structure of the raw material (613,032m<sup>3</sup> of gross timber mass, 311,702m<sup>3</sup> of industrial lumber) indicate that there is a significant potential for more and faster development in the coming period. Considering that the large wood-processing industrial complexes inherited from the period of socialism have collapsed, the future of this sector will rely on the growth and development of SMEs. Unfortunately, the products most represented in wood processing are of low processing depth, so that investments in advanced processing phases and furniture production should be highlighted.

##### *ICT*

The development and application of information and communication technologies is of significant importance for the development of SMEs in all sectors as well as for the development of the IT sector itself, especially software services. Even though the general level of development in Montenegro is low, we may discuss potentials for development in this sector on the basis of the following indicators:

According to two mobile-telephone operators, Monet and ProMonte, there are a large number of mobile-telephone users (95% and even 107%, depending on the season). Such penetration can only be found in the highly-developed countries of Western Europe. There are 130,000 Internet users (19% of the population). According to some studies, actually 40% of households own a PC.

##### *Human-resources potential*

The SME sector is characterised by a lack of trained and experienced personnel compared with SMEs in developed countries. By and large, the education system does not cover entrepreneurship, even though in recent years this problem has been addressed with greater care, and there are plans to introduce entrepreneurship as a mandatory subject in elementary, secondary, and university education. Inadequacies in the education system lead to a lack of motivation among young people to tackle entrepreneurship and start their own business activity. Furthermore, managers of existing SMEs are oriented towards traditional production lines with a very low productivity and low levels of technology and innovation. In the future, the development of the SME sector should rely on a growing input of knowledge as basic resource.

### *Market potential*

The demand for products and services forms the basis for the establishment, growth, and development of SMEs. Their market potential reflects the overall level of consumer society development on the one hand, and the level of development and intensity of industrial cooperation on the other. Considering the size of the Montenegrin market and its absorption capabilities, it is clear that the goods and services produced are mostly destined for the domestic market and cannot serve as a basis for accelerated growth. It is necessary to influence the increase of competitiveness among domestic producers on the domestic market, and to offer incentives to induce them to place their products on other markets as well. Greater competitiveness is the result of clustering, strategic subcontracting, the introduction of ISO quality standards, organisational and technical-technological innovation, etc.

*A Montenegrin entrepreneurship society* is the key vision of Montenegro of the strategy for the development of small and medium-sized enterprises 2007-2010 (draft version) developed by the Directorate for the Development of SMEs. The key conditions that have to be provided are: Elimination or reduction of business barriers to the lowest possible level; provision of a quality education system; introduction of entrepreneurship from elementary schools to universities; creation of a system of support institutions; assurance of macro-economic stability.

### **Mission**

The mission is to create a business environment favourable to the development of a competitive sector of small and medium-sized enterprises in order to consolidate economic development and macro-economic stability and increase the standard of living.

The main goals for the development of SMEs are:

- Increase the number of SMEs
- Increase the SMEs' share in overall employment
- Increase the SMEs' share in export (competitiveness, internationalisation)
- Increase the SME's share in the GDP

Operational goals

- Create an incentive environment for the development of SMEs; eliminate business barriers
- Regulate the system of statistical monitoring for the SME sector
- Strengthen the institutional support for the development of SMEs
- Strengthen the financial support for SME development
- Provide incentives for SME competitiveness and exports (internationalisation)
- Support SMEs through the creation of public-private partnerships
- Provide incentives for innovation and technological competitiveness (R&D projects)
- Education
- Provide incentives for the development and use of information (communication technologies)
- Promote entrepreneurship

# 8. Romania

*By Ciprian Nicolescu*

## 8.1. Brief historical introduction

During the communist period, state ownership in Romania was harshly and totally imposed through state control of all economic and social processes. Compared to other Central European countries, therefore, Romania started with a serious handicap in terms of its middle class in 1989. In the Czech Republic, Hungary, and Poland, the Prague Spring, Kadar's reforms, and the reformist wave encouraged by Rakowski produced a strong intermediary social stratum with typical middle-class patterns as well as material and cultural living standards in the final years of communism. The official statistics have always shunned that phenomenon for easily understandable reasons; however, Western sociologists estimated that the emerging middle class accounted for about 30% of the active population in the Czech Republic, 20-25% in Hungary, and 15% in Poland. Unlike the Central European countries where market mechanisms and even private-economy elements had been introduced, the Stalinist model of a centralised economy continued to prevail in Romania. Hence, except for the party nomenklatura, a better-off social category, the middle class accounted for only 4-5% of the active population in this country.

The middle-class structure (as identified in various countries) differs according to the specificity of each country, its particular features, and its stage of development. In Romania, a middle class is currently forming, but it is economically weak and unevenly distributed in the territory. It is composed of:

- a. Segments traditionally belonging to the middle class, such as entrepreneurs and SME owners; and
- b. segments resulting from the labour professionalisation which also existed in the communist society.

Entrepreneurs form the main component of the middle class, which has the strongest impact on the state and the development of the Romanian economy:

They take the initiative in setting up SMEs, which constitute the largest and most dynamic component of the economic system;

they are those who generally turn SMEs into larger and stronger companies;

and they play a major direct and indirect role in remodelling the economic environment, increasingly giving it an entrepreneurial character under conditions of accelerating economic change.

Unlike most Central European countries, the first SMEs were established in Romania quite late, in 1990. Their development was more difficult and complex as the 40 years (1950-1990) in which the entrepreneurial spirit was stifled represented a great obstacle to overcome. A retrospective analysis of the development of entrepreneurship over the last 17 years since the fall of communism reveals, in our opinion, several development stages:

- a) 1990-1995: a relatively swift development of SMEs due to several factors, such as the introduction of a legal option to establish such companies, the existence of various market opportunities and niches not yet covered by other economic actors, tax breaks granted in the first years of operation, and relatively easy - especially informal - access to various resources of the state sector. It should be mentioned that this spectacular, mainly quantitative development occurred while SMEs were far from being a priority or a main focus of attention for the executive and legislative bodies as well as most political leaders. However, the entrepreneurial spirit of a large part

of the population and the countless economic opportunities on the domestic market facilitated the establishment of a relatively high number of SMEs. In spite of their relatively low economic potential, they developed into quite a large sector, considering the situation in the early '90s, especially in comparison with other Central and East European countries across the western border of Romania.

b) 1996-2000: a slower pace of SME development. The number of newly-founded SMEs declined, and more SMEs closed down. At the same time and - in our opinion - more significantly, most SMEs still in operation had a lower economic potential than in previous years. The reasons for this untoward development are manifold, being related to a generally unfavourable economic situation and a lack of differentiated treatment for SMEs, the previously-granted breaks in the first years of operation having been cancelled.

A differentiated approach to SMEs was finally launched against the background of these developments, prompted by the action taken by SME organisations headed by the National Council for the Private Medium-sized Enterprises in Romania and supported by several experts and part of the business press. Without going into details, a number of factors should be mentioned in this context. The law on SMEs was finally adopted in 1999 after a long-drawn-out process; an agency for the SMEs was set up; and the first special programmes aimed at supporting SMEs were implemented - marketing, development funding, financial guarantees, etc. During that period, many political leaders finally became aware that without developing an efficient SME sector, neither the economic reform nor the market economy have a future in Romania.

c) 2001 to the present: re-launch of the development of the SME sector. Consolidated macro-stabilisation permitted entering the next stage, that of building and improving a functioning market economy. The reform process aimed at harmonising all components of economic and social life in order to finalise and consolidate structural reforms. Its success was predicated on strengthening financial discipline and developing and operating an efficient environment for business as well as for national and foreign capital. This was done by promoting and implementing policies and mechanisms in line with EU standards since Romania joined the European Union on January 1, 2007.

## 8.2. Legal framework for SMEs and trade in Romania

Highly significant for the SME sector, the legal and procedural framework includes two categories of regulations: general, i.e. valid for all companies, and specific, i.e. exclusively relating to the activities of small and medium-sized enterprises.

General regulations are obviously quite numerous. To show their complexity, we shall mention below only the main fields to which such regulations refer. They include legal regulations on private property, the establishment of companies, changes in the core business of a company, the development and liquidation of companies, taxation, accountancy, financial banking, labour relationships, labour contracts, and litigation.

It is worth mentioning that some of these regulations are part of the pre-war legislation, including the commercial code, the civil code, and the code of civil procedure, which are not sufficiently harmonised either with the regulations still in force after the communist period or with the very many new regulations adopted after 1989.

The legislation specific to small and medium-sized enterprises includes the following regulations: Decree Law no. 54/1990 on the organisation of economic activities based on free initiative; Government Ordinance no. 25/1993 on the promotion of small and medium-sized enterprises; Government Decision no. 805/1994 on economic and financial facilities granted to small and medium-sized enterprises; Government Decision no. 216/1995 on the organisation and functions of the Romanian



Development Agency; Government Decision no. 975/1998 on setting up a National Agency for SMEs; Law no. 133/1999 on inducements for private entrepreneurs to set up and develop small and medium-sized enterprises; Law no. 346/2004 on the establishment and development of small and medium-sized enterprises.

The strengths and weaknesses of the current legislative framework applicable to the business environment in Romania are the following:

### 8.2.1 Strengths:

1. Legislation is harmonised with the Community acquis, ensuring the premises for the development of the Romanian economy as a functioning market economy in line with the principles, norms, mechanisms, institutions, and policies of the European Union and ensuring legal stability in the future.
2. From the standpoint of setting up a business, the legal framework has been improved, with the following strong points: Creation of a dedicated office; fewer documents needed for starting up a business; shorter deadlines (an entrepreneur needs 11 days to obtain the necessary documents); fewer formalities to obtain approval for a new business (five sets of documents have to be filled in to start a business) etc. Consequently, Romania ranks 7th (of 175 countries) in terms of easiness to register a company, quite an honourable position.
3. Implementation of tacit approval, in accordance with Government Emergency Ordinance no. 27/2003, as an alternative way of issuing or renewing authorisation by the public administration authorities.
4. Regulation of the lump-sum tax and preservation of the taxation regime for micro-enterprises according to Law no. 71/2003 of the fiscal code as amended.
5. Reform and improvement of the procedure for legal-construction changes and bankruptcy under Law no. 85/2006 on insolvency proceedings.
6. Legal framework on decision transparency in the public administration and the three-party social dialogue.
7. Reform of the civil-service legislation, increased transparency in the public positions system, stronger measures to prevent and fight corruption, and improvements in judicial proceedings.

### 8.2.2. Weaknesses:

1. Excessive bureaucracy as regards the statements to be submitted by employers on employees and mandatory contributions to the social welfare fund.
2. Excessive bureaucracy in the authorisation procedures for setting up new businesses.
3. A very large number of normative acts, continuous changes in existing legislation, and daily issues of fresh normative acts creating major difficulties in terms of their assimilation and enforcement.

Enforcing the legislation which translates the Community acquis will create major difficulties for the business environment since over 200 normative acts have to be enforced after Romania's EU accession on January 1, 2007. A large number of these normative acts contain obligations for entrepreneurs (in such fields as competitiveness, consumer protection, labour relations, industrial health and safety, environmental protection, etc.).

4. Failure to observe legislation in force, one example being the repeated violations of Art. 26.1 of Law no. 346/2004, which promotes the establishment and development of small and medium-sized enterprises. The law provides for the annual allocation

from the state budget of funds worth 0.2% of the GDP for financing development programmes and measures to support the establishment of new enterprises and the development of medium-sized enterprises at the national and local levels.

5. Scanty progress in improving the general administrative capacity; failure to finalise the public-administration reform; delays in the effective implementation of the judiciary reform, in the fight against corruption in general and top-level graft in particular (a serious and widespread phenomenon), in the totally transparent, accountable, and strict implementation of all ethical and deontological codes of conduct for civil servants; defects in the consistent imposition of penal sentences that would convey a strong message of dissuasion to future corruption offenders, in the implementation of IT-interoperable tax systems, in increasing and consolidating the administrative capacity, and in cooperation between central and regional structures.

6. Failure to finalise the legal and institutional framework regulating the mechanisms and structures needed for participating in the European Structural Fund and lack of adequate legislation on public-private partnerships in this field.

7. The labour market lacks flexibility, and taxation of the workforce is very high.

8. High taxation and over-taxation, lack of regulations to eliminate the tax on reinvested profits and simplify the tax administration.

9. Lack of legal provisions to combat payment delays in transactions with public authorities and institutions.

10. Formalism in implementing legislation on decisional transparency in the public administration and the three-party dialogue. More than once, the three-party dialogue is 'quantitative' rather than 'qualitative'; the proposals put forward by the employers' associations and the endorsements of the Social and Economic Council are not efficiently used.

### 8.2.3. Recommendations to improve the legislative framework

Proposals to improve the legislative framework refer both to the business environment in general and to the laws specific to SMEs. Their goal is to eliminate the weak points and to capitalise on the opportunities of Romania's EU integration.

#### 8.2.3.1. The business environment in general

1. Develop a simple, clear, and stable legislation; ensure a favourable and predictable legal framework for the business environment.

2. Ease formalities for businesses willing to enter or leave the market and reduce the administrative formalities needed to obtain authorisations, approvals, and endorsements.

3. Strengthen efforts and adopt measures aimed at attaining a satisfactory performance of law endorsements;

increasing the general administrative capacity; finalising the public administration reform; effectively putting into practice the reform of the judiciary; boosting the fight against corruption; achieving a totally transparent, accountable, and strict implementation of all ethical and deontological codes for civil servants and a consistent application of their responsibility; implementing IT-interoperable tax systems; consolidating the institutional framework, including greater and better-consolidated administrative capacity and cooperation between the central and regional structures; developing the functional framework to improve participation in the European Structural Fund and ensure its assimilation; preparing payment agencies and their administration and

controlling the integrated system; regulating public-private partnerships; boosting the general administrative capacity in the environmental-protection field and making significant efforts to ensure that the authorisations issued to companies by the local and regional administrations are in line with applicable standards; the authorisations cover industrial-pollution aspects and fall under the Guideline for the Integrated Control and Prevention of Pollution.

4. Boost private initiative and investments and consolidate free competition.
5. Increase the transparency of the business environment and government policies.
6. Improve relations between public authorities and entrepreneurs by eliminating red tape, simplifying control procedures, and changing the attitude towards investors.
7. Implement IT systems for administrative procedures relating to the establishment and operation of enterprises.

### 8.2.3.2. Supporting SMEs in particular

1. In conformity with the state budget law, allocate annually funds worth 0.2% of the GDP to finance development programmes and measures aimed at supporting the establishment of new enterprises and the development of medium-sized enterprises at the national and local level according to Art. 26.1 of Law no. 346/2004 on promoting the establishment and development of small and medium-sized enterprises.
2. Gradually increase the funds allocated to stimulating the establishment and supporting SMEs from 0.2% of the GDP at present to 0.4% of the GDP in conformity with the government programme for 2004-2008.
3. Initiate regulations for the adoption of concrete measures to facilitate the SME's access to public utilities, services, and networks needed for their activity.
4. Preserve special-taxation regulations for micro-enterprises.
5. Initiate a normative act to simplify fiscal administration (once-a-year VAT returns for SMEs as practiced in the EU, i.e. in France, Ireland, Italy, Luxemburg, the Netherlands, Austria, Sweden, and the United Kingdom).
6. Regulate reverse VAT taxation in case of obligations resulting from public contracts for the acquisition of goods and services concluded between SMEs and public authorities.
7. Approve programmes for human-resource training, marketing, and improving the quality of products and services to facilitate the SME's access to the single European market.
8. Develop consultation and information centres and networks, business support services, and solution portals for SMEs and back their cooperation networks, research centres, and universities, professional and life-long training organisations, financial institutions, and consultants.
9. Introduce economic incentives to encourage SMEs to become service suppliers for the big enterprises in the national economy.
10. Ensure easy access for SMEs to public services in line with the European Commission's recommendations and international practices.
11. Support access to the database on European legislation and assist SMEs in implementing a modern and competitive management based on the components of quality (ISO 9000), environment (ISO 14000), and marketing.
12. Support SME access to Community and international programmes.
13. Carry out special programmes for SMEs to:  
develop the industrial-cluster system in all regions and promote industrial clusters based on the principle of international specialisation and industrial complementar-

ity with the EU member states, the Central and East European countries, and other neighbouring countries; enhance export promotion; reintroduce programmes that facilitate the launch of a business by providing the starting capital and the funds to consolidate that business; use venture-capital funds and starting capital mainly to introduce the results of research in production and to improve the services offered; boost innovative research and develop centres of excellence; and assist micro-enterprises in the traditional and handicraft industries.

### 8.3. Institutions of self-administration of SMEs and trade in Romania

The institutional framework for SMEs is upheld mainly by the public administration, that is by the government, the National Agency for Medium-sized Enterprises and Crafts, the local administration, and the regional development agencies. Remember that this field was extremely unstable in the period from 1990 to 2000 on account of the many incoherent structural and functional changes it had suffered, with hardly any beneficial impact on the SMEs.

The National Agency for Medium-sized Enterprises and Crafts (ANIMMC) exerts the greatest influence on the activity of SMEs. Operating as an expert body of the central public administration, it is subordinated to the government, coordinated by the prime minister, and financed by the budget of the General Secretariat of the government. Its goal is to implement the government programme for the development of medium-sized enterprises, cooperation, and domestic crafts. At the national level, the agency operates through eight territorial offices for small and medium-sized enterprises in each of the eight development regions which, corresponding to the NUTS-II level of the EU, were established in 1998 to coordinate the regional development needed for Romania's accession to the European Union.

The functions of the National Agency for Medium-sized Enterprises and Crafts are strategic, i.e. drafting, developing, and implementing the government's strategy and policies in the field of medium-sized enterprises and domestic crafts; regulatory, i.e. ensuring the development of the normative and institutional framework necessary to reach the objectives and develop the programmes in its field of activity; managerial, i.e. managing and distributing budget and non-budget funds to boost the development of medium-sized enterprises and domestic crafts; representative, i.e. acting as the representative body of SMEs both in Romania and abroad on behalf of the Romanian state and with the government's approval; and governmental, i.e. supervising the endorsement and observance of regulations in its specific field and controlling the institutions and bodies under its authority or coordination. The system of non-governmental SME institutions has also developed significantly.

The leading organisation whose activity has had large-scale positive effects with major implications for the Romanian SMEs is the National Council of Private Medium-sized Enterprises in Romania (CNIMMPR). This is an independent, non-profit, non-governmental, and apolitical public-interest organisation. The National Council of Private Medium-sized Enterprises in Romania (CNIMMPR) is the only representative SME employers' organisation at the national level. Its aim is to promote and defend the economic, production, trade, legal, and other interests of the Romanian SMEs on the international, national, regional, and local plane.

The National Council of Private Medium-sized Enterprises in Romania aims at promoting and representing private enterprises in their relations with the public authorities as well as with other bodies and organisations in Romania and abroad; stimulating, by specific means, the establishment and development of small and medium-sized enterprises with Romanian or foreign private capital; representing and promoting the interests of private SMEs at the international, national, regional, and local level; and

working to establish a legislative and institutional framework that is favourable to the private sector and especially to the SMEs.

The National Council of SMEs represents the interests of small and medium-sized enterprises by promoting legislative initiatives in cooperation with the ministries concerned; promoting legislative amendments to remedy defects identified by member associations or by the National Council's members in consultation with all stakeholders; increasing public awareness of SME issues through mass-media coverage, the SME Review, and the annual publication of an SME white paper; sending national and regional representatives to three-party consultations; promoting public-private partnerships; and mobilising the parliamentary group for the support of SMEs to solve the development issues of the private sector and the business environment.

The National Council of the Private Medium-sized Enterprises in Romania has 8 regional federations and 98 local territorial structures. It is a member of the European Union of Handicrafts and Small and Medium-sized Enterprises affiliated to WASME (World Association of Small and Medium-sized Enterprises). It has concluded cooperation protocols with many foreign SME organisations, such as the Israeli Small and Medium-sized Enterprises Authority (ISMEA), ASSOMECANICA Italia (the national federation of SMEs in the Italian mechanical industry), the confederation for professional training of Italian handicrafts and small enterprises (ECIPA), the Federation of Indian SMEs (FISME), the Italian Confederation of the Small and Medium-sized Industry (CONFAPI), the Association of Small and Medium-sized Enterprises in Singapore, the All-China Federation of Industry and Trade, the Employers' Association in Croatia, etc.

Along with the National Council for Private Medium-sized Enterprises in Romania there are other national representative employers' organisations. Although less focused on SMEs, they do cover a significant number of such enterprises. Among the most important of them are: the Romanian Employers' National Confederation, the National Union of Romanian Employers (UNPR), the National Council of Employers in Romania, the General Union of Industrialists in Romania, etc.

The institutional framework for SMEs in Romania was organised on the European institutional model. The institutional platform for social dialogue was launched in 1997, when the law on the organisation and functions of the Economic and Social Council was adopted. This platform created a national institutional framework within which both sides of industry could be informed and consulted about draft laws on the implementation of Romania's economic policies. The dialogue between governmental authorities and employers and their involvement in the development of SMEs constitute strategic instruments and objectives for all Central and East European countries. Whatever organisation they may have adopted, be it independent governmental organisations (Poland, Bulgaria) or general directorates or departments within ministries (Hungary), the public authorities involved with SMEs in Central and East European countries play (along with governmental organisations) a significant role in developing the entrepreneurial phenomenon and creating a business-friendly economic environment.

## 8.4. The role of SMEs in the economy of Romania

Small and medium-sized enterprises (SMEs) are the backbone of the Romanian economy; it is a thriving sector that has multiple economic, technical, and social functions.

The SME sector plays a critical role in the economy for several reasons:

It generates the largest portion of the gross domestic product (GDP) (almost 67% in 2005), provides jobs for a large proportion of the employed population (almost

57% in 2005), is the only sector capable of creating jobs to absorb the personnel laid off by state-owned enterprises because of restructuring and modernisation, mainly produces the middle class which plays a crucial role in ensuring Romania's social and political stability, generates, to a large extent, technical innovations that may be used by the economy, is the most dynamic sector in the market economy as shown by the large number of SMEs, the volume of their turnover, and the number of their employees, which is much higher than that of big enterprises, provides products and services at much lower cost than big companies, mainly because of lower overheads and the higher labour volume and intensity due to the permanent presence of the entrepreneur in the company and the increased motivation of its personnel, is highly flexible and adaptable to market requirements, underpinned by the small size of the enterprises and the rapidity of decision-making due to the entrepreneurs' personality and their permanent involvement in current activities, represents one of the main sources of income for the state budget (taxes, VAT, etc.), offers opportunities of professional and social advancement to a large part of the population, especially the most active and innovative segment that acts as the driving force of the economy, provides the mainstay of an economic background that is adequate for a market economy characterised by flexibility, innovativeness, and dynamism, and contains the nuclei of future big companies, especially in the new fields of the economy and in its top branches that are based on a complex and efficient technology.

Integration in the European Union confronts small and medium-sized enterprises with numberless changes in the business environment caused by economic resizing. Given the experience of the neighbouring countries that joined the Union three years before, it is estimated that the number of Romanian companies will drop slightly at first, not necessarily because of an invasion by foreign companies but because of the introduction of new conditions in their daily activities, conditions to which some of the companies will not adapt easily. The effects of these new conditions will be felt mostly by the SMEs operating in those fields where the Community *acquis* demands the obligatory implementation of standards relating to the environment, quality, hygiene, food and product security, and labour-protection norms. What is more, some SMEs will be affected by the application of certain rules conforming to the Community *acquis* that relate to state assistance, the elimination of fiscal and quasi-fiscal subsidies, and the strengthening of financial discipline. The process of finding a place in the European Internal Market, Romanian companies will adapt their approach to the new instruments specific to the Community trade policy, taking into account the implementation of the Community trade policy in relations with third countries: common customs duties; the EU's generalised system of preferences (GSP); trade defence measures; preferential trade and cooperation agreements concluded with third countries; trade accords within the World Trade Organisation (WTO); and the application of rules specific to the European Internal Market in relations with Member States.

The business environment in Romania needs experts, 'integration vectors', and representatives of the public and private sectors and of civil society to ensure the promotion of the companies' interests in the Romania- EU relationship by actively participating in debates, consultations, and negotiations and by setting up alliances to ensure the adoption of rational decisions, by contributing to the development of Community strategies, proposals, and offers for the management of Community programmes, by lobbying in the Community institutional structures, by monitoring of the effects of the Community policies, and by initiating common trade-defence measures; and the provision of information, assistance, and consultation regarding the new regulations, mechanisms, and instruments specific to the Community trade policy.

The SMEs in Romania will have to capitalise on the strengths they are benefiting from (low costs of labour, high qualification of the labour force, novelty of the Romanian products on the European market) and endeavour to minimise or eliminate negative aspects (outdated production technologies, low energy efficiency, low performance in the field of environmental protection). One of the greatest opportunities offered by European integration which should be capitalised upon by as many SMEs as possible is the structural fund. SMEs can benefit from the structural fund in two ways: On

the one hand, they may benefit from these funds in developing their own business activity and, on the other hand, they are the future managers of the projects funded. Accessing and managing Community funds will also be a challenge, as this calls for adequate technical and financial training in companies as potential beneficiaries of this assistance. Romania will be allocated 5,974 million euros between 2007 and 2009 for structural activities.

As to the development of the SME sector, specialists estimate that by 2013 its turnover will be 4 times bigger than in 2005, the contribution to the GDP (the gross domestic product) will amount to 80%, and the share of the labour force employed by SMEs will reach 75%.

### 8.4.1. Priorities and recommendations related to the development of SMEs

To coherently and efficiently solve the numberless problems facing the SME sector at present, starting from the causes that generate them, one needs to take action in the main fields that are actually responsible for the way they work. In the following, we will present selectively and theoretically the solutions developed in the form of recommendations, taking into account the anticipated impact on the activities of the SMEs, the economy, and the population.

#### **Differentiation of corporate-profit tax rates by activity and income size**

In the fields that consume a large amount of capital and are characterised by complex activities, it is only natural to reduce profit tax. We therefore suggest that the lowest corporate-profit taxes be levied on industry, agriculture, and building as well as on transport and telecommunications companies, service providers, and trade companies. To implement these proposals, which meet urgent needs, one needs a new fiscal policy which recognises that economic development is based on encouraging investments, and that sectoral and size differences in the economy should be taken into consideration.

#### **Tax exemption for profits reinvested by SMEs in the industrial, agriculture, transport, telecommunication, and other sectors**

The growth of investments depends on the capitalisation of companies and the sums destined for modernisation and development. Consequently, we suggest that SMEs in fields that consume a large amount of capital, produce industrial and agricultural merchandise, and implement investments, should benefit from total tax exemption on reinvested profit.

#### **Stimulating job creation and SME exports by granting fiscal incentives**

Creating jobs is a priority for the Romanian economy and society. Consequently, we propose to reduce the corporate profit tax for those SMEs that create jobs for personnel laid off for reasons of restructuring and privatisation. This recommendation can be put into practice by revising the labour, employment, fiscal, and export policies.

#### **Offering financial incentives to SMEs that invest in economic areas faced with special restructuring problems or a low development level**

The serious social and economic problems facing certain areas with extensive restructuring can be solved mainly by a fast and comprehensive development of SMEs. To this end, we suggest that the SMEs that are established and create jobs in these areas should be granted more financial incentives so as to attract internal and exter-



nal capital to these areas and to develop profitable businesses creating many jobs and contributing to the rapid resolution of the complex problems.

### **Gradually creating a system of guarantee and coguarantee funds at the national and regional level to finance investment**

A large number of entrepreneurs cannot realise their valuable business ideas because they do not have enough capital. The development of a solid system of guarantee funds for SMEs would partially solve this problem. At present, there are several guarantee funds in Romania (e.g. The National Credit Guarantee Fund for SMEs), but the resources available to the fund are relatively small so that its real impact on SME development is rather low.

### **Direct and permanent participation of entrepreneurs in bilateral and multi-lateral economic inter-governmental meetings with other countries**

The expansion of exports and imports, which is vital for Romania's economic development, largely relies on the involvement and efficiency of SMEs. Nevertheless, it has been noted that, by virtue of a routine and a mentality influenced by 50 years of communism, it is still the big companies and the managers of private as well as state-owned and public companies that participate in government actions to promote external economic relations. This is the all the more striking as, at present, more than a half of Romania's import and export trade is conducted by private SMEs. Consequently, a radical change of mentality is required, along with the involvement of SMEs in government activities meant to promote economic relations. This implies the establishment of a system of permanent cooperation between economic ministry and government agencies on the one hand and representative SME organisations on the other. Practically, each ministry and government agency, depending on its profile, should support deals proposed by SMEs. Also, meetings should be facilitated between delegations of businesspeople from abroad which are invited by the government and interested entrepreneurs. Moreover, it would be extremely useful to involve entrepreneurs in governmental economic delegations whose activity and major interests are in line with the objectives and programme of a given economic mission.

### **Setting up a national resource bank which specialises in SME issues**

The performance and functionality of SMEs depend more and more on rapid and cheap access to information, which, in the current economic context, represents a fundamental vector of development. The resources and personnel available to most SMEs are not necessary for them to obtain, on an economical basis, the vital information they need. In order to overcome this situation, we suggest setting up, at the national level, an information bank that specialises in SME issues and fulfils multiple functions: as a source of up-to-date economic information (fiscal, customs-related, bank-related, monetary, etc) about the major regulations that affect SMEs; business needs and opportunities with local and foreign partners; the reliability of potential partners from the country or abroad; the equipment and state-of-the-art technologies in various fields of activity, etc. Linking this bank to the information centres of the EU would be of equal interest to entrepreneurs from other countries.

### **Systematic organisation of training programmes for entrepreneurs, managers, and craftsmen in SMEs**

Entrepreneurial activity is very specific; it needs a comprehensive and wide range of knowledge and skills related to the development, implementation, and capitalisation of a business idea with a small number of people. Similarly, managerial activity within SMEs implies numerous peculiarities that are due to the small size of the company, its



small staff, and its limited technical, material, financial, and information resources. As the qualities, knowledge, and entrepreneurial and managerial skills required differ greatly, SME entrepreneurs and managers need specific training programmes. In their workforce, SMEs use workers with classical professions as well as workers specialising in less well-known jobs, mainly traditional occupations and/or technologies (wheelwrights, belt makers, blacksmiths, potters, pretzel makers, millet beer makers, etc.). This second category of employees needs specific training that is not usually provided by the education system; hence the organisation, at the local level, of special training programmes for these rare professions.

### **Setting up a strong nationwide network of consulting centres also providing managerial and entrepreneurial training for SMEs**

The performance of SMEs in the developed countries proves that success is not possible without basing the SME's activities on professional managerial and entrepreneurial concepts, methods, and techniques. Of course, this is valid for Romania too. Past experience shows that only a small number of SMEs systematically use the capabilities of professional management. The main causes that led to this situation are the limited supply of high-quality consultancy and managerial training and its relatively high cost, which most Romanian SMEs cannot afford. These causes can be eliminated only by developing a strong nationwide network of consultancy and managerial training centres that should cover the whole country and solve the problems of supply and price mentioned above.

### **Developing a national network of business incubators and science parks**

At present, mankind is witnessing an unprecedentedly fast pace of scientific progress. Consequently, competitive innovation has become a key factor in the performance of a large number of SMEs, operating in industry, communication engineering, services, transport, agriculture, and even trade. This makes it necessary for Romania to efficiently implement the promotion of SMEs with a focus on innovation by methods employed with good effect in other countries. International practice recommends especially business incubators and science parks (technopoles). There are almost 20 business incubators and industrial parks in Romania at present, but their functionality is reduced.

### **Including representatives of SMEs organisations in the governing bodies of the central and local public administration**

Public administration greatly influences the activity and performance of SMEs. To ensure that the specific problems that face the SMEs are made known and taken into account, and to capitalise on their big potential, it is imperative that representatives of SME organisations participate in the governing bodies of the public administration at all levels. Concretely, we suggest that representatives of the main SME organisations in a certain area or field be included, as full-fledged members, in the participative management bodies of ministries, governmental agencies, counties, municipalities, communes, etc. In this way, decisions could be made and efficient actions undertaken to consolidate and develop SMEs while taking into account their particular characteristics.

### **Organising a national mass-media campaign to improve the image of the entrepreneur as a key character of the market economy**

In Romania, it has been noted that, although entrepreneurs have a substantial role in, and positively contribute to, society and the economy their actions and results are mainly perceived as negative by the mass media and the population. There is, therefore, a blatant discrepancy between entrepreneurial reality and its perception

by the public. The main cause of this discrepancy is the fact that the mass media almost exclusively cover cases of entrepreneurs breaking the law or negative aspects of entrepreneurial activity, elements that are of great interest to Romanian readers, listeners, or viewers. Of course, such an approach was facilitated by the numerous negative or doubtful aspects of entrepreneurial activity in the incipient stages of the complex and contradictory process of evolution towards a market economy. With a view to eliminating or at least diminishing the aforementioned discrepancy, which has numerous negative economic effects on the activity of SMEs in particular and on the economy in general, we believe it is necessary to launch a campaign in the mass media to present the positive aspects of entrepreneurial activity, which are predominant.

### **Facilitating the development of representative SME organisations**

To meet this requirement, we suggest the following measures: Providing financial support from the state budget to the representative SME organisations; tax exemption for the revenues of representative non-profit SME organisations; including persons appointed by representative SME organisations as permanent full members in the governing bodies of all ministries, governmental organisations, county and local councils, etc. to promote and defend the SMEs' specific interests.

### **Improving the economic legislation relating to SMEs with a view to eliminating contradictory elements and discrepancies and making it fully operational without delay**

The economic and financial activities and results of the SMEs are directly, indirectly, and profoundly influenced in various ways by the quality of legislation. That is why it is essential that the legislation on SMEs should be complete, rigorous, simple, and easy to apply. To this end, action should be taken at several levels: revising and modifying incomplete legal provisions which are inadequate or too general; establishing clear-cut, precise, and easily applicable methodologies or instructions for the administration of laws, ordinances, and other normative acts; increasing the degree of harmonisation of Romania's legal regulations with laws and other valuable practices of the EU.

## **8.5. Supporting SMEs and trade as a step towards creating a social market economy**

The social model of a market economy tends to turn into a prototype for the European Union in general. The growth-stability-equality triangle that forms the foundation of the European social model and makes up the nucleus of the Lisbon Strategy is, however, embodied in specific formulas reflecting the social, economic, political, and cultural contexts in the various countries or areas of Europe.

Of the countries of Central and Southeast Europe that joined the EU in May 2004 we may say that they comprise two large groups of highly distinct social models. The first model, which is inspired by neo-liberalism, is implemented in the Baltic States, where there is almost no social welfare. The second is the reformed continental model as applied in Poland, Hungary, the Czech Republic, and Slovenia, coming close to a social-cohesion model.

In Romania, the communist state with its paternalist policies sustained massive social-welfare expenditures for 50 years. For that reason, the public expects much of the social interventionism of the state, especially since the growth of post-communist capitalism gave birth to a society characterised by deep inequalities among its members. The European-type social market economy Romania is heading for implies

that the state takes care of its citizens and acts to ensure equal opportunities, remove injustice and abuse, defend the underprivileged, and create a feeling of social solidarity and responsibility. The principal source of such assistance is productivity which provides the means for protection. Romania's low productivity and the large share of the non-working population that is being assisted has often engendered resistance to pressures on the budget. The need to balance social benefits against the productivity level demands significant and sustainable economic growth rates.

The underlying principles of the Romanian social market economy are: the economic mechanism needs to rely on the market which, in turn, needs to enjoy the highest possible freedom of operation mainly in price and wage policy. Market mechanisms cannot by themselves set the course of social affairs, which is why they need balancing against social objectives, an a-priori postulate the guarantor of which has to be the state, as it is the guarantor of social welfare and free bargaining among the social partners. State interventionism and dirigism are acceptable only to the extent to which they do not impair competition and are required for surmounting difficult times of economic restructuring.

In the long run, the enforcement of a model of development informed by social market economy will generate, both in Romania and in other countries of Central and Southeast Europe, a range of benefits of which we can name the following: creation of new jobs, high employment rates, mitigation of states/situations of conflict in society, protection of minorities, bridging the social divide, deepening democracy, protection of the environment, better relations among the various social categories and classes, sound pension and family allowance schemes to provide high social security through the public authorities, diminishing corruption, less red tape, increased economic security for a public faced with various risks (illness, unemployment, family imbalances, etc.) provided by public communities, and so forth.

A social market economy of the European type can only be achieved in Romania by developing a robust SME sector, capable of contributing to sustained economic growth. The most important steps to promote the middle class/SMEs as a prerequisite for creating a social market economy include:

1. introducing into the programmes of the political parties the establishment and development of the SMEs as a main element, and putting such political options into practice;
2. improving legislation and reducing bureaucracy to smoothen and expedite the process of establishing new enterprises;
3. building a functioning public administration characterised by little bureaucracy and corruption, to foster the incorporation of new companies and strengthen and support those that exist;
4. developing national strategies and policies agreed on by all political parties, the main objective being to support the numerical and qualitative growth of the middle class and enhance the strategic choices through which the objective can be achieved;
5. stepping up and developing market economy-specific financial mechanisms affordable to small and medium-sized entrepreneurs (stock exchanges, commodity exchanges, venture capitals, leasing companies);
6. adopting specific legislation regulating the establishment and development of SMEs, with special attention to industrial parks, technopoles, spin-offs, clusters, company networks, etc.;
7. mitigating taxation of labour and income to foster the enhancement of individual and corporate capabilities to invest in business;
8. conducting extensive nation-wide campaigns focussed on building a public culture which favours entrepreneurship as well as opening and cultivating businesses;

9. introducing to the curricula of higher, secondary, and primary education subject matters designed to develop entrepreneurship among the young, to equip them with the managerial, economic, and technical skills necessary to a good entrepreneur;

10. setting up a system for the effective and fast absorption of EU funds promoting the multiplication of SMEs and the growth of their potential;

11. designing and implementing dedicated national, regional and local programmes that focus on training, counselling, and addressing existing entrepreneurs, young people, women, and members of national minorities who wish to become entrepreneurs.

An exceptionally important role in building a social market economy is played by the development of a socially-responsible entrepreneurship. Romanian SMEs should follow the example of their counterparts in the various countries of the EU and the world that have adopted social-accountability codes of conduct and accepted arrangements for monitoring the results of such policies. Approaches to enhance corporate social responsibility as a key component of SME management in Romania include:

1. disseminating of the idea of corporate social responsibility through the mass-media;

2. organising information seminars on corporate social responsibility on the national, regional, and local plane;

3. organising crash training courses for existing entrepreneurs which focus on the content of, and ways to implement, corporate social responsibility;

4. organising visits to the European Union for representatives of SME organisations on the sectorial and local levels so that they can acquaint themselves with best practices in corporate social responsibility;

5. awarding prizes, medals, trophies, etc. to top-ranking SMEs at the national, regional, and county level in recognition of the high interest in corporate social responsibility shown by those entrepreneurs.

Recommendations for the creation of a social market economy: All the recommendations and action options previously listed contribute directly and indirectly towards building a social market economy. On top of that, here are a few suggestions:

1. Incorporate in the post-accession strategy of Romania (2007-2013) the substantial elements that are specific to the social market economy.

Correlating the development of the physical infrastructure and human capital is the most effective approach to maximise the competitiveness of the Romanian economy. The physical infrastructure includes investments in transport, the environment, telecommunications, and energy. Generating economic growth, these lead to the development of related economic activities. Investment in human capital includes education, professional training, life-long learning, strengthening relations between and among research, development, and innovation, public health politics, as well as modern and effective social and occupational policies. It provides sustainability to economic growth in the medium and long term, as an educated and healthy population performs well and is capable of adjusting to the economic environment of the European Union and the world.

Another aspect that needs to be considered is to continue reforming sectors of major importance at the same time: the judiciary, the fight against corruption, the public administration, improving competitiveness both at the macro-economic level - with emphasis on fiscal and budgetary policy, agriculture, and rural development - and at the micro-economic level, focussing on the support of - especially innovative - SMEs.

Equally, the absorption of EU funds is an objective in its own right within the post-accession strategy. EU funding will make a notable contribution towards making up Romania's economic and social backlog compared to the level of development in the other EU member states.

2. Include to the Romania-EU convergence programme, which our country is supposed to develop in 2007, elements that give priority to the social aspects of social market economy.

Preparations for the accession included structural, legislative, and institutional reforms, economic resizing, and social restructuring. After January 1, 2007, Romania is expected to cope with a significantly changed environment that calls for a reasonable and effective strategic conduct. Romania needs to keep economic growth fast, balanced, and sustainable for as long as possible. It also needs strong and effective institutions, a consistent legal system, and a predictable fiscal system.

The European model is bivalent, economic and social. It presupposes economic growth, social cohesion, and convergence. Well-designed macro-economic policies form the basis of sustained economic growth. At the same time, a high rate of economic growth leads to economic stability and long-term social cohesion. Both the transition and the accession only be legitimised by social acceptance and by ensuring that the growth-development-modernisation trio functions properly.



# 9. Serbia

by Prof. Dr. Radmila Grozdanić

## 9.1. Introduction and Background

Historical aspect: During its long history, Serbia faced various political, social, and economic large- and small-scale changes. Especially during the Middle Ages Serbia was considered highly developed both economically and culturally. The socialism of ex-Yugoslavia and the wars in the region caused by the collapse of the Federal Republic of Yugoslavia, Serbia lost this position as a relatively highly developed state and even the leading position in the Balkans itself. Slobodan Milošević's rule of power, the economic embargo imposed by the EU as well as the NATO bombardment in 1999 further degraded the economic situation in the country.

When the democratic opposition won the elections and came into power in the year 2000, it was a sign for a better Serbian future.

**Territory and populace:** The territory of Serbia extends in southeast Europe, occupying 88,361 square kilometres, with 9,778,991 inhabitants (*according to the last census held in 2002*), 82.86% of Serbian nationality, and an average population density of 111 inhabitants per square kilometre. The capital city is Belgrade. Serbia is divided into 29 regions which, in turn, are divided into a total of 189 municipalities. Serbia has three autonomous provinces, Vojvodina and Kosovo and Metohija. The estimated population for the year 2011 is 10,304,770.

**Economic aspect:** Serbia has a great historical experience and tradition of entrepreneurship and trade, from the middle of the 19th century up to the present day.

After World War II, the Serbian economy was a centrally planned and socialist, with a centrally-planned state mechanism of production and distribution. At the beginning of the 1980s, the then SFRY fell into a debt crisis as a result of many years of postponement of economic and political reforms. Although the organisation of the economy and society was in many ways more liberal than in other countries of the so-called communist block, with many elements of a market economy, the final result was a community with a highly pronounced redistributive role of the party and the state.

Despite some successes of the Yugoslavian economic system, the country faced various economical crises. Especially the late 1980s revealed the mismanagement and the failures of the socialist system and precipitated a deep economical crisis which influenced the break-up of the Federal Republic of Yugoslavia. During the time of the Balkan wars in the 1990s, Serbia experienced an economic and social collapse. The nature of the authoritarian regime and numerous mistakes in economic policy, international isolation, the dissolution of the market of the former Social Federal Republic of Yugoslavia, wars in the neighbourhood, and NATO's intervention against Serbia in 1999 caused a drastic 50% slump in the GDP per capita compared to the previous decade, placing Serbia among the last countries in Europe. The industry used only 20-30% of its nominal capacities, and the banking sector arrived at the edge of bankruptcy. The official unemployment rate was over 30%, and even amongst those who were employed, one in three was superfluous. During that period, economic isolation favoured the development of a shadow economy (its volume reached 50% of the national product), corruption and organised crime. This tough economic and social situation was additionally aggravated by an enormous influx of refugees from Bosnia and Herzegovina and Croatia, as well as by internally displaced persons from Kosovo and Metohija (their number reaching 10% of the population of Serbia in certain years). All this contributed to a dramatic decline in living standards, an increase

of poverty, the dissolution of social values, exclusion from global trends, a significant lag in development tendencies, increasing apathy amongst the majority of the populace, and the absence of reasonableness and tolerance especially among the younger generation. In brief, with the deep economic crisis, almost all other dimensions of human development in Serbia worsened.

After the fall of Slobodan Milošević's regime in 2000, Serbia entered a period of speedier reforms and economic growth, attaining a 6.3% growth rate in 2006. New economic reforms were prepared by the democratic government with the aid of experts from western countries and international organisations, predominantly influenced by the IMF, the World Bank, and the EAR. The construction of transitional blocks started with a general liberalisation of economic activities. Regulated and state-controlled prices as well as the currency exchange rate and interest rates formed more freely, and the citizens' options of undertaking economic activities were also liberalised. The second transitional block was a programme of stabilisation with the primary goal of restraining inflation, controlling the budgetary deficit, and decreasing the external debt. The third block of transitional activities was a structural transformation with the goal of creating new market-economy institutions. The main component of transformation was privatisation not only by transforming state into private property, individual or corporate but also by creating a new private sector and enhancing the effectiveness of management in enterprises and economic activities. The transformation included the banking sector, the reform and elimination of the monopoly held by certain state banks, as well as the improvement of financing possibilities for the new private sector. The goal of the tax reforms was to build a modern financial market, and they included the introduction of numerous regulations in the taxation system and management, the most important being the value added tax. A process of replacing the old system of state social security is under way, with the goal of improving the sector of social care and security. The old system, under which health, pension, and disability insurance were fully subsidised by the state, is being replaced by a new, market-type system of social security and protection only partially supported by the state. These reforms in the area of social security are still going on. The endeavours of the Serbian democratic government to establish and create an institutional and legal environment and framework for safeguarding the right of property, human rights, the role and transparency of market laws, the rule of law, and its policy of competitiveness and infrastructural reforms is regarded as a special aspect of the transition to a socially-responsible market economy according to the German model.

After the political changes in Serbia in 2000, a certain improvement was noted in human development. The HDI reached 0.772 in 2002, a 6% improvement over 1999. The main reason for this HDI growth was the increase in the GDP per capita.

From 2000 until 2007, 350 new laws were passed and a number of institutions founded to support a modern market economy and the completion of privatisation and restructuring in the economy. Numerous measures were adopted to increase the number of new enterprises and stores and raise the proportion of high-tech companies. In 2006, the GNP was \$47.77 billion or \$5,713 per capita.

From 2000 until 2003, two thousand new SMEs were founded, followed by 7,000 new enterprises in 2004, 10,600 new enterprises in 2005, and 11,300 new small enterprises and artisan shops and agencies in 2006. In May 2007, the SME sector comprised 277,000 economic entities including 72,000 small enterprises, 2,500 medium enterprises, and 202,000 artisan shops, independent agencies, and businesses. An analysis of the trend of the democratic changes between 2000 and 2007 shows that the transitional processes are speeding up, and that, due to the economic-policy measures taken and the creation of a new market system, the environment in which small and medium enterprises and shops are operating is rapidly changing, and that the SMEE<sup>1</sup> sector itself is undergoing a substantial restructuring.

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1 *SMEE - Small and medium-sized enterprises and entrepreneurship.*



In conditions of relatively stable prices, a high real growth of the gross domestic product (5.5% p.a. on average), and continual improvement in business conditions, the SMEE sector has been developing rapidly in terms of both numbers and unit economic strength. The SMEE largely contributed to the high rates of gross output growth (54.1% in 2005), and they play an important role in the recovery of the economy and employment (60% of employed in the economy). Serbia was nicknamed "The Balkan Tiger" for its high rates of economic growth.

Although considerable progress has been made in reform from 2000 until 2007, the national economy has not recovered significantly, and it is marked by a low level of technological and market capability in its industrial enterprises, an unsatisfactory quality of products and services, a large foreign-trade deficit unsustainable in the long run, a negative discrepancy between the number of newly opened jobs and the redundancies caused by the privatisation process, resulting in a decrease in total employment and an increase in the number of unemployed persons to around one million, a still-high proportion of public spending in the national product, and a low rate of investment from 1990 to 2005 of 12% on average. This cannot lead to any rapid management of the factors for increasing the living standard of the population, although the middle class is rising. The key determinants of the potential growth of exports, investments, and savings are still low. The positive elements of the current performance of the Serbian economy can only be sustained by faster macro-economic and structural adaptations and reforms. On the political level, Serbia accepted the most important strategies, such as the national development strategy, the national investment plan, the national employment strategy, the poverty-reduction strategy, the national strategy for technological development and innovation, the strategy for the development of local self-government and others, and the problem of their implementation now poses itself. A positive feasibility study for joining the EU will show Serbia's priorities in the forthcoming period.

## 9.2. The legal framework for the development of SMEs and trade in the Republic of Serbia

The creation of a consistent system of measures, programmes, and necessary institutions to support effectively the long-term development of entrepreneurship under the conditions existing in the Republic of Serbia was governed by the constitution and the following laws:

- *The company law* which regulates the legal position of economic entities in conformance with global standards of company regulation, modern, liberal, and harmonised with the EU guidelines and the European legal system; *the law on entrepreneurs*; *the law on accounting*; *the law on the agency for economic registers*; *the mortgage law*; *the law on financial leasing*; *the law on bankruptcy proceedings*; and *the law on electronic signatures*. There are no special regulations for the SME sector. The regulations that apply to economic entities as such are applied to the SME sector as well, with a selective approach in a small number of laws that primarily regulate the issues of registration and financial bookkeeping.

Until 2007, in the Republic of Serbia,

- the economic system has been substantially reformed by passing 350 systemic laws;
- the system of registration of economic entities, especially artisan shops, has been modified (the time for founding a SME was shortened to 5 days, and the initial capital decreased to 500 Euros);

- the one-stop shop principle of support services for the SMEE sector has been introduced; and
- the Council for Regulatory Reform of the Economic System was created.

The activities undertaken by the *Agency for Economic Registers*, established in 2005, enabled faster and cheaper creation of companies with an obligatory initial investment of only 500 Euros and a five-day legal deadline for issuing a decree. As of 2006, entrepreneurs are also entered into the Agency register, and the procedure of registering new entrepreneurs has been simplified, with a mandatory fee of around 6.5 Euros. With all other taxes (for issuing an ID number), the price of registration itself does not exceed 25 Euros. The Agency has developed a wide network of local offices working at municipal headquarters. This provides a unique, up-to-date electronic database on all economic entities in Serbia, including special registers on mortgage rights and financial leasing. Since 2007, a register of annual financial reports has been kept as well, which allows an insight into the database and thus simplifies the decision-making of interested investors and potential business partners.

This legal framework for each kind of enterprise is completed by a number of contemporary legal solutions such as the *law on foreign-trade operations*, the *law on foreign-currency operations*, the *law on free zones*, the *law on mandatory social-insurance contributions*, the *law on personal income tax*, the *laws on financial leasing*, the *mortgage law*, the *law on the protection of competition*, and the *law on financing local self-government*.

#### ***New strategic documents:***

The first key document to be mentioned is the *national strategy of SME development and the strategy of trade development*, with the following goals: To increase the total number of small and medium-sized enterprises and private entrepreneurs from around 270,000 (in 2002) to around 400,000 (in 2008), and to create more than a million new job vacancies in the SME sector.

The *national employment strategy 2005-2010* contains directions and activities to be undertaken in order to solve problems successfully and develop an efficient labour market in accordance with the other development goals of the country. The strategy also accepts the Lisbon Strategy goals from 2000, which refer to full employment, quality of work, and social cohesion, as well as the unification of the labour market. The *national employment action plan* for the period 2006-2008 has also been adopted, as well as the *strategy of stimulating and developing foreign investment* which aims to facilitate access and support foreign investors. The *judiciary system reform strategy* as well as the action plan for strategy implementation were passed with the goal of realising a new, independent, transparent, responsible, and effective judiciary system by 2011. The Ministry of Economics has passed a *plan to encourage the development of SMEs in the period 2005-2007*. In 2006, the **SME Council** was formed, an inter-ministerial body in charge of monitoring the development of the SME sector and proposing measures for its improvement. The main objective of this plan is to establish an efficient and effective process of creating and implementing the SME policy and to remedy basic limitations in institutions and laws, the insufficient knowledge of entrepreneurs and employees, the underdevelopment of the market for business services needed by SMEs, unfavourable financing conditions, the insufficient number of innovations, and the slow implementation of modern technologies. The plan was formulated on the principles of the European Charter for Small Enterprises. The activities of the SME Council will impart a multi-disciplinary and inter-departmental character to the policy of stimulating this sector. The adoption and implementation of the strategy for the development of expert education, the broadening of the education for entrepreneurship, the institution of the "one-stop shop" principle, the adoption of the national innovation strategy and the action plan to implement it, and the

adoption of the national programme for developing existing and establishing new incubator centres are under way.

### **Definition of small and medium-sized enterprises according to Serbian regulations**

*Small and medium-sized enterprises (SMEs), according to the law on accounting of the Republic of Serbia, are divided into small, medium-sized, and large, depending on the average number of employees, the total income, and the value of assets on the day the financial reports for the last business year are composed.*

**Small enterprises** are legal entities fulfilling at least two out of the three following criteria: That the average number of employees is less than 50; that the total annual income is less than the equivalent of 2,500,000 Euros in dinars; that the average value of assets is less than the equivalent of 1,000,000 Euros in dinars.

**Medium-sized enterprises** are legal entities fulfilling at least two out of the three following criteria on the day the financial reports are composed: That the average number of employees is between 50 and 250; that the total annual income is equivalent to between 2,500,000 and 10,000,000 Euros in dinars; that the average value of assets is between the equivalent of 1,000,000 and 5,000,000 Euros in dinars.

**Large enterprises** are legal entities with higher figures for at least two out of the three criteria listed for medium-sized enterprises.

In the Republic of Serbia, an enterprise can be founded in accordance with the company law and the law on entrepreneurs.

According to the company law, all societies are divided into four basic legal forms: General partnerships, limited partnerships, limited-liability companies, and public limited companies.

To improve the efficiency of the process of implementing the EU Charter for the Development of SMEs, endorsed by the Republic of Serbia, in the forthcoming period, a SME development and policy index has been created by the European Commission Directorate General for Economic Affairs. This instrument should serve national SME policy-makers in self-evaluation and in determining the level of policy development in each country. The index rates the level of development on a scale from 1 to 5 for each indicator of development within the 10 principles, i.e. areas in which the development of small enterprises is supported. A summary assessment based on the index shows that, in the process of implementing the EU Charter, Serbia stands between levels 2 and 3 out of the 5 projected levels of development. By 2006, Serbia had made significant advancements in the following areas:

- **More favourable and faster SME start-up.** The process of registering has been simplified for entrepreneurs, the time limit was shortened, and the costs of registration reduced for all economic entities.
- **Better legislation and regulations.** The government has defined SME development as one of its priorities in economic policy. Furthermore, the government passed a decree on the creation of an SME Council that will make the process of formulating and implementing SME policy more effective.
- **Available resources.** Under this principle, different forms of training for SMEs are being reinforced by the Agency for SMEs and the network of entrepreneurship centres of the National Employment Agency. This particularly applies to novice entrepreneurs.
- **Improving business on domestic and foreign markets.** Several analytical documents pertaining to the increase of exports and the competitiveness of small enterprises have been produced, and a number of ac-

tivities with secure financial support have been organised with the aim of promoting and encouraging exports. Decisions by numerous municipalities to support the development of local entrepreneurship and artisanship are becoming more and more frequent, especially in the following areas: Tourism, opening of ethno-centres, transitional centres for excess labour force, development of modern artisanship, establishment of telehouses, IT centres, and establishment of virtual enterprises.

- **Taxation and financial issues.** There have been reductions of taxes on profit and employee incomes. The system of financial leasing has been successfully implemented in SME financing. Moreover, significant funds for SME financing are allotted by the following national funds: The Development Fund of Serbia, which grants loans with a repayment period up to 5 years, a grace period of one year, and an interest rate of 1%-5%; the Guarantee Fund that extends 50%-80% guarantees to banks for shares in SME loans; the fund for the insurance of loans, export businesses, guarantees, and revolving capital (SMECA)<sup>2</sup>, which started to operate in 2004, with the founding capital secured by the World Bank (12 million Euros) and the Italian government (10 million Euros). Other important funds are: Alma – the Guarantee Fund of Novi Sad, the Leskovac Guarantee Fund, and the Regional Fund for South Serbia. In addition to that, significant legal groundwork has been done for the financing of self-employment and the employment of novice entrepreneurs through the National Employment Agency and the micro-credit line of the Development Fund. Other national funds created for the development of SME and trade are: The fund for the insurance and financing of foreign trade businesses – SMECA, export insurance and financing, credit lines of international financial institutions, EAR, EBRD, EIB. Municipal financial support for SME development includes the municipal credit scheme for SMEs and agriculture, credit guarantees, a guarantee fund, loan interest subsidies, self-employment grants, municipal benefits through local tax reduction, compensation for city-owned construction land, financing of training, SME consulting and start-up, financing of consulting for farmers.
- **Strengthening of technological capacities.** The government passed a law on innovation activities that influence the increase of technological capacities and competitiveness of the SME sector, and non-refundable funds for raising innovative and technological capacities have been secured. According to research conducted by the *World Bank* and the *International Finance Corporation (IFC)* and their *Doing Business Report 2007*, Serbia has improved its rating significantly. On the list of 175 countries analysed, *Serbia ranks 68th in terms of its legal framework for doing business*. In comparison with other countries of the region, Serbia achieved the greatest improvement in the legal conditions for business in the last two years. At the same time, the introduction of an electronic database in the foreign-trade business reduced the period needed to obtain a customs declaration and even for foreign trade transactions: At the moment, *11 days are needed for exports, and 12 for imports*. Flexibility of regulations in the labour area is indicated by the *rigidity of employment index* (38 for Serbia). As a rule, the closer this index gets to 100, the smaller is the flexibility of labour legislation, i.e. the more processes have to be gone through to employ new workers, set working hours, and dismiss redundant employees. The investment climate for business has also improved, both from the aspect of easier access to loans (the *credit reporting index* is 5) and from the aspect of investor protection (the *investor protection*

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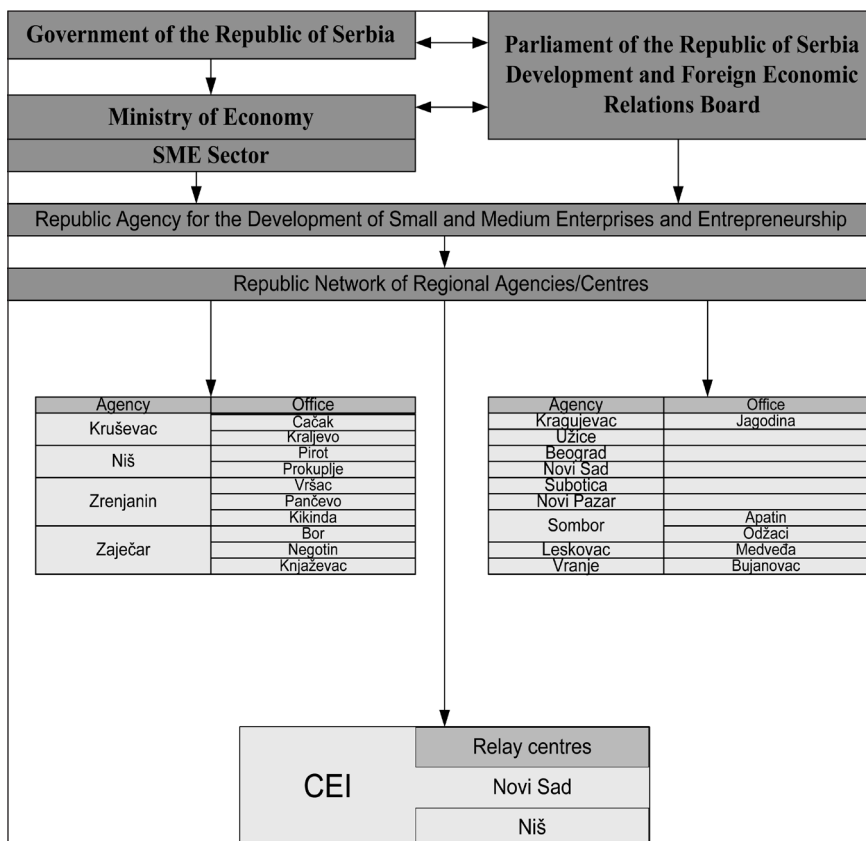
2 SMECA - Serbia and Montenegro Export Credit Agency.

index is 5.3). The higher these indices, the higher the level of information on loans (interval 0-6) or the level of investor protection (interval 0-10). Finally, the procedure of terminating business operations has been shortened, either by contractual dispute settlement (635 days) or in the regular way (2.7 years). Compared to other countries, Serbia holds a very good position that is in certain segments of business even better than those of new EU members.

### 9.3. The institutional infrastructure of SMEs and trade in the Republic of Serbia

The following governmental and other institutions in charge of creating and implementing the policy of development of small and medium-sized enterprises and trade exist in Serbia.

*Existing institutional infrastructure for the support of SMEs in the Republic of Serbia*



**Ministry of Development, SMEs sector** – monitors and analyses SME business, proposes measures and instruments for development as well as measures for SME investment stimulation, and performs other tasks in conformance with the law.

**The National SMEs Agency and the network of regional agencies and SMEs centres (RASMEE)** was established by the law on the Agency for the Development of Small and Medium-sized Enterprises in 2001, with the main goal of supporting (helping, consulting, and protecting) the development and interests of the SME sector.

Previous activities of the RASMEE aimed at:

- Strengthening and further development of the national network
- Consulting (legal and economic), education/training (of potential and existing SMEE, trainers, consultants, instructors)
- Promoting, publishing, innovation and invention, international cooperation, IT support, analysis and statistics of SMEE
- Projects of importance for the improvement of SMEE business
- Research, competitiveness, quality
- Participation in the preparation of national regulations and the removal of administrative obstacles of importance for SMEE development, work on simplifying legal regulations, taxes and customs, analysis of SMEE position
- Creating and proposing economic-policy measures to stimulate SMEE development, participation in the implementation of economic-policy measures with the aim of providing support to SMEE

### **Regional agencies for SMEE development**

In principle, regional agencies may be created and may function in various organisational and legal forms. Under the programme of state development and support of SMEE in 2001-2002, the model of forming a regional agency as a limited-liability company has been accepted. The model of a regional agency founded by the state in conformance with the law on the Agency for the Development of Small and Medium-sized Enterprises was accepted and implemented in 2003.

Members of the state network are required to implement and catalyse concrete support for potential and existing SMEE by

- implementing government measures, RASMEE;
- expanding the state network by creating new agencies and strengthening existing ones; constantly reinforcing and balancing the quality and quantity of regional agency services, the efficiency of business operations; enhancing operational reliability; meeting clients' needs; promoting constant enlargement of business; improving relations with local self-government and other relevant actors in the area;
- analysing "gaps" in the services provided by SMEE regional agencies, with the aim of developing better mechanisms for identifying the SMEE sector's problems and needs and providing solutions to these problems;
- reinforcing and developing a stronger and better coordinated state network, analysing successful proposals and identifying potentials in regions important for SMEE development; and
- providing permanent education for employees in regional agencies/centres in the SMEE area

Several new institutions were established in the previous years as a result of the work of RASMEE. Altogether, there are now 14 regional offices distributed over the whole country, which work closely together with local and international partners and have already realised a large number of domestic and international projects.

**Financial institutions.** All banks in Serbia function as universal banks. Banks primarily focus on banking services for the general population and the economy, mostly through crediting/depositing operations. All but five are authorised by the National Bank of Serbia (NBS) to do business with foreign countries. Seven banks have started operations in investment banking, mostly in securities on the Belgrade stock market. A few banks are registered leasing companies (for example Raiffeisen Leasing, Hypo Leasing). Furthermore, 30 foreign banks have registered branch offices in Serbia. Besides banks, eight savings and loan banks, two savings and loan cooperatives, and one savings bank also operate on the banking-service market. In addition to that, 37 insurance companies as well as 80 broker-dealer companies have been doing business on the Serbian financial market. The adoption of the law on investment funds made it possible for these financial institutions to be present on the domestic financial market. At the beginning of 2007, the first domestic investment fund started to operate.

The National Bank of Serbia is the Serbian Central Bank. Its authority is specified in the law on the National Bank of Serbia (Official Gazette of the Republic of Serbia, No. 72/2003). The National Bank of Serbia is autonomous and independent and reports directly to the Parliament of the Republic of Serbia. The main goal of the National Bank of Serbia is to realise and maintain the stability of prices. Furthermore, the NBS is responsible for the supervision of banks and insurance companies.

**Banks,** depending on the level of investment risk, require a collateral 1-2 times greater than the sum borrowed. Mortgages, chattel mortgages on equipment, stocks and personal property, guarantor's bonds, and the like are usually required as collateral. It is not unusual for several different types of collateral to be required.

More than 70% are short-term loans for revolving assets and liquidity of up to 90 days, with the possibility of revolving. Loans to medium-sized and large enterprises are most readily approved. Only 30% are long-term investment loans, less used by SMEs. (The average value of capital in small enterprises is 50,000 Euros, and these enterprises make up over 90% of all enterprises in Serbia.)

There are two credit lines from the EIB and the EU of 20 million Euros each. Credit lines are placed with several commercial banks through the Central Bank as the agent. Credit conditions are very unfavourable. The Central Bank receives loans at the quarterly EURIBOR interest rate, and the both Central Bank and the commercial banks raise the interest rate by another 6% (through the foreign-currency clause). Loans are given only to enterprises with an impeccable balance sheet in the last two years that can secure the requisite collateral. The repayment period depends on the loan purpose and ranges from 3 to 10 years, with a period of grace of 6 months up to one year.

In 2004, three years after the European Agency for Reconstruction opened a credit line for the development of small and medium-sized enterprises with an initial capital of 15 million Euros, the Revolving Fund was formed.

**Institutions of financial leasing.** In the absence of other instruments of financing, financial leasing became very popular in a very short time, and it is now frequently utilised by SMEs in Serbia. As there is a great interest in, and need for, factoring services, there are two factoring companies operating in Serbia.

**Donor institutions.** In 2004, representatives of the EIB, in their contacts with the Serbian government, expressed their willingness to finance SME development in Serbia with an additional 45 million Euros. Of this sum, five million Euros are earmarked for micro-crediting.

Certain donors are prepared to secure funds for SME financing through bilateral agreements. Examples are the arrangements offered by the Spanish and Italian government.



**Institutional centres of the National Employment Agency for the development of entrepreneurship**, 22 of them, were founded in the period from 2002 to 2006 in Serbian municipalities. The government has allotted funds of approximately 14 million Euros to the operation of these centres.

In order to secure the survival and development of newly-founded companies in their first year of operation, training and mentoring is being carried out at the National Employment Agency centres for entrepreneurship. Cooperation with employers has been intensified, and the concept of entrepreneurship as well as the development of the SMEE sector in the Serbian economy are being promoted. Information acquired through organised meetings with employers enabled a more realistic insight into the state of this sector. Examples of good practice have been used in contacts with potential entrepreneurs.

**Municipal offices for local economic growth**, in those municipalities where they have been created, present important institutionalised forms of support to SMEE development. In 28% of municipalities, offices for local economic development have been established, and 27% of municipalities have some other type of institutionalised form of SMEE support, such as municipal information centres, business information centres offering expert assistance, information and presentations for SMEs and business novices, centres for SME development, one-stop shops for citizens and SMEs which operate as service and information centres, service centres performing work for unions of independent artisans and entrepreneurs, incubation centres for development and business, call centres, SME info-desks, export and networking clubs, employment offices giving support in finding employment through different kinds of initiatives, with an important role being played by local councils. In the course of the last two years, 2005-2006, most of the municipalities, 64% of them, that had regional agencies and centres for the development of SMEs operating on their territory, assessed their cooperation with these agencies as excellent. (Results of a UNDP survey in 2007.) In the 2005-2006 period, besides their fiscal and social functions, municipalities started to develop their economic function more intensely, inspiring a speedier development of small and medium-sized enterprises and agriculture on their territory by allotting budget funds to subsidies and other financial inducements. The aim was to promote entrepreneurship and its advantages, to organise local competitions for the best technological innovations, entrepreneurial ideas, image projections, and activities in order to develop the culture of entrepreneurship and enhance growth rates by motivating local participants.

**Cooperation of institutions for SMEE development.** For the established institutional support to the development of the SMEE sector at the national, local, and regional level, it is very important to secure the highest possible participation in joint support activities, to build an integral approach to information, and to unite incentives through horizontal cooperation with the following institutions: Municipalities, the NGO sector, industrial associations, chambers, the National Employment Agency, banks, centres for requalification, and consultants. Regional agencies for SME development cooperate well with regional chambers of commerce on a partnership basis, and partnership relations and good cooperation also exist between RA/RC for SMEE and trade as well as other associations of entrepreneurs and syndicates, with the National Employment Agency, the newly-formed employment councils, and centres for adult requalification. However, there is rivalry and competition in certain areas where support services are offered.

Cooperation with municipalities in which regional agencies and centres for SMEE development operate is getting more important, both for the agencies themselves and for the municipalities. Cooperation with municipalities is outstanding in financing sub-centres of regional agencies, founding and operating local offices for economic



development, developing plans and strategies for local economic development in industrial zones, BID zones, business incubators, and techno-parks, and in creating and operating industrial clusters.

An especially interesting area of cooperation is the group of RA/RC activities to support the SMEE sector by loans, financial guarantees, and grant schemes at the local level. In this context, it is important to note that 54% of regional agencies and centres for SMEE development in activities related to monitoring, selecting, and training potential recipients of funds, and that regional agencies and centres for SMEE development cooperate in providing financial support and start-up grants as well as in carrying out local schemes for novices in creating and managing personal businesses. This cooperation is expanding, witness the fact that more than 80% of agencies are involved in these activities. This is highlighted by the cooperation between regional agencies and centres for SMEE development and international organisations providing start-up grants, of which 76% participated in these activities in the last two years.

**Institutions of standardisation and quality control.** Due to a need for establishing more solid and more substantial cooperation at the local level, regional agencies and SMEE centres believe that the following is necessary:

- Improving the coordination of SME support activities from the local to the national level in order to institutionalise cooperation at all levels and increase the contribution of institutions to employment and competitiveness of the private SME sector
- Improving the division of work between providers of services with the same content in order to avoid overlapping as much as possible
- Improving cooperation with regional industry chambers and trade associations on joint projects and creating joint contacts within general trade associations with municipal financial support
- Reducing competition between institutions and strengthening partnership within the network of regional agencies and centres itself, as well as cooperating on the organisation of the network of institutions for the support of local development

## 9.4. The share of SMEs in the results of Serbian economy

In the period from 2000 to 2005, the real gross domestic product (GDP) grew quickly at an annual average rate of 5.5%, with the highest growth rate of 9.3% achieved in 2004. International comparisons show that in 2005, Serbia achieved a significantly higher economic growth rate than the EU-25, but the GDP per capita is still far under the EU-25 average. Estimates say that in 2005, the GDP per capita in Serbia amounted to around 2,600 Euros, which is 11% of the EU-25 average (23,500 Euros).

Despite the high trade deficit reached in 2005, Serbia achieved a positive trend in foreign trade. The highest volume of foreign trade was with the EU (51.2%) and the neighbouring countries of Bosnia and Herzegovina (6.9%) and Croatia (3.0%), while the highest deficit was realised with Russia (oil, gas, raw materials) at 24% of the total economic deficit. In the foreign exchange structure, raw materials and products at lower stages of processing dominate, which indicates that the attained level of structural change is still insufficient for faster economic growth and development. The high deficit of the trade balance in the observation period was neutralised by a steady surplus in services and net transfers, while the growing capital balance

surplus contributes to the balance of payments surplus. In 2005, the share of the external sector in the overall economic activity reached 62.4% and the coverage of imports by exports increased (42.7%), but the Serbian economy is still facing an unfavourable export structure, low diversification of exports, the lack of an export strategy, and low competitiveness. In comparison with neighbouring countries, the results of foreign-trade activities are more favourable than in the last few years (increased share of exports, decreased share of imports, and deficit reduced to ¼ of economic activity).

**Investment climate.** In comparison with development requirements, current investment activity is at a low level. Increasing investments in the economic infrastructure, new technologies, and equipment are basic preconditions for higher GDP growth rates, enhanced competitiveness, and growing exports. In order to overcome the technological lag and achieve economic development, investments of around 25% of the GDP will be necessary. In 2004 and 2005, significant progress was made in creating a stimulating business environment and inviting FDI. The fact that the amount of foreign direct investments in Serbia reached 5.4 billion Euros in 2006, and that around 35 billion Euros in foreign direct investment is planned for 2007, shows that Serbia, with its private sector and middle-class values, is becoming more and more attractive to foreign investors. The tax rate on corporate earnings has been reduced from 14% to 10%, and is now one of the lowest among the transitional countries.

### 9.4.1. The development of the SME and trade sector

From 2000-2007, SMEs in Serbia were very important for economic development, especially for increasing the social product of the Republic, employment, and innovation; attracting direct foreign investments; a more balanced regional development; the substitution of imports; and enhancing the export competitiveness of the domestic economy. All this can be observed in the overall improvement of economic performance and is supported by the World Bank survey on business results (2007 Business Report). In 2006, 99.6 million Euros in long-term loans, 8.9 million Euros in short-term loans for independent artisans, 25.8 million Euros in start-up loans, and 42.1 million Euros spent on special programmes for regional development were invested into the SMEE sector through the Development Fund. Loans granted to the private-sector economy accounted for 28% of the gross national product of Serbia in 2006.

**Number of enterprises.** In 2007, the small and medium-sized enterprises sector, including entrepreneurs, numbered 277,000 enterprises and shops (in 2004 – 285,139; in 2005 – 276,695). The SME sector accounts for 99.7% of enterprises in Serbia, as well as 72% of entrepreneurs, and 82% of 72,000 registered enterprises are small, the smallest with up to 9 employees.

Out of the total number of SMEs, 42% operate in the area of trade and repair of motor vehicles and personal and household goods, 16% in manufacturing, 10% in transport, warehousing, and connections - mostly medium-sized enterprises. SMEs are concentrated in work-intensive and service-providing businesses with a faster capital turnover and a shorter production cycle. Out of the total number of SMEs, 47% are concentrated in Belgrade and the districts of Niš, South Bačka, and South Banat.

**Employment.** Between 2000 and 2006, the total employment dropped by 1.3% for enterprises and 14% for institutions and organisations, bringing down the employment rate to 51%, the lowest in the region (only Turkey is behind Serbia). The rate of unemployment is 20.8%, again the highest in the region (the EU average is 8.7%).

A positive trend in employment has been achieved only in the SME sector, namely in shops and micro-enterprises, from +14.8 % in 2000 to +25.3% in 2006. Self-employment has been growing at a 3% rate. In 2006, 59% of all employees in Serbia (810,862) were employed in SMEs, 46.5% of them privately owned. The highest employment rate within the SME sector is in medium-sized enterprises (33%) and small enterprises (31%). Nominally, around 70,000 new jobs were created by SMEs, with the highest increase in independent businesses and artisanship, the pillar of new employment with 33.4%.

Of all SME employees, 73.2% are concentrated in the following sectors: Trade (47.9% in shops), the processing industry and construction (46.3% medium-sized enterprises).

Besides a million unemployed, there are problems of long-term unemployment, the structure of the unemployed on the labour market, the problem of young educated unemployed people, the problem of women, and especially the new potential workforce surplus of around 65,000 from public enterprises entering privatisation in the next year. Within the national budget, 29 billion dinars have been allotted for severance pay and self-employment for 170,000 workers, and another 2 million Euros are planned for the surplus workforce and their self-employment in the SME sector. This is going to be absorbed only if conditions are secured for a dynamic SME sector, namely if its fiscal and parafiscal burden is significantly decreased and its business environment improved.

## 9.4.2. Results of SME business operations

**Total turnover.** In 2006, the share of SMEs in the total turnover as an indicator of activities, market growth, and productivity of enterprises and employees, was over 70%. Enterprises in the private sector have a decisive influence on the level of turnover reached in the economy at 73.3%, with a dominant influence of independent businesses/entrepreneurs, making up 37% of the total turnover in the Republic in 2006. Thus, 95.3% of the turnover of all privately-owned enterprises is generated by micro-enterprises, 93.55% by small, and 77.8% by medium-sized enterprises. The 47% increase of the SME share in the turnover points to the positive fact of a more serious development.

The share of SMEs in the total turnover of the Republic has decreased from 68% to 65.5% in real terms. On the other hand, large enterprises increased their share by 2.7% and their turnover by 7.7%.

Productivity in the SME sector has increased by 14.4% per enterprise and by 3% per employee. Measured both per enterprise and per employee, the turnover of SMEs is 5 times as high as the economy average. In addition to that, the productivity increase in the SME sector was accompanied by a 7.7% increase in employment, while employment in large enterprises simultaneously decreased by 0.1%.

SMEs dominate in turnover in all sectors except for raw materials, transport, warehousing, and connections. The highest turnover share of 28.9% was achieved by SMEs in trade, manufacturing, construction, repair of motor vehicles and personal and household goods, real-estate, rentals, and business services.

From the regional point of view, SMEs had the most important turnover in Belgrade and in the districts of Niš, South Bačka, and South Banat.

**SME productivity.** In the period from 2000 to 2006, productivity indices in the SME sector were below average and declining, whereas those of the large enterprises were above average and rising. Large enterprises have the highest productivity index compared to the average of the overall economy, while medium-sized enterprises have the lowest. Within the SME sector, micro-enterprises are the most productive. In 2006, only large enterprises logged an increase in productivity and improved their

efficiency. As regards ownership, all private SMEs had the highest – albeit decreasing – level of productivity.

The productivity of the Serbian economy has grown in the last two years, and a comparative analysis also indicates that its growth rates in the last three years were the highest achieved within the region.

**SME labour costs.** In the last 6 years, the SME sector improved its operational efficiency by lowering labour costs. Micro- and small enterprises had below-average, albeit growing, labour costs, while medium-sized enterprises had labour costs above the average of the economy. With regard to ownership, private enterprises have a small share, while social and state enterprises have a large share of labour costs in business expenses. Small cooperative enterprises have been the most effective. Micro- and small private enterprises have the lowest labour costs per employee and per hour. The indices of small and medium-sized cooperative enterprises are also above average. SMEs, both private and social, are the most competitive with regard to labour costs per employee and per hour. Taking into consideration the fact that unit labour costs in the SME sector are continuously decreasing, it is reasonable to expect their cost competitiveness to improve.

### 9.4.3. Gross domestic product and competitiveness

**Gross domestic product.** The share of SMEs in the GDP realised in Serbia is 54.1%, and the share of the private sector is 64.4%. The 30.5% share of medium-sized enterprises in the GDP among SMEs is the greatest, whereas with regard to ownership, privately owned enterprises have the greatest share at 86.7%. SMEs are constantly increasing their share in the GDP generation. The 12.3% real growth in GDP of SMEs is above the average of the Republic (7.5%) and of the big systems (2.3%). Real growth in GDP was achieved in the entire SME sector, especially in medium-sized enterprises (79%), medium-sized cooperative and small state enterprises, while the business operations of SMEs having other forms of ownership were unprofitable. As for increases in derived indices, the highest increase of GDP per enterprise (38.4%) and per employee (40.5%) was realised by micro-enterprises, while medium-sized enterprises are the most competitive.

The GDP attained indicates a revitalisation of business activity and an increased influence of SMEs on the overall economic activity, as well as a mild influence on structural reforms. However, the SME sector is still not the leader in structural reforms. Economic activity is determined by large economic systems because 694 large enterprises (0.3% of all registered enterprises) create about 40% of the GDP and are superior in terms of business activity, productivity, efficiency, and competitiveness to the SME sector, measured by GDP per enterprise and employee as well as by the GDP share in the turnover.

SMEs have a prevailing influence on generating GDP in all sectors of the economy, except for mining and quarrying, electricity, gas and water supply, transport, warehousing, and connections. The largest shares in the GDP generated by SMEs are held by manufacturing (27.8%), trade (33.3%), and real estate (10.5%). Medium-sized enterprises account for the largest share of the GDP realised by SMEs, whereas independent businesses/entrepreneurs hold the largest share in the following sectors: hotels and restaurants, trade, transport, financial brokerage, health and social work, and public services. Small enterprises dominate in fishing. Regionally, 61% of the SMEs GDP was realised in Belgrade and the Niš, South Bačka, and South Banat districts.

**Efficiency of business operations.** The efficiency of business operations analysed on the basis of profit and profitability rate indicates that SMEs are the most profitable part of the Serbian economy, accounting for 50.4% of the Republic's profit and with a realised profitability rate of 40% (the economy and large enterprises have a 36% profitability rate).

The decisive influence of the SME sector on the realisation of profit is related to the GDP, not to a decrease in labour costs, which in fact increased by 31.5% (21.8% in the economy and 15.1% in large enterprises).

Within the SMEs sector, small enterprises had the greatest influence on the realisation of profit. Medium-sized enterprises are still facing problems caused by unfinished privatisation processes.

With regard to ownership, all private enterprises made a profit. Within the SMEs sector, all mixed, small, cooperative, and micro state enterprises operated without profit. In 2006, the private sector realised 69.3% of the total profit in the economy, with a dominant influence of SMEs in profit generation in the private sector (over 70%). SMEs have a prevailing influence on the level of realised profit in all business operations, except for the capital-intensive sectors where large enterprises are doing business. SMEs realised 70% of their profit in trade (38.2%) and manufacturing (30.8%). The most profitable enterprises in Serbia, realising 73.1% of the profit in the economy, are located in the territory of Belgrade (55.5%) and the district of South Banat (17.6%). The dominance of these districts is also prominent in the realisation of the profit of the SME sector in the economy (64.2%).

The private SME sector of economy is the most profitable, with a 49.4% rate (the average for the private sector in the economy and the large enterprises is 43.4%). Within the SME sector, micro- and small enterprises are the most profitable. The higher profitability of privately-owned medium-sized enterprises compared to the profitability of all medium-sized enterprises indicates the necessity of completing the privatisation process. The SME sector has above-average profitability rates in almost all sectors, except for the following: fishing, the energy sector, transport, warehousing, and connection, due to the unprofitable business operations of medium-sized non-privatised enterprises. SMEs in trade, construction, mining and quarrying, and manufacturing have the highest profitability.

**National competitiveness.** In the analysis of the World Economic Forum of 2005, an improvement in was noted in the national competitiveness of the Serbian economy, although the competitiveness indices are at a low level. Out of 117 countries, Serbia ranks 85th in global competitiveness, 80th in macro-competitiveness, and 86th in micro-competitiveness. Macro-competitiveness is up due to improvements in the indices for technological development and the quality of public institutions, while the deterioration of the macroeconomic environment index had an adverse effect.

What is disturbing is the low competitiveness at the micro-level and the deterioration of the strategic and corporate-solutions indices and the business environment index.

#### 9.4.4. International comparison

Although the statistical basis of reporting on SMEs is still insufficiently aligned with Eurostat, some comparative indices can be derived:

The Index of SME development (based on three economic parameters: share of private ownership in GDP, share of SME sector in GDP, and share of the labour force of the SME sector in the country's total employment) distinguishes between countries with fast progress and an index of \$500-2,200 per capita, countries with medium development and an index of \$100-500 per capita, and countries with delayed development in transition and a lower SME development index of \$100 per capita. In 2006,

Serbia had an SME development index of \$650 per capita, thus falling into the group of developed countries, although the index varies regionally within the country.

Overall entrepreneurial activity: The TEA index includes

- Information about owners/entrepreneurs from a representative sample of the total adult population
- Location of owners and managers of companies founded
- Identification of those who expect their company to make an innovative change on the market and create new business in the forthcoming period as well as entrepreneurial companies within the region as a percentage of the overall number
- Percentage of business operations in an entrepreneurial firm. The index reflects both aspects.<sup>3</sup>
- The sample consists of all companies and businesses in the country.

In this area, Serbia falls into the group of countries with a low activity. The concept of national entrepreneurship itself includes people who create new companies (the start-up phase), young companies up to 3.5 years old, some innovative and growing companies; entrepreneurship among existing firms that create innovations on the market and focus on growth; a national infrastructure oriented towards adaptation through coordinated centralised efforts, cooperation among the major participants, the government, researchers, education, and financing. In this area, Serbia falls into the fifth group of countries with little-developed activities.

## 9.5. Support for SMEs with the aim of creating a social market economy in the forthcoming period

The above-average business activity and results of the SME and trade sectors considerably influenced the increase in the efficiency of business operations in the overall Serbian economy. Initial positive results of the structural changes and privatisation measures initiated are most evident in the strengthening of the private sector and, consequently, the middle class as the most competitive part of the economy.

In the forthcoming period, Serbia will primarily encourage the creation of a strong private sector through the foundation of new and the development of existing SMEs, especially medium-sized enterprises that will take the initiative in development and the application of innovations and technical-technological advances so as to increase the productivity and competitiveness of the economy. To that end, measures will be taken to improve the simulative business environment and establish a market of financial and non-financial services adjusted to the development needs of this sector. This is precisely why *support measures in the Republic of Serbia aim at restructuring the Serbian economy by developing existing and creating new SMEs, raising the level of internal and external competitiveness of enterprises that won, in a five year period, a share of more than 70% in the GDP, export, and employment, significantly increasing the share of the private sector in the GNI, increasing the number of enterprises and artisan shops, encouraging innovative entrepreneurship, and modifying the industrial and service structure of the SMEs.*

To enhance the efficiency of the process of implementing the EU Charter in the forthcoming period, Serbia intends to improve the realisation of the EU Charter in the context of SMEs by general measures, and to accomplish significant improvements

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3 As in the original text, it is not clear which "both" aspects are in question.

under the following EU Charter principles: More favourable and faster start-up; better legislation and provisions; more available capabilities; improvement of business activities on the domestic and foreign market; tackling taxation and financial issues; and strengthening technological capacities. To that end, apart from adopting the National Innovation Strategy, the following issues are on the 2007 agenda:

- Securing a budget line for the development of innovative SME businesses that will not be a part of public expenditure
- Increasing the promotion of innovativeness and creating a network of promoters of innovative businesses in Serbia
- Organising donor conferences for the development of innovative businesses in Serbia

The possibilities of electronic *communication between small and medium-sized enterprises and trade* and the public management have improved, but more work will have to be done on creating new forms and contents, particularly through web presentations of all state bodies and questions and answers facilities on the web pages of the Republic Agency for SME development, the Agency for Economic Registers, the Ministry of Finance, the Ministry of Agriculture, and the Serbian Chamber of Commerce, through facilities for downloading forms and applications for open competitions for incentive or credit funds of the Development Fund, the National Employment Agency, the Ministry of Agriculture, the Ministry of Economics, the Ministry of Tourism, the Solvency Centre, the tax and customs administrations, and through providing direct access for SMEs to the Business Cooperation Network (BCN).

***Improvement in the level of knowledge and capability within the SME sector.*** In this segment, it is necessary to redefine relations between the economy, education, and scientific research institutions on an entirely novel basis. The knowledge and capability of entrepreneurs significantly lags behind the need for creating a consistent, export-oriented, and innovative SME sector. The biggest improvement in overcoming this state of affairs was achieved when a study of entrepreneurship was launched in specialised high schools and the number of private high schools, colleges, and universities that offer entrepreneurial knowledge increased.

- *Formal education.* The development of formal education in Serbia aims for integration in the contemporary European educational space, securing vocational skills and knowledge in compliance with the volatile requirements of contemporary business, creating a qualified workforce as a competitive advantage of Serbia, founding and developing small and medium-sized innovative enterprises, and supporting the business advancement of existing enterprises. The strategic goal of the further development of specialised education in Serbia is to position it amongst the factors of technical-technological, socio-economic, and individual development. Its specific goal is to provide young people and adults with opportunities to acquire the skills, knowledge, and capabilities required for work and employment as well as with further education and learning. The reform of the *education at applied-science universities* envisages the introduction of a subject named "Entrepreneurship" in the educational system, starting with the 2007/2008 school year. The realisation of a pilot project of entrepreneurial education in experimental high school classes continues. Under the project "achievements of young people in Serbia", young people are trained for business and entrepreneurship. "The business innovative programme" is also devoted to the development of young entrepreneurs in Serbia. In the areas of *university education*, reforms based on the principles of the Bologna Declaration are continuing. The number of colleges and universities where subjects related to the acquisition of



entrepreneurial skills are studied is growing notably. An integral part of the programme for the reform of specialised education is adult education. New centres for adult education will be opened, located in cities where an industrial revival is expected and aimed at growing into leading regional institutions.

- *Non-formal education.* Possibilities of obtaining additional entrepreneurial knowledge and skills through non-formal education are improving, as can be measured by the scope, quality, and content of educational programmes. However, the level of these services is still not sufficiently adjusted to the real needs and possibilities of existing and potential SMEs. Programmes of non-formal education will be implemented by the following institutions on an ongoing basis: the Republic Agency for SME Development, the National Employment Agency, and the Serbian Chamber of Commerce and their networks as well as by other providers that will, in the meantime, obtain licenses for their programmes, with compulsory introduction of service standardisation and continuous adjustment of the programme content to new circumstances and the users' needs.

**Financial support.** The Serbian government and international donors will work in parallel on the creation of new credit lines and guarantee funds in the SME and trade area, with the goal of overcoming the lack of financial means and credit capacity in this sector and facilitating access to banks, with the following important aspects:

**Micro-financing as a strong support for a successful business start-up.** To improve the access to capital for new enterprises, local and regional networks of micro-finance branch offices will be created that include banks and NGOs. Apart from these laws,<sup>4</sup> the entrepreneurial sector must become an integral part of the local banks' customer base in municipalities and comprehensive cooperation on risk protection and the development of SME projects must be instituted at the local level.

In the forthcoming period, a comprehensive and transparent process will be established to develop and implement a policy of start-up development support and a start-up fund will be created together with the legal regulations required to enable the foundation and functioning of micro-finance institutions, new forms of non-financial support (vouchers) intended to facilitate access to consultation and other similar services, with the public, commercial, and civil sector communicating and acting in partnership.

Further strategic goals of SME and trade stimulation as the first step in the creation of a socially responsible market economy:

- Eliminating all legal, administrative, and fiscal barriers and adopting governmental measures to create an environment which favours the growth of existing and the creation of new SMEs and improves their competitiveness on domestic and foreign markets
- Adjusting education at all levels with the aim of recognising entrepreneurial values and culture, stimulating innovativeness, acquiring modern managerial knowledge, and facilitating lifelong education and professional improvement for a more efficient enterprise management
- Providing high-quality non-financial services in an organised manner, with the aim of improving business efficiency and competitiveness in the country and abroad and raising the level of business performance of domestic entrepreneurs and enterprises as a prerequisite for attracting foreign investment

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4 It is not clear which "laws" the author refers to.



- Creating a financial system of new institutions and programmes of financial support to secure the profitability of business operations for existing and new private SMEs, with the goal of raising their level of competitiveness and their capability to absorb foreign investments in accordance with the level of development and the needs of each development phase in the SME business
- Increasing efficiency in the use of resources created by restructuring or privatisation (workspace, equipment, installations, trained labour force) in order to promote new profitable units, productive employment, the development of local communities while providing special support for the initiatives of entrepreneurs from different target groups, rural and undeveloped areas, and the development of business cooperation among existing SMEs in the country and abroad

To proceed further in the direction of a free market economy, the Serbian government plans the following measures:

1. Creating a more creative and stimulative institutional and legal environment
2. Improving access to information and business services
3. Developing SME performance through modern forms of institutional support
4. Facilitating access to capital and the support of financial institutions for the SMEE and trade sector
5. Implementing programmes for the development of SME competitiveness and innovativeness

As the transition from financing social security and care entirely from the state budget to a social-market form of financing is still under way, the Republic plans, in the forthcoming period, to introduce further systemic provisions in the areas of health care, social care, work disability, and unemployment protection to do justice to more economic aspects besides freedom and social justice, as well as to seek public-private partnerships in developing long-term solution for social issues.

In the forthcoming period, the moral concept of the SME sector will be developed as well, including the encouragement of individual freedoms, solidarity in alleviating the spread of inequality, and subsidiarity. Institutions will have a more important role to play in managing relations between individuality and solidarity, and the importance of individuals and SMEs as promoters of change will grow.

Although it is hard for the Serbian economy to improve the performance of the economy and its international competitiveness by increasing the gross value added of the SME and trade sector in conditions of totally liberalised trade and open international competition, an attempt will be made to strike a balance between the economic and the social principle in the economic, social, and political programme the newly-elected government is working on at this moment.

In view of the new requirements set by international competition, new ministries have been formed for ecology and the information society, and the goals of the government concentrate on employment measures, the creation of new workplaces in all areas, decreasing poverty, and helping employees who will not be able to cope with new competitive labour-force demand on the market through training, requalification, improving the efficiency of the labour force, and more favourable social programmes.

The development of social partnership, tripartism, and social contracts at all levels, with the cooperation of all stakeholders in their realisation, has been initiated in Serbia, and it will be continued with more vigour.

***The main macro-economic projections for the 2004-2010 period*** point out the

necessary requirements that Serbia will try to fulfil in order to reach a certain level of competitiveness in the Serbian economy and improve the standard of living:

Bearing in mind the very low GDP per capita (around \$2,500) as well as the huge number of unemployed (the official unemployment rate is around 20%), it is essential for Serbia to reach a long-term annual GDP growth rate of at least 5% and thus a GDP of \$4,000 per capita by 2010. Only with such an economic growth rate will it be possible to raise the living standard as well as employment and work productivity, which is the prerequisite for achieving two main goals – decreasing unemployment and increasing competitiveness.

One of the prerequisites of dynamic and sustainable economic growth is macro-economic stability, which can be achieved by creating external and internal balance. The only way to realise this is a significant increase of exports (to 35% in 2010) as well as an inflow of foreign direct investments of over one billion dollars annually.

It is necessary to make changes in the expenditure of the GDP in the forthcoming period, as well as to secure a significant decrease of private and public spending in favour of increased savings to provide the investments needed.

In addition to that, this projection anticipates a gradual decrease of the share of public spending in the GDP from around 46% in 2003 to 43% in 2010. Changes in the structure of public spending are also very indicative: The share of education is increasing while that of pensions, social care, defence, and public order and safety is decreasing. The reason for this change in spending (social expenditures) lies in the fact that the present expenditure on education (in % of the GDP) is lower than the EU standard. Furthermore, the decreasing defence expenditures will be possible due to reforms of the defence system which will reduce the number of employees in the armed forces, whereas the decrease in social expenditures will be compensated by a private-public partnership.

# 10. Summary

by Anna Katharina Bölling

## 10.1. What are the differences and similarities between the *Mittelstand* and “Small and Medium Sized Enterprises” (SMEs)?

Since the present report deals with the promotion of the *Mittelstand*, and the related question of trade, in South Eastern Europe (SEE), a brief definition of this German term is called for.<sup>1</sup> Among other things, this should clarify its similarities to and differences from the general term “SMEs”.

In the countries of SEE, use of the term “SMEs”, which are usually defined by reference to statistical data, is common. The small or medium companies which the term describes are differentiated from “Large Size Enterprises” (LSEs) by reference to two variables: number of employees and annual turnover. In Germany, the epithet “SMEs” is not common, in contrast to the term *Mittelstand*. Although the two terms are to a certain degree identical, to be described as *Mittelstand*, a company must meet more than the simple statistical hurdles required for qualification—or non-qualification— as an “SME”.

The German term *Mittelstand* covers economic and social as well as political aspects, which can hardly be deduced from official statistics. A *Mittelstand* company is characterised not only by size-related factors but also by qualitative and other quantitative features, which are in turn of special interest for our understanding of sociological questions, including the motives for actions, ways of behaving and self-assessment, peer feedback as well as special patterns of thinking. These factors also influence “the choice of the legal form of the enterprise as well as its way of financing, innovative behaviour, the number of products or offered services and the managerial attitude to run the business.”<sup>2</sup>

With this in mind, the definition given by the German chancellor Ludwig Erhard in 1956 still seems valid: “If we comprehend *Mittelstand* only from a material point of view, if we only read from statistical data [...] the term *Mittelstand* has taken a dangerous turn. *Mittelstand* cannot gain its full meaning through material definitions [...] it is moulded by personal attitudes and convictions in the social, economic and political process.”<sup>3</sup>

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1 Cp. Günterberg, Brigitte/Wolter, Hans-Jürgen: *Mittelstand in der Gesamtwirtschaft – Anstelle einer Definition*, in: *Unternehmensgrößenstatistik 2001/2002 – Daten und Fakten*, p.1-23, Institut für Mittelstandsforschung, Bonn 2002.

2 Günterberg, Brigitte/Kayser, Gunter: *SMEs in Germany. Facts and Figures 2004*, IfM-Materialien Nr. 161, Institut für Mittelstandsforschung, Bonn 2004, p. 1.

3 Erhard, Ludwig: *Mittelstandspolitik*, in: Rüstow, Alexander (Ed.): *Der mittelständische Unternehmer in der sozialen Marktwirtschaft*, („Wenn wir Mittelstand nur vom materiellen her begreifen, wenn man Mittelstand sozusagen nur von der Steuerungstabelle ablesen kann...dann ist dem Mittelstandsbegriff meiner Ansicht nach eine sehr gefährliche Wendung gegeben. Der Mittelstand kann materiell in seiner Bedeutung nicht voll ausgewogen werden sondern er ist, ...viel stärker ausgeprägt durch eine Gesinnung und eine Haltung im gesellschaftswirtschaftlichen und politischen Prozess“ (translation by the author).

## 10.2. What role do *Mittelstand* and trade play in modern economies?

### 10.2.1. Social Role

Taking the above-mentioned definition of *Mittelstand* as the basis for our further considerations, it is obvious that the development of a healthy and stable *Mittelstand* in SEE can constitute a cornerstone in efforts to promote democracy, social market economy as well as civil society in these countries.

Within the bounds of its abilities and duties, the *Mittelstand* has, since its emergence during the time of the Industrial Revolution, always played a key role even in these areas. Basic ideas such as individual and social responsibility as well as self-determination—ideas which are indispensable for each democracy and free market economy—also represent the ideological basis of the *Mittelstand*. No democracy and no free market economy has existed without the essential support of the bourgeois *Mittelstand*. In SEE, burgeoning socialist structures undermined the role of the *Mittelstand* and thereby destroyed both democracy and the free market economy.<sup>4</sup>

Despite these tendencies, the *Mittelstand* has gained its special importance due in particular to its capacity to exert a strong social influence. Its decentralized structures, its loyalty to locations and sustainable planning over many generations have, together, allowed such developments. In addition SMEs, as the economic heart of the *Mittelstand* safeguard the majority of jobs in modern economies and in so doing contribute to a high degree of social satisfaction.

The various types of *Mittelstand* can also provide alternatives to corruptive tendencies such as nepotism, embezzlement and oligarchy and therefore effect a long-term elimination of these phenomena.

Against the background of all the possibilities provided by the development of a strong *Mittelstand* it seems to be of particular importance to support the *Mittelstand* and SMEs in SEE and to thereby create stable political and economic structures as a step towards long-lasting peace and security in the region.

### 10.2.2. Economic role

Despite all methodological and theoretical objections, it seems necessary to define firms by their size in order to identify the real economic weight of the *Mittelstand*. Yet, the wide variations in national and international schemes for classifying the size of firms presents a challenge. In the available country reports, one can, for example, observe that several authors apply the local definition of SMEs (e.g. Serbia, Macedonia, Moldova), whilst others resort to international or European definitions (e.g. Croatia). On the basis of the raw quantitative data found in these reports, this summary defines the SME according to new guidelines of the European Commission, which came into force 2005:

Enterprise category	Number of employees	Annual turnover	Annual balance sheet
Micro	up to 9	up to 2 Million (\$/year)	up to 2 Million (\$/year)
Small	10-49	2-10 Million (\$/year)	2-10 Million (\$/year)
Medium	50-250	10-50 Million (\$/year)	10-43 Million (\$/year)

Source: *The new SME definition. User guide and model declaration, European Commission 2004.*

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<sup>4</sup> This summary is based on the country reports in hand. Due to a lack of space the author does not refer to them in every single case.

On the basis of these definitions and the available data, the central role of the *Mittelstand* in the European economy in general becomes clear. The *Mittelstand* and SMEs are often referred to as the backbone of the European economy, providing a huge potential source of jobs and economic growth. SMEs are a major source of entrepreneurial skills, innovation and employment. In the EU-25, they represented 99.8% of all enterprises in 2003; they employed about two thirds of the workforce and generated more than half of its value-added (57.3%). Furthermore between 2001 and 2003, SMEs were the main driver of employment growth in the EU's non-financial business economy. One can thereby determine their particular dominance within the fields of construction, distributive trades, hotels and restaurants, real estate, renting and business activities (in particular marketing, software, research and development).<sup>5</sup>

A high degree of production on the part of the SMEs also indicates a high level of wealth for the economy in question. Only when a country has reached a certain level of economic development will the consumer's demand focus on individual desires. A further advantage of the *Mittelstand*, which is not to be underestimated, is its relevance for public finances. Considering for instance German tax revenue, one can observe that SMEs contribute more than 70% of all the taxation levied from enterprises. The *Mittelstand's* role as a financial pillar of the public finances is even more emphatic if, as in Germany, the social system is financed by the national budget. In Germany, 62.2% of all social security contributions stem from SMEs.<sup>6</sup>

Finally, networking allows SMEs to today combine the advantages of their smaller scale and greater flexibility with economies of scale and scope in larger markets on a regional, national and global level. Compared to larger firms, *Mittelstand* and trade can better respond to alternating market conditions and customer preferences as well as shorter product life cycles. In addition, new means of communication make it easier for these companies to get in touch with international partners in foreign countries. Western governments have already recognised the significant role of—as well as the size-related obstacles for—SMEs and therefore provide a wide range of assistance especially aimed at fostering “clusterisation” and global activities.

### 10.3. What is the general situation of *Mittelstand* and trade in SEE?

During the socialist period, the economies of SEE were characterised by central-planning and state-owned enterprises. Several waves of nationalisation consolidated the dominance of huge state-owned enterprises and eliminated the SME sector. Although clear differences in the development of socialist structures could be determined, the SME sector had to make a completely new beginning in 1989/1990 in all the countries. The liberalisation of the economies caused a real reestablishment boom in the whole region. In addition, many new SMEs developed during the early phase of privatisation, when state-owned SMEs were completely privatised; other SMEs were established during the process of decentralisation of these state-owned companies.

In this context, it can be held that the *Mittelstand* took on a central role especially during the first years of transformation. SMEs contributed first of all to the creation of the principle of competition and to its wide social acceptance. They also opened new business fields, strengthened human capital through the principle “learning by doing” and adjusted themselves to different consumer needs and demands.

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5 Cp. Statistical datas in Eurostat: *European business*, in: [http://epp.eurostat.ec.europa.eu/portal/page?\\_pageid=2293,59872848,2293\\_61474735&\\_dad=portal&\\_schema=PORTAL#SME](http://epp.eurostat.ec.europa.eu/portal/page?_pageid=2293,59872848,2293_61474735&_dad=portal&_schema=PORTAL#SME), 1. July 2007.

6 Cp. Hamer, Eberhard: *Volkswirtschaftliche Bedeutung von Klein- und Mittelbetrieben*, in: Pfohl, Hans-Christian (Ed.): *Betriebswirtschaftslehre der Mittel- und Kleinbetriebe. Größenspezifische Probleme und Möglichkeiten zu ihrer Lösung*, 4. Edition, Berlin 2006, p. 38.

Comparing the situation of SMEs in SEE by reference to key data, one faces various difficulties, which arise mainly from the different classifications and schemes used in the different countries (see above). Moreover there is no adequate general statistical overview providing a suitable basis for a overall comparison. Although a report edited by the World Bank in 2003 attempts to provide a database for the situation of SMEs across the globe, it does not include the countries examined in this study and is therefore unsuitable for our purposes.<sup>7</sup>

Bearing in mind that in the enlarged European Union of 27 countries, SMEs constitute 99.8% of all enterprises, employ more than two third of the workforce and achieve 57.3% of the value added, results for SEE drawn from the data in the country reports provide an ambiguous picture.

It can be inferred from the data that, in most of the countries examined, SMEs represent the decisive factor for the local economies. Following the privatisation of the huge state-owned enterprises the total share of SMEs has reached values similar to the average of 99.8% in the EU25 ( Bulgaria 99%, Croatia 99.6%, Serbia 99.7%). They also employ the majority of the total workforce (Romania 57%, Albania 66%, 76% Macedonia) and contribute a large part of the GDP (69.3% Macedonia, 54.1% Serbia, 67% Romania). *Mittelstand* and trade in SEE benefit to an increasing degree from strong economic growth, relatively liberal trade systems and in a couple of countries (particularly Macedonia) from a reform of corporate tax in favour of companies in general.

Despite many programs and measures undertaken by the local governments SMEs are still facing a lot of serious problems, which can be divided into external and internal challenges.

As internal obstacles for the further development of the *Mittelstand* and trade in the region one can regard the low level of education and training, the outdated technology in the majority of SMEs, the strong focus on local markets and the orientation of the enterprises concerned around traditional production, which in turn is connected with low productivity on a technological level.

The external weaknesses for SMEs in SEE are, first of all, an insufficient bureaucracy, an abundance of red tape, a widespread system of corruption and nepotism, and a flourishing grey economy. A lack of transparency in the business environment as well as inadequate collaboration between public authorities, universities, politicians and the *Mittelstand's* own organisations of self-administration and trade are also barriers hindering a further economic upswing.

Although significant differences in the legal and political conditions in the different countries do exist, one has to remember that all the states examined have a host of problems to contend with. The failure of a sustainable monetary, credit and financial policy and the resulting instability of these young economies hinder general economic progress. In some countries, government institutions don't have a clearly defined concept of the role of *Mittelstand* and trade. The system of statistical data survey too is not fully developed.

In the special cases of Bosnia Herzegovina and Kosovo, the unsettled status questions also have a strong negative impact. One can also observe a relatively high level of social dissatisfaction, which results essentially from a high degree of unemployment or wages below the general average. The absence of a feeling of social responsibility amongst entrepreneurs and the dearth of a general entrepreneurial spirit also influence this dissatisfaction.

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<sup>7</sup> Ayyagari, Meghana/Beck, Thorsten/Demirgüç-Kunt, Asli: *Small and Medium Enterprises across the globe, a new database, August 2002, revised August 2003, in: www.worldbank.org, 1. July 2007.*

## 10.4. What are the concrete steps for a further development of the *Mittelstand* and trade in SEE?

Due to their special size, SMEs show specific strengths and weaknesses which may require particular policy responses. Even in the high developed Western economies they traditionally face problems such as a lack of financing, low productivity, regulatory burdens, limited managerial capabilities and difficulties in exploiting technology. Additionally, globalisation and an increasing degree of technology make these problems today more significant. From these traditional barriers and the special obstacles in SEE (see above) there arises a situation posing particular difficulties and challenges for SMEs in these countries.

In the following summary, the main recommendations given by the majority of the country reports regarding their efforts to support the development of *Mittelstand* and trade in SEE are recapitulated.

### 10.4.1. Assurance of macro-economic stability

The basic condition for each economic upswing, for a sustainable improvement of living conditions and in the final instance for a stabilisation of the political system is a stable macro-economic environment. Consistent growth and inflation rates foster this stability as do low unemployment rates and a consolidated balance of foreign trade. SMEs in particular rely for their wellbeing to a high degree on an environment of macro-economic security and reliability due to their size-related problems.

Although in the countries of SEE, macro-economic problems are still apparent, one can observe an increasing degree of macro-economic stabilisation. This process of normalisation was also confirmed in the last annual progress reports of the European Commission.<sup>8</sup> Due to a lack of space it is not possible to reproduce the macro-economic details of the SEE states in the present summary. Readers are referred to the abovementioned reports of the European Commission.

### 10.4.2. The challenges of "clusterisation" and globalisation

Fostering public-private partnerships and small-firm networks and clusters might be the fastest path to a dynamic SME development. Grouped in local systems of production, the *Mittelstand* can often be more flexible and responsive to customer-needs than large companies. *Mittelstand* firms can share the costs for training, education, research and marketing and can combine their resources. Clustering also makes a contribution to the exchange of personnel and technology, and can provide new possibilities for efficiency gains. Experiences with local and regional clusterisation, for instance in Nürnberg, Germany, or in Arezzo and Modena, Italy, have proved that clustering generates benefits for different groups of firms. It leads to increasing competitive advantages and is characterised by the continual emergence of new entrepreneurial firms.

These kinds of local networks based on mutual assistance can also help the concerned companies to meet the challenges of globalisation. Against this background,

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<sup>8</sup> Country reports of Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia can be found under: [http://ec.europa.eu/enlargement/key\\_documents/reports\\_nov\\_2006\\_en.htm](http://ec.europa.eu/enlargement/key_documents/reports_nov_2006_en.htm), 2. August 2007.

the governments of the countries of SEE have –as a first step- to recognise that the size of SMEs often prevents them from “going global”. Through special programs for these companies, the same range of financial and risk management services, including insurance, bank-guarantees and detailed advice as are available in the countries of the EU must be available. Furthermore, governments and special agencies founded by these governments should enable smaller firms to participate in foreign exhibitions and trade fairs; they should prepare marketing tools in foreign languages and circulate advertisements abroad.

### 10.4.3. Strengthening education and training

The SME-sector in SEE is in general characterised by a lack of trained and experienced personnel and a significantly low degree of management culture. Inadequacies in the education system also lead to a lack of motivation among young people to display entrepreneurship and start their own business activities. Therefore it seems to be necessary to bring into being a range of reforms concerning education, training and a better coordination between the firms and the educational establishment. To achieve a wide acceptance of the local education systems and to create internationally competitive managerial capabilities and a well-qualified workforce local governments should adopt programmes with the aim of moving in this direction. In a context in which the universities and the lower educational bodies in many countries of SEE have not yet been reformed, it is hardly surprising to find old socialist structures partly still in place. Although radical reforms based on the principles of the Bologna Declaration have already got off the ground, there still remains a lot of work to do.

Furthermore the number of universities that provide targeted programmes for adult education has to be increased along with the number of special information centres for adult education. In a fast-changing global world it is especially important to support the life-long learning process and to offer those entrepreneurs who finished their education under the socialist system continual refresher training of the skills, knowledge and capabilities required for work and employment.

Training programs dealing with the latest technological developments have to take place. Entrepreneurs have to be motivated to use new information and technological systems; investments in trendsetting industries such as biological, medical and various technical sciences have to be fostered and a new multi-disciplinary education system has to be introduced. The link between entrepreneurial thinking and acting, scientific, humanistic and economic skills as well as access to new technologies could be more than conducive to meeting the challenges of globalisation and European competition.

### 10.4.4. Improving the access to finances

One major obstacle for the growth of the *Mittelstand* and trade has always and everywhere been funding gaps. The diversity of the profitability, survival and growth of the companies concerned, especially compared to larger firms, brings special financing problems. Early stages of growth are characterised by a high degree of uncertainty, both on the production side and in marketing. Managers and owners of SMEs often lack professional commercial experience as entrepreneurs, and the smaller, more innovative firms amongst them operate in markets of high complexity and rapid change.

In general, it can therefore be said that SMEs often have trouble obtaining finances because banks and traditional lending-institutions are averse to risky ventures. In the countries of SEE these problems are often accompanied by a lack of trust in the existing financial system. Measures to rebuild the credibility of banks and lending-in-



stitutions must therefore be the first steps taken to enhance entrepreneurs' access to finances. Moreover, the liberalisation of the entry of foreign banks into local markets could both boost the trust in the system in general and strengthen the competitiveness of the financing sector.

Governments should furthermore provide information about the possibilities for national and international subsidies and credits, the advantages of equity investments and the support offered to venture capital. They can also affect the supply of funding to SMEs by introducing rules and regulations to encourage banks, venture capitalists and capital markets to create uniquely tailored programmes for SMEs. In addition, they can promote a stable and flexible business environment, place a greater emphasis on training in line with the special requirements of SMEs and harmonise the existing financial policy framework across border, thereby enabling the *Mittelstand* and trade to share financial resources as well as their experiences in gaining financing.

### 10.4.5. Efforts to cut the red tape

Reducing regulatory burdens and cutting the red tape for the *Mittelstand* and trade could be one of the greatest spurs to entrepreneurship. Problems stem from the socialist history, failures during the transformation process and/or from regulatory systems developed to serve the needs of large enterprises. Sometimes there is a lack of coordination between the existing regulations and laws. SMEs in SEE criticise the high costs of compliance with local regulations: they often face complicated paperwork and economic guidelines that prohibit certain activities. Furthermore, excessive bureaucracy in all these countries hampers the formation of new companies, stimulates corruption, and makes public administration more expensive.

As a first step, then, it seems indispensable to launch a process to raise awareness of the significant role of the *Mittelstand* and trade in the local economies and of their special needs and requirements. In many countries of SEE, a clear definition for SMEs must also be established, distinguishing them from large companies. It also seems more than necessary to introduce special guidelines and laws especially for these types of enterprise. Connected with these basic steps to promote the *Mittelstand* and trade in the region, the existing system of statistical monitoring for the SME sector must be regulated.

Further measures to contain the bureaucracy in the countries in SEE must include the development of a clear, simple and stable legal framework, which works in a way favourable and predictable for the business environment. Formalities for businesses seeking to enter and to leave the market must be eased, and a general reduction of the administrative formalities counts amongst the basic requirements for the further development of SMEs in the region.

In addition, communication problems among ministries, and between ministries and entrepreneurs have to be eliminated; reform in the key areas judicial and public administration has to be driven forward. Only with a functioning judicial and public-administration system will the countries of SEE be able to implement a stable and healthy market economy in general and promote the development of the *Mittelstand* and trade in particular. The fight against corruption and the grey economy also represents a factor that exerts strong influence on these developments. In this context, the *acquis communautaire* and the recommendations and other instruments of the EU could serve as a beacon for further reforms.

## 10.5. How is it possible to transfer the cornerstones of social market economy to the Balkans?

### 10.5.1. What are the basic ideas and the roots of the German model of social market economy?

Germany's complete military and political defeat in the Second World War posed the question of establishing a new economic order which would be in a position to solve the social as well as the economic post-war problems, to legitimize the new West German state and leave behind the period of constant economic crises that had characterised the Weimar Republic. In this spirit, elements of both capitalism and socialism were taken up, modified and refined to create the new "third way" model of a social market economy. In contrast to the economic concepts adopted by the Weimar Republic and the German Democratic Republic (GDR), the term "social market economy" was defined as an idea of regulatory policy "with the aim of linking free initiative with the social progress achieved by the benefits of market economy on the basis of a free competitive economy."<sup>9</sup>

Although one can find various ideas developed by several economists in the run-up to the establishment of the Federal Republic of Germany (FRG) or even to the Second World War, one can look upon Alfred Müller-Armack (1901-1978) as the mainspring of the social market economy—the man who crucially influenced its implementation and its contents design. Together, the then Federal Minister of Economics and future Chancellor Ludwig Erhard, and Müller-Armack, an economist who later became State Secretary in the Ministry of Economics, devised the term social market economy and led the young West German state to an economic boom in the 1950s and 1960s (*Wirtschaftswunder*). In this context, Müller-Armack combined the consolidated findings of the Freiburg School with a strong social and ethic moral concept, which in turn originates from catholic social teaching and Christian as well as European thoughts in general.

Based on the assumption that the liberal laissez-faire-principle bore the responsibility for social and economic crises—including the Great Depression and fascist regimes in Europe—Wilhelm Röpke (1899-1966) and Alexander Rüstow (1885-1963) developed during the 1930s and 1940s a concept of a third way<sup>10</sup>, which was supposed to avoid the extreme tendencies of capitalism and socialism.

In line with Rüstow's and Röpke's radical criticism of laissez-faire capitalism, the Freiburg School around Walter Eucken (1891-1950) coined, with the central idea of order, another principle of social market economy. This neoliberal economic theory is called ordoliberalism. Eucken firstly proposed to define different forms of economic order and to create a typology of economic systems. Orientated around the question "who is the key-player in the process of economic decision-making?" he developed

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9 Müller-Armack, Alfred: *Soziale Marktwirtschaft*, in: *Id.: Wirtschaftsordnung und Wirtschaftspolitik. Studien und Konzepte zur Sozialen Marktwirtschaft und zur Europäischen Integration*, 1. Edition, Freiburg 1966, p. 243-249, p. 245, („deren Ziel es ist, auf der Basis der Wettbewerbswirtschaft die freie Initiative mit einer gerade durch die marktwirtschaftliche Leistung gesicherten sozialen Fortschritt zu verbinden“, (translation by the author).

10 The „Third way“ concept was especially coined by Wilhelm Röpke and Alexander Rüstow, who were forced into the Turkish exile by the national socialists. Cp.: Röpke, Wilhelm: *Die Lehre von der Wirtschaft*, 11. Edition, Zürich 1968 and Rüstow, Alexander: *Das Versagen des Wirtschaftsliberalismus*, 3. Edition, Marburg 2001.

for the first time the dualistic theory of economic orders, which still retains its validity. Thanks to Eucken, one now speaks of commanded and free market economies.

Due to his hypothesis that the collapse of laissez-faire capitalism was caused by economic freedom, which released self-destructive forces, he allotted the state the role "to create conditions for the development of functioning market forms and monetary orders"<sup>11</sup>. Thereby he strictly distinguishes between economic process and the economic order, which has to be established by the state based on non-economic values such as subsidiarity, solidarity and individualism. For the Eucken's purposes, such an order had to protect particularly the competition and monetary order.

In express contradistinction to this ordoliberalism, Müller-Armack<sup>12</sup> stressed that a pure policy of order would not be enough to establish a new, consciously arranged market economy. Alongside a system of welfare policy, he added to the model put forward by the Freiburg School the possibility for state-run activities in the economic process particularly in the trade cycle policy.

According to Müller-Armack, the trade cycle policy performs the task of regulating the economy, helping it avoid major fluctuations especially in the fields of inflation, unemployment and large blunders as regards production factors.

Despite the Freiburg School and its position that a well-designed competitive order would solve all social problems, Müller-Armack laid great emphasis on the social element of his theory. Therefore the idea of social reconciliation ("Soziale Irenik")<sup>13</sup> was at the centre of his concept of a social market economy. In this sense, it embodies an order of peace which was one of the main reasons for its widespread acceptance in the young FRG. The principles of subsidiarity, solidarity and individualism, which had already been used by Eucken and which can be traced back to Humanism and Christianity, were of particular importance for him.

The principle of subsidiarity, which affords the people responsibility rather than favouring state intervention, finds mention in the works of Aristotle and Thomas Aquinas and affected German catholic social teaching in the 19th century. Today it is not only part of the German constitutional framework but also one of the main principles of the European Union.

Solidarity as another basic idea advocated by Müller-Armack goes back to the Christian value of charity. In addition, one can find the theme of charity in the Islamic believe, where it is fixed in the five pillars of Islam—these describe the five duties incumbent on every Muslim who is able to carry them out.

The third key issue, which has to be mentioned in the context of the roots of social market economy is the concept of individualism, which sets the human-being at the centre of every society and which also places the welfare of every single person above any idea of collectivism. This conviction is still a foundation of European societies.

When combined with strong and dynamic economic growth, this idea of a general social safeguard for the population—a safeguard still well-known under the slogan "Prosperity for all" ("Wohstand für alle")—has ensured a high degree of social satisfaction and a strong source of legitimation for the German state and its institutions in general. However it was clear to Erhard and Müller-Armack, that social redistribution had to take second place after essentials such as personal initiative and motivation as well as entrepreneurial spirit. As the willingness to own advantages and personal

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11 Eucken, Walter: *Grundsätze der Wirtschaftspolitik*, 2. Edition, Tübingen/Zürich 1955, p. 55, („Bedingungen herzustellen, unter denen sich funktionsfähige Marktformen und Geldordnungen entfalten können“, translation by the author)

12 Cp. Müller, Armack, Alfred: *Wirtschaftsordnung und Wirtschaftspolitik. Studien und Konzepte zur Sozialen Marktwirtschaft und zur Europäischen Integration*, Freiburg 1966.

13 Cp. Quaas, Friedrun: *Soziale Marktwirtschaft: Soziale Irenik*, in: Hasse, Rolf H./Schneider, Hermann/Weigelt, Klaus (Ed.): *Lexikon Soziale Marktwirtschaft. Wirtschaftspolitik von A-Z*, Paderborn 2002, p. 384-387.

responsibility are basic conditions for solidarity, equal opportunities have to take priority over the equality of redistribution.

## 10.5.2. Is the German concept of social market economy—particularly in the context of globalisation—old-fashioned or outdated?

In the last 15 years, the German economy didn't receive consistently positive headlines. The international rankings showed that Germany was undergoing a period of constant decline and that it had lost ground particularly in the field of competitiveness. Although there are signs that the negative economic trend in Germany has begun to reverse in the last two years, there is no doubt about the existence of structural problems as witnessed by the implementation of social and economic reforms which aim to overcome them.

Nevertheless these structural problems do not express the weakness of the concept of social market economy *per se*, but are instead the negative side-effects of an economic policy which actually overrode the main principles of this model. Because it was already clear for Müller-Armack that "the social market economy is according to its concept neither a finished system nor a recipe, which is ones given, valid in the same way forever"<sup>14</sup>, he underlined the notion that it would always be "necessary to place new emphasis in order to meet the requirements of a changing time"<sup>15</sup>.

The social market economy isn't therefore a fixed concept, which sets out clear instructions for economic policy makers. Its progenitors outlined its basic principles alone, setting it up with the intention that it ought to respond to dynamic variances, which arise thanks to the circumstances of time and place. Facing serious problems, German economic policy-makers should also use the model of the social market economy as a compass for an economic orientation to find their way back to its old strength.

Despite the way that new developments in technological progress and the growing international interconnectedness associated with globalisation have changed the global business and social environment, the basic foundations and values of our society—and thus of the model of social market economy—have remained constant. Freedom and justice, social responsibility and the firm conviction that the welfare of human-beings has to be placed at the centre of our society (and therefore of each economic order) remain the fundamentals of Christian values, of each enlightened state as well as of the European Union. Since this is exactly the firmament upon which the social market economy is based, there is no need to consider new economic concepts that might fit some changing economic setting.

In a long-term perspective, those countries which manage to react in the quickest and most sustainable manner to ecological and social challenges, will benefit much more from global competition than underdeveloped nations which instead will face far reaching social crises and will suffer from the results of a massive and continuing destruction of the local environment.

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14 Müller-Armack, Alfred: *Zur Einführung: Zeitgeschichtliche Notizen*, in: *Genealogie der Sozialen Marktwirtschaft. Frühschriften und weiterführende Konzepte*, 2. Edition, Bern 1981, p. 11-18, p. 15, „Die Soziale Marktwirtschaft ist gemäß ihrer Konzeption kein fertiges System, kein Rezept, das, einmal gegeben, für alle Zeiten im gleichen Sinn angewendet werden kann.“ (Translation by the author)

15 *Ibid.*, p. 15, „nötig ist, Akzente neu zu setzten gemäß den Anforderungen einer sich wandelnden Zeit“ (Translation by the author)

### 10.5.3. Why do the countries of SEE need to understand and implement the main values of a social market economy?

For a wide range of reasons it appears worthwhile to transfer the basic convictions underpinning the social market economy to the countries of SEE. Above all it has to be noted that the economic system of the social market economy is peaceful order aiming at a high degree of social satisfaction and at a widespread consensus over individual rights. The idea that non-economic values such as solidarity, subsidiarity, charity and individualism are located at the centre of an economic order recognises the worth of every single human-being. It therefore reflects all the Christian and Humanistic values upon which European culture is based and offers essential advantages over purely economic systems.

Only through the combination of economic and social elements fostered by politico-economic stakeholders can an agreeable economic climate emerge, conducive to long-lasting, sustainable and stable social reconciliation. For the young SEE states in particular these developments could lead to a stabilisation of their still fragile democracies and to a wide acceptance of democratic values in local societies. These improvements could in turn weaken the grey economies and result in a reduction of corruption, embezzlement and nepotism. Furthermore, social satisfaction and a degree of prosperity shared by wide parts of the local population together influence economic growth, employment data and rates of investment.

Another advantage of the concept of social market economy, which cannot be underestimated is the unanimity of the system. In contrast to many single different economic suggestions in other economic systems, the individual components of social market economy are coordinated and therefore form an exactly aligned system. Social market economy links the economic order with the political and social orders and thereby provides a framework for the development of the rule of law and democracy.

Moreover, the central idea of order is the key to a consistent economic policy with long-term effects. It hinders overzealous activism economic policy. The fundamental distinction between the economic process and the economic order can be regarded as another of the advantages of the system of social market economy. By reference to German post-war economic policy, it can be shown that long-term reforms can cause economic growth and political stability.

### 10.5.4. What are the basic and more advanced steps for the creation of a stable free market economy in SEE which adopts the main principles of a social market economy? What could be the role of the *Mittelstand* and trade in this process?

In general, has to be noted that the countries of South Eastern Europe lack a fundamental understanding of the German system of social market economy. Until now, neither a discussion about the advantages or disadvantages of the different systems has started, nor have the basic ideas of the social market economy been adopted by political stakeholders in the region. In many countries, politicians and researchers assign the term social market economy to the German economic order, but they are not

aware how they could benefit from its assets. Furthermore, the German model has often been regarded as outdated or old-fashioned and therefore as useless for the SEE's emerging economies. Like the Czech president Vaclav Klaus, who has stood for a "market economy without adjectives" for years, political decision-makers in SEE often prefer the anglo-saxon model of a free market economy.

It therefore appears necessary, in a first step, to inform local politicians, researchers, entrepreneurs and ultimately wide parts of the local citizenry about the system of social market economy. Thereby, the fundamentals of the social market economy should be introduced and a discussion about the German economic situation—and the drawbacks peculiar to its realisation in Germany—should be started. The special advantages of an economic system orientated around social values should be underlined and the differences between the academic blueprint and the long history of the economic reality should be pointed out. In addition, the benefits of creating a distinction between the political order and the political process should be emphasised, and the advantages of the unanimity of the system defined.

Indications concerning the answer to the query "What is a social market economy?" could be provided by the constituent and regulating factors set out by Walter Eucken. The constituent factors of a social market economy are: the functioning mechanism of market prices (*Marktpreismechanismus*); the primacy of monetary policy (*Primat der Währungspolitik*); the principle of open markets (*Prinzip der offenen Märkte*); private property (*Privateigentum*); liability (*Haftung*); freedom of contract (*Vertragsfreiheit*) and the constancy of economic policy (*Konstanz der Wirtschaftspolitik*).<sup>16</sup>

These factors were complemented by regulating principles, which embody first of all the social element of the social market economy: state-run control of monopolies (*staatliche Monopolkontrolle*); an income policy (*Einkommenpolitik*); individual budget analysis (*Wirtschaftsrechnung*) and regulations in the case of abnormal market-behaviour (*Regelungen bei abnormalem Angebotsverhalten*).<sup>17</sup>

Furthermore, the effects of social-market instruments could be shown by exploring their concrete implementation in different policies. The degree to which social and economic subsystems can be linked under the umbrella of the social market economy should be emphasised, as should the fact that this abstract system can provide solutions for awkward economic-political questions including employment, environmental and competition policies.

Measures moving in this direction can comprise information seminars on a local, regional and national level and wide-spread information campaigns among entrepreneurs, politicians, researchers and media organisations. Furthermore, special prizes or trophies could provide further incentives to establish socially responsible entrepreneurship.

In this context, it appears to be of particular importance to involve *Mittelstand* and trade as the driving forces behind every economic upswing and to harness their special influence on politicians and wide-parts of the local citizens. Underlining their specific role in enhancing social responsibility therefore represents an important step in the promotion of social market economy.

With the assistance of these awareness-raising campaigns it should be pointed out that the principles underpinning the system of social market economy can at any time and place be used as a compass for political and economic decision-making.

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16 Cp. Zinn, Karl Georg: *Idee, Entwicklung und Politik der bundesdeutschen Wirtschaftsordnung*, in: <http://www.tu-chemnitz.de/wirtschaft/vwl2/downloads/material/KarlGeorgZinn.pdf>, 2. August 2007, p.30 ff.

17 Cp. *ibid.*: p. 33ff.

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