

# **STABILITY PACT**

**SOUTH EAST EUROPE COMPACT FOR REFORM,  
INVESTMENT, INTEGRITY AND GROWTH**



**SOUTH EAST EUROPE REGION  
ENTERPRISE POLICY PERFORMANCE  
A REGIONAL ASSESSMENT**

Prepared by

**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT  
AND EUROPEAN BANK FOR RECONSTRUCTION AND DEVELOPMENT**

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INVESTMENT, INTEGRITY AND GROWTH**

## **SOUTH EAST EUROPE REGION ENTERPRISE POLICY PERFORMANCE A REGIONAL ASSESSMENT**



**ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT**

**The Stability Pact for South Eastern Europe** is a political declaration and framework agreement adopted in June 1999 to encourage and strengthen co-operation among the countries of South East Europe (SEE) and to facilitate, co-ordinate and streamline efforts to ensure stability and economic growth in the region. (see [www.stabilitypact.org](http://www.stabilitypact.org))

**The South East Europe Compact for Reform, Investment, Integrity and Growth (“The Investment Compact”)** is a key component of the Stability Pact under Working Table II on Economic Reconstruction, Development and Co-operation. Private investment is essential to facilitate the transition to market economy structures and to underpin social and economic development. The Investment Compact promotes and supports policy reforms that aim to improve the investment climate in South East Europe and thereby encourage investment and the development of a strong private sector. The main objectives of the Investment Compact are to:

- Improve the climate for business and investment.
- Attract and encourage private investment.
- Ensure private sector involvement in the reform process.
- Instigate and monitor the implementation of reform.

The participating SEE countries in the Investment Compact are: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Romania and Serbia and Montenegro. Building on the core principle of the Investment Compact that “ownership” of reform rests within the region itself, the Investment Compact seeks to share the long experience of OECD countries. It provides region-wide peer review and capacity building through dialogue on successful policy development and ensures identification of practical steps to implement reform and transition.

The work of the Investment Compact has been actively supported and financed by seventeen OECD member countries: **Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Norway, Sweden, Switzerland, Turkey, United Kingdom and United States.** (see [www.investmentcompact.org](http://www.investmentcompact.org))

## ACKNOWLEDGEMENTS

This report is an output of one of the Regional Flagship Initiatives of the Investment Compact for South East Europe. The Investment Compact is a key component of Working Table II of the Stability Pact for South East Europe. The report provides a synthesis of the individual country Enterprise Policy Performance Assessments (EPPA) undertaken for all SEE countries in 2003 and a comparative cross regional picture of these policies in the region. It has been jointly produced by the OECD and EBRD, with research and data provided by expert regional consultants based in SEE countries, as well as advice from Country Economic Team members in each country.

The Enterprise Policy Performance Assessment process was instigated and directed by Declan Murphy, Programme Director of the Investment Compact (OECD) in co-operation with Antonio Fanelli (Principal Administrator, OECD), Francesca Pissarides (Senior Economist, EBRD) and Ricardo Pinto (OECD consultant to the Investment Compact) and builds on the extensive work of both organisations in enterprise development in SEE countries and other transition countries. The outputs of the process, undertaken in the second half of 2002/early 2003 and to be conducted annually, comprise the country reports and regional assessment report and highlight, in particular, feedback from SME investors as a key element of the analysis and assessment.

All the EPPA reports provide recommendations and an agenda for action by SEE Countries. The implementation of action will be monitored twice yearly in the Monitoring Instruments of the Investment Compact.

The main authors of this report are Antonio Fanelli (OECD), Ricardo Pinto (consultant to the OECD Investment Compact Team) and Francesca Pissarides (EBRD). The report has benefited significantly from input by Declan Murphy (OECD), Charlotte Gray (EBRD) and Peter Sanfey (EBRD). The preparation of the final report for publication was undertaken by Georgiana Pop, OECD.

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The assessments and views expressed in this report are those of the Investment Compact Team of the OECD secretariat and the EBRD Office of the Chief Economist and do not necessarily reflect the views of the institutions participating in this enterprise policy performance assessment or of OECD and EBRD Member countries.

## FOREWORD

Economic revitalisation of the South East Europe (SEE) region is primarily dependent on private sector investment. Through the Investment Compact process, Stability Pact partners support and promote structural policy reforms to improve the climate for private enterprise and increase investment. This Regional Enterprise Policy Performance Assessment (EPPA) is designed to assist countries in SEE to become more competitive by stimulating entrepreneurship and enterprise development.

Small and Medium-sized Enterprises (SMEs) in the SEE region face major challenges. As well as lack of scale, resources and the capacity to handle complex business management, they frequently suffer from a complicated and bureaucratic environment that is a legacy of the past. The challenges of business entry, survival and growth are great. Developing a framework for dynamic entrepreneurship is fundamental in creating healthy and competitive market economies, and thus generating new jobs, exports and economic growth.

To harness the potential offered by the SME sector, some important questions are addressed:

- What are the key features of good performance in SME policy making?
- How do the countries of the SEE compare with each other in tackling these key features?
- How do they fare in relation to EU and OECD member countries?
- What issues should be prioritised in order to match international good performance?
- What progress is being achieved and how is this changing over time?

This regional report is the first attempt to systematically address these important questions on a *cross-regional* basis. It focuses in particular on two key elements in evaluating enterprise policies: how do SME owners and managers perceive the policy performance of governments in the SEE region; and how do the countries compare with each other in relation to key dimensions of good performance in SME policy making?

The Regional EPPA draws on the practical experience and views of SME representatives and expert advisors, as well as the Organisation for Economic Co-operation and Development (OECD) and the Office of the Chief Economist at the European Bank for Reconstruction and Development (EBRD), two Stability Pact partner organisations that have been closely involved in the reform process in transition countries. It completes the first cycle of policy performance assessments started in the second half of 2002 that led to the publication of nine individual EPPA country reports and this regional synthesis.

Measurable progress has been made across the six dimensions of good performance that the report focuses on. Nevertheless, reforming the environment for entrepreneurship and ensuring effective implementation of enterprise policy remain important and urgent priorities. The report sets out a detailed **Agenda for Regional Action**, which governments in the region are strongly encouraged to implement.

The report provides valuable insights into the key issues confronting the governments of the SEE region. It is also directed to the organisations representing entrepreneurs, to the donor agencies of the OECD member countries and the International Financial Institutions providing technical and financial assistance in the area of enterprise development, and in general at the whole SME community in South East Europe.

The Enterprise Policy Performance Assessments contribute to supporting enterprise development in the region through monitoring performance and instigating action to **implement policy reform**. A new cycle of Enterprise Policy Performance Assessments will be conducted by the OECD, EBRD and EC in partnership with SEE Countries in 2004.



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## EXECUTIVE SUMMARY

### 1.1. Overview

1. Small and Medium-sized Enterprises (SMEs or small enterprises) are of critical importance to the economic growth prospects of developed as well as transition economies. They account for 99.8% of all enterprises and two-thirds of all jobs in European Union (EU) countries (EC, 2002a), however, their importance does not rest only on being employment generators. They play an important role in strengthening economic performance, something which is particularly important during the general slowdown in global economic growth. They are adept at responding to market opportunities; and a subset of high growth small firms are particularly important in raising innovation, productivity and competitiveness. The challenge for governments is to:

***"... provide a business environment that supports the competitiveness of this large heterogeneous business population and that promotes a vibrant entrepreneurial culture."*** (OECD, 2003a, p.7)

2. This South East Europe (SEE) Regional Enterprise Policy Performance Assessment (EPPA) focuses on six key issues, which together constitute a framework enabling governments in the SEE region to develop a supportive environment for small businesses in the SEE region:

- Institutional framework for SME policy.
- Rule of law and the regulatory environment.
- Tax policy for small businesses.
- Financial instruments for fostering small businesses.
- Advisory services supplied to new and small businesses.
- Business incubator support to start-ups.

3. The above framework arose from detailed research and case experience with transition economies (OECD-UNIDO, 1999). It is consistent with the European Union's (EU) enterprise policy accession agenda, as set out in its Charter for Small Enterprises (EC/DG Enterprise, 2000), to which the countries in the SEE region have become signatories in June 2003. The EPPA work and the EC Charter are complementary and closely inter-related (see figure 1-1). Future up-dates of the Regional EPPA report will increasingly integrate with the EU's Charter (see Annex 1), as the OECD, EBRD and the EC (DG Enterprise) co-operate closely on the agenda for small enterprise development in SEE.

4. Under the EPPA approach SME investors are extensively researched so as to provide practical feedback on key small enterprise policy issues. Their views and perceptions on what is necessary for the SME sector – from the business perspective – are vital to the success of government policy making and reform. These perspectives are combined with other information and analysis (e.g. costs, benchmarks, indicators of good practice, etc.), thus allowing a regional comparative analysis, focusing on highlighting good performance and trends in the region.

5. The report sets out the main small enterprise development trends in the region and presents **an agenda for regional action**.

**Figure 1-1. Links Between EPPA and EU Charter for Small Enterprises**

<b>EPPAs</b>	<b>EC Charter</b>
Institutions	Representation of Small Business Interests
Regulations	Cheaper and Faster Start-up Better Legislation and Regulation Improving Online Access
Taxation	Taxation and Financial Matters
Finance	Taxation and Financial Matters
Advisory Services	E-Business Models and Small Business Support
Business Incubators	E-Business Models and Small Business Support
Not covered as separate sections at present	Education, Training and Entrepreneurship Availability of Skills Obtain more from the Single Market Strengthen Technological Capacity

## 1.2. Agenda for Regional Action

### *Institutional Framework*

6. The state has a central and lead role to play in establishing the framework for small enterprise policy development, so as to maximise the contribution of new jobs, business growth, productivity, and competitiveness. Most countries of SEE have been very active in this regard, and in some cases there has been significant institutional change but an excessive degree of uncoordinated and sustained reform.

7. The SME institutional framework across the region is increasingly supported by strategies, action plans, and implementing agencies, etc. However, these are rarely underpinned by adequate national and international resources to implement the programmes of activity for the benefit of small enterprises and start-ups. Securing the *sustainability* of institutions that support SMEs is not easy and requires not only a stable environment, but also active proponents of SME policy and the necessary means to attract and retain competent staff.

8. In general, there is a lack of regular and effective dialogue and consultation between government and the business sector. Policies, programmes and activities to stimulate start-ups and/or assist the development of existing enterprises require the active awareness and involvement of the private sector. While the government must do its part, the SME policy community equally needs to organise itself so as to act as a more effective partner with the government than is the case at present.

9. There is a need to improve co-ordination and build wider synergies between the activities of the institutions operating at national level (ministry of economy, SME agency, etc.) and the institutions operating at local level, supporting SMEs and regional development. Often the impact of the government policy in support to small business is not felt beyond the capital and the main cities. The network of Regional Development Agencies, now operating in several SEE countries, could be used better to provide valuable inputs to the national institutions and could be used for delivering policy at local level.

10. It is difficult for Ministries/Agencies responsible for small enterprise policy to secure resources with which to implement their policies, programmes and strategies. The wider use of performance measurement mechanisms would enable them to assess the extent to which they are meeting their objectives. It would also enable them to demonstrate to politicians and stakeholders the Ministries'/Agencies' performance, an important element of being able to secure more stable and adequate budgets. Countries could also begin by publishing "annual reports" disseminating more awareness of their activities and assessing the extent to which the SME strategy is being implemented.

## **Regulatory Environment**

11. Barriers to business entry throughout the countries in the SEE region remain unnecessarily high. At the entry stage, the number of procedures, the lengthy delays and costs of registration, and the minimum paid-up capital requirements, all make the process very slow, costly and complex. In addition, companies in the SEE countries face complex and often non-transparent procedures for obtaining and renewing permits and licences, particularly building and land development permits, with a negative impact on the company operations.

12. Various measures to simplify and speed-up registration, including the creation of a single registration form and identification number, the introduction of electronic on-line registration, a single point of contact to facilitate registration, and introduction of the "silence is consent" principle, would help lead to greater entrepreneurship and economic dynamism.

13. Consideration should be given to removing the need for active court involvement in the registration process. The lack of resources, bottlenecks and unclear procedures in many courts all contribute to serious delays and additional compliance costs for enterprises, especially micro- and small businesses.

14. Collectively, the burden on business operation deriving from administrative barriers is one of the key factors, together with tax policy, pushing firms to operate, totally or partially in the informal economy. The high incidence of the informal economy not only reduces the level of state revenue collection, but also leads directly to a high degree of unfair competition vis-à-vis formally registered firms.

## **Tax Policy**

15. The tax system is of critical importance to new or small enterprises. Although the virtues of a simple, clear and stable tax system are increasingly recognised, no country in SEE has so far implemented it on a consistent basis.

16. The tax systems in the SEE region experience constant changes, often with little or no advance warning or adequate training either for the tax administration or for businesses. The general lack of consultation, information and preparation contributes to low levels of trust between business people and the tax services.

17. While tax rates and incentives are for governments to determine, selected measures to reduce the burden on the small enterprise sector should be considered. These could include:

- Setting benchmarks for VAT refunds and ensuring that they are respected.
- Reducing reliance on pre-paid taxes.
- Simplifying payment procedures, including frequency and method of payment.
- Clarifying all taxes, incentives, penalties, etc. and ensuring that tax officers are fully trained to administer these.
- Creating dispute resolution procedures, mechanisms and ombudsmen.
- Establishing structured Business-Government dialogue and information provision.

18. In many countries, the tax inspectorate is in need of urgent reform. It is often feared by entrepreneurs throughout the region because there are numerous inspectorates with unclear roles and responsibilities, operating in an uncoordinated manner and imposing a significant time cost on entrepreneurs. There is also a strong perception that such inspectorates have the power either to impose unreasonable penalties or to extract rents from small enterprises. They should be streamlined and their remit and procedures should be more clearly defined and monitored.

### ***Access to Finance***

19. Reform of the banking sector has proceeded rapidly throughout the SEE region, although the timing and depth of the process varies. Privatisation, combined with the entry of foreign strategic investors, has assisted the process of restructuring and recapitalisation of the commercial banking sector, spreading as a result better banking practices, greater competition and higher profitability of banks.

20. At the same time, the level of bank intermediation remains low, partly as a reaction to the various banking crises, which led banks to be more risk averse. In line with this general aversion to risk, bank credit to the enterprises in most countries is increasing at a slower pace than bank credit to households. Furthermore, there is evidence of a clear link between the rapid increase in consumer lending and the entry of foreign investors into the banking sector. Thus, although banking reform is a prerequisite for efficient financial intermediation, it does not of itself ensure improved access to finance for enterprises.

21. The best mechanism to provide finance to small enterprises is to create dedicated channels for this activity, such as microfinance banks, credit lines and public sector/NGO support for activities that are not normally handled by commercial banks, such as start-ups. In this context the experience of the microfinance banks in the region has been excellent in providing access to credit to SMEs, especially micro enterprises.

22. However, legal and regulatory barriers in the SEE region continue to impede the development of such dedicated mechanisms for providing assistance to small enterprises. Excessive restrictions exist in the banking sector, such as very high minimum capital requirements, high loan loss provisioning requirements and restrictive definitions of acceptable collateral.

23. The challenge remains to find the balance between prudential regulations and a flexible framework facilitating lending activities, especially where other aspects of the regulatory environment are defective. For example, the lack of effective land registries and cadastres precludes firms from using property as collateral. As a consequence commercial banks require high levels of collateral, thus affecting the ability of firms to borrow from formal channels.

24. Throughout the SEE region, the state continues to make efforts to provide finance directly to enterprises. Examples include credit guarantee funds and state-run programmes to provide subsidised finance to small enterprises. These schemes, although designed to deal with a market failure by improving enterprises' access to bank credit, often produce unwanted and damaging long-run consequences, and should be re-considered. The state is generally ill-equipped to select the best among the pool of small enterprises. Direct or indirect state intervention in the credit market tends to create distortions, introduce non transparent discriminatory practices and produce opportunities for rent seeking.

25. State-backed and managed credit guarantee funds can lead to the misuse of taxpayer and donor resources, and they may end up by slowing down the development of the local banking system, as guarantees tend to relax the behaviour of banks, rather than stimulate them to implement appropriate lending methodologies and proper risk evaluation.

26. Governments in the SEE region should focus on the proven areas of market failure, such as assistance to start-ups and stimulating the development of mutual credit guarantee schemes, set up by groups of private entrepreneurs. Further efforts are also required to improve the legislative and regulatory framework so as to assist the diversification of sources of funding such as leasing, credit reference sources, etc.

### **Access to Business Advisory**

27. The continuing market failure in the provision of advice, information and consultancy to start-ups and newly-established enterprises as shown by the EPPA research means that there will be a continuing need for Business Advisory Centres (BACs), targeted almost exclusively at the small enterprise sector.

28. BACs have largely failed to become financially sustainable through charging for services such as information, training, advice, and consultancy. Many have disappeared completely once donor funding was terminated while others have had to transform themselves radically so as to deliver services to their traditional clients (start-ups and small enterprises) as well as others willing to pay for those services. The issue of how both the new and established BACs will continue in future remains largely unresolved in the SEE region.

29. Both governments and international organisations need to recognise that the great majority of these centres will not be able to rely on the private sector to be financially sustainable. On-going financial support will be required if they are to deliver the services to businesses which would otherwise not be available. Such an expectation needs to be built into the process of establishing and implementing BACs by donors and SEE countries more systematically than may have been the case hitherto.

30. Part of the reason for their inability to become established is that the quality of their services is considered to be highly variable, the range of services is not always attuned to the needs of the market, and clients do not always obtain sufficient value-added. There is thus an urgent need for a much greater focus on international standards, qualifications and certification in order to generate a greater willingness on the part of entrepreneurs to use their services and pay for them.

31. The SME sector should take greater responsibility for the provision of business services that it considers to be essential, rather than continuing to rely on government or international organisations to do this for them. In certain countries such as Romania and Bulgaria, small enterprise-oriented networks of support, information and advice provision are becoming established on a voluntary basis and delivering a wide range of services customised to the specific needs of small enterprises.

### **Incubators**

32. Few national governments have established a clear policy vis-à-vis development of business incubators. They typically fail to spell out their rationale for developing business incubators as opposed to other forms of business support, the exact institutions with responsibility for implementing these policies, the long term resources required for the development of business incubators, etc.

33. Entrepreneurs, business representative organisations, as well as national, regional and local authorities know remarkably little about business incubators. Despite extensive experience and good practice established elsewhere, such information is rarely available. There is a need for good practice experience and information on business incubators to be systematically disseminated in the SEE region.

34. Business incubators are known to improve start-up and survival rates, facilitate technology transfer and innovation, generate employment and have a positive influence on economic development (OECD, 1999, 2000; OECD-UNIDO, 1999). However, there is a paucity of rigorous impact assessment of incubators in SEE.

35. The prevailing emphasis across the region is on employment generation or "poverty reduction" centres. While commendable in its latter aims and motives, there is a need for business incubators that focus on "business and wealth creation" and thereby attract ambitious people with the initiative and skills to build sustainable growth companies. In general such people would not be the target of poverty reduction measures but could ultimately be a key player in addressing the challenge of poverty reduction, new job creation and local development.

36. Business incubators in the SEE region are almost exclusively funded by international organisations and International Financial Institutions (IFIs), with little national, regional or local government support once donor funding runs out. The size, occupancy rate, number of tenants, etc. of business incubators in the SEE region are typically well below the international norms, raising concerns about their effectiveness and financial sustainability once donor / IFI subsidies terminate.

37. Moreover, there is a lack of attention devoted to issues such as good governance, transparency of operation, criteria for entry / exit of companies, range of services provided, special institutions to promote business clusters and networking, etc. in the SEE region, which international experience highlights as being of importance for enterprise development.

## INTRODUCTION

### 2.1. Nature of the Report

38. The SEE Region EPPA provides a comparative assessment of enterprise policy performance across the SEE region. It identifies a series of benchmarks and good practice, presents assessment ratings on policy performance by entrepreneurs (owners and managers of small businesses), research on governments' performance in relation to enterprise policy, and highlights the key trends for the eight countries in question. The report shows where SEE countries stand relative to each other and successful practice in OECD countries, thus providing policy-makers with concrete pointers for reform.

39. The report focuses on six broad dimensions of the framework and environment supporting SME growth and development that are considered to be particularly important for governments in transition economies to implement, if they are to make small enterprise policy effective (OECD-UNIDO, 1999) namely:

- ***Institutional framework for SME policy:*** the general fragility of the small enterprise sector in transition economies necessitates an institutional support framework. Although no single best practice model exists, successful practice suggests that there are certain elements which government should undertake in order to ensure that the institutional infrastructure supports small enterprise development.
- ***Rule of law and the regulatory environment:*** in some countries, entry and exit obstructions and other administrative obstacles may merely constitute irritants to small enterprise development. However, in the context of transition economies where small enterprises possess limited human resources and financial means, these may represent a major barrier to doing business and contribute to the increase in size of the gray economy. A related factor is that the poor operation of the judiciary, combined with its limited ability to enforce contractual obligations, often adds to the barriers encountered by small enterprises.
- ***Tax policy for small businesses:*** tax policy and administration are of fundamental importance in an environment where small enterprises have very limited time and resources to deal with the tax system. Instability, complex systems and burdensome monitoring and inspections are issues of importance to small businesses which need to be tackled urgently. The necessity for a stable, clear and simple tax system is particularly evident in the region.
- ***Financial instruments for fostering small businesses:*** Commercial banks and other financial institutions have traditionally considered small enterprises as being a highly risky category of business. Yet, access to formal sources of finance is of crucial importance to the start-up, growth and competitiveness of enterprises that have traditionally relied heavily on family, friends and other informal sources of working capital and investment funds.
- ***Advisory services supplied to new and small businesses:*** market failure is common in the provision of information, advice and other services to stimulate the creation of start-ups and assist the development of new firms. After about ten years of experience with the provision of business support services of various sorts, it is important to assess the extent to which these services are being provided in an effective and sustainable manner in the region.
- ***Business incubators (support to new firms):*** newly established firms have a high mortality rate. Business incubators can help businesses in their early days, for example by pooling resources and know-how,

by providing timely guidance and support services or by reducing costs such as rents. An assessment of the development of these support structures in the SEE region is of importance.

40. Other dimensions of enterprise policy, such as provision of infrastructure, nature of the labour market and development of a culture of entrepreneurship, also play a role in relation to small enterprise policy performance in the SEE region. These dimensions are covered in other reports and some aspects, especially those related to the EU Charter for Small Enterprises, will be incorporated in future regional EPPA analyses (see figure 1-1.).

## 2.2. Methodology

41. This report draws on a series of OECD-EBRD Enterprise Policy Performance Assessments carried out in 2002-2003 in all countries of the Stability Pact for SEE in order to monitor the development of institutions, policies and programmes to support the SME sector. The individual country EPPAs (see OECD-EBRD, 2003a to 2003i) place a strong emphasis on the views of small private enterprises concerning their experience of the key barriers to carrying out their business and undertaking new investment. This is an important aspect of assessing the progress made by governments in implementing policies that stimulate the further development of SMEs. The country EPPAs provide a "snap-shot" of the business and investment environment and highlight key issues in need of policy reform.

42. This report is the first edition of the *SEE Region Enterprise Policy Performance Assessment* (SEE EPPA) report. The SEE EPPA is designed to complement the country EPPAs by monitoring recent developments across the region as far as enterprise policy is concerned, thus seeking to share region-wide experience and stimulate further policy dialogue and development in the countries in question, as well as in the SEE region as a whole. The SEE EPPA complements the individual country EPPAs by:

- Focusing on the same six key dimensions of small enterprise good practice.
- Employing the qualitative analysis obtained from the country reports.
- Combining qualitative analysis with quantitative elements (e.g. costs, benchmarks, etc.).
- Presenting comparative information, focusing on good performance and trends.

43. The methodology employed in the Regional EPPA, building on the individual country EPPA research, is set out in Annex 2. The Investment Compact intends to repeat this exercise on a regular basis, highlighting and monitoring the evolving nature of enterprise policy in the region.

## 2.3. Economic Indicators

44. The recent stability in SEE and the strengthening of ties with the EU has helped the region as a whole to achieve substantial growth over the past three years. This has also been assisted by on-going domestic restructuring. In 2002 Gross Domestic Product (GDP) in the region grew by nearly 5% on average, with particularly strong growth in the three largest economies, Bulgaria, Croatia and Romania. Recent inflation performance has also been good, with low inflation now established in most countries and significant reductions in the two countries still in double-digits, Romania and Serbia and Montenegro. However, both fiscal and current account deficits are typically high in the region, and the risk of spiralling twin deficits is exacerbated by the region's big expenditure requirements, falling aid flows and an already substantial debt burden. The SEE region has so far had limited success, compared with for example Central East Europe, in financing high investment requirements through private capital flows. To bridge the gap created by falling official flows and to push the SEE region onto a higher growth path, the region will have to establish an attractive investment climate for domestic and foreign investors alike.

45. Turning to enterprise-specific issues, table 2-2. provides some statistics on SMEs in the SEE region. Whereas SMEs now account for an average of 98.1% of all enterprises in SEE, not far from the EU-plus (European Union 15 + Iceland, Liechtenstein, Norway, Switzerland, also known as EU-19) average of 99.8%, other measures of the state of the enterprise sector show significant differences between the two regions.

**Table 2-1. Basic Economic Indicators (2002)<sup>1</sup>**

	AL <sup>2</sup>	BiH	BG	HR	MK	MD	RO	SCG
Population (millions)	3	4	8	4	2	4	22	8
GDP per capita in €	1,661	1,461	2,106	5,364	1,981	404	2,220	1,995
Gross average monthly earnings in €	165	293	136	724	185	45	175	150
Unemployment rate in % of labour force	16	41	17	15	32	7	8	28
GDP index 1989=100	114	54	80	87	75	39	88	51
General Government Expenditure in % of GDP	29	56	37	50	42	32	33	48
Private sector share in GDP	75	50	75	60	60	50	65	45
FDI cumulative 1989-2002 per capita in €	322	210	594	1,506	496	211	441	219

Source: EBRD

SME density is extremely low, averaging 13.7 per 1000 inhabitants, compared with 52.8 in the EU-plus countries. In the SEE region, SMEs are less important as employers than in the EU-plus region, accounting for an average of 47% of total employment in the enterprise sector, as compared to an average of 66% in the EU-plus area. The share of the private sector in GDP is also still very low at 58% in the SEE region, well below the same value for the advanced transition countries set to become EU members in 2004.

**Table 2-2. Selected Enterprise Information**

	2002	2001	2000	2002	2000	2001	2000	2001	2000
	AL	BiH	BG	HR	MK	MD	RO	SCG	EU-plus <sup>3</sup>
Number of SMEs	56,237	30,000	224,211	63,135	32,759	22,138	306,073	70,940	20,415,000
SMEs per 1,000 inhabitants	18.2	7.9	28.7	14.3	16.4	5.2	10.3	8.5	52.8
Share of SMEs in total number of enterprises, of which:	99.5	99.3	99.7	99.3	99.0	90.0	99.7	98.4	99.8
Share of micro-enterprises in total number of Enterprises	95.8	84.8	92.3	85.5	90.7	72.2	92.3	n/a	93.1
Share of small enterprises in total number of enterprises	2.7	11.2	5.7	11.3	5.9	17.8	5.7	94.4	5.9

Source: EBRD and EC (2002b)

46. Despite the anecdotal evidence suggesting that a significant degree of entrepreneurial spirit and activity exists in SEE, the data show that the density of SMEs in the SEE countries is lower than the density in the wider Western European region (EU-plus). SMEs in the SEE region are still relatively few for the size of these economies and they have not yet reached their potential in terms of either employment or production. High unemployment persists in the region, especially in Bosnia and Herzegovina, FYR Macedonia and Serbia and Montenegro. New job creating enterprises are urgently needed. The rate of new enterprise creation needs to be dramatically increased if the region is to match the levels of Western Europe. This underlines the continuing importance of developing an appropriate policy framework to assist start-ups and more established small enterprises in the SEE region.

## NOTES

1. Note: data in italics relate to 2001.

2. International licence plate codes have been used to identify the SEE countries: AL = Albania; BiH - Bosnia and Herzegovina; BG = Bulgaria; HR = Croatia; MK = FYR Macedonia; MD = Moldova; RO = Romania; SCG = Serbia and Montenegro (where the republics of Serbia and Montenegro are separated, they are identified as SER and MON respectively).

3. Notes: EU-plus = European Union 15 + Iceland, Liechtenstein, Norway, Switzerland (also referred to as EU-19); Albania: data includes enterprises in the agricultural sector; Croatia: micro-enterprises include sole proprietors; Moldova: medium sized enterprises are included in the large category.

## INSTITUTIONAL FRAMEWORK

### 3.1. Introduction

47. Since the beginning of transition towards a market economy, all SEE countries have put SME development at the top of their economic policy priorities and have embarked on building the institutional framework for the elaboration and delivery of policies and programmes for the SME sector. The SME sector is expected to be a source of new jobs and regional economic development. Institution-building is the first step needed to put in place an effective SME policy. If the institutions are not properly designed, adequately financed, well managed and their performance regularly evaluated, they will end up wasting resources, pursuing inappropriate policies and damaging government credibility vis-à-vis the business community. In assessing policies designed to enhance enterprise performance, it is essential to examine where the SEE countries stand in creating their own institutional framework.

48. This section examines the entrepreneurs' perception of the effectiveness of the institutional framework, as derived from the individual country Enterprise Policy Performance Assessments (EPPA). It examines the structure of the institutional frameworks established in the SEE region and measures their main features against key indicators of successful experience. Conclusions are then drawn on what has been achieved and what remains to be done.

### 3.2. SME Insights

49. The EPPA country research was undertaken in the eight countries of the Stability Pact for SEE. In addition to the in-depth focus group discussions on key issues confronting small enterprise managers and owners, assessment ratings were obtained for each of the six dimensions of good practice explored in relation to the business environment, which mirror the structure of this regional report.

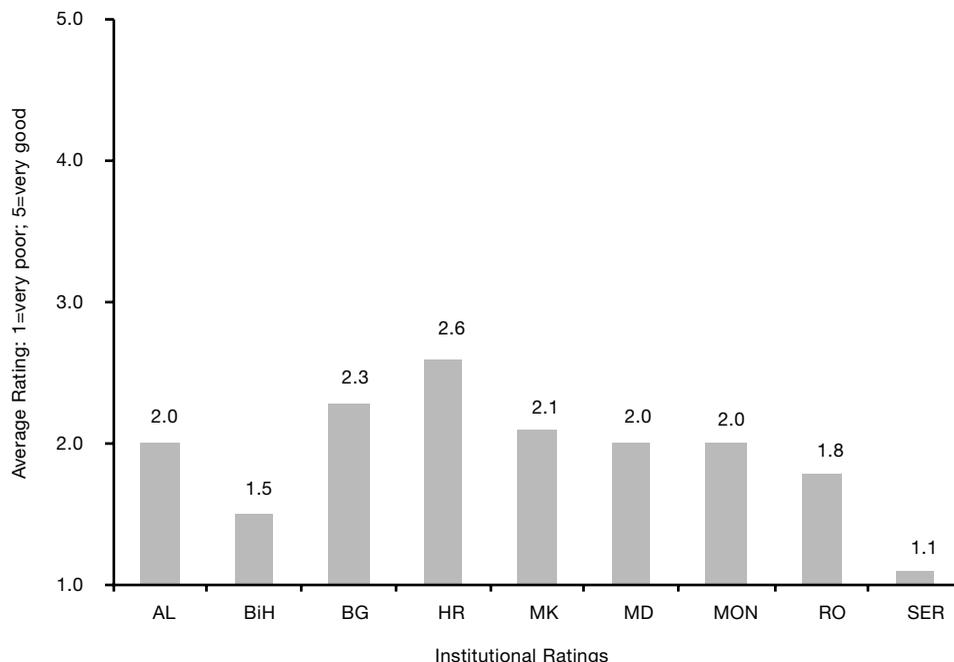
50. The average ratings used to represent the views of the entrepreneurs ranged from 1 to 5 (read as follows 1 = very poor, 2 = poor, 3 = satisfactory, 4 = good and 5 = very good). For each dimension of good practice, the average ratings were analysed, resulting in the "Perceptions of the Institutional Framework" presented in figure 3-1. The same approach is used in the other sections of this report pertaining to the SME insights. The ratings provide an indication of the perceptions of the focus group entrepreneurs in each country. Cross-regional comparisons provide useful insights, sharing of experience, and will become more useful for policy makers as the EPPA process is repeated next time.

51. Entrepreneurs in SEE are usually highly dissatisfied with the performance of the state institutions in charge of SME policy. The results of the focus groups indicate that SME managers and owners view these institutions as largely ineffective. They are perceived more as an additional layer of government, operating with its own bureaucratic logic and rules than as an institutional partner working towards common goals. This is a fundamental issue that needs to be tackled by all SEE countries.

52. What emerges from the focus groups views is a high level of mistrust as to the willingness and ability of the government to actually implement policy measures that benefit small business. Entrepreneurs generally complain that official policy statements are seldom followed by concrete actions. New institutions

are set up with ambitious targets, but behind them there is often an unclear strategy and limited human and financial resources. Policies are often designed and introduced without consulting the SME community. There are frequent institutional changes, driven mainly by political rather than operational considerations and, therefore, a lack of continuity in building more lasting and effective institutions and policies.

**Figure 3-1. Perceptions of the Institutional Framework**



53. Long delays in policy implementation and poor communication have aggravated the entrepreneurs' negative perception of the institutional framework. Perceptions are particularly poor in Bosnia and Herzegovina and Serbia. The first case may reflect the frustration of the business community towards a framework perceived as very complex, fragmented and crowded by a large number of institutions operating at state and entity level without any apparent co-ordination and substantial progress. Serbia appears to be more a question of timing and communication. At the time the focus groups were conducted (second half of 2002) Serbia was still catching-up with other SEE countries, having initiated its economic and democratic transition considerably later than the others, but progress has been made since then. Entrepreneurs in Croatia and Bulgaria gave comparatively better ratings regarding the existing institutional arrangements, probably as a result of the fact that those two countries have conducted an active SME policy for several years, within a relatively stable institutional framework.

54. The ratings also reflect the fact that generally the resources (staff and budgets) tend to be limited and far from secure in nature. Most of the SEE countries allocate limited financial and human resources to SME policy and, as a result, entrepreneurs are critical of the lack of visible programmes to stimulate small business activity. The relatively better rates scored by Croatia and Bulgaria probably reflect the fact that they have been actively working on programmes in support of the small business sector longer than most of the other SEE countries.

### 3.3. Comparative Policy Assessment

55. In addition to obtaining insights from small enterprise owners and managers on the key institutional issues, the research also sets out a number of indicators of good performance derived from research in transition economies (see OECD-UNIDO, 1999) against which the SEE countries are reviewed.

56. The architecture of the institutional framework varies considerably among the SEE countries, however, national policies may be compared by looking at some of their key features. The general aspiration in this area is to have a three-tier institutional framework (ministry + national SME agency + regional SME offices) but **what really counts is how the institutions actually perform and fulfil their tasks.** For each key feature of the institutional framework, benchmarks of good performance have been identified and the position of each SEE country tested against them.

**Table 3-1. Institutional Benchmarks of Good Performance<sup>5</sup>**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)	Benchmarks of Good Performance
Institutions responsible for SME policy/strategy development	1	4	2	1	1	1	1	1	1	1
Government-approved strategy	Yes	No (yes RS, DB)	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Structured Action Plan for implementation of strategy	No	No (yes RS, DB)	Yes	Yes	No	Yes	No	Yes	No	Yes
An institution responsible for policy/strategy implementation	No	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Existence of budget for implementation of SME strategy	No	No (yes DB)	Yes	Yes	No	No	Yes	Yes	No	Yes

57. The first consideration emerging from table 3-1. is that the process of building the institutions to support the SME sector in SEE is well advanced. All countries have at least one institution (in two cases more than one) responsible for SME policy and strategy development and nearly all countries have an officially approved SME development strategy.

58. The weakness in the institutional framework lies in the implementation. Not all countries have structured action plans, clear implementation responsibilities or a properly defined system for resource allocation from the state budget. Even when a strategy and a budget allocation exist, the resources are often not commensurate with the strategy objectives. A structured institutional framework, supported with strategies and action plans, is of little practical consequence if not underpinned by adequate national and international resources so as to achieve the expected strategies and implement the programmes of activity. The most likely outcome of the discrepancy between stated government objectives and actual implementation is a high level of frustration among both entrepreneurs and the responsible civil servants. Even the most qualified and motivated government officials struggle in this environment.

59. A third consideration refers to the high level of institutional instability typical of the region. In most OECD member countries political changes do not necessarily lead to institutional and personnel changes unless there is a major turn in policy. In SEE, political change arising from elections or government re-shuffles, tend to have a direct impact on the institutions (such as closure) and their key personnel. This affects the capacity building process and results in major problems with continuity of policies, initiatives, etc.

60. The current impression is that many countries in SEE continue to experiment to find the "right" model for SME development. These range from having a separate SME Ministry, making the agency a part

of another Ministry, forming a separate agency, having both a Ministry and Agency, a unit/agency under the Prime Minister's office and other variants (see box 3-1). Institutions are often not given enough time, clear mandate and adequate resources to prove their effectiveness and build their skills and capacities. Changes are often made without objective evaluation of the features of the previous configuration and staff performance. Since December 2002 there have been major institutional and personnel changes in SME institutions in Romania (the Ministry has been changed into an Agency), Bosnia and Herzegovina (new SME Directorate at state level), Croatia (new agency created in 2003), Albania (an Agency for SMEs created for the second time) and FYR Macedonia (new agency to be created), etc.

#### Box 3-1. SME Institutions in SEE

There are many different institutional arrangements in the SEE region. The information below highlights the key arrangements, including recent developments in 2003:

- Albania: Ministry of Economy (policy); Small Business Development Agency (implementation; created in 2003).
- BiH: Ministry of Foreign Trade and Economic Relations, Department for Entrepreneurship (policy; state level - created in 2003); Federation (Ministry of Energy, Mining and Industry, Department for Entrepreneurship and Production Handicrafts); Ministry of Industry and Technology, Department of Private Entrepreneurship (Republika Srpska); Regional Development Agency (District of Brcko).
- Bulgaria: Agency for Small and Medium-sized Enterprises (policy and implementation, reporting to the Council of Ministers); Ministry of Economy (finances the Agency).
- Croatia: Ministry of SMEs (policy); Agency for SMEs - HAMAG (implementation; created in 2003).
- FYR Macedonia: Ministry of Economy (policy); Agency to Support Entrepreneurship (implementation; to be created).
- Moldova: Ministry of Economy (policy and implementation).
- Montenegro: Agency for Small and Medium-sized Enterprises Development (policy and implementation, reporting to the Prime Minister).
- Romania: Ministry of SMEs and Co-operatives (policy and implementation - changed to agency in 2003).
- Serbia: Ministry of Economy (policy); Republican Agency for the Development of SMEs and Entrepreneurship (implementation).

61. Despite these changing structures, the institutional framework is evolving in a positive way in several SEE countries. Table 3-1. shows that in principle, a government-approved small enterprise strategy exists in almost every country of SEE with the exception of Serbia (subsequently approved in early 2003) and BiH (strategies exist for the District of Brcko and Republika Srpska). Bulgaria, Croatia, Montenegro and Romania as well as the District of Brcko in BiH, are considered to have a sound resource base, where the state budget funds are fairly significant and supplemented by EU, donor funds and International Financial Institutions (IFIs), thus providing a significant degree of financial capacity to implement meaningful programmes of activity.

62. The lack of formal performance measurement of progress in implementing SME policy and evaluating of quality/professionalism of activity is a weakness in the region. It inhibits institutions from knowing the SME development progress that they are making; deprives them of a tool for persuading government of fund their activities on a stable and on-going basis; and reduces their capacity to demonstrate progress to SMEs and the wider stakeholders. Table 3-2. presents a second set of institutional features relative to the benchmarks of good performance.

**Table 3-2. Additional Institutional Benchmarks of Good Performance**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)	Benchmarks of Good Performance
Inter-Ministerial Co-ordination and Consultations on SME	Yes	No (yes, DB)	Yes	Yes	No	No	Yes	Yes	Yes	Yes
SME Donor Co-ordination led by government/agency	Yes	No	Yes	No	No	Yes	No	Yes	Yes	Yes
Existence of institutions responsible for policy/strategy implementation at regional level	Yes, other	Yes, other	Yes, own	Yes, other	Yes, own	Yes, other	Yes, own	Yes, other	Yes, own	Yes
Regular SME stakeholder consultation mechanisms	No	No (yes, FBiH, DB)	Yes	No	No	No	No	Yes	Yes	Yes
Number of SME definitions used	1	None (1 FBiH)	1	1	1	1	1	1	3	1
Compatibility of SME definition(s) the EU definition	No	No	No	Yes	No	No	Yes	No	No	Yes

63. Institutional co-ordination is key to a well-balanced and effective policy towards the small business sector, since many SME issues touch upon areas in the remit of a number of ministries and government bodies (economy, finance, labour, justice, etc.), local administration and multilateral and bi-lateral donors. The SEE countries fare relatively well in terms of inter-ministerial co-ordination. Almost every country has instituted some form of inter-ministerial co-ordination, with the exception of Moldova, FYR Macedonia and BiH (the District of Brcko has such a mechanism) and all the countries, excluding BiH and Serbia operate on the basis of one SME definition, recognised by all the state institutions.

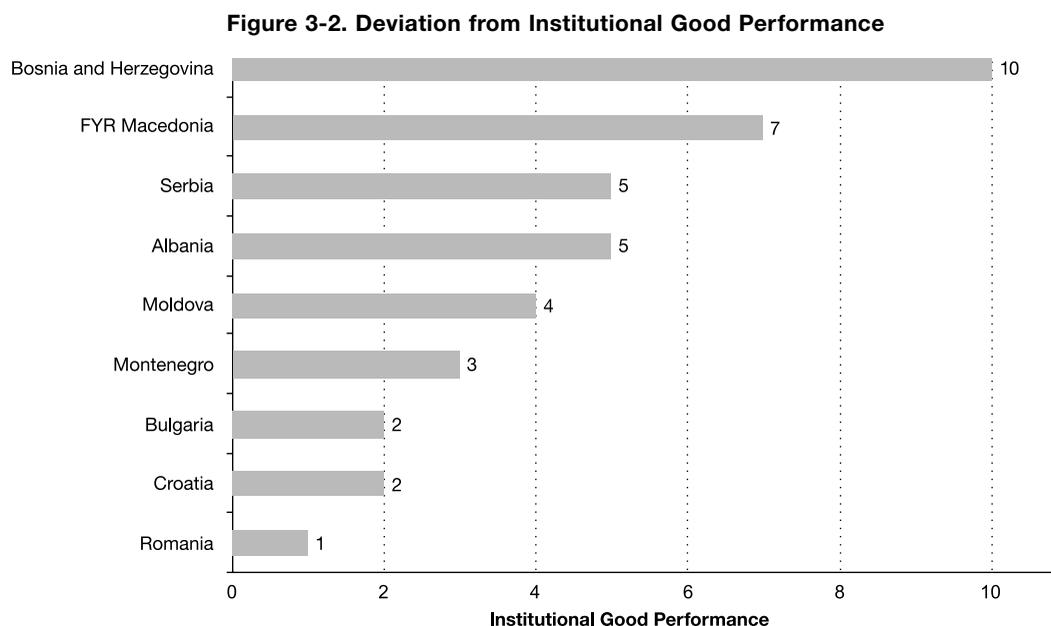
64. However, the effectiveness of all of these mechanisms is unclear at this stage since such initiatives are relatively new. Inter ministerial co-ordination meetings need to be held regularly, ideally under the authority of a senior cabinet member, and at the lower level, effective communication links have to be established among different policy institutions. There needs to be a regular and structured evaluation as part of a wider overall evaluation of enterprise policy performance.

65. External technical and financial assistance to the SME sector is significant in all SEE countries and supplements the internal human and financial resources. While the SEE countries are generally quite successful in mobilising international support for their SME policy, they often remain weak in ensuring that external support is structured around the government's priorities for the development of SMEs. Government-led donor co-ordination is in place in Albania, Romania, Serbia, Moldova and Bulgaria, with varying degrees of effectiveness. Some informal donor co-ordination happens in other countries. This should occur regularly, ideally led by the government, in order to maximise effectiveness.

66. A third dimension of policy co-ordination concerns the level of dialogue and co-operation between national and local institutions. All SEE countries have established local development institutions that are involved in SME support activities. The SME Agencies in Bulgaria, Serbia, Montenegro and FYR Macedonia have developed their own regional networks, which tend to be rather loose structures. The other countries tend to rely heavily on existing arrangements such as regional, county and local authority structures, as well as IFI and donor-funded initiatives, which typically include Regional Development Agencies (RDAs), as well as small business advisory centres of various types and the network of Chamber of Commerce offices. By and large, the regional institutional infrastructure is inadequate. Often the channels of co-ordination and communication between national and local institutions are rudimentary or not yet properly structured.

67. Dialogue between the government and the business sector is vital at all key stages of policy-making: during the elaboration of the strategy, the identification of the policy targets, the preparation of the action plans, the selection of policy tools and the policy implementation phase. This dialogue is also the conduit for building trust in government initiatives. In the SEE region, systematic policy consultation in the small enterprise policy area is still the exception rather than the rule (see table 3-2).

68. Over the last few years most SEE countries have established consultation forums at national government level to discuss the main economic issues (budget, infrastructure development, labour and social policy), but the voice of the small business community is seldom heard. Only Serbia, Bulgaria and Romania have established channels of communication dedicated to the SME sector, although these are not yet well developed (OECD-EBRD, 2003i, 2003c and 2002). Many SME development agencies now include private sector representatives as board members. This is a positive development, but does not substitute for regular policy consultation. Building an effective mechanism of policy consultation is a complex process. The current weakness of the small business sector representation in most of the SEE countries, with the exception of Romania, highlights the need for greater government efforts in this area. Policy dialogue should not be restricted to organisations such as the Chambers of Commerce, the Employers' Federations and Social and Economic Councils at the national level. To sum-up the current institutional framework for enterprise policy development, figure 3-2. maps out the degree of deviation from benchmarks of good performance in each SEE country, taking the issues detailed in tables 3-1. and 3-2. into consideration.



69. Bosnia and Herzegovina shows the largest divergence from the benchmark. The SME policy institutional framework at the state level is still very under-developed, while the two Entities retain the lead in SME policy making. The picture at Entity level is quite complex, while the District of Brcko has made substantial progress in introducing successful practices. At the other extreme, Romania does well in terms of institutional development, although these achievements may be threatened by the level of institutional instability which continues. Croatia and Bulgaria have scope for further development at institutional level

whereas the other SEE countries are at an intermediate stage of building and operating a structured SME policy framework. They are all moving in the right direction. Serbia and FYR Macedonia have some catching up to do, but both have been among the most active in institution-building since the beginning of 2003.

### NOTE

4. The benchmarks good institutional performance are derived from OECD-UNIDO (1999). Due to its complexity, the information for BiH refers to the state of BiH unless otherwise specified (Federation of BiH - FBiH, Republika Srpska - RS and the District of Brcko - DB). The republics of Serbia (SER) and Montenegro (MON) are treated separately as their SME arrangements are different and some of the research preceded the establishment of the State Union. Where information is only available for the State Union of Serbia and Montenegro, the tables and graphics indicate this accordingly (SCG).



## REGULATORY ENVIRONMENT

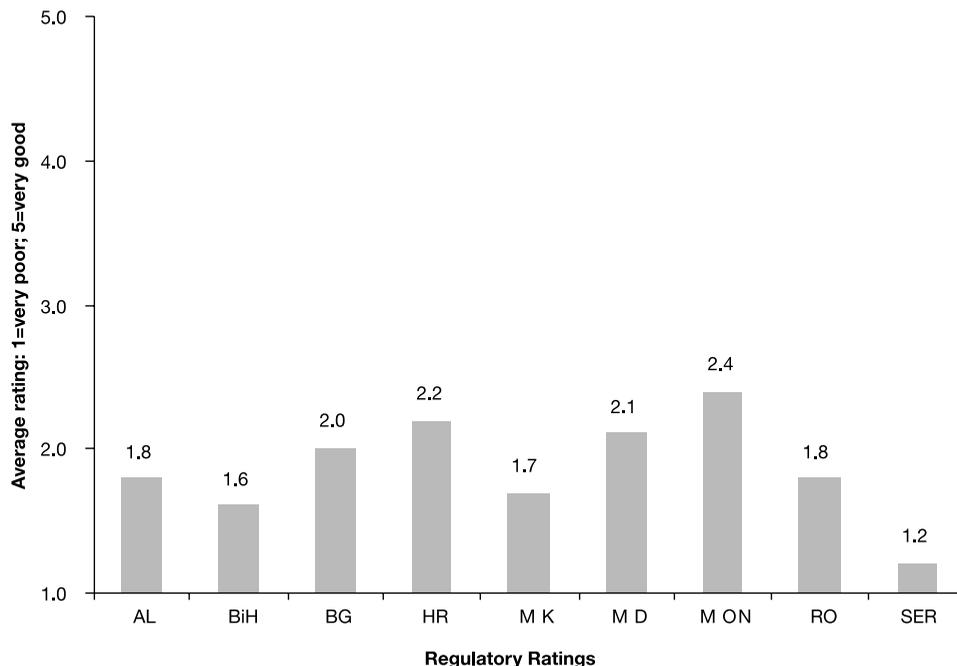
### 4.1. Introduction

70. The regulatory environment in SEE is generally very problematic for small and medium-sized businesses. High administrative barriers and protracted and complex compliance procedures have serious consequences for smaller enterprises, particularly start-ups, as they often divert very limited resources away from productive activity. In addition, a poor regulatory environment provides enterprises in the gray economy with an incentive and justification for conducting informal business operations. Regulatory reform is, therefore, a crucial component of government enterprise policy.

71. This chapter begins, with an overview of SMEs' perceptions of the regulatory environment expressed by SME managers and owners in the EPPA research. This is followed by a review of the key aspects associated with business regulations. The focus is mainly on business entry barriers and company registration procedures, making use of other research built up in recent years by the World Bank and FIAS<sup>5</sup>. This information is used to assess how SEE countries perform against a number of benchmarks derived for the EU country context.

### 4.2. SME Insights

Figure 4-1. Perceptions of the Regulatory Framework



72. Based on the entrepreneurs' assessment of the regulatory situation in their respective countries, none of the countries of SEE attained a "satisfactory" rating with respect to the regulatory environment. Company registration procedures have been greatly simplified and accelerated in Montenegro, following the implementation of the Enterprise Law (2001). It now costs €11 to register a company and courts must register firms within four days. The positive consequences for enterprises may be detected in the rating obtained for Montenegro (see also table 4-1). At the opposite end of the spectrum, BiH and Serbia are struggling with the regulatory and legal barriers to investment, as reflected in the earlier analysis and related reports (see OECD, 2003a; OECD-EBRD, 2003i and 2003b; FIAS, 2001 and 2002).

73. Entrepreneurs in general maintain that the regulatory environment remains expensive, opaque and problematic for small businesses in the SEE region. In recent years, there has been greater recognition at government level of the need to simplify the business environment. Almost every country has recently undertaken a survey of legal and administrative barriers to business. These have been typically followed-up with Business Simplification Task Forces of various sorts (e.g. Romania, Bulgaria, FYR Macedonia and Croatia), designed to identify problems and solutions and move ahead rapidly with implementation. These programmes tend to be ambitious in scope and in general, with the exception of Montenegro, small business representatives detect little "concrete" improvement as of the end of 2002, when the EPPA fieldwork and research was completed.

74. Business people are uniformly concerned about the level of informal activity, as well as the degree of bribery and corruption which is involved in doing business in the SEE region. The actual degree of unfair competition that results for the formally registered firms varies from country to country. Governments have typically responded by establishing Anti-Corruption or Informal Activity programmes and institutions. The entrepreneurs are not impressed with the results achieved so far and call for rapid and visible results on the ground, starting with a stronger political commitment to tackling these issues.

### 4.3. Comparative Policy Assessment

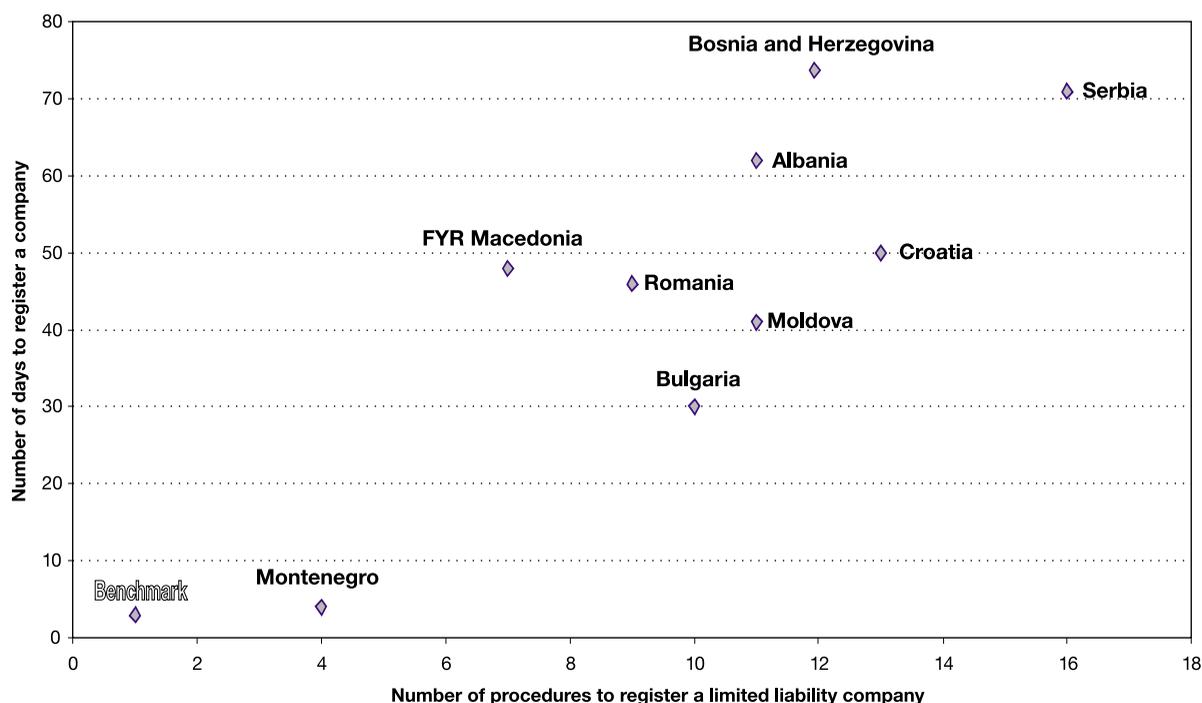
**Table 4-1. Business Entry Benchmarks of Good Performance<sup>6</sup>**

	AL	BIH	BG	HR	MK <sup>7</sup>	MD	MON (SCG)	RO	SER (SCG)	Benchmarks of Good Performance
Number of procedures to register a limited liability company	11	12	10	13	7	11	4	9	16	1
Days to register a company	62	74	30	50	48	41	4	46	71	3 days
Costs to register a company (€)	655	656	132	746	240	118	11	579	194	210
Minimum paid-up capital for mandatory procedures relating to limited liability companies (€)	770	5,100 FBiH, 2,560 RS	2,560	2,560	2,500 local or 5,000 foreign	625 1,250	1	60	5,000	3,000

Source: World Bank (2002) and EC (2002a)

75. An excessive number of procedures are involved in most countries of SEE for the registration of a new limited liability company. Best international practice suggests that a single procedure could eventually be feasible in the SEE region. Montenegro has led the way in this area introducing in 2001 an extensive reform of company registration that has sharply reduced the number of procedures required. Its experience indicates that the benchmarks are not out of reach for the SEE countries.

Figure 4-2. Costs and Time Required for Business Registration



Source: World Bank (2002)

76. Similarly, the number of days required to register a company are excessive, resulting in delays, costs and frustration for potential entrepreneurs, some of which may be discouraged from becoming entrepreneurs and/or encouraged to operate in the informal economy. The worst performer is Bosnia and Herzegovina (74 days, although it should be noted that the District of Brcko has set itself a target of eight days), closely followed by Serbia<sup>9</sup>. By far the best performer is again Montenegro, followed by Bulgaria, which is able to register firms within 30 days. Croatia has set itself the same 30 days target, but appears to be failing to achieve it. Romania is reportedly approaching the 20 days mark in 2003. Best international practice among OECD member countries suggests that a target of three days should not be beyond reach, eventually reduced to one day.

77. In addition to time, the average entrepreneur in SEE has to spend financial resources on government duty and professional fees, and to satisfy the minimum capital requirements. These are significant in relation to the low per capita income. The experience of Montenegro shows that by cutting steps and procedures (including curbing the mandatory capital requirement), it is possible to bring down registration costs substantially.

78. The rationale behind the different levels of minimum paid-up capital for limited liability companies is unclear in the SEE context. This amount varies a great deal from as low as €1 (in Montenegro) to around €5,000 in Serbia, the Federation of BiH and FYR Macedonia (in the case of foreign-owned companies). Most SEE countries fall below the EU benchmark (€3,000), arguably a high benchmark for the economic conditions in the SEE region. A high minimum paid-up capital requirement may well offer some protection to suppliers and creditors, but it also acts as a significant barrier to entrepreneurship and new business formation in the SEE region.

79. Table 3-2. contains data on a number of other regulatory dimensions in relation to benchmarks of good performance.

Table 4-2. Regulatory Benchmarks of Good Performance

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)	Benchmarks of Good Performance
Single registration form	No	No	No	No	No	Yes	Yes	Yes	No	Yes
Single identification number	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Court approval for registration	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	No
Single point of contact for registration	Yes	No	No	No	No	Yes	Yes	Yes	No	Yes
Internet registration	No	No	No	Yes						
Principle of "silence is consent"	No	No	No	No	No	No	Yes	No	No	Yes

80. With low cost IT and Internet technology now more available, it should be possible to register companies swiftly and at minimal cost (one day in some OECD member countries). Why this is not yet happening is a question related to the quality of the institutional and legal framework and the efficiency of the public administration. Company registration by Internet, currently not possible in any of the SEE countries, is increasingly becoming a policy target for governments such as in Montenegro, but there is likely to be stiff resistance from the commercial court system, for which this is a major revenue source.

81. A first step in seeking to simplify and shorten the process is to enable entrepreneurs to register companies using a single registration form and a unique identification number. Romania, Montenegro and Moldova already use a single form, although the process is reportedly still complicated. All countries except Albania have implemented a single registration number, thus ensuring a more effective co-ordination and exchange of information among state administrations. The process of creating "one-stop-shops" for the registration and licensing of new enterprises, as well as the re-registration of existing firms, is still at the early stages in the SEE region. By far the most advanced country in this respect is Romania, where the Chamber of Commerce and Industry took the lead in establishing a wide network of "one-stop-shops" throughout the 42 counties in the country, thus securing a high degree of convenience for entrepreneurs. Although this process has been far from smooth (for example, the responsibility has been transferred from the Chambers of Commerce to the Ministry of Justice) and is not yet functioning to the satisfaction of Romanian entrepreneurs (see OECD-EBRD, 2003h), it provides an example for building up "one-stop-shop" networks.

82. The second step is forcing administrations to respond to entrepreneurs by introducing an automatic approval (silent consent), a practice first adopted in the SEE by Montenegro where, if there is no response within four days of submitting a company registration form, the assumption is that the company has been registered (see OECD-EBRD, 2003g). Implementation of this concept is an important development, which should accelerate the process of registration, increase transparency in the licensing regimes and generally reduce the compliance burden, which enterprises face on a day-to-day basis. Romania and Bulgaria have introduced silent consent in the meantime, and other countries in the SEE are expected to follow suit in the coming years.

83. In all the SEE countries, the courts play a role in the company registration process. They may either have a passive role, as a depository of the legal documents, or an active role, examining and approving the registration of firms. The more active the court involvement, the longer and less transparent the registration process tends to be. The court systems throughout the SEE region are under-resourced and in urgent need of reform. Court registration adds very little to the quality of the process, but guarantees to the courts a steady source of income and, to unscrupulous officials, an entrenched rent seeking position that can be exploited for personal advantage. It is not entirely surprising that in many countries, proposals for company registration reform are blocked by the resistance of some elements in the judiciary who are unwilling to lose this lucrative function.

84. The regulatory environment covers much more than just company registration. Company registration is in fact just the "tip of the iceberg". Entrepreneurs have indicated that all across SEE there are still major issues with the procedures for obtaining operational licences, building permits and respecting environmental and industrial standards. But what most concerns entrepreneurs is the inequality in the application of the law. Entrepreneurs who work according to the rules often face unfair competition from companies operating informally and avoiding taxes, social security obligations and other rules and regulations. The pressure is such that many small businesses are compelled, sometimes for the sake of sheer survival, to operate intermittently between the formal and the informal sectors.

**Table 4-3. Informal Economy in SEE<sup>9</sup>**

	AL	BiH	BG	HR	MK	MD	RO	SCG	CEE average
Informal economy (as % of GNP)	33.4	34.1	36.9	33.4	45.1	45.1	34.4	29.1	22.7
Percentage of firms making bribes frequently	36.4	22.4	32.8	12.9	22.7	34.3	36.7	15.9	22.6
Average bribe tax as a % of annual firm revenue	3.3	0.9	1.9	0.6	0.8	2.1	2.6	1.5	1.1
Corruption Perceptions Index (10 highly clean - to 1 highly corrupt) and rank (out of 102)	2.5 (81)	n/a	4.0 (45)	3.8 (51)	n/a	2.1 (93)	2.6 (77)	n/a	4.0 (45)

Source: EBRD (2002); Schneider (2002a); Transparency International (2002).

85. The weight of the informal economy is significant throughout the SEE region, averaging around one-third of the economy as measured by the Gross National Product (GNP). Measurement of the informal economy is a notoriously difficult exercise and the above should be seen as indicative only. For example, recent research suggests that the informal economy may have been reduced to between 25% and single digit levels of GDP in Croatia (Ott, 2002), depending on the methodology employed. In Moldova, indications suggest that the informal economy may be close to 70% of GDP. The exact extent of the informal economy may be debated, however, what is not questioned is that its existence remains a continuing challenge for all SEE countries with significant implications, such as the reduced tax base and the high levels of unfair competition for the companies operating in the formal economy.

86. A high level of informal activity is often associated with a correspondingly high incidence of corruption and bribery. Poor public governance provides fertile ground for the growth of the informal sector. The proportion of sales that is paid as unofficial "rents" to public officials as measured by the BEEPS<sup>10</sup> provides an indication of the scale of the issue. The "bribe tax" is particularly problematic in Albania (3.3%), Romania (2.6%) and Moldova (2.1%); but is somewhat less so in Croatia (0.6%), FYR Macedonia (0.8%) and BiH (0.9%), compared with the Central and Eastern European (CEE) average of 1.1%. A high proportion of enterprises (between 12.9% in Croatia and 36.7% in Romania) in SEE make bribes frequently (see EBRD, 2002).

87. Every country of SEE is currently implementing government-approved initiatives designed to counteract the effects of the informal economy, but there is still little hard evidence that this is having the desired and rapid enough effect as far as formally registered enterprises, both large and small, are concerned. The Transparency International Corruption Perceptions Index (CPI) identifies the degree of corruption as seen by business people and risk analysts, and ranges between 10 (highly clean) to 1 (highly corrupt). As illustrated by table 4-3., only Bulgaria attains the average levels of CPI in CEE countries, while Croatia is not far away. All other countries for which information is available perform significantly worse on this index.

## NOTES

5. Data provided in this section might differ from those provided by national authorities. Information on the methodology used to collect these data can be accessed at: <http://rru.worldbank.org/DoingBusiness/Methodology/EntryRegulations.aspx>

6. Information for procedures, duration and cost derived from World Bank (2002) Doing Business Project; costs to register a company were converted from \$ to € (€ 0.96 per \$, 30 December 2002); the benchmarks are derived from EC (2002a) Benchmarking the Administration of Business Start-ups.

7. The information for the Republic of Montenegro is derived from OECD-EBRD (2003g); information for FYR Macedonia is derived from FIAS (2003).

8. The data collected by the World Bank are for Serbia and Montenegro together. However, the sample is largely composed of companies located in Serbia, therefore, the information is used as an approximation for Serbia. Data for Serbia only are not available.

9. Source: Derived from Schneider (2002a and 2002b); frequency of bribes and bribe tax derived from EBRD (2002) Transition Report. Other estimates of the weight of the gray economy are available from different sources, but are not quoted in this report as the methodologies used differ across countries and made comparisons impossible. CEE average for Czech Republic, Hungary, Poland and Slovak Republic.

10. The EBRD jointly with the World Bank launched the Business Environment and Enterprise Performance Survey (BEEPS) in 1999. The BEEPS asks enterprises to evaluate economic governance and state institutions and assess the extent to which the business environment creates obstacles to the operation and growth of their businesses. In 2002, a second stage of the BEEPS was undertaken, surveying close to 6,000 firms across 26 countries of the region.

## TAX POLICY FOR SMALL BUSINESSES

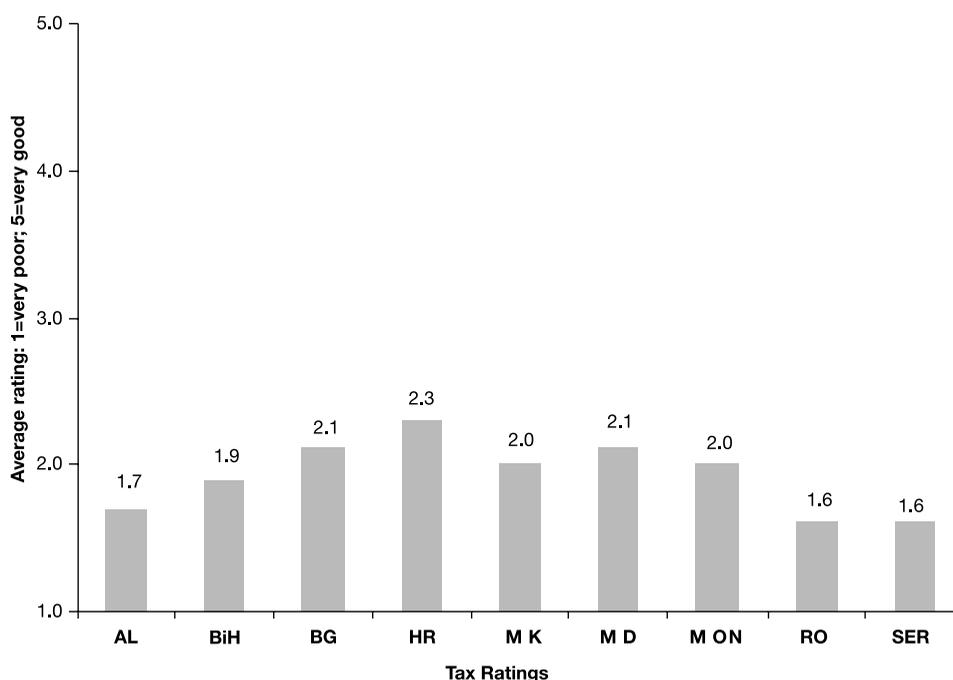
### 5.1. Introduction

88. Tax policy has a major impact on enterprise development. Given the limited access to bank credit, working capital is a scarce and costly resource and companies have few options for balancing cash flow fluctuations. Therefore, it is not only the total tax burden on companies that matters, but also the way the tax administration affects companies' cash flows, on even a temporary basis, for instance by requiring tax prepayments or by delaying VAT refunds.

89. The design of the tax regime and the quality of the tax administration are of crucial importance to small enterprises. The creation of a tax system that is stable, clear and simple is essential for businesses with limited capacity and resources to devote to onerous fiscal compliance procedures. In this chapter, a number of comparisons are made of successful practice, which is beginning to be implemented in the SEE region. As in the other chapters, the analysis starts with the SMEs' perception of the tax system.

### 5.2. SME Insights

Figure 5-1. Perceptions of the Tax Framework



90. In common with entrepreneurs around the world, those in the SEE region voice a number of complaints about the tax system in general, but the degree of dissatisfaction varies across countries. For instance, Croatian entrepreneurs rated their tax system relatively better (2.3) than other SEE countries. Moldova benefits from its innovative patent tax system. Bulgaria and FYR Macedonia also recorded rates slightly above "poor". By contrast, Romania and Serbia are rated lowest (i.e. 1.6 or between "poor" and "very poor"). Although Romania has a relatively modern tax regime, the poor rating may reflect the large number of different taxes and the complexity of the tax administration. The recent elimination of a large array of incentives targeted at small and/or new enterprises may also have affected entrepreneurs' opinions.

91. The key problems concerning tax regimes in SEE are not so much related to their structure, but to their implementation. Entrepreneurs highlight three main problems common to all SEE countries: the chronic instability due to frequent and often sudden changes of the tax laws and regulations; the lack of transparency, internal consistency and co-ordination between local and national regimes; the poor quality of the tax administration, which is often viewed by the entrepreneurs as inefficient and inflexible, partly because there is little consultation and training, and the high levels of corruption.

92. Entrepreneurs in SEE evaluate tax policy as ineffective in encouraging and supporting new and existing small enterprises. It is thus worth noting the main reasons in more detail:

- **High degree of instability in the tax system:** rapid and frequent changes to the structure of the taxes, their rates, related incentives, administration, etc.
- **Tax system characterised by a high degree of complexity:** the most extreme example is BiH where the two entities (Federation and Republika Srpska) and the District of Brcko apply their own taxes and operate their own administration. In all countries of SEE, there tend to be numerous taxes at national, regional and local level, the frequency of payment is often high and the rules and regulations are unclear.
- **Lack of either consultation or advance warning for proposed changes to the tax system:** with some exceptions (such as the Tripartite Councils in Romania and FYR Macedonia's draft Corporate Income Tax law), very limited progress has been made in involving the private sector proactively in the process of developing the tax system.
- **Poor training and advance preparation for new taxes:** clear and timely information is rarely disseminated in advance of changes. Training is provided infrequently, not just to business people, but also to the tax administrators at national, regional and local level. The latter are, therefore, often inadequately prepared for the changes.
- **Entrepreneurs fear the tax inspectorates:** there is an excessive number of inspectorate services, such as in Romania and FYR Macedonia, with unclear roles and responsibilities. The number of inspections per inspectorate can be very high and the visits are typically not co-ordinated, thus imposing a significant burden upon entrepreneurs. The rules and regulations that the inspectorates abide by are often neither stable nor transparent. It is not uncommon for inspectorates to issue internal memoranda on topics that should be communicated to tax-payers, but which are not made accessible to entrepreneurs, invariably putting them on the defensive during inspections.
- **Fines and other penalties are common:** the lack of transparency in the process means that the inspectors are always able to find a reason to impose fines on enterprises and it is not unusual in certain countries for such fines to equate fairly precisely to the tax reimbursements that are due to the firms.

### 5.3. Comparative Policy Assessment

93. The basic structure of the tax regime applied to SMEs in the SEE countries does not differ significantly from that of the OECD countries. Typically SMEs in SEE are subject to a number of taxes based on the income generated by the business activity, such as: a) corporate income tax (CIT), b) personal income tax levied on the value added generated or on the company turnover for individual businesses under a certain size, c) VAT and/or sales tax on business transactions, d) property tax or land

development tax on real estate assets owned or leased by the company, e) taxes on labour, such as social security contributions, pension contribution, etc. and f) local taxes.

**Table 5-1. Basic Tax System**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)
Corporate Income Tax (CIT) (rate in %)	25	30 FBiH, 10-20, RS	23.5	20	15	25	15 / 20	25	20
Frequency of CIT payment (monthly, quarterly and annual)	Q	M	Q	A	A	Q	A	Q	M
Maximum Personal Income Tax (rate in %)	20 Q	30 FBiH, 10 RS	29	45	18	25	40	40	20
Frequency of PIT payment (monthly, quarterly and annual)	Q	M	M	A	M	Q	A	M	A
Social Security Contributions (employer and employee)	34.2	47 FBiH 42 RS	32.2	17.1	18	29	20	23.3	16.3
	11.7	19.2 FBiH 19.5 RS	10.5	20.6	15	1	20	11.7	16.3
Taxes which must be pre-paid	All	1	2	3	0	5	0	3	0
Changes in CIT rates and regulations in preceding 2 years	3	3 FBiH, 2 RS, 1 DB	2	1	1	2	1	2	1

94. One result of the lack of co-ordination between local and national regimes is the multiplication of charges imposed on companies. Even if the overall tax burden is low, the cost of compliance for the companies is significant. For instance, Bosnia and Herzegovina has a particularly complicated tax system, whereby the entities and the District of Brcko have their own taxes (19 in all), rates, administration, etc. Romania also stands out as a case of multiple taxes, as companies have to deal with a total of 15 different regular tax payments, due to compulsory contributions to independently administered funds. The Romanian government is currently consolidating tax charges and is committed to streamlining the state funds.

95. As mentioned before, a constant complaint made by entrepreneurs in SEE is that tax laws and regulations change frequently, at short or no notice. Those changes are partly the result of the process of upgrading and restructuring of the tax regimes. A number of changes are due to the introduction of tax incentives, which are then followed by sudden withdrawal because they are viewed as ineffective or unsustainable. The uncertainty generated by these changes should be compensated for over time by the introduction of a more stable and fairer regime.

96. An indication of the degree of instability in the tax system can be gauged by the number of changes to corporate income tax (CIT) in the last two years (January 2001 to December 2002). All countries have experienced at least one change, with Albania and the Federation of BiH experiencing as many as three adjustments to CIT. When the other changes to the tax system as a whole are taken into consideration, there is a good deal of turbulence in the tax system throughout the region.

97. However, probably the biggest problems relate to the quality and the functioning of the tax administration. The first issue is the frequency and the timing of tax payments. For example, Serbia and BiH require monthly payments of CIT, rather than quarterly and annual payment. In some countries (Albania, Moldova, Romania and Croatia) a number of taxes, including CIT, have to be pre-paid, based on the tax charges for the previous period, or an assessment made by the tax office of future profit. Frequent tax payments with inflexible deadlines and without the possibility to compensate between tax credits and liabilities, may seriously disrupt the cash flow of small firms. Since these firms operate with very low levels

of working capital and have limited or no access to bank credit, this adds to the pressure to under-report a company's profit and turnover.

98. Over the last two years there have been some positive developments in tax policy in SEE. The CIT rates in the region are relatively low by international standards (see OECD, 2003b), ranging between 10% and 30%. The Federation of BiH has the highest rate (30%), while FYR Macedonia (15%) and Montenegro (15-20%) have low CIT rates. Personal income tax rates (PIT) are also on a par with international standards. The maximum level of PIT is as high as 45% in the case of Croatia, whereas it is 18% in the case of FYR Macedonia and 10% in Republika Srpska (BiH).

99. Several countries have introduced new taxation regimes for small enterprises and individual entrepreneurs, such as an SME tax in Albania and the patent taxes in Albania and Moldova. The experience of Moldova is worth noting. Individuals may purchase a temporary licence to carry out business activities such as retailing, workshops, crafts, etc. The patent works both as a temporary business licence as well as a form of tax pre-payment, exempting individuals from having to keep records of their activities. The patent licence has been well received, however, once the business starts growing the usual difficulties of obtaining licences, dealing with the tax office, coping with state inspections, etc. re-appear.

**Table 5-2. Tax System Measures to Promote SMEs**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)	Benchmarks of Good Performance
Tax incentives for start-ups/ investments favouring SMEs	No	No (yes FBIH, DB)	No	No	Yes	Yes	Yes	No	Yes	Yes
Simplified tax system for small enterprises and sole proprietors	Yes	No	No	Yes	No	Yes	No	Yes	Yes	Yes
Single tax submission form	No	No	Yes	No	Yes	No	No	No	No	Yes
Internet based tax submission	No	No	No	No	No	No	No	No	No	Yes
Single point of information on all aspects of tax for businesses	No	No	Yes	No	No	No	Yes	No	No	Yes

100. In order to reduce the compliance burden on small enterprises and partly in order to increase tax collection rates, thereby stimulating a reduction in the levels of the informal economy, Croatia, Serbia, Romania and Albania have introduced a simplified tax system.

**Table 5-3. VAT / Sales Tax Features**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)	OECD
Type of tax	VAT	Sales	VAT	VAT	VAT	VAT	VAT	VAT	Sales	VAT
VAT (% & frequency)/ planned date for introduction of VAT	20 A	2005	20 M	22 M	19 M	20 M	17 M	19 M	2004	31.6
VAT Turnover Threshold (€)	14,000	n/a	39,000	11,400	20,000	7,000	18,000	45,000	n/a	n/a
VAT Refund Period (in months)	n/a	n/a	3	0.5	3	1.5	3	1	n/a	n/a
Standard Sales Tax (%)	n/a	20 FBIH, 18 RS, 18 DB	n/a	n/a	n/a	n/a	n/a	n/a	20	n/a

Note: OECD data derived from OECD in Statistics (2003c)

101. Bulgaria and FYR Macedonia have introduced a single form for tax submission, as has BiH in the case of handicrafts. None of the countries has made much progress with the possibility of allowing Internet-based tax submissions, as is increasingly common in OECD member countries. Only a minority, such as Bulgaria and the Republic of Montenegro, have established a single point of information for all aspects relating to taxation for enterprises.

102. One of the most critical issues for entrepreneurs is how the value added tax (VAT) is administered. VAT is a neutral and universal tax, where the tax burden is shifted to the final consumer, thus avoiding distortion of business activity. Most countries of SEE have now introduced VAT. The rates range from 22% in the case of Croatia to 17% in the case of Montenegro. Serbia and BiH have undertaken to introduce VAT in 2004 and 2005 respectively. A number of issues are worth highlighting with respect to experience in the SEE region:

- VAT avoidance is still widespread throughout the SEE. For instance, in most SEE countries VAT on imported goods is charged at customs, together with customs duties. Companies that are able to avoid customs control or to under-report their import activity have a good chance to get away, both with customs duty and VAT, thus acquiring a considerable price advantage vis-à-vis importers operating according to the law, as well as towards local manufactures who have to charge VAT.
- The thresholds for charging VAT and claiming a refund vary to a surprising degree, with Bulgaria and Romania setting relatively high thresholds in comparison to Croatia. In most cases, VAT registration is voluntary, thus enabling firms to pass on the costs to the final user/consumer. However, in cases such as Bulgaria, this is not an option and may disadvantage smaller enterprises.
- The duration of the VAT refund period or the length of time firms must wait before they can reclaim the VAT they have paid up-front for goods and services varies. The average in the SEE region is around three months, but in Croatia it is a mere two weeks. The conditions can be stringent, for example in Albania, where the VAT refund can only be made if the taxpayer has carried forward a VAT tax credit for six consecutive months and the total refund claimed exceeds 400,000 Lek (about €3,000). In reality, the tax administration operates much more slowly than the official targets, with entrepreneurs estimating that it typically takes twice as long. In addition to the cash flow problems caused by this issue, the relatively high inflation rates in some countries can result in significant real costs to enterprises and may be particularly problematic for export-oriented or capital-intensive enterprises.



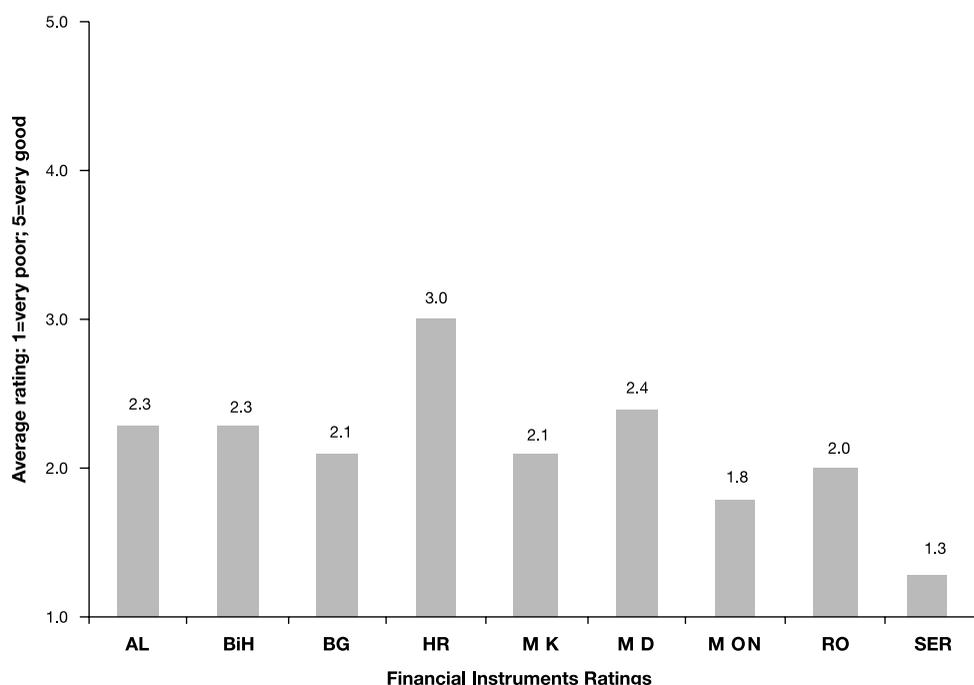
## FINANCIAL INSTRUMENTS FOR FOSTERING NEW AND SMALL BUSINESSES

### 6.1. Introduction

103. This chapter provides an overview of the SMEs' perceptions of their ability to access finance. It then discusses some of the issues affecting availability of finance for entrepreneurs in the SEE, providing guidance to policy-makers as regards to actions that can be taken to improve this particular aspect of the business environment.

### 6.2. SME Insights

Figure 6-1. Perceptions of Access to Finance



104. SMEs in SEE rate their access to finance slightly above the "poor" mark, except for Croatian SMEs, which rate it "satisfactory". Croatia possesses a relatively more sophisticated banking sector compared with the other countries of the region and this helps to explain the better rating. However, Croatia is followed by Moldova (2.4), whose banking system is arguably weaker than in that of the other SEE countries. Thus, the health of the banking system alone is not a sufficient explanation for the ratings given by the SME owners and managers. Both Serbia and Montenegro rate this dimension around the "very poor" mark. This in turn can be explained by the fact that both republics started the process of economic transition late and are still in the initial stages of banking sector reform.

105. The BEEPS (see endnote 10), also run in 2002, provides some additional interesting insights on the problems faced by small business in relation to finance. The entrepreneurs were asked (see table 6.1) to rate the severity of obstacles pertaining to several aspects of the business environment, including lack of access to finance and cost of finance. The ranking of finance among all obstacles listed in the BEEPS questionnaire indicates that perception of this aspect of the business environment is worse for the enterprises interviewed in the BEEPS than those interviewed in the focus groups. Finance is in fact ranked as the most severe obstacle in Bosnia and Herzegovina, Bulgaria, Croatia and Serbia and Montenegro, whereas it ranks last only in Albania and second in all other countries.

**Table 6-1. Perception of Severity of Lack of Finance, Data on Availability of Finance and Sources Tapped by SMEs (BEEPS 2002)**

	Ranking of finance among all obstacles	Rating access to finance <sup>11</sup>	Share of SMEs which accessed finance in total SMEs interviewed		Of those SMEs which accessed any type of finance			
					Share of internal funds in total finance accessed		Share of bank loans in total finance accessed	
					Working Capital	New Investment	Working Capital	New Investment
Albania	5	2.5	99.3	95	89.1	87.5	3.4	4
Bosnia and Herzegovina	1	2.6	99	68	74.2	73.5	13.2	16
Bulgaria	1	2.9	99	68	75.4	78.9	9.5	9.6
Croatia	1	2.5	92	66	59.1	52.4	14.5	21.2
FYR Macedonia	2	2.4	100	73	66.9	63.9	12.4	11.2
Moldova	2	2.8	100	73	76.5	76.8	12.4	11.2
Romania	2	2.7	99.5	86.6	75.5	78.4	11.3	10.5
Serbia and Montenegro	1	2.7	97	87	87.4	90.1	5.3	4.3

Source: EBRD

106. Financial constraints affect entry, development and growth of small enterprises all over the world. However, because of the poor level of development of the financial sector in SEE as compared to western economies, and because of the relatively higher risk aversion of banks in SEE, the severity of this constraint is much stronger in this region than it is in advanced market economies, for all enterprise sizes.

107. The 2001 European Network for SME Research (ENSR)<sup>12</sup> ran a survey of 7,600 SMEs in 19 countries of Western Europe (EU plus Iceland, Liechtenstein, Norway and Switzerland) through computer assisted telephone interviews. Entrepreneurs were asked to identify from a series of listed potential obstacles the single most important constraint to doing business. Lack of skilled labour appears to be the most frequently (20-30% of sample) quoted "major constraint", affecting relatively more small- and medium-sized companies than micro-sized ones. This is followed by "no obstacle at all" (15-20% of sample) and "other obstacles than those in the list" (12-15%). Administrative regulations affect highly between 10% and 16% of enterprises in the sample and access to finance between only 8% and 15% of enterprises, with relatively more micro enterprises isolating this as their major obstacle than enterprises of larger size.

108. The results of the two surveys are not directly comparable in that the BEEPS enterprises were not asked to rank the top obstacle to doing business, whereas the ENSR sample was. However, the comparison in terms of relative importance of obstacles quoted shows finance as one of the most highly rated obstacles in the SEE countries against a mere fifth obstacle in the 19 western European countries.

109. Moreover, one can compare the extent to which entrepreneurs managed to obtain the finance they needed, and where they found it. Table 6-1 shows that, with the exception of Croatia, most SMEs managed to access the finance they needed for their working capital requirements, either from internal or external sources.

110. However, the situation for financial requirements for new investments is quite different. With the exception of Albania, where 95% of SMEs interviewed managed to obtain funds needed to expand, only 68-78% of SMEs in the other countries of SEE managed to access funds for new investment. The advantageous position of Albanian SMEs is well explained by the large availability of remittances. In fact internal funds account for a far larger share of the finance accessed by Albanian SMEs than in any other country, with the exception of Serbia where remittances are also important. Internal funds dominate by far the sources of finance tapped by entrepreneurs, thus compensating for lack of availability of funds from external sources. Of all external sources of finance available the most relevant is the banking sector (differentiations by ownership of bank are not meaningful as entrepreneurs' knowledge of the ownership structure of banks they borrow from is unreliable). Bank loans account for between 3.4% and 14.5% of finance accessed to satisfy the working capital requirements of SMEs and for between 4% and 21.2% of finance accessed to meet SMEs' investment needs.

111. SMEs in all focus groups recognise that the commercial banking system is becoming more stable, competitive and offering a wider range of services, a process which is partly connected with the privatisation of the banking sector. Yet SMEs in the focus groups do not think that commercial banks respond adequately to the needs of the SME sector by offering sufficient access to credit. Apart from the usual lack of finance for start-ups, the more established SMEs are also critical of the commercial banks' requirements. The level of interest rates and the collateral requirements for loans to small enterprises are perceived to be unaffordable. The lack of competition among commercial banks for the small enterprise market is another source of complaint.

112. Entrepreneurs in the region, both in the focus groups, just as those interviewed and in the BEEPS, relied heavily on internal funds (family/friends and remittances) for starting a business. The principal regional success story, according to entrepreneurs in the focus groups, has been the establishment and development of microfinance institutions and in particular of microfinance banks set up by International Financial Institutions (IFIs). Microfinance institutions are now in operation in all countries of SEE and, despite the fact that the loans are extended on a purely commercial basis, many entrepreneurs are happy to accept the terms and conditions of the loans as the only alternative would be the extortionary rates charged by moneylenders. The relatively high levels of disbursement and repayment of loans may help send out a reassuring message to the rest of the banking industry in the SEE region, vis-à-vis the reliability of the small enterprise sector.

113. Entrepreneurs in the focus groups, along with those interviewed in the BEEPS, have insignificant access to non-banking external financial sources. The leasing industry is largely underdeveloped with the exception of Romania, Croatia and Bulgaria. Venture capital funds targeting the small enterprise sector are few and have not managed to reach sustainable investment volumes. Credit reference sources are unheard of and credit unions are either underdeveloped or treated with caution. The lack of an adequate legal, regulatory and supervisory framework continues to hinder diversification of the sources of finance for the small enterprise sector.

### 6.3. Comparative Policy Assessment

114. Given the unbalanced development of the financial sector in the region, with banking dominating the sector in terms of assets and, according to the entrepreneurs interviewed, being the most important external source of funds, the focus of the comparative policy assessment will be mostly on banking. The question is what needs to be done to enhance the role of the banking sector in intermediating savings in general and in providing finance for the SME sector in particular. A healthy banking sector is the key prerequisite for providing access to finance for SMEs. Thus this chapter initially examines the state of health

of the sector and its ability to intermediate savings, and then looks at how other factors can influence either directly or indirectly the degree of bank intermediation.

115. The timing and depth of the process of reform of the banking sector and its impact on the functioning of the sector varies widely across the countries of the Stability Pact region, but the pattern of reform is common to all of them. Table 6-2. contains selected indicators of the reform process. The countries of the SEE region, as all other transition countries, inherited from the previous regimes banking systems that were structurally unable to efficiently intermediate savings.

**Table 6-2. Indicators of Banking Sector Reform**

2002	Share of assets of banks with more than 50% state ownership in total assets of banks (%)	Share of assets of banks with more than 50% foreign ownership in total assets of banks (%)	Share of non-performing loans in total bank loans (%)	EBRD index of banking reform and interest rate liberalisation <sup>19</sup>
Albania	54.1	45.9	5.6	2+
Bosnia and Herzegovina	6.24	76.7	11.5	2+
Bulgaria	14.1	75.2	10.4	3+
Croatia	4.0	90.2	11.5	4-
FYR Macedonia	1.9	44.0	35.7	3
Moldova	13.4	36.7	7.6	2+
Romania	43.6	52.9	2.3	3-
Serbia and Montenegro	35.6	27.0	28.5	2+

Source: EBRD and IMF

116. Transition to a market economy involved in the early stages of transition dismantling the inherited mono-bank system and the creation of an independent central bank and of a separate tier of state-owned commercial banks. This step was followed by the clean-up of the bad loans of the commercial banks usually through a recapitalisation process and the privatisation of the commercial banks, usually through direct sale to a foreign strategic investor, who possessed the relevant know-how and could improve corporate governance and provide the necessary capital. Both privatisation and the entry of foreign strategic shareholders in the SEE banks stimulated recapitalisation and restructuring of the sector. At the same time the legal and regulatory framework for the banking sector was set up and gradually improved to ensure efficient entry and exit in the sector, effective regulation and supervision and the provision of an expanded range of financial services on offer.

117. Foreign ownership resulted in stronger capitalisation, improved banking practices, higher profitability, increased competition (as evidenced by decreasing spreads between lending and deposit rates) but also increased risk aversion. Increased risk aversion de facto implied reduced lending activity. When and where the growth of bank lending resumed, the beneficiaries of this activity were mainly low risk segments of the economy: large foreign-owned companies, local blue chip companies and households. Entry of foreign investors was universally linked to a rapid increase of retail banking (i.e. loans to households). Thus although banking reform is a prerequisite for efficient intermediation of savings, it alone by no means guarantees in the short-medium term that enterprise access to official financial sources is improved.

118. Despite the profound transformation undergone by the banking systems of the countries in the region, the level of banking intermediation is still low (in 2002 domestic credit averaged about 30.6% of GDP in the SEE area, as compared to 135% in the Euro area), and in particular domestic credit to the private sector is even lower at an average of 21.7% of GDP in the region in 2002, as compared with 113% in the Euro area (in 2001). The level of domestic credit to private sector in relation to GDP is low, not only as compared to the average of the EU countries, but also compared to that of countries at a similar level

of development as approximated by GDP per capita. It is interesting to note, however, that there is a positive correlation between privatisation and the degree of bank intermediation to the private sector and an even stronger one between foreign ownership and bank intermediation to the private sector. Yet, given the low levels of domestic credit to the private sector in relation to GDP, privatisation and foreign ownership are necessary but not sufficient conditions for making bank finance more accessible to the private sector.

**Table 6-3. Domestic Credit**

	Domestic credit in % of GDP, 2002	Domestic Credit to Private sector in % of GDP, 2002	Cumulative growth rate of bank credit to private sector, 2000-02	Cumulative growth rate of bank credit to enterprises, 2000-02	Cumulative growth rate of bank credit to households, 2000-02
Albania	44.9	6.8	99	147	-46
Bosnia and Herzegovina	34.8	38.2	93.8	45.6	248
Bulgaria	25.2	18.7	101.7	111	73.5
Croatia	63.8	55.8	32.1	9.9	75.9
FYR Macedonia	18.2	16.4	-7.5	-12.8	67.4
Moldova	29.9	17.5	n/a	n/a	n/a
Romania	13.4	8.4	7.2	4.5	48.7
Serbia and Montenegro	14.5	15.4	-60.2	-63.8	135.5

Source: EBRD, IMF and Cottarelli et al (2003)

119. The low levels of bank intermediation are partly a consequence of the severe recession experienced by all SEE countries in the first years of transition. The economic downturn led to the accumulation of bad loans in the banks' portfolios. The subsequent clean-up of banks' portfolios in advance of privatisation then led to a significant reduction in the assets of the banking sector (the most notable example was Bulgaria, where banking sector assets dropped from 350% of GDP in 1991 to 34% in 1997). In some cases the accumulation of bad loans and/or exogenous shocks led to banking crises, which further shrank bank loan portfolios. As a reaction to banking sector crises, more stringent banking regulations and supervisory practices were introduced and this induced more prudent lending behaviour. Even in the absence of banking crises, more risk-averse behaviour always followed privatisation to foreign owners. Table 6-3. also shows how much faster credit to households is increasing than bank credit to enterprises in the region (with the exceptions of Albania and Bulgaria). In FYR Macedonia and Serbia and Montenegro domestic credit to the enterprise sector has actually been decreasing in the past three years. It will take decades for the market alone to reach the levels of intermediation observed in western countries. For this reason corrective measures need to be undertaken.

120. The simplest way to speed up the provision of finance to the small enterprise sector is that of creating banking channels entirely dedicated to that activity. The experience of microfinance banks in the region has been excellent in terms of outreach to the smallest and poorest. Table 6-4. shows the very large number of loans of very small size in each country in which a microfinance bank or institution is set up. The low arrears signify that the loans extended are of good quality: a pre-requisite for commercial viability and maximum recyclability of funds. To a lesser extent, a significant contribution to the provision of finance to a slightly larger segment of the enterprise sector has come from dedicated credit lines. Table 6-5. contains summary statistics for a selection of dedicated SME credit lines financed by the joint co-operation of EU and EBRD. The average loan size is larger than that of the microfinance institutions and the number of loans is smaller. NGO activity has complemented the former two types of programmes by making finance available to those who would never manage to access bank finance (e.g. start-ups, or enterprises in areas devoid of bank branches).

**Table 6-4. Microfinance Banks and Institutions in Operation at December 2002**

December 2002	Name	Start date	Total number of loans issued	Total volume of loans issued, US\$	Average Loan outstanding, US\$	Arrears % over 30 days
Albania	FEFAD Albania	Jan-96	12,430	80,654,495	5,479	1.98%
Bosnia and Herzegovina	MEB Bosnia	Nov-97	15,652	78,169,568	5,376	0.55%
Bulgaria	ProCredit Bulgaria	Oct-01	6,827	42,906,933	5,930	0.03%
Moldova	MEC Moldova	Dec-99	2,304	11,036,695	3,766	0.00%
Romania	MIRO Romania	Jan-00	3,472	19,043,959	4,087	0.54%
Serbia and Montenegro	MFB Yugoslavia	Apr-01	5,973	49,419,438	6,788	0.46%

Source: EBRD

121. The legal and regulatory environment is, however, not always conducive to the establishment and development of these three types of programmes. In some cases, the excessive tightness and rigidity of the legal and regulatory regime restrict lending to the smallest borrowers. For example in Serbia the NGO channel is ruled out - no institution without a banking license is allowed to lend money. In Moldova a very high minimum capital requirement and the legal impossibility of transferring a portfolio of loans from one institution to another with the same or related owners precludes the transformation of micro-finance institutions into micro-finance banks, thus making them perennially dependent on donor funding.

122. In most countries, minimum capital requirements are applied uniformly across the banking sector, without any variation to reflect the nature of the financial institution in question. High loan loss provisioning requirements and restrictive definitions of acceptable collateral in Bulgaria can limit the activity of a microfinance bank, if rigidly enforced. Albanian banking legislation<sup>14</sup> specifies minimum criteria for assessing credit risk that make the provisioning levels for many micro-loans disproportionately high in comparison with the actual risk undertaken by the bank. Luckily the implementation of these stringent regulations in Albania and Bulgaria is relatively flexible and, therefore, the activity of the local micro-finance banks is not de facto hindered by the regulatory system. In other cases the legal and regulatory regime may be too lax. In FYR Macedonia, for example, it was suggested that regulations on the shareholding structure of banks (including stricter eligible criteria for banks' shareholders) and related party transactions should be tightened, in order to prevent improper interference in banks' business by shareholders.

**Table 6-5. Selected Dedicated Credit Lines Financed by EU/EBRD in Operation at December 2002**

December 2002	Name	Start date	Total number of loans issued	Total volume of loans issued, US\$	Average Loan, US\$
Bulgaria	Union Bank	Jul-00	950	19,079,286	20,083
Bulgaria	Hebros Bank	Sept-01	297	8,008,320	26,964
Bulgaria	Raiffeisen Bank	May-02	47	734,131	15,620
Romania	Alpha Bank	Dec-99	79	3,079,769	38,984
Romania	Banca Transilvania	Jan-01	343	15,019,224	43,788
Romania	Romanian Commercial Bank	May-02	518	27,602,243	53,286
Romania	Banca Agricola Raiffeisen	May-02	3	25,906	8,635
Romania	Bank Post	May-02	45	1,040,603	23,125
Romania	Volksbank	May-02	10	383,898	38,390

Source: EBRD

123. The pressing challenge in the legal regime is finding the delicate balance between prudential regulation of the banking system and a flexible framework facilitating microfinance activities. In some cases changes to facilitate lending to the smallest businesses have already taken place. FYR Macedonia for example has passed a special Law on Microfinancing Banks, whose provisions on the minimum capital requirements take precedence over conflicting provisions of the country's Banking Law. In Romania, banking legislation on assessing credit risk and the corresponding provisioning levels to be applied, failed to incorporate the specific features of micro-lending. However, after lengthy discussions, the National Bank of Romania has recently agreed to authorise the EBRD-sponsored Microfinance Bank to rate all loans under €10,000 in the top category, thus requiring minimal provisioning.

124. The generally weak and underdeveloped banking sector in the region has produced severe financial crises, which have motivated central banks to impose stringent regulatory requirements on financial institutions. While the consolidation and strengthening of the banking system is a laudable objective, microfinance operations have often suffered, due to an inflexible regulatory environment that inhibits their expansion and makes their long-term sustainability a precarious task. Designing the optimal legal regime for maintaining a healthy banking system responsive to the needs of small businesses requires active dialogue among government officials, policy makers and those multilateral financial institutions that provide technical assistance in the region.

125. Other aspects of the regulatory environment affect the ability of financial institutions to effectively intermediate savings. In particular, land reform has produced mixed results in the region with delays in developing land registries and functioning cadastres. This has precluded firms from using real estate as collateral in their efforts to access bank finance. Legal reform to enforce contractual obligations and their implementation have been uneven and rarely satisfactory. As a consequence banks tend to require excessive levels of collateral as they find it risky, if not impossible, to collect when a loan is not repaid. Finally, accounting standards are still inadequate, thus precluding banks from accessing the necessary information from would-be borrowers. Although these aspects of the regulatory environment do not at first sight appear to have a particular influence on the SME sector, they in fact weigh heavily on the ability of enterprises to borrow from official channels. Advances in land reform, improvements in the enforcement of contractual obligations and in raising accounting standards are necessary to indirectly improve the access of SMEs to commercial sources of finance.

126. The role of the state in the banking sector has dramatically reduced over the past decade. However, despite the fact that the share of assets of banks with majority state ownership in total bank assets is now relatively low in the region at 27% (see table 6-2.), there are constant attempts by governments in the region to support the small enterprise sector through direct provision of finance to the sector, in order to correct what are perceived as market failures in credit allocation. Therefore, the concept of a well-functioning private financial sector being more efficient than a state-run financial sector does not yet appear to be ingrained in the regional culture. Examples of direct state intervention in this field include the numerous state guarantee funds and state-run programmes to provide subsidised finance to small businesses.

127. However, the experience of both OECD and transition countries shows that the state, through its network of civil servants, is generally unable to select the best among the pool of small borrowers. In addition leaving the decision to allocate subsidised loans to the discretion of politicians and civil servants in the absence of market mechanisms that would penalise the finance providers for taking the wrong lending decisions, creates plenty of room for political patronage and possibly corruption. It could be argued that, in order to counterbalance the lack of credit skills and limit political influence, the state could contract to the private sector the management of state supported lending schemes and guarantee funds. Yet there are several reasons why this would be problematic to implement. In most of the SEE countries the current legal framework does not allow to entrust to management of state-funds to truly independent managers and some form of political control has to remain in place. Even if this obstacle is overcome, an effective monitoring and reporting system should be introduced in order to avoid the mismanagement of state funds. Ideally, in order to gain independence, the private managers should be able to finance themselves out of fees alone, rather than government funds.

128. There is finally a fundamental issue concerning the provision of credit guarantees by the state. Shifting the risk balance from the commercial banks to the state will in the short term help to increase the loan volume, but over the medium term may slow down or even reverse the development of a sound banking sector. Guarantees per se relax the behaviour of banks. At a point in transition when banks are on the steep part of the learning curve in terms of using appropriate lending methodologies and evaluating risk correctly, the state is de facto inviting them to take it easy by offering a guarantee in case the loan is not repaid, and may encourage the application of lax credit assessment procedures by commercial banks. Unfortunately there have been many examples of state sponsored guarantee schemes which ended up creating large liabilities for the commercial banks and ultimately for the government, pushing away the prospects of sustainability of provision of finance to SMEs. In order to ensure an efficient market mechanism for direct provision of finance to SMEs, the role of the state in the direct intermediation of savings should be minimal.

129. There are of course exceptions but these are few and well identified. The first is the case of start-ups, never considered as potential clients by official financial institutions. In that case, should a government want to stimulate entry into the sector, alongside improvements in the administrative and regulatory structure for setting up businesses, it could provide guarantees for those would-be entrepreneurs that lack the initial start-up funds. The second case is that of guarantee funds set up by groups of private entrepreneurs, mutual guarantee funds. These are common in Western Europe and have served over the years as an essential tool to provide finance to SMEs and lower the banks' perception of the risk associated with small businesses. Historically, they were set up through guilds and other business associations. In transition countries where this tradition is missing, the state could play a key role in stimulating the establishment of such financial structures. In the initial phase the state could even consider contributing to the capital, but the mutual element should remain dominant.

## NOTES

11. The scores can be interpreted as follows: 1 = no obstacle; 2 = minor obstacle; 3 = moderate obstacle; 4 = major obstacle.

12. European Commission (2002b), Observatory of European SMEs n.1: Highlights from the 2001 Survey.

13. Scale: 1 = little progress beyond establishment of a two-tier system to 4+ = standards and performance norms of advanced industrial economies: full convergence of banking laws and regulations with the standards of the Bank for International Standards; provision of full set of competitive banking services.

14. Article 5.2 of the Albanian Regulation on Credit Risk Management approved by Decision of the Supervisory Council [of the Bank of Albania] no. 13, 21.02.2001.

## ADVISORY SERVICES FOR NEW AND SMALL BUSINESSES

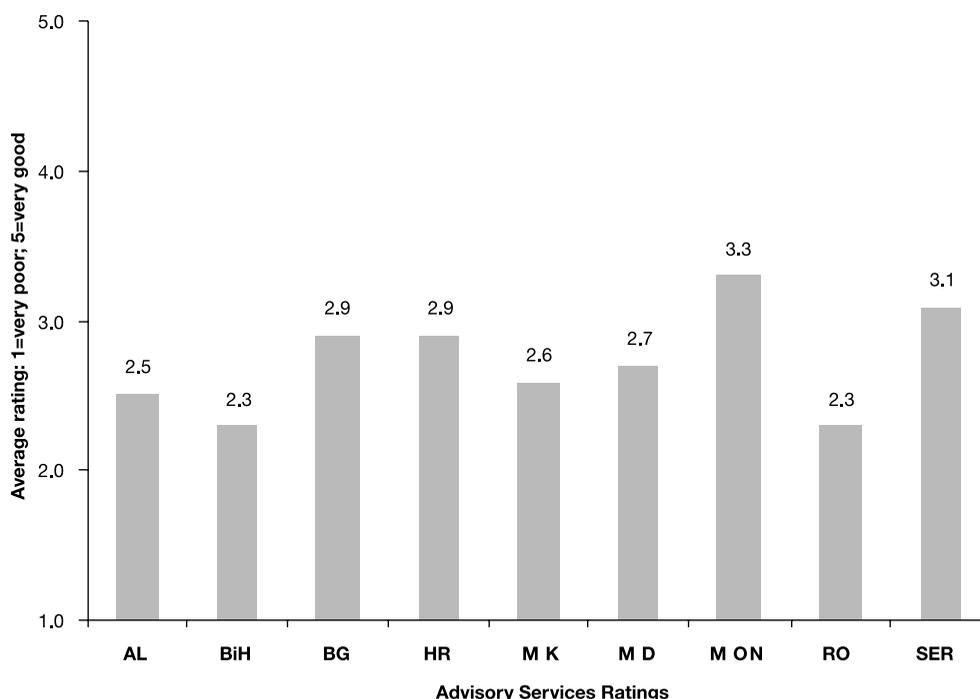
### 7.1. Introduction

130. Potential entrepreneurs looking to become self-employed or start up a new company frequently do not have very clear knowledge of what is involved in registering, financing, expanding and managing an enterprise. In this context, the availability of information and advice to potential and new enterprises can be of crucial importance to their survival, development and success in generating economic growth, employment and wealth.

131. Business advice for start-ups and young enterprises is particularly important for development of the enterprise sector. One common area of market failure is that of provision of information to potential and new entrepreneurs, particularly in transition economies. Therefore, in assessing enterprise performance, it is important to analyse the extent to which business advisory services are available and well-functioning.

### 7.2. SME Insights

Figure 7-1. Perceptions of Business Advisory Services



132. Small enterprise managers and owners rate the access to business advisory services higher than the other five dimensions of the business environment assessed in this regional report. In Bulgaria, Croatia, Montenegro and Serbia the ratings were close to or above the "satisfactory" level, although this

does not necessarily mean that entrepreneurs consider these services to be adequate and appropriate to their needs, as illustrated below.

133. Entrepreneurs are quite concerned about what they consider to be a lack of sufficient support to start-ups and newly established enterprises. Although their principal feedback was on the lack of sufficient tax and financial incentives and subsidies to assist the sector, notwithstanding the above generally satisfactory ratings, there is still a perception that there is a general lack of business information, data and support. Where this support does exist, it is viewed by entrepreneurs as being concentrated in and around the capital city and/or unaffordable for small enterprises.

134. Much international and donor effort has gone into raising the human capital and capacity of the advisors in the Business Advisory Centres (BACs) that have been established in all countries of SEE. The skills, experience and quality of the BAC staff are generally considered to be quite good, but could be enhanced through, for example, greater first-hand experience of working with local enterprises. The state-provided advisory services delivered through regional, country and local authorities are generally considered by entrepreneurs as being not up to their standards and expectations. By contrast, private sector providers, such as consultancies and training specialists are rated better by the entrepreneurs. The main private sector networks in the SEE region are the Chambers of Commerce, however, representatives of small enterprises also tend to be unenthusiastic about the services offered by these organisations.

135. Entrepreneurs are increasingly looking for services which go beyond the basics (e.g. business planning, applications for credit, training, etc.) to advice and analysis capable of adding real value to their operations (e.g. quality assurance and control, EU standards for exports, efficient production methods, targeted market research, etc.). There is little evidence that BACs are responding sufficiently quickly to the range of services that are increasingly demanded. As a consequence, there remains an underlying reluctance among entrepreneurs to use business advisory services unless these are provided at no cost or at a subsidised rate. If SME owners and managers begin to perceive greater value-added for their operations, they may become more willing to engage BACs and other business service providers in future.

### 7.3. Comparative Policy Assessment

**Table 7-1. Advisory Service Benchmarks of Good Performance**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO	SER (SCG)	Benchmarks of Good Performance
Business Advisory Centres	50	25	24	21	12	25	8	50	34	Yes
BACs per 1,000 SMEs	0.9	0.3	0.1	0.3	0.4	1.3	0.1	0.2	0.5	n/a
Professional bodies issuing accreditation in this sector	No	No	No	Yes						
Regional Development Agencies	10	2	33	6	6	0	0	8	15	Yes
Science / Technology Parks	0	0	0	2	1	1	0	0	0	Yes
Euro Information Correspondence Centres	0	1	8	1	0	1	1	8	1	Yes

136. In the absence of market provision at affordable rates in the SEE region IFIs, international organisations and bilateral donor agencies have taken the lead in establishing BACs focusing on start-ups and young firms through free or subsidised business advice and services. The number of BACs per 1,000 small enterprises is an indication of the degree of provision of such services. These vary from a relatively high proportion in Moldova (1.3 per 1,000) and Albania (0.9 per 1,000) to very little in Montenegro, Bulgaria and Romania.

137. There is a continuing expectation that BACs will become financially sustainable within a relatively short period of 2-3 years. Experience shows, however, that potential entrepreneurs and small enterprises rarely have the financial resources (or willingness) to provide BACs with the regular financial income stream necessary to maintain and expand their operations. The consequence is that once subsidies dry up, BACs either close down or seek to diversify their activities to enterprises more able to pay commercial fees, such as larger and more established enterprises. The issue of financial sustainability continues to be of overriding importance in every country that is endowed with BACs or other similar initiatives.

138. None of the countries in the SEE region has established professional qualifications and accreditation in relation to business advisory services, such as Certified Management Consultant (CMC) status, an internationally recognised certification by the International Council of Management Consulting Institutes (ICMCI), although Croatia had a certification body and FYR Macedonia intends to establish one. This is a response to the fact that entrepreneurs remain critical of the range, quality, cost and value-added of using the business advisory services currently on offer. Without a much greater focus on internationally recognised qualifications and accreditation, it is unlikely that BACs will secure financial sustainability and be independent of state budgets.

139. Countries that are slightly more advanced in the process of transition demonstrate decreasing levels of reliance on BAC-type arrangements, or indeed the Chamber of Commerce networks. Bulgaria and Romania are beginning to establish their own business support organisations. These are voluntary organisations totally focused around the needs of the small enterprise sector. An example of a successful initiative of this nature is the National Council for Private SMEs in Romania, which represents over 55,000 SMEs through over 70 branches dedicated to promoting the needs of the small enterprise sector in Romania and abroad. Greater self-reliance rather than donor led services should be the goal.

140. Other forms of activity designed to stimulate entrepreneurship and economic growth, such as Regional Development Agencies (RDAs) and Euro-Info Centres, are rapidly becoming established in the SEE region. Whilst the BACs typically focus on start-ups and young small enterprises, RDAs tend to concentrate on regional and economic development more generally. In anticipation of large scale regional structural funds upon entry in the EU, Romania and Bulgaria have established RDA networks with a strong SME development dimension, since fairly substantial SME-oriented funds are already provided by the pre-accession/Phare instruments and are expected to increase upon accession. Other countries, such as Albania, have witnessed a re-branding of BACs into RDAs, partly as a survival strategy. BiH has already established two RDAs and several others are in the pipeline, suggesting a trend in the region.



## BUSINESS INCUBATORS: SUPPORT TO START-UPS

### 8.1. Introduction

141. Business incubators have become an increasingly popular policy instrument for economic and employment development in OECD member countries. Recent studies suggest that today there are over 4,000 business incubators in operation throughout the world. Incubation is essentially about providing fertile conditions in order to foster new business ideas, innovation in encouraging entrepreneurial spirit and practical steps in providing the environment and facilities to ensure implementation of action. Incubators can help to tackle many challenges faced by all countries that aspire to build the SME sector, such as: how to stimulate new enterprise and the rate of new company start-up; how to support early stage businesses and enable them to survive and grow; how to promote more local and regional development; and how to nurture technology development and the application of academic research.

142. Box 8-1. highlights some main features of business incubators. OECD member countries have utilised incubators in a wide variety of ways. In addition to the objectives outlined below, incubators have sometimes been developed in response to industrial restructuring through plant closures or technological obsolescence and in partnerships with local communities and major companies. They have also been used to promote enterprise in minority, social and ethnic groups where the level of entrepreneurship has been seen as inadequate. In brief, the range and scope of incubators has been wide and innovative in its application and this trend continues today in many transition economies.

#### Box 8-1. Business Incubators in OECD Member Countries

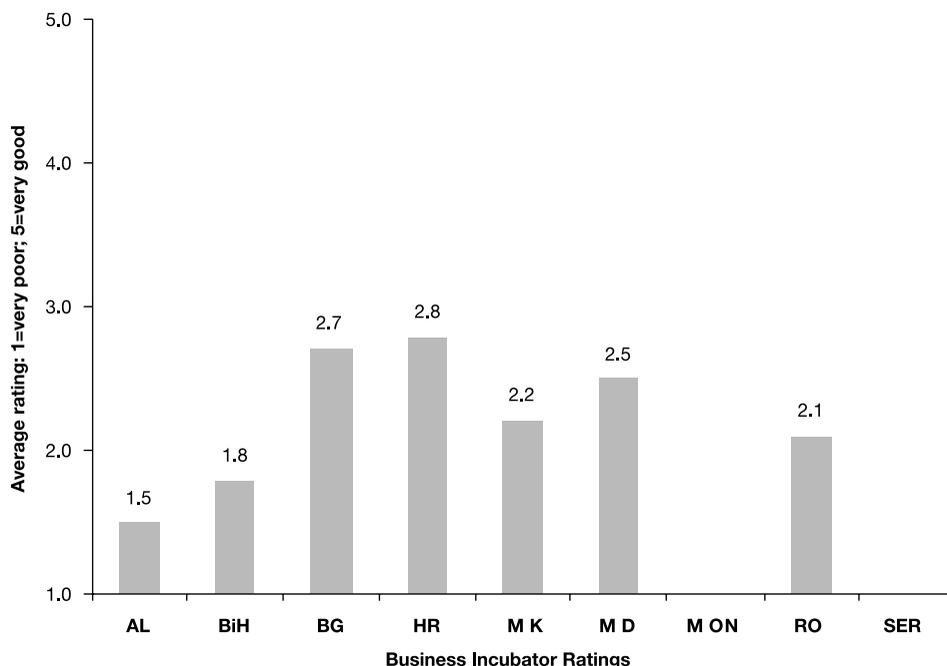
"There are now around 50 incubators in Australia, and some 200 incubator type institutions in France. In Germany approximately 200 incubators offer premises for some 5,000 companies and 200 research institutions. Over 100 incubator schemes of different sorts operate throughout the United Kingdom, and there are estimated to be at least 550 incubators in the United States. The European Business Innovation Network has created a network of some 120 Business Innovation Centres (BICs) throughout the European Union, the majority of which also perform a business incubation function...The underlying objectives of business incubation programmes are similarly diverse. These objectives have included: combating unemployment by means of enterprise creation and improved rates of survival; redressing local and regional economic decline; nurturing a climate conducive to entrepreneurship; expanding the supply of infrastructure; providing a nursery for the commercialisation of university research (especially through technology incubators); upgrading the technological capabilities of firms in a given location; fostering the development of specific industries and technologies; and even affording a safe haven for legitimate entrepreneurship in areas where crime is a constraint on business." OECD (1999)

143. The primary focus of most business incubators has been to provide new and young developing firms with premises, infrastructure and a range of services and support that can improve their ability to survive and establish their operations during the early developmental period. The combined features of

good physical facilities, focus on start-ups and SMEs and availability of "soft" advisory and support services are what distinguish business incubators from industrial centres or parks (OECD-UNIDO, 1999, pp.51-53). Business people tend to find incubators attractive since they can assist in reducing business barriers in transition economies by pooling know-how and lowering fixed costs.

## 8.2. SME Insights

Figure 8-1. Perceptions of the Business Incubator Framework<sup>15</sup>



144. The ratings given by entrepreneurs to business incubators in South East Europe are highly variable. They approach the "satisfactory" level (rating: 3.0) in Croatia and Bulgaria, both countries with fairly extensive experience of business incubators. The Albanian and BiH situation with low ratings is quite different. There are a few of them, with specific remits (such as returning displaced persons in the case of BiH), and they are generally poorly equipped. In general it is clear from the EPPA research that SEE countries are not adequately aware of the potential of business incubators and have not used them constructively or creatively to the extent that OECD and many developing countries have.

145. Despite extensive use and documented case experience with business incubators in OECD member countries, entrepreneurs in SEE, as a rule, know little about business incubators. Although incubators have been established in the region for 6-10 years, very little information has been disseminated on their potential for support to business, entry rules, effectiveness, best practice, etc. Nevertheless, the EPPA research also shows that once entrepreneurs understand what incubators are about, they regard them as offering a great deal of potential in enhancing the survival prospects of newly established enterprises. They see the common support services provided by incubators as being particularly useful in the SEE context, where the legal and regulatory barriers, access to suitable real estate, etc. are particularly difficult to come to terms with, and affect the survival rate of newly established enterprises.

146. Entrepreneurs are typically unaware of the existence of government policy in relation to fostering business incubators in their respective countries. There is also a lack of understanding and implementation of good governance principles in relation to entrance and exit criteria, operating conditions, services, charges, etc.

### 8.3. Comparative Policy Assessment

**Table 8-1. Business Incubator Benchmarks of Good Performance<sup>16</sup>**

	AL	BiH	BG	HR	MK	MD	MON (SCG)	RO <sup>17</sup>	SER (SCG)	Benchmarks of Good Performance
Number of business incubators	2	1	8	11	8	2	0	5	0	n/a
% of operating costs from public subsidies	n/a	0	n/a	80%	n/a	0	-	0	-	25%
Incubator space at or above benchmark (m <sup>2</sup> )	n/a	Yes (6,800)	No (1,000)	No (1,025)	n/a	n/a	-	No (1,750)	-	2,000-4,000
Number of incubator tenants at or above benchmark	n/a	Yes (26)	No (10)	No (8)	No	n/a	-	No (12)	-	20-30
Incubator occupancy rate at or above benchmark (%)	n/a	No	No (80%)	Yes (85%)	No	n/a	-	No (65%)	-	85%
Maximum tenancy (months)	36	60	36	n/a	36	24	-	36	-	36
Survival rate of tenanted firms (%)	n/a	93%	n/a	n/a	n/a	n/a	-	75%	-	85%

147. There is relatively little data on business incubators in SEE. With the exception of Montenegro, every country in the SEE region has some experience of business incubators. Croatia, Bulgaria, FYR Macedonia and Romania are the best endowed. The great majority of business incubators were established in the 1990s, but some have been terminated in the meantime. Fewer have been created since 2000, although all the countries in SEE aspire to establish more of them in the near future.

148. Incubators typically require a certain minimum amount of space (2,000 - 4,000m<sup>2</sup>), tenants (20-30) and occupancy rate (85%) to be viable and have the prospect of being financially sustainable, but the business incubators in the SEE region operate well below these broad benchmarks. Only the Romanian incubators approach the minimum threshold in terms of size. Although the BiH business incubator complies with the benchmark for the minimum size and number of tenants, the others lie far below. Only the Bulgarian and Croatian business incubators approach the occupancy rate benchmark. With the exception of Moldova, all other countries for which there is information comply with the benchmark of a tenancy period of 36 months. The survival rate of tenanted enterprises varies from 93% in the case of BiH to 75% in the case of Romania. The relatively low survival rate of tenanted firms in Romania may be part of the reason why only five of the 10 business incubators that were originally created continue to be viable.

149. Based on the limited data available, the business incubators in the SEE region do not appear to have the capacity to become financially sustainable in the near future. Part of the reason for this is that donors and IFIs have tended to treat business incubators as an element of the process of reducing the impact of state owned enterprise restructuring and/or closure, which means that they typically have a poverty mitigation focus, rather than focusing on individuals/enterprises with high growth potential and a long term perspective. While recognising the importance of the former, there equally needs to be a greater focus on the latter, so as to develop sustainable incubators, which harness the skills of ambitious and innovative entrepreneurs.

150. There also appears to be a very limited focus on developing links and joint ventures with universities and research institutes as a means of capitalising on R&D, thus capturing the benefits of innovation. The SEE region benefits from having a relatively large proportion of well trained and highly

qualified engineers, software programmers, scientists, etc. which business incubators could target. However, this is rarely the focus of business incubators in the SEE region and in some countries, such as in Serbia, academics are actually debarred from participating in this type of initiative.

## NOTES

15. Ratings for Serbia and Montenegro are not given as they had yet to implement business incubators (with the exception of Belgrade, where a private sector operator has taken the lead in establishing a technology incubator) at the time of the EPPA research.

16. Benchmarks derived from DG Enterprise (2002b) Benchmarking for Business Incubators; and from the OECD LEED Programme good practice experience with business incubators in OECD member countries.

17. A 2003 survey by the National Agency for SMEs suggests that 18 business incubators were in existence, however, as of December 2002, five were known of.

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*Annex 1.*

## **EUROPEAN CHARTER FOR SMALL ENTERPRISES**

(adopted by the General Affairs Council, 13 June 2000,  
and welcomed by the Feira European Council, 19/20 June 2000)

Small enterprises are the backbone of the European economy. They are a key source of jobs and a breeding ground for business ideas. Europe's efforts to usher in the new economy will succeed only if small business is brought to the top of the agenda.

Small enterprises are the most sensitive of all to changes in the business environment. They are the first to suffer if weighed down with excessive bureaucracy. And they are the first to flourish from initiatives to cut red tape and reward success.

At Lisbon we set the goal for the European Union to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth, more and better jobs and greater social cohesion.

Small enterprises must be considered as a main driver for innovation, employment as well as social and local integration in Europe.

The best possible environment for small business and entrepreneurship needs therefore to be created.

### **Principles**

In urging for this, we

- Acknowledge the dynamic capacities of small enterprises in answering to new market needs and in providing jobs;
- Stress the importance of small enterprises in fostering social and regional development, while behaving as examples of initiative and commitment;
- Recognise entrepreneurship as a valuable and productive life skill, at all levels of responsibility;
- Applaud successful enterprise, which deserves to be fairly rewarded;
- Consider that some failure is concomitant with responsible initiative and risk-taking and must be mainly envisaged as a learning opportunity;
- Recognise the values of knowledge, commitment and flexibility in the new economy.

The situation of small business in the European Union can be improved by action to stimulate entrepreneurship, to evaluate existing measures, and when necessary, to make them small-business-friendly, and to ensure that policy-makers take due consideration of small business needs. To this end, we pledge ourselves to:

- Strengthen the spirit of innovation and entrepreneurship which enables European business to face the challenges ahead;
- Achieve a regulatory, fiscal and administrative framework conducive to entrepreneurial activity and improve the status of entrepreneurs;

- Ensure access to markets on the basis of the least burdensome requirements that are consistent with overriding public policy objectives;
- Facilitate access to the best research and technology;
- Improve access to finance throughout the entire life-cycle of an enterprise;
- Improve our performance continuously, so that the EU will offer the best environment for small business in the world;
- Listen to the voice of small business;
- Promote top-class small business support.

### **Lines for action**

By endorsing this Charter, we commit ourselves to work along the following lines for action, taking due consideration of small business needs.

#### *1. Education and training for entrepreneurship*

Europe will nurture entrepreneurial spirit and new skills from an earlier age. General knowledge about business and entrepreneurship needs to be taught at all school levels. Specific business-related modules should be made an essential ingredient of education schemes at secondary level and at colleges and universities.

We will encourage and promote youngsters' entrepreneurial endeavours, and develop appropriate training schemes for managers in small enterprises.

#### *2. Cheaper and faster start-up*

The costs of companies' start-up should evolve towards the most competitive in the world. Countries with the longest delays and most burdensome procedures for approving new companies should be encouraged to catch up with the fastest. Online access for registration should be increased.

#### *3. Better legislation and regulation*

National bankruptcy laws should be assessed in the light of good practice. The learning from benchmarking exercises should lead us to the improvement of current practices in the EU.

New regulations at national and Community level should be screened to assess their impact on small enterprises and entrepreneurs. Wherever possible, national and EC rules should be simplified. Governments should adopt user-friendly administrative documents.

Small enterprises could be exempted from certain regulatory obligations. In this context, the Commission could simplify competition legislation to reduce the burden of compliance for small business.

#### *4. Availability of skills*

We shall endeavour to ensure that training institutions, complemented by in-house training schemes, deliver an adequate supply of skills adapted to the needs of small business, and provide lifetime training and consultancy.

#### *5. Improving online access*

Public authorities should be urged to increase their electronic communication with the small business sector. Thus, companies will be able to receive advice, make applications, file tax returns or obtain simple information online, therefore faster and more cheaply. The Commission must lead by example in this area.

### 6. *More out of the Single Market*

Small businesses are feeling the benefits from the reforms underway of Europe's economy. The Commission and Member States must therefore pursue the reforms underway aiming at the completion in the Union of a true internal market, user-friendly for small business, in critical areas for development of small businesses including electronic commerce, telecommunications, utilities, public procurement and cross-border payment systems.

At the same time, European and national competition rules should be vigorously applied to make sure that small businesses have every chance to enter new markets and compete on fair terms.

### 7. *Taxation and financial matters*

Tax systems should be adapted to reward success, encourage start-ups, favour small business expansion and job creation, and facilitate the creation and the succession in small enterprises. Member States should apply best practice to taxation and to personal performance incentives.

Entrepreneurs need finance to translate ambitions into reality. In order to improve the access of small enterprises to financial services, we will:

- Identify and remove barriers to the creation of a pan-European capital market and to the implementation of the Financial Services Action Plan and the Risk Capital Action Plan;
- Improve the relationship between the banking system and small enterprises by creating appropriate access conditions to credit and to venture capital;
- Improve the access to the structural funds and welcome initiatives by the European Investment Bank to increase funding available to start-ups and high-technology enterprises, including equity instruments.

### 8. *Strengthen the technological capacity of small enterprises*

We will strengthen existing programmes aimed at promoting technology dissemination towards small enterprises as well as the capacity of small business to identify, select and adapt technologies.

We will foster technology co-operation and sharing among different company sizes and particularly between European small enterprises, develop more effective research programmes focussed on the commercial application of knowledge and technology, and develop and adapt quality and certification systems to small enterprises. It is important to ensure that a Community patent is available and easily accessible to small enterprises.

We will foster the involvement of small enterprises in inter-firm co-operation, at local, national, European and international levels as well as the co-operation between small enterprises and higher education and research institutions.

Actions at national and regional levels aimed at developing inter-firm clusters and networks should therefore be supported, pan-European co-operation between small enterprises using information technologies enhanced, best practice in co-operative agreements spread, and small enterprises co-operation supported to improve their capabilities to enter pan-European markets and to extend their activities in third country markets.

### 9. *Successful e-business models and top-class small business support*

The Commission and Member States should encourage small enterprises to apply best practice and adopt successful business models that enable them to truly flourish in the new economy.

We will co-ordinate Member States and EU activity to create information and business support systems, networks and services which are easy to access and understand, and relevant to the needs of business; ensure EU-wide access to guidance and support from mentors and business angels, including through websites, and exploit the European Observatory on SMEs.

*10. Develop stronger, more effective representation of small enterprises' interests at Union and national level*

We will complete a review of how the interests of small businesses are represented at EU and national level, including through the social dialogue.

We commit ourselves to progress towards these goals using the open method of co-ordination of national enterprise policies. The Multi-annual Programme for Enterprise and Entrepreneurship, the Cardiff process on economic reforms, the Luxembourg process on employment policies and other Community programs and initiatives will be used to this end. We will monitor and evaluate progress annually on the basis of a Commission report on the relevant issues at the Spring Summits.

We will use effective indicators to assess progress over time and in relation to the best in the world to reinforce our learning, searching for better practice in all fields that affect small business to continuously improve our performance.

## Annex 2.

### RESEARCH METHODOLOGY

- I. The EPPA methodology has been designed to provide insights and assessments of the performance in the *implementation* of policies to improve the investment environment for businesses. The EPPAs have been conducted on a standard basis in all countries of the region and provide a benchmark for (a) highlighting key reform issues (b) measuring private sector insights and assessments of the business environment (c) assessing progress on a country by country basis and (d) comparative cross-country review for the SEE region.
- II. The main components of the country EPPAs, on which this regional analysis builds, are as follows:
  - A template of questions derived from extensive case study work on good practice in transition economies and OECD country experience (OECD-UNIDO, 1999) was used in the qualitative discussions.
  - Country-based experts/consultants were selected for their enterprise policy knowledge and experience. They undertook the research, collected the information and produced the first draft of the country EPPAs.
  - Focus group research: group discussions were held with SME representatives in each country, based on the template of questions. Over 250 firms participated.
  - Individual SME interviews were carried out to validate the focus group research and to provide further insights on key issues.
  - Expert interviews were undertaken in order to cross-reference the information from the focus groups, contribute to views and deepen the analysis.
  - Desk research was carried out to complement the qualitative research (existing reports, databases, strategies, laws, etc.).
  - International perspectives on good practice were incorporated by utilising expertise from OECD, EBRD as well as policy experts from OECD member countries.
- III. Under the guidance of OECD, the focus group research with the SME owners and managers was carried out by local consultants in the eight countries of the Stability Pact (the regional analysis separates Serbia and Montenegro for SME policy reasons, thus resulting in nine country EPPA reports) using a structured brief and template of questions developed by OECD and EBRD. The focus group research took place through the second half of 2002.
- IV. Generally, three focus group discussions were organised in each country. The locations included the capital city, an economically dynamic area and an economically depressed area in order to capture a range of economic scenarios. Four focus groups were held in BiH, reflecting its administrative specificities, and five in the case of Romania, reflecting the size of the country in comparison with the other countries in the SEE region participating in the exercise.
- V. The following sectors of activity were typically represented in the focus group discussions, although some allowance was made of the particular nature of the economies in question: manufacturing, trade, services, IT, agriculture, etc. The participants included representatives (owners and managers) of micro, small and medium-sized companies, ranging from start-ups to established firms. Standard templates were used for the discussion and the systematic collection of ratings in the focus groups.

- VI. The analysis in this report is based on the methodologies described above (focus group research, expert interviews, secondary data collection, etc.). It is complemented by secondary material collected by local consultants; use of Business Environment and Enterprise Performance Survey (BEEPS 2002) data where relevant; and benchmarks and/or indicators of successful experience derived from OECD-UNIDO-EC-EBRD research.
- VII. The information has been analysed by the OECD and EBRD, resulting in the assessment presented in this regional EPPA. The emphasis is on providing a regional overview of the key trends and issues, rather than the identification of detailed policy recommendations, as these were presented in the individual country EPPAs. The regional comparisons generally speak for themselves, allowing the respective countries to draw their own conclusions and frame appropriate policy reforms.
- VIII. The Investment Compact intends to up-date the individual country EPPAs and the SEE regional EPPA analysis on a regular basis, now that the regional baseline has been established via this report.
- IX. The organisations involved in the EPPA research are briefly highlighted below:

**Albania:** 31 small businesses took part in three focus group discussions in Tirana (capital city), Vlora (economically dynamic area) and Shkodra (economically depressed area). The following organisations also participated in the research, thus validating and enhancing the discussions with small enterprise managers and owners: Business Promotion Department (Ministry of Economy), Ministry of Finance, Chamber of Commerce and other SME-related institutions.

**Bosnia and Herzegovina:** 30 small businesses took part in four focus group discussions in Sarajevo (capital city of the State and Federation of BiH), Banja Luka region (Republika Srpska), Jajce (economically deprived cantons in the Federation) and Srpsko Sarajevo (less dynamic regions of the south-eastern part of Republika Srpska and District of Brcko). The following organisations also participated in the research: Chamber of Foreign Trade of BiH, Foreign Investment Promotion Agency of BiH, Association of Entrepreneurs of Doboj (regional business organisation), World Vision (international micro-finance and development organisation), Brcko District Development Agency and World Lutheran Union (NGO providing advisory services and technical assistance).

**Bulgaria:** 18 small businesses took part in three focus group discussions in Sofia, Haskova and Plovdiv. The following organisations also participated in the research: National Association of SMEs (a business organisation), Agency for SMEs (the state implementation institution), BARDA (the association of regional development agencies), Varna Business Agency (a regional NGO dealing with advisory services), Bulgarian Craftsmen Chamber and the National Transport Chamber (branch organisation).

**Croatia:** 18 small businesses took part in three focus group discussions in Zagreb (capital city region), Primorsko-Goranska County (Rijeka region) and Medjmurje County (Cakovec region). The following organisations also participated in the research: Ministry of Crafts, Small and Medium Entrepreneurship; Croatian Bank for Reconstruction and Development; Croatian Chamber of Commerce; Croatian Association of Business Consultants; Technology Park "Technopark"; Faculty of Economics, Rijeka; Faculty for Tourism and Hotel Management, Rijeka; Business Incubator Porin, Rijeka; Centre for SME Development, Rijeka Municipality; Technology Innovation Centre, Rijeka; Office for Economic Development, Primorsko-Goranska County; Centre of Entrepreneurship Medjmurje, Cakovec; Chamber of Crafts, Cakovec; Croatian Employment Bureau, Cakovec; Sector for Economic Development, Medjmurje County Administration; and the Financial Agency, Cakovec.

**FYR Macedonia:** 20 small businesses took part in three focus group discussions in Gostivar, Skopje and the surrounding region. The following organisations also participated in the research: Chambers of Commerce, Business Associations, NGOs and business consultants.

**Moldova:** 47 small businesses took part in three focus group discussions in Causeni (South), Chisinau (Centre) and Balti (North). The following organisations also participated in the research: Ministry of Economy, World Bank, Chamber of Trade and Industries, etc.

**Montenegro:** 18 small businesses took part in three focus group discussions in Podgorica, Herceg Novi and Bijelo Polje. The following organisations also participated in the research: Agency for SMEs (state implementation institution), Montenegro Business Alliance, Faculty of Economics, European Agency for Reconstruction, Centre for International Private Enterprise, Central Bank of Montenegro, Opportunity Bank, Firm Level Assistance Group and USAID.

**Romania:** 53 small businesses took part in three focus group discussions in Bucharest, Transylvania and Moldavia. The following organisations also participated in the research: Associations of SMEs, Chamber of Commerce and Industry, Association of SMEs and Association of Small and Medium Crafts, Chambers of Commerce, Confederation of Private Entrepreneurs and Association of Women Managers.

**Serbia:** 22 small businesses took part in three focus group discussions in Belgrade, Central Serbia, Vojvodina and South Serbia. The following organisations also participated in the research: Centre for Economic Development, Faculty of Economics and legal/tax experts, etc.



Annex 3.

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**The Organisation for Economic Co-operation and Development (OECD)** groups 30 member countries sharing a commitment to democratic government and the market economy. With active relationships with other countries, Non-Governmental Organisations and civil society, it has a global reach. Best known for its publications and statistics, its work covers economic and social issues from macroeconomics, to trade, education, development and science and innovation. Over time the OECD's focus has broadened to include extensive contacts with non-member economies and it now maintains co-operative relations with some 70 of them. These contacts aim to further economic integration by making the OECD's experience available to other countries and enabling the OECD to profit from the insights and perspectives of non-members. (see [www.oecd.org](http://www.oecd.org))

**The European Bank of Reconstruction and Development (EBRD)** was set up in 1991 to support the development of market economies in central and eastern Europe and the Commonwealth of Independent States following the collapse of communism. The EBRD supports the economies of its 27 countries of operations by promoting competition, privatisation and entrepreneurship. Taking into account the particular needs of countries at different stages of transition, the Bank focuses on strengthening the financial sector, developing infrastructure and supporting industry and commerce. The EBRD is the largest investor in South Eastern Europe and is also an active contributor to the Stability Pact. (see [www.ebrd.com](http://www.ebrd.com))

