



УНИВЕРЗИТЕТ У БАЊОЈ ЛУЦИ  
ЕКОНОМСКИ ФАКУЛТЕТ  
FACULTY OF ECONOMICS  
UNIVERSITY of BANJA LUKA

# 1st REDETE Conference

**ECONOMIC DEVELOPMENT AND ENTREPRENEURSHIP  
IN TRANSITION ECONOMIES:  
A Review of Current Policy Approaches**

**CONFERENCE PROCEEDINGS**



**Banja Luka,  
October 27-29, 2011**

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**FACULTY OF ECONOMICS**

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**Banja Luka, October 27-29, 2011**

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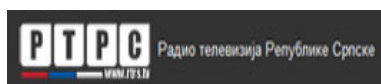
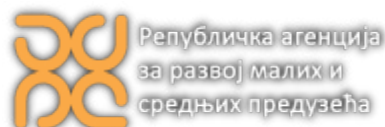
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## FORWARD

More than 20 years have passed since the collapse of the single-party socialist systems, suggesting that it is an appropriate time to review the state of play concerning entrepreneurship and economic development, and assess the extent to which current policies are appropriate to developing a sustainable SME sector and promoting entrepreneurship. In transition economies, the commanding ethos was to make the rapid transfer from a socialistic highly-controlled economic structure to a “free-market” structure. The problem is that economic development and real entrepreneurship have been stifled by the so-called free market almost as effectively as it had been by socialism. Many small enterprises were put out of business by large mostly foreign-owned conglomerates. State structures in transition economies have tended to take a bureaucratic approach to the problems associated with the SME sector. Due to a lack of systematic and fair transition in many of those economies, the gap between the rich and poor has widened significantly. The only exceptions have been countries such as Slovenia, which has tended to embrace a German/French “social market” model and return large sectors of important economic activity in public control, whilst ensuring a fairer division of wealth through a Scandinavian style tax and welfare system. Arguably, the theory of entrepreneurship has not hitherto, distinguished between entrepreneurs operating in different business environments or considered differences between entrepreneurship in wealthy and poor countries at various stages in economic history.

The opportunities for entrepreneurs in developing countries are broader in scope than in those in developed markets, yet developing country entrepreneurs face an increasing number of barriers to realise these opportunities. For example, entrepreneurs in emerging markets heavily rely on informal sources of finance to start-up their businesses, due to the lack of a regular supply of commercial loans. Statistical evidence suggests that about 90 percent of the people in developing countries lack access to financial services from institutions<sup>1</sup>. Financial markets in most of those countries are set up to maximise the profit in a short time where the lending cost normally exceeds profit margin of legitimate businesses. While entrepreneurial opportunities are broader and resultant strategies are naturally self-hedging in developing countries, limited personal and family savings and an absence of financial innovation severely limits the growth prospects of promising start-ups in developing countries. In this particular context, a number of questions arise such as how do we design markets for entrepreneurial finance in developing countries? How do we extend financial innovations such as hedging and insurance to entrepreneurs in developing countries, in ways that allow them to manage risk more effectively? How do we move away from a reliance on complex financial instruments to finance business activity, towards simpler and more basic credit/savings or other microfinance models?

Being part of the neo-liberal ideology, governments of many transitional countries have not done much to ‘protect’ SMEs and entrepreneurs from Bretton Woods’s institutions<sup>2</sup>, that contribute to the concentration of economic power in the hands of private capital, or more accurately, of financial capital. Public intervention and the support of entrepreneurial growth has been inconsistent and not always clearly focused. The managers of state SME development organisations are frequently bureaucrats with no solid understanding of the problems of the entrepreneur.

Another important and upcoming research theme within the fields of economic development and entrepreneurship is poverty and its reduction. According to a World Bank report from several years ago (2008), more than 1.4 billion people live in conditions of poverty in developing countries<sup>3</sup>, fact in a direct relationship with the problem of finance mentioned above. Even in the EU about 80 million people lived below the poverty threshold<sup>4</sup>. Poverty reduction is considered the first objective of the Millennium Development Goals. This is a good reason to believe that ‘indigenous’ entrepreneurship can reduce the poverty in those countries. In the conference call we encouraged researchers to submit papers on this vital topic.

Empirical research conducted in transition economies shows that SME and entrepreneurship contribution to economic and social progress is affected by unstable environments and an institutional context that has yet to establish the framework conditions for sustainable private sector development. This is directly linked to deep-rooted and wide spread corruption in transitional countries, which is another legitimate concern for genuine entrepreneurs. Unequal processes of privatisation, increasing corruption and organised crime, have disrupted the transition towards a market economy. These processes have destroyed fair competition and the potential for a free and healthy private initiative. In the early stages of transition in particular, the new class of entrepreneurs that had emerged have had advantages related to the structural and institutional transformation of economies due to their previous managerial roles in former public enterprises and their governmental connections. Such

1 Robinson, Marguerite S., (2002). “The Microfinance Revolution: Sustainable Finance for the Poor”

2 The World Bank and the International Monetary Fund, its sister organization, created at Bretton Woods New Hampshire in 1944, are referred to as the Bretton Woods Institutions (BWIs).

3 World Bank (2008). World Development indicators: Poverty data. Washington DC:

4 Wolff, P. (2009). ‘Population and Social Conditions’. EUROSTAT, Statistics in focus —46/2009. Luxembourg: Office for Official Publications of the European Communities.

an environment has created space for a large informal economy. Two political science scholars<sup>5</sup> (Key Notes): were invited to the conference to address these problems from; a) the perspectives of transitional theory (used to help explain the context in the post communist countries including the Western Balkans) and, b) political economy (explains the link between the business and political elites) and the geneses of the most recent global economic and financial crises. The next REDETE conference will include more topics of this kind.

In order to better comprehend an increasing number of problems that face transitional economies, the rational to initiate this conference is well justified. Indeed, scholarly researches into topics implied by the Conference title are scarce. It is argued that entrepreneurship in developing countries is the most understudied important global economic phenomenon today. This was also clearly stressed by the Conference Key Notes<sup>6</sup>, calling for a more integrative research into both economic development and entrepreneurship.

We deliberately combine these two inseparable areas considering the fact that in many transitional countries 'clumsy' economic reform and often irregular privatisation wiped out most of the manufacturing sector dominated by large firms. Entrepreneurship and SME development is seen as one of the key avenues for overall economic development. Development is explained either by increased inputs or by technological change which somehow happens out there, yet economists often ignore the role of the human agency or entrepreneurship.

Moreover, Porter states in a number of papers in the Harvard Business Review, that national prosperity is created, not inherited. It does not grow out of a country's natural endowments, its labour pool, its interest rate, and its currency value as classical economists insist. Globalisation has wiped out these traditional advantages. The key factors of production today, which include – technology, intellectual and financial capital, and managerial skill – are not rooted in a nations' soil but are eminently transportable across borders. The advent of the Internet has accelerated this process of freedom from national boundaries. All this applied to developing or countries in transition and, their economic prosperity will increasingly rely on entrepreneurship and innovation.

In general, the topic of this conference was closely related to the economic development and entrepreneurship in transitional countries, reflecting the new shifts that are becoming apparent in the economic system. Amongst other themes a high number of papers presented at the first REDETE conference were focused on the distinctiveness of entrepreneurship in developing and transition economies and the implications for policy development. Several papers critically analyze existing policy approaches and particularly those that involve elements of policy transfer. Financing entrepreneurial or small business activities is another important topic that has been well covered. One of the outstanding questions which this and future REDETE conferences seeks to address is: How do we best harness intellectual assets in a form of research that brings together theory and practice in a synergistic process? It is fair to say that for too long have we relied on theoretical modelling based on conceptualised data gathering, which we seek to turn into methodology that is then applied to real-world situations. We seek to challenge this philosophy.

Obviously the 1st REDETE conference did not address all the themes and issues mentioned above, nevertheless, we strongly believe that the papers that were reviewed, discussed and presented and at the opening conference - Economic Development And Entrepreneurship In Transition Economies: A Review Of Current Policy Approaches - in Banja Luka in October 2011 will increasingly contribute to our research development and knowledge through continued regular and constructive collaboration. We are proud to be able to attract young and less established researchers from transitional countries in particular, who require genuine help from experienced scholars to guide them through the publishing process. As we are very much committed to establishing a REDETE forum, we use this opportunity to invite you to the 2<sup>nd</sup> REDETE conference, which will be held in October 2012.

London, Banja Luka, January, 2012

Programme Committee Chairpersons

*Jovo Ateljevic & David Smallbone*

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Part One:  
Finance, Accounting, Corruption

**AGRICULTURE LENDING IN BOSNIA AND HERZEGOVINA - FROM THE EXPERIENCE OF IFAD PROJECTS**

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**Abstract**

In the transition period agriculture in Bosnia and Herzegovina did not need to pass through serious privatization, as in other socialist countries, but had a need for other types of reforms. Agricultural production in Bosnia and Herzegovina (BaH) has always been a subject of investment of private capital, but on the other side always faced with constraints in the form of lack of funds to finance development of that type of entrepreneurial activities. An important condition for ensuring the growth and development of agriculture is to provide a stable source of funding necessary for new investments, while credits has a crucial role. In this regard, significant is foreign aid which Bosnia and Herzegovina has received and receives from international donors and creditors, including the International Fund for Agricultural Development (IFAD). During the last fifteen years in Bosnia and Herzegovina IFAD designed, financed and supervised the implementation of five projects, the first starting from emergency and continuing with development projects. All these projects were related to establishing and expanding the modalities of financing and diversification of agricultural and other entrepreneurial activities in rural areas. Lending began with the distribution of credits in kind, continued with the awarding of cash credits through banks and MCOs and continued with the establishment of the first saving and credit associations in BaH. The first lending target group were only farmers and later it spread to SMEs, the first only livestock production and then also to all other entrepreneurial activity in rural areas. In the implementation of all IFAD credit lines in Bosnia and Herzegovina participated 25 financial institutions so far (15 banks, 7 MCOs and 3 SCOs) that extended about 16.000 credits to farmers and SMEs from the target group in the total amount of 67 million BAM. Based on case studies and lessons learned from implementation of these projects the paper describes modalities of lending activities and give some conclusions and recommendations that may be useful in planning and management of further agriculture development funding in Bosnia and Herzegovina, and in similar, less developed, countries.

**Keywords:** Agriculture, Lending, Bosnia and Herzegovina, IFAD



## 1. INTRODUCTION

Agriculture is the economic activity that plays a significant role in most developing countries in terms of its contribution to the creation of gross domestic product (GDP), employment, participation in foreign trade, etc. In developed countries, agriculture is less important in terms of the foregoing contributions, but it is becoming increasingly important in terms of sustainable management and protection of natural resources.

In BaH, a country in transition, agriculture plays both roles. Agriculture participates in the creation of GDP with 6.5% with a tendency to further decrease (GDP, 2010) <sup>1</sup>; informally employed about 20% of the active labour force<sup>2</sup>, it is involved in foreign trade with 15% (analysis of foreign exchange of BaH, 2011)<sup>3</sup>. Agriculture is becoming increasingly important from the standpoint of rational and responsible use of agricultural land, groundwater protection and other issues of preserving the natural environment.

If we want to ensure the development of agriculture and improve its competitiveness, there must be investments in agriculture. Majority production resources in agriculture in BaH have been and still are owned by small private sector. The majority of over 500,000 farms are not able to modernize and increase their production without new investment. Own funds of the farms as a source of financing investments, are insufficient and therefore the agricultural holdings, and other entities in agriculture (SC, Ltd, Coops) need funds necessary for accelerated development, which they borrow i.e. take credits. Agricultural credit is crucial for raising full potential of available natural resources in agricultural development. Share of agriculture in the total mass of credits in the RS and FBaH is low among banks (from 1.3 to 1.8%), and much more at MCO (33 to 36.5%) (Vučenović & Vaško, 2009).

Agriculture is often characterized as a high risk sector. Rural Finance Learning Centre lists several potential risks in agriculture: production and yield risk, price and market risk, lack of diversification, political risk (Bankakademie, 2011), which makes financial institutions reluctant to sell their free funds to this sector. Regardless of the number of projects, and governmental and other interventions, lack of credit is a problem of development, particularly of small agriculture in BaH.

Thus, the Agriculture Development Strategy of the Republic of Srpska until 2015 (adopted 2006) includes one of the measures for its implementation, which is providing farmers access to credit (including the establishment of a special Agricultural Bank) and establish a broader range of rural financial services (RS Agriculture Development Strategy, 2006). The Medium-Term Strategy of development of the agricultural sector in the Federation B&H also notes that the establishment of credit lines, which would be focused on agricultural production, are the needs that should not be questioned. It further argues credits for agricultural production with an interest rate not exceeding 3-5%, with long periods of investment lending, a special type of short term credits, including cooperatives and SCO in credits to agricultural producers (Medium Term Development Strategy of the agricultural sector in the Federation of BaH, 2006). And the World Bank, in its recent study on the state of agriculture in BaH noted that limited availability of credit remains a problem of agricultural development in BaH due to high interest rates, long procurement procedures and rigorous requirements for the provision of loan repayment (Agriculture Sector Policy Note for BaH, 2010).

With these facts, the International Fund for Agricultural Development (IFAD) faced, which came to BaH immediately after the last war with the aim and intention to help the poor population in rural areas to rehabilitate war damage by giving multiple contributions to the development of their agricultural production and improving living conditions within the framework of several projects that were implemented in BaH over the past fifteen years. Lending to agriculture was an integral part of all these projects, and in this paper it is all about lending to agriculture in BaH from the experience of IFAD projects. During the implementation of these projects there has been a shift from lending (only) to agriculture to rural financing that overlap each other, but certain elements are different (IFAD Decision Tools for Rural Finance, 2010).

1 According to thematic bulletin 01 Gross Domestic Product by Production Approach, 2000-2009, participation of agriculture in GDP in B&H in 2001 was 7.89%, in 2005 was 7.38% and in 2009 was 6.5%, Agency for Statistics of Bosnia and Herzegovina, Sarajevo, 2010, p. 26.

2 According to Labor Force Survey 2010 in 2008 it was 20.6%, in 2009 was 21.2% and in 2010 was 19.7%, Agency for Statistics of Bosnia and Herzegovina, Sarajevo, p. 37.

3 According to own calculations, based on analysis of data from the BaH foreign trade in 2010, the Ministry of Foreign Trade and Economic Relations, agricultural products classified in the tariff group 1-24 of harmonized customs tariffs have participated with 7.8% of total BaH exports, with 18.4% of total imports, accounted for 14.8% of total BaH foreign trade and 30% of its total foreign trade deficit.

## 2. MATERIAL AND METHOD OF WORK

The starting material for the research project are the data from the Project Units (Project Implementation Unit from the Federation of Bosnia and Herzegovina and Agriculture Projects Coordination Unit from the Republic of Srpska), progress or completion reports of certain projects, as well as personal experience some of the authors of this work, who participated in the implementation of IFAD projects in BaH.

International Fund for Agricultural Development implemented the following projects in BaH and Herzegovina in the period 1998-2010:

- Emergency Farm Reconstruction Project – Restocking (EFRP);
- Small Farm Reconstruction and Development Project (SFRDP);
- Livestock and Rural Finance Development Project (LRFDP);
- Rural Enterprise Enhancement Project (REEP);
- Rural Livelihood Development Project (RLDP).

Besides the focus on information and documentation relevant to the implementation of these projects, there have been explored any other written and available sources on the topic of agriculture lending in BaH. Because of public-deficient knowledge of the role of IFAD projects in agriculture lending in BaH and poor written sources on the subject, authors have decided to summarize them and publish in this work with particular focus on lessons learned that can be used in planning and implementing similar interventions in developing countries such as BaH. The research hypothesis is - whether the modalities used in agricultural lending under IFAD projects in BaH can be successfully multiplied and used for the same purpose in other areas from other sources?

The subject of the research is agriculture lending in BaH, and as a research method, method of case studies of IFAD projects in BaH in the period 1996-2010 has been primarily used. During the research the other conventional scientific research methods were used such as the following: desk research, analysis, synthesis, comparison, methods of descriptive statistics, etc.

## 3. RESEARCH RESULTS AND DISCUSSION

At the end of the nineties of last century, agriculture lending in BaH was a rarity. Most of the non-private banks were in extremely weak financial condition, while the small private banks were undercapitalized. Directed lending on a non-commercial basis still prevailed among state-owned banks. Accounting and regulatory standards did not conform to the needs of a market-based banking system (Bosnia and Herzegovina Post-Conflict Reconstruction and the Transition to a Market Economy, 2004). Besides not having enough long-term sources of financing in general, banks were not ready to lend to agriculture because of the high risks that this production carries with it, turning in a time to a favourable SME sector. SWOT and other analysis that were done for the agricultural sector at that time (and later) confirmed that lack of funds for investment and inaccessible and costly credits are one of the major constraints to growth and development of agricultural production in BaH. In a situation of lack of internal resources for financing, solution is sought (and found) in securing external resources (grants and loans) to credit domestic agriculture.

After the war, especially since the end of the nineties of last century, the microfinance sector in BaH has had impressive growth, which was significantly contributed by two projects funded by the World Bank (Local Initiative Project I and II). Most MFIs offer a similar range of loan products, essentially credits as they are not allowed to offer other financial services. Microfinance services, mainly credits, have reached a significant part of population (Planet Rating, 2011). On the role and achievements of microfinance in the development of BaH there are varying opinions, as the number and value of micro-credits grew steadily, but the indicators of growth and development of the sectors that are credited, were much weaker and showed slower progress, for example, as pointed by Betman (Welle-Strand at all, 2010). Some other studies have reached conclusions that could not clearly demonstrate the impact of micro credits on revenue growth of their customers, among other things because the majority of micro credits in BaH were used for employment or maintaining existing jobs, which is dominated by agricultural production.

Of course, that the pace of economic growth is affected by many factors, of which loans are just one of the necessary prerequisites. It is also true that in BaH after the war, much greater priority was given to social than economic objectives, i.e. that the micro finance balanced between the financial and

social objectives (Matul & Tsilikounas, 2004).

Numerous critics of lending by MCOs, particularly those who advocate for the interests of agriculture, in the first place put high interest rates that are charged by MCO and even today they charge the farmers. Therefore, donors, development agencies, government and individual ministries in various ways sought to provide better resources and conditions for lending to agriculture.

In this situation, the International Fund for Agricultural Development (IFAD) was one of the first international development organizations that begun working on solving this problem in BaH in an organized way. IFAD began operations in BaH in 1996 shortly after the conclusion of the Dayton Peace Accord. Since then IFAD has supported four projects in the country and provided a total of US\$ 57.1 million in loans ([www.operations.ifad.org](http://www.operations.ifad.org)). In its first two projects EFRP and SFRDP the lack of credits for the purchase of cattle was resolved by imports of livestock and distribution in the form of quasi (in kind) credits. BaH transformed IFAD loan funds into livestock (mainly of imported origin) and thus urgently increased number of livestock destroyed during the war (Vaško, 2000).<sup>4</sup> These interventions were meaningful for that period because there was no time and other assumptions that livestock would gradually increase based on (only) reproduction and the number and genetic performance of, significantly destroyed, main herd. Farmers have not received the money, but cattle, i.e. credited in the amount of the purchase price of livestock.

The first Emergency Farm Reconstruction Project (EFRP) was implemented only in the Federation of BaH in the period 1996-97 and dealt with the renewal of the livestock on the basis of imports. Due to lack of data on the implementation of this project, only a conclusion that during two years, heifers imported in the value of 10 million BAM equivalent, which were distributed to 3,974 farms nearly in all municipalities in the Federation of BaH.

### 3. SMALL FARM RECONSTRUCTION PROJECT

The second one, Small Farm Reconstruction Project (SFRP) was implemented on the territory of both entities of BaH (Federation of BaH and the Republic of Srpska) in the period 1998-99. Under this project, farmers were granted over 8,000 credits in kind, mainly distribution of cattle (heifers, sheep and goats) in the total amount of about 24 million BAM, for a period of 5 years with a grace period of 12 months and an interest rate of only 2% (Table 1 in Appendix). In the absence of other means of ensuring repayment of the credit, guarantors were used, who were not employed persons, and they rather were farmers or neighbours of the borrowers. This mechanism of providing the credit repayment was simple and acceptable to debtors, but later proved to be unusable (possibility of collecting a debt from the guarantors were modest, although the majority of non-performing credits were never prosecuted).

This project had positive effects because it was helpful (the perception that it is aid and not a credit dominated!) to thousands of rural households out of which a large number used these credits properly and began the reconstruction of livestock that was destroyed by war. Rural households primarily increased production of milk and meat for their own consumption, and to a lesser extent and for the market. The consequences of genetic improvement through imported animals as well as examples of systematic rearing of offsprings of imported animals are still evident in BaH. However, implementation of this project faced with the following problems:

- Imported heifers in their genetic and productive performance did not conform to local conditions of their housing and feed (it was very common that animals lost condition of the throat, significantly lower milk yields than expected, delays and lack of re pregnancy etc.);
- Selection of beneficiaries was burdened with social criteria (favouring refugees, returnees, displaced persons, war invalids and the socially vulnerable groups, etc.), partly due to the conditions of IFAD project to support poor population groups;
- Discontinuity of responsibility for the selection of credit beneficiaries (municipalities), extending the credits (government through the PIU/PCU) and collection of credit repayment (bank);
- Broken market connections and the inability of the organized sale of milk and meat and the absence of project activities that would remove these restrictions, significantly reduced the opportunities to achieve some income;

<sup>4</sup> For example: research was implemented in a limited area, Mrkonjić Grad and other 6 municipalities, showed that war damage of cattle were 83%, sheep 81% and tractors 45%.



- Part of the credit product was mandatory insurance of livestock against mortality (whose premiums were included in the credit amount) during the first year of holding, which has been extended by a very small number of beneficiaries (combined reasons for the absence of tradition of agricultural insurance and inertia of insurance companies);
- Very low level of repayment of credits due to insufficient income (majority of animals were distributed based on the model of so-called. “social package” with a minimum number of livestock per household (in the Republic of Srpska even 93.9% of credits were granted on the model of one heifer-one household), lack of previous experience with the credit (SFRDP report, 2009), and the absence of political will to sanction this practice seriously.

Since it was practically an emergency one-year project (that was being extended for another year) there were not conducted any extensive study on effects and impacts of this project to its beneficiaries. Based on research conducted in late 2009 in the territory of the Republic of Srpska, 81.7% of beneficiaries have confirmed that livestock contributed to the recovery of their farms, but there was no detailed quantitative analysis.

#### 4. LIVESTOCK AND RURAL FINANCE DEVELOPMENT PROJECT

The lessons IFAD has drawn from its country experience indicate that: (i) efforts to increase agricultural production and productivity, while essential, are not sufficient to reduce rural poverty unless there is an accessible market in which farmers can dispose of increased production at remunerative prices; and (ii) credit is needed to finance agricultural investment and value addition (B&H COSP, 2005).

Based on experience gained during the first two projects with the allocation of exclusive in kind credits, IFAD in collaboration with local governments, designed the new (third) Livestock and rural finance development project (LRFDP). Within this project, which was implemented in the period 2002 to 2008, there was a credit line designed for the purchase of livestock and agricultural machinery, which was implemented through the intermediaries, i.e. commercial banks (9) and micro-credit organizations (2). The goal was to replace the emergency (with dominant social objectives) focus of intervention and transfer it to sustainable agriculture as a stable (and very often only) source of income of rural households.

This and all subsequent IFAD projects in BaH have been implemented on a selected area (limited number of municipalities that met certain criteria). The project, on a competitive basis made available funds to banks and MCOs from which financial intermediaries extended cash credits to the project target group. Beneficiaries of bank or MCO received the money and for that money buying cattle or agricultural equipment of their choice. This model was a significant improvement over the previous projects because banks were given full autonomy in terms of choosing borrowers and borrowers were given the freedom to choose subjects of lending. In this way, there was given almost 14 million BAM of credits for the 1,934 agricultural households and 6 million BAM to over 500 credits to SMEs and small family entrepreneurship (details in Table 1 in Appendix). This model of credits also had some limitations that are primarily manifested as:

- The difficulty of finding guarantors (almost exclusive way the banks and MCOs insisted as guarantees for repayment of credits);
- Poorer quality cattle, which was obtained mainly in the local market;
- Lack of increase in livestock at the state level (because the same animals only changed owners through its purchase);
- Expensive insurance of cattle purchased from the credit (which was not used for a long time due to high premiums charged by insurance companies).

Although financial institutions freely determined the level of interest rates, it was very good with the banks (5.75 to 9.95%). With 6.5% interest on an annual basis a five-year IFAD credits (lending conditions LRFDP project in the RS) were the most favourable credit conditions in the market of the Republic of Srpska. MCO for the same credits accounted slightly higher interest margin, which resulted that more credits were disbursed through banks than through the MCO.

The second contribution of the LRFDP project was the fact that it broke up the pre-assumption that farmers were not good and eligible beneficiaries of bank credits IFAD credit repayment at the time, that has never been below 95%, draw the way for many lines of credit that followed in the years

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5 Only 7.9% of credit beneficiaries used some credit before.

from other projects sources, but also from own resources of banks. One of them was a World Bank project Small Scale Commercial Agricultural Development Project (SSCADP) which used similar model as LRFDP that introduced credit line for lending to agriculture (not only livestock but also fruit and vegetable crops) through the commercial banks and MCOs as intermediaries to Herzegovina region. The final report of this project noted that the credit subcomponent has substantially helped in increasing Bank and MCO willingness to lend to the agricultural sector. This is reflected in a fourfold increase of the portfolio of Nova Bank in the agricultural sector. Similarly, MCOs now deal with small farmers readily and these prove to be one of the most reliable segments of borrowers to make timely repayment of credits and that small farmers with a diversified production have a much lower risk than commercial banks estimate (SSCADP Completion Report, 2010).

Both in case of banks and MCOs guarantors were almost exclusively an instrument of security credits (2-3, depending on the size of the credit) that was difficult to provide in some less developed municipalities, but the number of cases where this instrument had to be used was sporadic, so that the guarantors were then much easier to find than in later years.

This project made many progresses in the field of agricultural lending: introduced healthy competition of more financial service providers for the same resources, did not limit the interest margin to providers, it expanded the list of agricultural activities eligible for credit and provided greater adaptability of credit conditions to the specific needs for individual groups of agricultural producers. Assistance in the dissemination of information and the first screening of potential borrowers, the project, using a network of farmers' associations and cooperatives that it founded and with whom it worked, helped banks to better reach out the borrowers and to successfully complete the evaluation of their creditworthiness.

The LRFDP completion report for part A (in FBaH) stated that real benefits of project credit line accrue from increases in livestock/rural enterprises production and productivity, incomes, employment and household food security (LRFDP Completion Report, Part A, 2008). The same report for part B (in RS) concluded that credits, especially in the very beginning of the project, was very important since those were the most favourable agricultural credits, and good terms and conditions encouraged a number of farmers to go into investments which they wouldn't have done without those credit funds (LRFDP Completion Report, Part B, 2008).

The second line of sub-credit was for SMEs but the interest in this kind of credits was much smaller because there were other available sources to meet similar needs (sometimes even under more favourable conditions) from the own resources of banks and other projects.

LRFDP project has had a breakthrough in the field of financial services, the establishment of the first Savings and Credit Organizations in BaH. The project has provided technical assistance in the adoption of the SCO Law in 2006 (only for the RS), and then the establishment of the first (and so far the only) three Savings and Credit Organizations in Berkovići, Srbac and Derventa, which were established in 2007. The idea was to mobilize the savings of the rural population and based on that collected deposits SCO would extend smaller amounts of credits and shorter repayment periods, with flexible guarantees to its members. The greatest improvement was made in SCO "Hercegovina" in Berkovici that started with initial 62 members and reached 246 members. So far it has approved 313 credits totalling 744,200 BAM, all exclusively for agricultural production. SCO "Gradina" Srbac was established by 30 members and currently the SCO has 72 members. This SCO meanwhile, has approved only 29 credits (larger amounts and longer repayment periods) and recorded an increased number of risky credits. The third SCO "Agroinvest" Derventa was established by 30 founders and it has increased to the current 89. So far, it has approved 156 credits amounting to 502,400 BAM<sup>6</sup>. From a four year distance of the first SCO in BiH, it could be concluded that this idea did not find a good ground, because SCOs in the meantime have not mobilized any savings, and their lending activities are solely based on its founders' initial and subsequent credits approved by the project so that, by the way, their actions do not differ significantly from the MCO. Their assets are insufficient to cover their fixed costs, and no significant increase in its appearance.

<sup>6</sup> Data have been updated as of 30.06.2011. and they have been taken out of internal data of Agriculture Projects Coordination Unit that monitors their performance.

## 5. RURAL ENTERPRISE ENHANCEMENT PROJECT

Model of lending developed within LRFDP project continued in Rural Enterprise Enhancement Project (REEP). Number of eligible activities for credits has been expanded, so that apart for livestock, credits could be used for all other types of agricultural (especially fruit production) and non agricultural activities in rural areas.

In this and in other projects, part of credit funds was intended to SMEs in sectors of agribusiness but number of used SME credits was below planned because in the same time, the same or similar credits were offered by almost all banks. Until mid 2011, 1,063 credits were disbursed to individuals within this project in the value of 11.6 mil. BAM and 55 credits to SMEs in the value of 2.6 mil BAM (Table 1 in Appendix). Except enlargement purposes, other characteristics of these credits were mainly same as in previous project (repayment of 7 years, grace period up to 12 months for orchards up to 3 years, with interest rate from 6% to 10%).

The shift in REEP project was to spread a network of financial intermediaries because the loan agreements signed with the project were made by most banks and MCOs from both entities. This provides better geographical distribution of credits and a higher level of competition so that some banks and MCOs offered lower interest rates than their competitors, although the input conditions were the same for all agents.

Farmers still have a need for additional resources that would fund their investments. In a survey of 1,390 rural households in 2008, which was conducted in 24 municipalities of the Republic of Srpska 72.4% of respondents said that the biggest obstacle to addressing their own business was shortage of funds (RS Strategic Plan of Rural Development, 2009). Lending is certainly one of the major sources of financing agricultural development, but according to the previously mentioned survey, less than 55% of households had never used credit, and 38% used some form of agricultural credits (10% for the purchase of cattle, 9.8% for raw materials, 8, 8% for purchases of machinery, 7.5% for the renovation of buildings and 1.7% for planting perennial plantations). Legal entities from the category of SMEs and cooperatives are in a somewhat more favourable position in terms of investment funding, because it is easier to obtain credits.

Regardless of whether the intermediaries in the lending were banks or micro credit organizations, the dominant instrument of ensuring repayment of credits were the guarantors. In terms of guarantors, MCOs were somewhat more flexible because they accepted and guarantors who have had informal sources of income, while the banks insisted on employed guarantors, preferably in the public sector. In addition to affirmative attitudes towards the IFAD credits, the problem of the impossibility of obtaining guarantors was one of the most common objections to the borrower, which is why the design of the next LRDP project introduced the possibility of their partial substitution mechanism of the guarantee fund, whose concept was elaborated in another paper by the same authors (Vaško et al., 2009).

Monitoring of REEP credit beneficiaries performances in the RS REEP project area (sample of 86 farms) shows that in the years after using credits (2010) those farms increased their assets, agriculture machinery by 28%, and livestock between 18% (sows) and 40% (milking cows) comparing it with the level before credits (2008). In the same period, dairy farms that used credits increased their milk production by 51%, milk sale by 58% and income from milk by 48%, mainly thanks to increased number of cows and less to increase of milk yield. Borrowers from the category of meat producers increased meat production by 17%, meat sale by 19% and income from meat production by 39%. Borrowers from the category of fruit producers increased their fruit production and sale of the fruit equally by 56% and their income from fruit production 32%. Total household income of the farms which used credits increased by 24.6%, but their income only from agriculture by 43.6% because they used dominantly credits for agribusiness. Net farm profit increased by 22.6% comparing it with situation before agriculture production expansion financed by credits from REEP project (REEP M&E Report, 2011). This data uncontested shows that credit, if it is properly invested, can give significant benefit for borrower and ensure enough income for credit repayment.

## 6. RURAL LIVELIHOOD DEVELOPMENT PROJECT

The next project, Rural Livelihood Development Project (RLDP), which became effective in 2010, will continue the lending, but only in the FBaH. The reason is that, at the time the RS formed Investment Development Bank (IRB), in fact the Fund, whose credit potential has been around 600 million BAM, of which a considerable part was allocated to agriculture lending. During three years of its operation IRB has extended 808 of micro credit for agriculture in the total amount of 14.5 million BAM and 80 credits to SME in agribusiness sector totalling 51.6 million BAM (FAO B&H sector study reports, 2011). Comparing this line of credits, it can be concluded that it has many similarities with previous REEP, LRFDP lines of credit, except that the IRB limits the interest margin for the financial intermediaries (which affected less interest in MCOs to use this source of lending to agriculture). Because of the procedures necessary to meet the legal requirements to join OFID funds to already approved IFAD loan funds, the credit line under the RLDP has not become effective yet. Its results and achievements will be made in a few years time.

## 7. RURAL BUSINESS DEVELOPMENT PROJECT

IFAD, governments, ministries and project units from both BaH entities (in 2011) have been preparing the latest project, Rural Business Development Project (RBDP), which in its design also has a dedicated credit line to support on and off farm businesses. Regardless of what the agriculture lending has become the practice of most financial institutions in BaH, it was stated that there is still a lack of long-term deposits and that agriculture is still underrepresented in the credit portfolio of most banks. Opening the door on lending to agricultural producers and rural population, it is envisaged that generally does not limit the activities, which would be eligible for financing as well as the number and types of financial intermediaries (banks, MCOs and SCOs) so that this line of credit has a more of rural finance, than the agriculture finance character.

## 8. CONCLUSION

International Fund for Agricultural Development (IFAD) has actively participated in the laying out, expansion and diversification of agricultural credit in Bosnia and Herzegovina with the (until now) 16,000 individual credits totalling 67 million BAM (excluding the effect of revolving). It began immediately after the war with the awarding the in kind credits, i.e. breeding animals, which was the beginning of the process of returning back the credit in the investment logic of the peasants, because, at that time, only donations were granted in BaH. On the other side, the banks (in the late nineties of the last century) were reluctant to credit farmers, so it was necessary to provide a dedicated (long-term) sources and create a special line of credit and credit products for certain types of agricultural production and a suitable investment. It continued with the awarding of cash credits for the purchase of livestock (dairy or breeding animals) approved by the several banks, and later several MCOs.

The highlight of the expansion of the number of intermediaries in lending has been the establishment of the first SCO, only in the RS (LRFDP project, 2002-08). The following IFAD Project (REEP, 2008-12) expanded the subject of credit to establish plantations of fruit, but the number of lending intermediaries was reduced to banks and MCOs. Recently, the latest effective IFAD project (RLDP, 2010-16) will continue to extend credit subject to virtually all types of agricultural production and related investments, and as intermediaries for distributing credit funds, all financial institutions that operate in the BaH market will be used.

IFAD projects have had a leadership role in finding the proper credit product for agricultural production and were the role model for other projects, including the financial institutions themselves that based on experiences of the implementation of IFAD credit lines, created and modified their own credit lines and products for agriculture.

Based on the experiences of five implemented IFAD projects in Bosnia and Herzegovina and related credit lines that were parts of these projects can be summarized as follows:

- In order to increase the size and scope of agricultural credits it has been important to provide a dedicated (long term) sources of financing;
- To help the credits to reach specific target groups (women, poorer beneficiaries, remote areas, etc.) or types of investments, they should be favoured in the procedure for extending credits and sometimes even specifically targeted (principle of positive discrimination);
- Credit products (according to purpose, amount, terms and conditions, etc.) should be tailored



according to the specific needs of agricultural production;

- Borrowers should be allowed the freedom to choose the amount and terms of credits and give them freedom in the manner and conditions of supply that are subject of credit;
- Proper guarantees securing the credit repayment are critical conditions for the use of credit by the majority of farmers (in which the MCO are much more flexible than the banks) and continuously look for alternative mechanisms for the elimination of “bottlenecks”;
- The interest rate isn’t a crucial prerequisite for a decision on the use of credit, but the interest rate still remains a significant psychological barrier for a decision on the use of credit, and
- On the contrary to the prejudices, the repayment of credits given to farmers was regular, with lower levels of delinquency than some other categories of borrowers with stable and secure sources of generating revenue.

The need for agriculture lending in BaH will increase in the future, bearing in mind the necessity for its rapid modernization in the context of meeting the requirements in the EU agenda. It is expected that the financial institutions will still diversify their credit offers for agriculture and that the need for the provision of external resources for these purposes will stop in the near future. We should not ignore the progressive role of IFAD and other development projects in Bosnia and Herzegovina, which they played in breaking down prejudices about the high risk of lending to agriculture, and in adjusting credit conditions to the specific needs of certain types of agricultural production.

Experience from Bosnia and Herzegovina in strengthening funds for lending to agriculture (such as into IFAD projects) and finding the most suitable credit products can be useful multiply and applicable for other countries with similar situation and development level.

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Table 1. IFAD credit lines in BaH in the period from 1996-2010

	EFRP (1996-97)	SFRP (1998-2000)	LRFPD (2002-08)	REEP (2006-10)	Total (1996-2010)
<b>Farmers Credits through Commercial Banks</b>					
Number of banks	0	0	9	6	15
Amount of extended credit (mil. KM)	9,733,958	23,687,194	10,263,555	1,035,800	44,720,507
Number of credits	3,974	8,293	1,748	163	14,178
Repayment period	5 years	5 years	Up to 5 years	Up to 5 years	
Grace period	12 months	6-12 months	6-12 months	12-18 months	
Interest rate (annual nominal)	2%	2%	5,75%-9,95%	8,39%-8,70%	
<b>Farmers Credits through MCOs</b>					
Number of MCOs	0	0	2	5	7

Amount of extended credit (mil. KM)	0	0	3,344,850	10,550,240	13,895,090
Number of credits	0	0	186	900	1,086
Repayment period			3-5 years	do 5 years	
Grace period			Up to 12 months	Up to 18 months	
Interest rate (annual nominal)			13%-18%	8%-18%	
SME Credits through Commercial Banks					
Number of banks	0	0	8	6	14
Amount of extended credit (mil. KM)	0	0	5,066,012	2,205,201	7,271,213
Number of credits	0	0	107	26	133
Repayment period			Up to 5 years	Up to 7 years	
Grace period			12-18 months	12-24 months	
Interest rate (annual nominal)			5,72%-6,32%	8,34%-8,70%	
SME Credits through MCOs					
Number of MCOs	0	0	2	5	7
Amount of extended credit (mil. KM)	0	0	1,061,800	437,500	1,499,300
Number of credits	0	0	422	29	451
Repayment period			3-5 years	Up to 7 years	
Grace period			Up to 12 months	Up to 24 months	
Interest rate (annual nominal)			13-18%	8,23%-12,50%	

Source: Internal data by Project Units (PCU/APCU)

## OPPORTUNITIES FOR FINANCING THE SMALL AND MEDIUM – SIZED BUSINESSES IN THE REPUBLIC OF MACEDONIA

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### Abstract

Small and medium-sized businesses are major part of the economy. The effective financing of such businesses makes a significant contribution to the economic growth and development. There are different types of financing the small and medium-sized businesses: internal funds; overdrafts and bank loans; leasing and hire purchase arrangements; stock market equity and corporate bond issues; venture capital or private equity; asset-based finance such as factoring and invoice discounting and trade finance. The capital market is alternative and competitive way of financing the business entities regarding the financial institutions, above all the banks. In the developed market economies the capital market allows the business entities to obtain the financial assets they need to realize their projects through issuing long-term securities. Considering the wide advantages these forms of financing offer, the subject of research of this paper shall be the opportunities of their implementation in the small and medium-sized businesses. Namely, an analysis and empirical research shall be conveyed of the current conditions of the small and medium-sized businesses related to their financing. In addition, recommendations shall be proposed for more efficient exploitation of the opportunities for financing on the capital market.

**Keywords:** Financing, Capital Market, Long-term securities, SME's

### 1. INTRODUCTION

The funding of business entities is a very important and complex process, which consists of planning, acquiring and use of the necessary financial resources for the current and developmental operation. The business entities can provide the necessary funds for investment projects realisation through internal and external sources. Internal funding provides greater autonomy, sovereignty and freedom during the financial decision making. However, quite often, business entities are unable to meet their need for capital only from internal financial sources, and therefore there is a need to acquire capital from external sources. In the developed market economies, the capital market gives an opportunity to economic entities to use different forms of funding. The efficient capital market enables acquiring of the necessary finances through: long-term investment loans, issuance of securities – shares and bonds; as well as use of different derivative financial instruments.



## 2. SIGNIFICANT FACTORS TO CONSIDER WHEN CHOOSING THE SOURCE OF FUNDING

The economic entities in the developed market economies have an option to choose the source from which to obtain the necessary capital. The choice between the equity or debt capital for business needs funding is a complex and complicated process. It is of utmost importance that they resolve certain issues through a detailed analysis, before they decide on how they will provide the necessary capital, whether by loans or by issuance of securities, primarily because the capital secured by an issuance of shares has a proprietary nature, and the capital secured by an issuance of bonds or loans has a debt nature. The reasons and motives for an economic entity on the capital market to find itself in a role of a user of equity or a debt capital are multiple and varied. The practice shows that the most important between them are the following:

- Maintaining an optimal balance between the equity and the borrowed (foreign) capital. Namely, these particular relations are basic indicators for the financial power and strength of the business entity, its creditworthiness, rating and business perspective. These parameters, as well as the relations between them, on the other hand, enable us to determine the place and the role of the economic entity on the capital market;
- The degree of indebtedness of the business entity. This indicator has an utmost importance in most cases when deciding on how to provide the needed capital. Namely, if the business entity is considerably indebted or approaches the limit of allowed debt, it does not have a choice, but to provide the necessary capital through issuance of shares;
- The degree of development and independence is also very significant factor that has to be considered. In a situation when the business entity has a successful and stable development, it is logical to decide on mobilization of debt capital, for a simple reason that this will allow it to maintain the high degree of independence and business autonomy in the future as well, which is a very significant prerequisite for maintaining the competitive advantage on the market in sharp economic conditions;
- The degree of risk of the investment capital for which the mobilization of financial resources is made. If the risk of the investment of the potentially mobilized capital is higher, the economic entity will give a priority to the issuance of shares, while on the other hand, if the risk is lower, then it will decide upon debt capital;
- Current conditions on the capital market according to which an equity or debt capital can be acquired;
- The market price of own shares (in case of joint stock company). If the current, market price of the shares is high and significantly exceeds their nominal value and there is interest for the shares among potential investors, it is realistic to assume that the necessary capital will be obtained through an issuance of shares because they are expected to be attractive on the market;
- The interest rate on the long-term loans granted from the banking institutions. In conditions of low-interest rates and a stable bank loan policy, the economic entities will decide to obtain the necessary funds by taking long-term loans from the banks;
- Tax policy and its instruments have a major impact on the decision to select the source that will provide the necessary funds. In situations when by tax deductions and benefits, bonds are being favoured, it is assumed that the economic entity will obtain the necessary capital by issuance of bonds. In cases when these tax deductions apply to the shares, the economic entity will perform mobilization of capital through issuance of shares.

Given all these factors when choosing one of the capital sources, the business entities should always consider the following:

- If they decide to provide the necessary capital through an issuance of bonds, then the ownership structure of the capital will shift in favour of equity capital; and
- If they decide to provide the necessary capital through an issuance of bonds or by loans, then the ownership structure of the capital will shift in favour of debt capital.

It is necessary to emphasize that there is no universal combination that can be used by all business entities in mobilization of the needed financial resources, and that is why before making a decision they should always make a detailed analysis of all the factors in order to choose the combination that will allow to maximize the value of the entity and minimize the costs for the capital.

### 3. EXTERNAL SOURCES OF FUNDING

The capital market is a very important segment of the financial market, mainly because on this market the business entities can obtain the necessary capital through loans from banking institutions or through issuance of securities.

Companies that provide the necessary capital by using long-term loans need to make profit from the invested capital that can not be lower than the loan interest, because the interest is the price of the capital. For a business entity to be able to get a loan, it is necessary for it to meet the following conditions:

- To be solvent;
- To use the granted loan for its purpose;
- To meet certain requirements stipulated by the loan.

Almost always there are restrictive provisions in the loan agreements among which these are more significant:

- The loan user needs to maintain a minimal level of net working capital, as a condition for providing of liquidity of the company;
- Restrictions in terms of expropriation of permanent assets;
- Restrictions on further long-term borrowing;
- Restrictions on status changes and significant changes in its organisation;
- Restrictions on the amount of the issuance of securities, for the protection of creditors;
- Restrictions on dividend payment to a certain percentage of the profits.

The developed capital market allows business entities to get the needed capital by issuance of long-term securities, shares or bonds. Before they issue securities, it is necessary for the business entities to obtain permission for the issuance by a competent state authority, mainly by the Committee for Securities. This permit is required in order to protect the interest of potential investors and to allow issue only to those business entities that have good creditworthiness and high rating.

Funding of the business entities through issuance of shares has range of benefits for the business entities including:

- This source of funding puts smallest pressure on the company, because the mobilized funds can be used permanently, and the dividend payment to the shareholders is made by an internal decision of the administrative bodies;
- The dividend doesn't have to be paid, and the unpaid dividend may be transformed into dividend shares;
- It increases the company's ability to mobilize funds from foreign sources.

Apart from the advantages, this source also has disadvantages i.e. issuance of common shares creates an opportunity to change the power structure because of the inclusion of new shareholders i.e. change in the ownership and executive structure. Also, this method of obtaining capital is followed by expenses for the issuance and selling of the shares.

On the efficient capital market, business entities can obtain the necessary capital through an issuance of corporate bonds. This kind of mobilization has range of benefits among which the most significant are the following:

- The ability to mobilize higher amounts of funds, because the bonds are being sold to a large number of interested subjects;
- Capital is being mobilized without changing of the structure of the equity;
- The costs related to the debt are restricted i.e. the only expense is the interest, which the issuer has to pay to the bond holders;
- Because the interest payment is an expense, it can create some savings for the business entity when paying the income tax.
- Insertion of a clause for early redemption of bonds if a cheaper source of funding becomes available allows flexibility in the financial structure.

As disadvantages of the funding through issuance of bonds, the following can be mentioned: the interest is a fixed cost that has to be compensated regardless of the results achieved, and if the business entity makes a negative financial result and is not able to pay the interest; its survival may be jeopardized. As another disadvantage, it can be mentioned that the loan agreement might make provision for certain restrictions for the issuer, such as ban on alienation of property, ban on additional issuance of securities, ban on payment of dividend over some specified amount (if the issuer is a joint stock company) etc.

In the structure of capital sources of the business entities in the developed market economies, bonds take the dominant part, followed by shares, than long-term loans.

#### 4. FINANCING OF BUSINESS ENTITIES IN THE REPUBLIC OF MACEDONIA

Republic of Macedonia is a small country with total area of 25,173 km<sup>2</sup>, with population of 2,052,772 inhabitants of whom 953,200 are capable of working, and gross domestic product amounting to 410,744 million denars. This country size determines the market. Macedonia is still underdeveloped country and is at the lowest level of the medium-developed countries. Macedonian economy is nearly two decades in stagnation as a result of which the unemployment rate is 32.1% and is the highest in relation to neighboring countries.

According to statistics, in the year 2010 in the country operate 75,497 businesses, from that 28,326 in the wholesale and retail, 8263 in manufacturing industry, in transport and communications activity 6417, scientific and technical activities 5228, building 4368, 3083 in agriculture, mining industry 164, administrative and catering services 2519, in rental real estate 415, housing and service providers 4433, health services 3166, professional, financial and insurance activities 408, education 992. Most of these businesses or 59,276 (78.5%) are with a very small number of employees i.e. 1-9 employees and only 203 entities (0.3%) have over 250 employees.

Most businesses that exist in the Republic of Macedonia are registered as limited liability companies (LLC and Ltd.) while as joint stock companies exist 700 entities from which in 2010 only 33 companies are listed on the Macedonian Stock Exchange.

Capacity utilization in the enterprises in recent years has ranged from 52-62%. There are more reasons for such low utilization percentage, but these are noted as most important: financial problems, insufficient domestic demand, slow conquest of foreign markets, competitive imports, uncertain economic environment.

Businesses in the Republic of Macedonia have still most of their investment projects financed with funds provided through expensive bank loans which certainly adversely affects their long-term financial balance and the capital structure. The maturity of the corporate sector indebtedness in the country can be seen from the following table<sub>2</sub>.

In million denars

Table 1 Maturity structure of debt of the corporate sector

Type of indebtedness	31.12.2007	31.12.2008	31.12.2009	31.12.2010
Short-term loans	78,259	90,866	92,475	52,565
Long term loans	79,434	115,012	130,581	120,967
Due and nonperforming loans	7,949	9,012	11,426	17,284
Total	165,642	214,890	234,482	190,816

Bank loans are still the dominant source of capital for the economic entities in the country, that is, the capital market mainly comes down to credit market. Borrowing by businesses in the long term means longer load from the cost of these sources of funding. Here it is necessary to highlight the risk of changing interest rates which is especially important because approved loans for the most part have variable interest rates.

In the Republic of Macedonia the capital market is poorly developed despite the existence of a large number of institutions that enable its operation. Namely, the Stock Exchange of securities exists more than 15 years, was founded in 1995 and today it has 19 members of which 13 brokerage houses and 6 banks, of which 11 are with more than 50% foreign capital. It trades shares, bonds and other stock material in accordance with the Commission for Securities.

1 Announcement of the State Statistical Office no.6.1.11 12. from 25/02/2011

2 Monetary Statistics of loans and savings banks, National Bank 2011.

Despite the country's businesses having the opportunity to mobilize financial resources available through the issuance of shares or bonds, relatively few of the companies finance its operations through the capital market. Their role as issuers of securities is very rare. Joint Stock Companies usually issue securities through a private offering. The following data are presented for the realized issuance of securities for the period 2007-2009 year.

Table 2 Review of types of issuers, number of issued decisions, value of issuance and type of offer of shares issued in the year 2007<sub>3</sub>

Number	Issuers of shares	Number of issued decisions	Issuance value Euro Denar		Public offering (PE)/ Private offer (PP)
1	Companies of the economy	1	2,673,850	163,722,777	PP
2	Banks	2	23,021,562	1,408,440,000	PP
3	Other financial institutions	6	2,541,033	155,450,502	PP
	Total:	9	28,236,445	1,727,613,279	PP 9

Table 3 Review of types of issuers, number of issued decisions, value of issuance and type of offer of shares issued in the year 2008<sub>4</sub>

Number	Issuers of shares	Number of issued decisions	Issuance value Euro Denar		Public offering (PE)/ Private offer (PP)
1	Companies of the economy	2	11,561,710	708,982,162	PP
2	Banks	4	70,964,738	4,343,827,455	PP
3	Other financial institutions	16	17,698,135	1,077,099,456	PP
	Total:	22	100,224,583	6,129,909,073	PP 22

3 Report of the Committee for Securities of the Republic of Macedonia 2008, page 9

4 Report of the Committee for Securities of the Republic of Macedonia 2009, page 9

Table 4 Review of types of issuers, number of issued decisions, value of issuance and type of offer of shares issued in the year 2009<sup>5</sup>

Number	Issuers of shares	Number of issued decisions	Issuance value Euro Denar		Public offering (PE)/ Private offer (PP)
1	Companies of the economy	3	84,517,900	5,169,570,105	PP
2	Banks	1	2,940,400	180,552,000	PP
3	Other financial institutions	3	733,910	44,996,956	PP
	Total:	7	88,192,210	5,395,119,061	PP 7

From the data presented it can be concluded that in three years only 6 businesses committed mobilization of funds through the issuance of shares and through private offer which is really insignificant if we take into account that the biggest problem of many businesses is their lack of funds.

## 5. ANALYSIS OF THE CONDUCTED SURVEY RESULTS

To explore the possibilities for financing of small and medium businesses in the Pelagonia region in Macedonia, a questionnaire of nine closed-type questions was prepared. Some of them are yes/no questions, and some are questions with more provided answers to choose one or more from. The questions were carefully selected in order to get a clearer picture as well as better quantitative analysis of the current situation of small and medium businesses associated with the forms of their financing offered by the capital market. The questionnaire was carried out on a representative sample of 55 target business entities from the Pelagonia region, out of which 31 business entities answered the questions. Survey was conducted from 15 June to 5 July, year 2011, in general through direct contact or e-mail with representatives of the management team in business entities.

Quality conclusions can be drawn from the quantitative analysis, based on which useful recommendations can be made.

To the first question – Are you familiar with the forms for financing small and medium-sized businesses? – 23 responded positively, or 74.2% of the surveyed establishments. Despite the fact that this is relatively high percentage of positive responses, 26% of the respondents had a negative response which points to the fact that the investments realized by these business entities are nonstrategic.

To the second question – Have you had any investments in the previous 5 years? - 97% responded positively, and only 1 business entity negatively.

To the third question, regarding the sources for providing needed funds for investment financing, which was a multiple choice question, 87.1% of the respondents answered that funds have been provided from own sources, 77.4% by bank loans and 29% from borrowings. From own sources as well as bank loans was the answer of 67.7% of respondents, while 7 or 22.6% of the surveyed establishments chose all three above-mentioned sources of financing. It's interesting that none of the businesses answered that the funds needed for investment financing in the previous 5 years were provided from leasing arrangements, shares, issuance of long-term bonds or factoring finance, options listed as potential sources of financing. The reasons for such answers should be either lack of familiarity of business entities for funding opportunities, or their lack of faith in certain funding sources.

The fourth question regarded planning investments in upcoming projects. 96.8% of the businesses confirmed having plans to invest in new projects in the future. Only one business entity gave a negative response to this question. This speaks of the fact that businesses are willing to develop in the future, but considering the sources of financing of those projects (which was stressed in the fifth question) most of them plan to provide the funds needed from own sources (87.1%) and by bank loans (83.9%), or in both ways (22 businesses or 71%). Not one of the businesses stated other source of financing for

<sup>5</sup> Report of the Committee for Securities of the Republic of Macedonia 2010, page 7



future planned projects. These ways of project financing are, above all, due to the low awareness of businesses of the advantages from providing funds through issuance of shares and bonds, which was part of the sixth question. Namely, 77.4% or 24 surveyed establishments answered that they are not familiar with the advantages from providing funds through issuance of shares and bonds, and 87.5% of those who said they were not familiar with the advantages of this way of financing said they needed additional education in this field (question no.7).

Interesting are the answers to the eighth question which asks whether businesses would use issuance of shares and bonds as one of the ways to provide the needed finances. Namely, 74.2% of the business entities gave a negative answer which in a way correlates to the answers regarding familiarity of businesses with such ways of financing and providing capital.

The last question concerns the transparency in the publication of data for the business entity. More than 30% of the surveyed establishments (10 businesses) stated that they are not ready yet for transparent publication of their data. This means that business entities observe their data as secret and fear the competition in case data regarding the ways of financing their activities is made public.

## 6. CONCLUSION

Companies in developed capital market countries have the opportunity to provide the needed finances not only from banking institutions in the shape of credits, but also through issuance of securities. The existence of developed capital market, rich in financial instruments, is an indispensable prerequisite for growth and development of business entities in every country. What kind of securities will be decided by the business entity depends above all on the policy of management, its financial structure and current capital market conditions.

The capital market in Republic of Macedonia is characterized with undeveloped primary market, limited liquidity of secondary market, a modest offer of investment alternatives and an expressed sensitivity of investors and their decisions regarding the economic developments in the region and internationally.

The level of capital mobilization through issuance of securities in our country is very low. This is primarily due to the lack of interest of the corporate sector for financing their activities through issuance of securities, which comes as a result of:

- Lack of familiarity of the management with the advantages coming from this way of financing;
- Reluctance of the company to open to the public – fear of financial reports publication;
- Fear of losing control over the company in case of issuance of new shares;
- Default on the securities issued by the issuers (the non-payment of dividend);
- Insufficient education of the public in terms of the advantages from investment of securities.

In order for the capital market in our country to function efficiently, especially to encourage business entities to provide the needed capital through issuance of securities, certain specific measures need to be taken:

- Organization of seminars and expert panels to educate managers about the opportunities offered by the capital market as an alternative way of financing;
- Formation of specific financial sectors in businesses equipped with experts to research capital market conditions and affect management in direction of making relevant decisions while choosing source of financing;
- Greater openness and transparency of companies who mobilize capital through issuance of securities, which will increase existing and potential investors' trust;
- Improvement of the established information system;
- Education of the public on the advantages of investing in long-term bonds;
- Establishing cooperation of the Macedonian Stock Exchange in greater international frames;
- Improvement of legislation and its efficient application;
- Improvement of the organizational and functional structure of the Commission for Securities and continuous improvement of its facilities and personnel techniques;
- Improvement and harmonization of capital market legislation with EU directives.

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## MECHANISM OF FINANCING SMES IN SERBIA AS MID-TRANSITION ECONOMY

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E-mail: [pedamarjanovic@yahoo.com](mailto:pedamarjanovic@yahoo.com)**Abstract**

SME financing is a rather complex and almost a rhetoric topic. In Serbia as a country which approached the privatization process that lead to a tycoon model, the stalemate is inevitable. General leap service and empty promises of reform and not so reform oriented governments for the last two decades did not make any real change in financing SMEs. Loans and grants from many international donors and agencies have being syphoned to the sector in such large quantities and also in the many empty handed press conferences and public venues paved with unfulfilled promises. In practice, the situation is more than grim, since most profitable SMEs are in the desperate needs for loan funds, but the interest rates and other costs are more than intolerable from the financial point of view. This paper is a form of vivisection what is really going on, taking into account the fact that Serbia is knocking at the door of new election in 2013. Promises, promises, inflation of promises and ever rising deficits of delivery and results is more than obvious. This research shall shed some more analytical light on the real financial performance of the sample of small group of SMEs in Serbia, in the region of Podrinje, relatively close to Republic of Srpska. Model of business performance metrics and management as well as benchmarking created by us shall be tested on the real financial statement data, followed by the extensive review and analysis of the real profitability and liquidity factors of those enterprises. Business, operational and financial performance of the SMEs in Serbia, region of Podrinje, shall be viewed in the light and optics of stimulation of the local and regional economic growth, and growth of employment.

**Keywords:** SME Financing, Performance Management, Transition Economy, Serbia**1. FINANCING GROWTH OF THE START-UP SME-S IN SERBIA - FORGONE OPPORTUNITIES IN THE LOST DECADE: 2001-2011**

The beginning of so called “new era of democratization, economic and social reforms” has being envisaged in the heads and minds of many progressive people and radical intellectuals in Serbia during the prolonged period of more than two decades after the Tito (1980) and the end of the Slobodan Milosevic era (2001). More or less, some kind of political consensus and intellectual compromised common ground has being created in a strategic orientation towards the market and strong democratic institutions based on the rule of law, with an eye on joining EU, also with a strong notion to reintegrate Serbia’s society and isolated economy into the regional and global institutions. In that context in the early years of the first decade of the 21st century, at least on the declarative verbal front, the Government of Serbia opted strategically to enter into radical economic reforms, especially at the SME sector, as some kind of a growth propulsor, that has being in accordance with prescriptions of the international donors, aid agencies and foreign governments, also in a harmony with financial and technical assistance guidelines and strategic policy options. Expectation gap on both sides at that moment was not as visible as it is the case nowadays. Some of the key proposed strategic options almost ten years ago have being the following now and then (Ljutić, 2003, pp.2-14):

- Adoption and harmonization of the Serbian SME sector regulation by adopting and almost transplanting with some small cosmetic alterations the American model (SBA Act) an at that time new liberalized regulation of the sector.
- Strong protection of the more than weak SMEs from very strong government at that time (which unfortunately is not nowadays very strong but more than gigantic and omnipotent in controlling anything and everything regarding material and financial more than scarce resources).



- Orientation to create a new system of financial institutions which shall service additionally the financial needs of the existing and emerging SMEs in Serbia.

Serbia economic growth strategy still see the only window of optimistic opportunity to integrate into EU, while establishing excellent political, diplomatic and economic ties with first of all USA and also with other OECD countries. In that context some of the main perspective areas have being and still are:

- Unquestionable orientation to develop SME sector in Serbia.
- To create a strong but lean institutional infrastructure supportive to the SMEs, within the framework of the long term strategic growth vision and policy
- Harmonization with the EU standards and regulation of the SME sector, as a prerequisite of negotiations of joining as a candidate country EU.
- Global reintegration by adopting the foreign policy orientation of friendly relations with USA, taking into accounts the globalization trends and influences, especially of the WTO and of the OECD.

Table 1 Economic Forecast for Serbia 2011/2012

2010 <sup>1)</sup>	2011	2012	
GDP per capita, current prices [dinar]	416,495	457,653	503,161
Real GDP growth rate [%]	1.6	2.7	3.6
Monthly gross wage per employee [dinar]	47,450	51,552	56,582
Monthly gross wage, growth rate [%]	7.5	8.6	9.8
Real gross wage, growth rate [%]	1.2	0.1	2.5
Labour productivity, growth rate [%]	6.6	2	2.2
Employment, growth rate [%] <sup>2)</sup>	-5	0.7	1.4
Registered unemployment rate [%] <sup>3)</sup>	26.9	26.4	25.5
Average inflation rate, consumer prices [%]	5.9	8.4	7.1
Budget balance [% of GDP]	-3.5	-4	-3.4
1)2010 partly estimated 2) Total employment excluding agricultural producers.3) Unemployed persons as percentage of unemployed persons plus total employment.			

Source: <http://www.vojvodina-cess.org/index.php?mediumid=2&pagid=143&stukid=923&action=register> Accessed: 30.07.2011

Based on the conclusions previous data of eminent economics professor Josifidis from the State University of Novi Sad, the unresolved problems of economic growth and policy for the current decade shall still be even more pronounced unemployment and sluggish domestic and foreign investments. On the other hand the main “lobby group” which protects the interest of the big businesses owned by the Serbian tycoons and ex-Milosevic, or why “ex” captains of the socialist industry who are nowadays proponents of the liberal capitalist ideas, gathered on the very beautiful mounting in Serbia named Kopaonik. In beautiful hotels, while spending lavishly the fruits and results of more than private privatization for them, have being able to create some kind of a document titled “Kopaonik Consensus” which consisted of 11 policy recommendation for 2011, and on the top business forum they have concluded that only sustainable reforms leads to sustainable development (Kopaonik Consensus, 2011, pp. 1-3). Although almost the whole Serbian Government was present there, in that Manifest they did not dare even to mention the SME sector. Based on that fact we could very easily make a certain conclusion that the top officials of Serbian government only mention SMEs and their employees when they meet them in person, and need them to vote for re-election. Serbia has made some progress in the areas of economic reforms and freedoms, but at the institutional front still remains a significant vulnerability and need for a large structural reform and adjustment of the SME sector in its preparation for the future within EU (IMF Executive Board, 2011). Only new supported program by

the Government of Serbia could help SMEs to restructure, and complete transition entering a path of more balanced and pronounced growth. Based on the official data from 2008, the share of SME sector in GVA was 59.1%. 67.2% in employment and 45.9 in exports (Government of the Republic of Serbia). Some rather small goals have being in the area of competition development support program for fast growing SMEs, as support project in the area of business services development (1 million Euros), Program for co-financing local initiatives for SME development, including business incubators, (0.5 million Euros), SME support program for introducing e-business (0.5 million Euros), and only 0.1 million Euros for the Program supporting SME's facing financial problems that can jeopardize their survival as a kind of a second chance. Either Serbian SME's are at large very profitable, most of them, or only the negligible number is facing difficulties of illiquidity based on such "very generous support".

In another study financed by the USAID which have tried to create some kind of a platform for the Serbian post-crisis economic growth and development model 2011-2020, SME sector is non-existing one, that is self-explanatory fact itself, and not any other comment is necessary (USAID, FREN, TEI, 2010). Different observers and analysts could see the same set of objective real data differently, depending not only on the level of objectivity but also based on the prospective interests also.

## 2. STIMULATING SMES GROWTH

In the official documents issued by the Government of Serbia, its agencies and research institutes, think-tanks and NGOs financed by the same government, the picture is full of colour, vivid, promising, where they express lavishly and generously assessment of their own activities, which is more than positive. In conclusion, there is a prevailing feeling of happiness with the significant progress in strengthening entrepreneurship and creating a competitive sector of small and medium enterprises by creating more favourable legal and regulatory framework, easier access to financial institutions, training of entrepreneurs and employees.

In recent research (Calic B, 2011, pp. 3-4), as review of current sources of SME external financing have benign included foreign donations, foreign credit lines (e.g. EAR, EU, EIB, Italian Government, etc.). Serbian Ministry for Economics and Regional Development has created the package of support measures of the economic policy. It is a form of grant scheme for SMEs existing at last three years in a row, independently owned, not a part of a holding corporation, and external investors hold less than 50% of equity capital. Grants are in the range of 1.000 to 15.000 Euros for the preparation of the technical and project documentation and between 1.000 and 8.000 Euros for the purchase of computer software (Serbian Ministry for Economics and Regional Development, 2011). They also offer financial support for the entrepreneurship focusing on the increase of the competitiveness, establishment of SME associations and unions, research and innovation, clusters, and also a small credit line for SMEs start-ups.

## 3. SERBIAN ECONOMIC AND FINANCIAL SYSTEM IN THE CONTEXT OF FINANCING SMES

Analytically observed the word system is a rather strong definition for the weak, fragmented and poorly coordinated institutions and scattered part of the national economic and financial system. Observations in retrospect only showed the Serbian economic and financial system at the had a chance at the beginning of the first decade of the 21st century to become well regulated and harmonized with the unwritten but really abiding international standards and practice. In reality the system more or less turned into some kind of deregulated chaos, from a "leap service" of more than attractive promises to a prolonged way to hell. As world globally, and Europe regionally has being entering economic, financial and banking crisis in the last few years, Serbia has lost its manoeuvring time, because instability at the South flanks of the EU (Greece, Italy, Spain, Portugal, who is next?) is not promising the EU shall even negotiate with Serbia as a candidate member country to enter the Union. Unconditional financial aid, grants and donors funds shall be curtailed very soon, so the Serbian government shall face the rude reality of the strong budgetary constraints, still more pronounces as the inflow from the privatization sales is almost nulled.

#### **4. REVIEW OF THE PERTINENT LEGAL AND OTHER REGULATION RELATED TO SMES IN SERBIA**

Reforms in the Serbia's financial and banking sector do last almost a decade, but instability and the risk of uncontrolled inflation are not eliminated at all. Banking regulation in Serbia is more or less reformed and based on the EU Directives and BIS Standards, while accounting and audit regulation have adopted the framework of the International Accounting Standards, International Financial Reporting Standards and of the International Standards of Auditing. Such standards based on our prolonged research and studies are more than cumbersome, unnecessary complex and very costly for the SME sector, and any suggestion to the Government, and especially to the Department of Finance is facing with a strong impenetrable wall of silence. On the opposite side, most SME owners and entrepreneurs consider costs of external accounting services as something unnecessary, while paying low monthly fees for external accounting services and outsourcing, but objectively assessed the value of those information is almost next to nothing for their needs in everyday management as well as for any kind of strategic business planning. In the field of fiscal system regulation VAT administration with very frequent reporting and payment of the VAT obligations is a heavy burden for Serbian SMEs since they lack the staff and management administrative infrastructure to support so frequent VAT reporting and payment. At the early 1990 at that time the Department of Economy of Serbia have established a working group to create a draft of the new SMEs law, with an aim to regulate the sector as a US SBA Law as a some kind of Ombudsman regulation, e.g. to protect weak SMEs from the strong government and big monopoly business, also very close to the Government. First so called "Reform Government" of Doctor Zoran Djindjic in early 2003 has an orientation to reform profoundly SME regulation and widely to apply EU related standards, but just after his assassination all the movements and discussions in that direction unfortunately have being stopped at once.

#### **5. HOW TO INCREASE THE AWARENESS OF THE SERBIAN GOVERNMENT AND THE GENERAL PUBLIC ABOUT THE IMPORTANCE OF FINANCING SMES GROWTH?**

Based on our preliminary intuitive analysis some strategic and operative goals could be contemplated in order to increase the real public awareness of the Serbian government and the general public that SME sector is important for the:

- Economic development and faster growth.
- Employment increase
- Social stability

In theory it is much easier to create any goal, but in real life practically the road to Hell is paved with good intentions. Since Serbia is now facing the done phase of privatization, while at the same time many of the previously privatized enterprises are knocking back at the Government door to be reprivatized since the most of new owners did not have any idea expect to grab the value of the property and to convert the existing industrial sites into profitable new construction grounds. The Government of Serbia could from now on count only on domestic fiscal income, may be they reconsider a possibility to start a creation of viable business infrastructure for the whole economy and especially for the SME sector, that is on the other side time consuming, costly, without any short term effects for the elections to be won. On the other side, life wisdom is teaching us again and again, if we do not mention the real problems in public that could be more than beneficial and profitable for the time being. Serbia's economy is more or less, please read much less, in some kind of reform process for almost two decades. A famous Russian director and intellectual Nikhita Mihalkov directed a film "Moscow Does Not Believe in Tears" and we could also drew a line of similarity that even to mention a word or a concept of "reform" in Serbia, most of the general public would respond with sarcasm and ask you in return: "Could we eat the reforms". The answer is obvious that reforms and especially economic ones are only the prerequisite or pre-condition for the real life positive changes. If the promised changes do not happen in ten or more years, than the support for any kind of reforms shall vanish like it has never existed before. It is very complex and almost insurmountable task to make a profound change from reforms in words to reform in deeds. On this pathway it is necessary and unavoidable the profound and deep structural reform of the public administration and government on all levels, to make a real change not only in perception, but also in the operational level by introduction market orientation and at the same time increasing public trust in the accountability of the government sector, especially the part which serves small and medium size businesses. The previous communist and socialist regimes (1980-2001) have being the real master minders of spin doctors for TV and public charades and

shows in public full of unreal promises. This medicine has stopped to be useful at the beginning of 21st century. The Serbian Government could try very hard from now on to create a public impression about very big support for business perspectives and financing SMEs, but this is not viable option any more, since more and more small businesses are stopping operations or going bankrupt since the rising illiquidity in the economy, where the main cause of illiquidity is government and illiquid privatized companies. SMEs in Serbia need new loans, grant schemes, venture capital financing and institutional support, all the elements which are lacking now. For Serbia Government the key question is how to increase the inflow of external capital and bank loans to SMEs, but such a question is much easier to ask than to answer.

#### **6. FINANCIAL AID AND GRANTS SCHEMES OF FINANCING SME SECTOR IN SERBIA BY THE EU COUNTRIES AND THE OTHER OECD MEMBER STATES**

We have quoted in our research on of the prominent politicians from the Province of Vojvodina, Mister Nenad Canak, MA,: “Gentlemen, where is the money?”, his beloved phrase for almost two decades. The real question for the SME sector in Serbia is – Where are hundreds and hundreds billions of dollars and euros of grants, loans and credit lines specially dedicated to finance SMEs in Serbia. The banks really administer credit lines for the SME sector, but when the private consultants contact the banks they are so secretive and not at all cooperative, so there is no any way to find out if these financial support reach at all the final recipients as it has being planned by the international donors. Possible solution is for the grant and finance agencies from the EU to properly audit those projects by their own internal and eventually external independent auditors, but not in any case by the existing auditors of those banks and financial institutions. SME owners and managers are not in an easy position vis-a-vis commercial banks, since most banks “prefer” to finance existing large clients and service with loans the private businesses of their shareholders than to grant to unknown SMEs. If Serbian SME sector does not ask nor the Government for any advice or prescription as it is the case now, it is not good business to give any advice at all. During the whole period 2001-2011 the Serbian Governments acted and reacted as the owners of ultimate wisdom and owners of eternal truth, by knowing everything about nothing, and knowing nothing about everything, that is the ideal of economics as a science. If we assume that the government has been more than knowledgeable and efficient, the result would be well developed, balanced, and strong SME sector which is very capable to enter EU competition and regulatory arena. The time will tell and shall be a better judge than any of us.

#### **7. WHAT TO OR NOT TO DO NEXT IN THE SME FINANCING IN SERBIA**

Based on our experience with SME sector as management consultants and external auditors for almost two decades we strongly advocate the following next steps necessary to adapt SME sector to EU standards and global competition pressures:

- Finally after many years of postponement to adopt new SME regulation, integral one, simplified based on the US SBA Act with a strong EU flavour.
- Strong protection of the SME from strong Government, unfriendly public administration, court system and big monopolies which are riding hand in hand with the Government
- To create a new system of financial institutions this shall serve additionally the needs of SMEs.
- The only real step forward is to introduce new check-up methodology to check up Government promises with reality.



## 8. ANALYTICAL RESULTS OF THE BUSINESS PERFORMANCE OF THE SAMPLE OF SMES IN THE REGION OF PODRINJE, SERBIA

SMEs in Serbia based on the Law on Accounting are not obliged to audit statutory accounts, but just to file the annual financial statements to the public register (Accounting and Auditing Law, 2006). Since the published data are limited in scope and depth most of such financial data, although from the very beginning unchecked are also limited (Business Registry Agency Law, 2004, 2009). The SME based on that law are not obliged to reveal their full financial data set (e.g. set of financial statements with full report), except to the creditors and investors on their demand, but that is covered with the clause of business confidentiality agreement. Such limitations are also extra problem for the proper financial statement and business performance measurement analysis. We have selected the sample of five different SMEs in the Region of the County of Podrinje, Serbia and applied the standard methods of statistical analysis of correlation. We have observed two closely related statistical variables which we considered relevant to determine the correlation relationship between the sources of financing and growth of the selected firms. The period we have covered is 2005-2008, relatively stable with not so much pronounced inflation and economic instability.

Table 1. Comparative Statistical Correlation Coefficients of the Five SMEs sample, County of Podrinje, Serbia

SME	Correlation		Commentary	
	Long Term Obligations/ Business Profit	Long Term Obligations/ Income from Sales	Long Term Obligations / Business Profit	Long Term Obligations/ Income from Sales
Klas	-0.99237	-0.88486	Extremely strong relation	Very strong relation
Banja	0.71293	0.73576	Strong relation	Strong relation
Fincel	-0.09292	0.76230	No relationship	Very strong relation
Toplana	-0.62417	0.88462	Strong relation	Very strong relation
Stim	-0.68942	-0.57824	Strong relation	Strong relation

Data Source: Original financial statements obtained through a courtesy of the managers of the five SMEs included in the statistical sample, 25 official tables. Data obtained and accessed on 19.04.2010

We have noticed that SME Klas has an extremely strong correlation relationship between the long term financial obligations and of the business income, e.g. profit, and also income from sales. SME Banja these two before mentioned relationships in both cases is very strong. SME Incel does not show positive relationship between the long term obligations and the profit from business operations, but on the other side it exist a strong relationship between the long term obligations and sales income. SME Toplana the relationship is from strong (correlation of long term obligations and business income) up to very strong as a reflection of the impact of long term debt obligations on the sales income. For the SME Stim it could be observed that both correlations relationships when we have analysed the impact of the long term debt on business profit and income from sales. When we have observed the whole sample consisted of the five SMEs we come to a conclusion that the correlation relationships are from extremely strong (SME 1), very strong (SME 3), strong (SMEs 4 and 5). Based on the previous results we have come to a conclusion that our research has confirmed the hypothesis of the positive influence of the mechanism of the sources of financing on the growth of selected business performance indicators of the analysed SMEs.

Table 2 Comparative Analysis of the Coefficients of Determination of the Selected Statistical Sample of 5 SMEs, County of Podrinje, Serbia

Selected SME	Coefficient of Determination	
	Long Term Obligations / Business Income	Long Term Obligations / Sales Income
Klas	98.48%	78.30%
Banja	50.83%	54.13%
Fincel	0.86%	58.11%
Toplana	38.96%	78.26%
Stim	47.53%	33.44%

Data Source: Original financial statements obtained through a courtesy of the managers of the five SMEs included in the statistical sample, 25 official tables. Data obtained and accessed on 19.04.2010

High values of the statistical coefficients of determination are also confirming to us our previous partial conclusions of the statistical correlation analysis that the impact of factors like long term financial obligation on one side and business income, e.g. profit from business operations on the other, are significantly contributing to the high positive results of the harmony of the texted variables X and Y. Calculation of the total rate of correlation for all five analysed SMEs which are included in the statistical sample in the County of Podrinje, Serbia is finally confirming that the correlation relationship is in the area of strong relationship. This fact is confirming additionally our hypothesis that obtaining and supplying the adequate sources of financing for SMEs has a strong relationship with the business growth of the before mentioned five SMEs, and consequently proportionally contribute to the local economic growth in the region. We have also applied the Altman test which is trying to predict eventual bankruptcy and also selected business performance individual measures; as well we have tried to project linear and exponential trends for the period 2005-2012. The before mentioned tests have also confirmed our general conclusions about strong influence of the sources of financing on the SME growth rates determined as profitability.

## 9. CONCLUSION

As in everything else, there at least two ways of thinking and analytical approaches, on at least try to be objective and real as much as possible regardless of the subject of our research that is something we have opted for. On the other side there is a possibility to choose a research subject something that we could be also objective, but the subject is irrelevant in real life, like exploring the technical model of SME financing in OECD countries. This paper have focused to shed some extra light that in Serbia there are no “Angels of Business”, even less venture capitalists, that stock markets and financial institutions only serving the financial needs of the SME sector on their Internet pages, while in practice still exist more than harsh reality of more than modest external sources of financing SME operations and growth.



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# THE SME FINANCING GAP IN SLOVENIA: A MACROECONOMIC PERSPECTIVE ON A MICROECONOMIC SME FINANCING PROBLEM<sup>1</sup>

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## Abstract

The country-cyclical substitution effect between trade and bank credit seems to be one of the “hottest” and most current research topics in both the banking and finance literature, as well as in the small business literature. Despite this, there exist several gaps in the study of this issue, ranging from contradictory and limited empirical evidence, to a lack of a unifying theory, and a general gap in studying this issue in non-Anglo-Saxon, smaller and emerging market contexts; especially in Central and Eastern Europe. Our paper builds on Biais & Gollier’s (1997) macroeconomic implications of trade credit and analyzes the counter-cyclical substitution effect between trade and bank credit in a series of cross-section robust regression and fixed effects panel regression models. This is done on a sample of Slovenian SMEs (including micro companies) for the 2007-2010 period. Our results do not only establish the existence of the substitution effect between trade and bank credit, but show how this effect is stronger in the initial phase of the current global economic crisis, and less strong in the subsequent deepening and bottoming of the crisis in 2009. Furthermore, we also show how the counter-cyclical substitution effect between trade and bank credit does not only differ across the various phases of the current global economic crisis, but also across different company size groups, where SMEs have actually become “double victims” of the crisis.

**Keywords:** SMEs, Trade Credit, Counter-Cyclical Substitution, Slovenia.

## 1. INTRODUCTION

The research on *bank vs. trade credit substitution*, which was started more than half a century ago by Meltzer (1960) and Schwartz (1974), has gained a new impetus within the current global economic and financial crisis. The so called *country-cyclical* aspect of this *substitution* seems to be one of the “hottest” and most current research topics in both the *banking and finance literature* (Burkart & Ellingsen, 2004; Mateut, Bougheas & Mizena, 2006; Ge & Qiu, 2007; Bougheas, Mateut & Mizena, 2009; Huang, Shi & Zhang, 2011), as well as in the *small business literature* (García-Teruel & Martínez-Solano, 2007; García-Teruel & Martínez-Solano, 2010). Despite Biais & Gollier (1997) positioning this topic as a *future research avenue* 15 years ago, Huang, Shi & Zhang, (2011, p. 1859) today still point to several research gaps in this area. These are further accompanied by “*somewhat contradictory [empirical] evidence*”. On a substantive level, they also outline a lack of a “*unifying theory*,” which does not only consider *substitution* between bank and trade financing, but also their possible *complementarity* at various levels of the economic cycle.

The bulk of research on *bank vs. trade credit* substitution, as well as its economic *cyclicity* has focused on large and developed countries (Huang, Shi & Zhang, 2011). This holds both for the banking and finance literature, and the small business literature. With regards to the banking and finance literature, the research on US companies (Peterson & Rajan, 1997; Nilsen, 2002; Danielson & Scott, 2004) and UK companies (Mateut, Bougheas & Mizen, 2006; Guariglia & Mateut, 2006) has undoubtedly shed important empirical evidence on the subject, which seems to support substitution. However, there seems to be a substantial empirical gap of similar research for non-Anglo-Saxon countries (García-Teruel & Martínez-Solano, 2010), and even more so for non-Western emerging countries – i.e. from Central and/or Eastern Europe (Mörec & Raškovič, 2011; Črnigoj & Mramor, 2009). While the recent rise of China as a global economic superpower has undoubtedly stimulated more research of emerging markets (see i.e. Ge & Qiu, 2007; Cull, Xu & Zhu, 2009; Huang, Shi & Zhang, 2011), China can by no means be considered an ordinary emerging market, yet alone a small one. The same holds i.e. for Cook’s (1999) research on Russian SMEs, too.

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A similar observation can be drawn from the small business literature, where the work by García-Teruel & Martínez-Solano (2010) published in the *International Small Business Journal* analyzes the determinants of the use of *trade credit* by European SMEs across seven countries, among which Greece is the closest proxy for an emerging economy. One has to point out to the research by Niskanen & Niskanen (2006) on Finish SMEs, which however focused only on the *commercial motives* for trade credit use among SMEs. Similarly to the banking and finance literature, large and developed countries seem to be receiving much more research interest in the small business literature as well. Thus, quite often findings from these environments are simply transferred or at best “adjusted” to emerging and non-western market contexts.

Our paper builds on Biais & Gollier’s (1997) “*macroeconomic implications of trade credit*” (Huang, Shi & Zhang, 2011, p. 1859), and Mateut, Bougheas & Mizen’s (2006) analysis of trade credit, bank lending and monetary policy transmission. In general, the paper focuses on the determinants of *trade credit* use among SMEs, and more specifically looks at the *counter-cyclical substitution effect* between bank and trade credit. This topic is usually analyzed from a microeconomic perspective, and is quite often related to a broader issue of SMEs’ capital structure and SME access to financing. Both have received exponential research attention over the recent decade (Rouse & Jayawarna, 2006; Claessens & Tzioumis, 2006; Hussain, Millman & Matlay, 2006).

We employ both a *cross-section robust regression model*, and a *fixed effects panel regression model* to determine the nature of the *substitution effect* and its *counter-cyclicity* across various company size groups, as well as across the current economic downturn. This is further complemented by descriptive statistics on a population of non-financial Slovenian companies with positive equity value between 2007 and 2010.

On a conceptual level, the paper also aims to bridge the chasm between the small business and the banking and finance literatures, which are interlinked through the study of the determinants of SME capital structures and their use of trade credit. In this context, the paper makes a series of contributions to both fields. *First*, by addressing the issue of trade vs. bank credit substitution in SMEs the paper builds and extends the work by García-Teruel & Martínez-Solano (2010) on the determinants of trade credit among SMEs. *Second*, our research responds to the recent call by Rahaman (2011) to gather new policy insights and test existing theoretical models in the current crisis context. It does so by analyzing the counter-cyclical nature of the substitution effect between bank and trade credit. To the best of our knowledge the study by Love, Preve & Sarria-Allende (2007) was so far the only one which specifically analyzed the counter-cyclical substitution effect between trade and bank credit within an economic crisis situation, and at the same time in the emerging market contexts (albeit the 1990s Asian and South American country-level crises).

*Third*, while the study of García-Teruel & Martínez-Solano (2010) focuses on seven EU countries - which were with the exception of Greece all highly developed - our analysis of Slovenian SMEs narrows the research gap among small and developing countries (Črnigoj & Mramor, 2009; Doern, 2009). In this regard, our paper is also motivated by a broader cross-country analysis of financing patterns in transition countries (i.e. Haas, Ferreira & Taci, 2010; Beck, Demirgüç-Kunt & Maksimovic, 2008). In particular, our study complements and extends the limited research on the SME finance gap in Eastern Europe.

*Fourth*, our research does not only include SMEs in the “traditional” sense (without companies with less than 10 employees), but includes *micro companies*, as well. Despite representing the bulk of the SME population this SME segment is generally excluded from the analysis in the majority of SME studies (i.e. Črnigoj & Mramor, 2009). This is done usually under the pretence of not being relevant or due to methodological challenges in dealing with sample heterogeneity and the corresponding treatment of outliers in regression analysis (Hampel, 2001; Huber, 1981).

## 2. SURVEY OF THE LITERATURE

García-Teruel & Martínez-Solano (2010, p. 215) define trade credit as a “*delay between the delivery of goods or the provision of services by a supplier and their payment*”. In general, the authors outline how “*for the seller this represents an investment in accounts receivable, while for the buyer it is a source of financing that is classed under current liabilities on the balance sheet*”. In this regard, we have operationalized trade credit in this paper as the *share of accounts payable in total liabilities* or simply the *share of accounts payable*. In a comprehensive theoretical overview García-Teruel & Martínez-Solano (2010, p. 215) outline “*various theories to explain the use of trade credit based on the advantages for suppliers and for customers*” which they group into *commercial, operational and financial* motives for the use of trade credit, as shown in Table 1.

With regards to the correlation between trade credit and bank lending Meltzer (1960) was the first to conduct a systematical analysis of the alleged *substitution effect* between bank credit and trade credit. This *trade-off perspective* was further expanded by Schwartz (1974), where the trade-off between trade and bank credit was more explicitly outlined, either with regards to varying costs of borrowing for different types of client companies in a “normal” and in a “constrained” (crisis) market setting. In this sense Schwartz concludes how companies “*with relatively low financing costs will borrow more from the bank during a contractionary period, in order to extend trade credit to downstream firms with higher financing costs and which encounter greater difficulty in borrowing from banks*” (Huang, Shi & Zhang, 2011, p. 1860). However, this “curtsey” is by no means an act of selfless *altruism*, but rather a management of long-term buyer-supplier relationships, which are in turn an important source of a company’s competitiveness (Dyer & Singh, 1998; Veludo, Macbeth & Purchase, 2006). More recently, this perspective has evolved into a comprehensive study of the so called *counter-cyclical substitution* between trade and bank credit, pursued by Biais & Gollier (1997); Burkart & Ellingsen (2004); Mateut, Bougheas & Mizena (2006); Love, Preve & Sarria-Allende (2007); Bougheas, Mateut & Mizena (2009); and Huang, Shi & Zhang (2011). This substitution effect is not only recognized in the banking and finance literature, but also in the small business literature, particularly within the work by Petersen & Rajan (1997), and García-Teruel & Martínez-Solano (2010).

Table 1: A summary of commercial, operational and financial motives for trade credit

Motive type	Role	Brief description	Reference*
COMMERCIAL MOTIVES	Form of price discrimination	Length of payment may be seen as a form of discount, which can be treated as a reduced price.	Brennan, Maksimovic & Zechner (1988); Mian & Smith (1992)
	Form of raising sales and connection to profit margin	Bigger trade credit does not only increase sales due to lower effective price, but is also connected to higher profit margins, since companies with higher profit margins are believed to extended also bigger trade credit.	Petersen & Rajan (1997)
	Tool of implicit guarantees	Bigger trade credit corresponds to a longer evaluation period by the customer, and can be seen as a signal of the quality of products, and their warranty.	Smith (1987); Lee & Stowe (1993); Long, Malitz & Ravid (1993)
	Reduction of information asymmetry	Bigger trade credit or a longer payment period calls for more trust between buyer and seller, and can be seen as a sign of signaling “good” intentions.	Pike, Cheng & Cravens (2005)
	Signal and tool for long-term relationship orientation	Trade credit may be extended due to trust and long-term relationship. It may be a sign of relationship commitment, and the vested interest of the seller in the long-term survival of the buyer.	Ng, Smith & Smith (1999); Cuñat (2007)
	Market segmentation tool	Trade credit can be used as an effective tool for segmentation of buyers, and a seller’s marketing and sales strategy.	Prendergast & Stole (1997, 2001)
OPERATIONAL MOTIVES	Tool for operating and cost efficiency	Separation of goods and payment for goods reduces illiquidity risk, which arises from an uncertain purchasing schedule and derived demand.	Farris (1981); Emery (1984, 1987)
	Operating flexibility	Trade credit, which enables both faster purchases and better market response, can act as a reward and stimulus in a time of low demand, and enables the constancy of delivery and production.	Emery (1984, 1987); Long, Malitz & Ravid (1993)
FINANCIAL MOTIVES	Information acquisition	Based on established and long-term relationships with the buyers, sellers have better access to information on buyer’s creditworthiness and can more efficiently evaluate the credit risk.	Emery (1984); Smith (1987); Mian & Smith (1992); Petersen & Rajan (1997)
	Better monitoring	Trade credit can establish higher buyer dependency. Therefore, interruption of regular supplies can have a quick and direct impact on the buyer. In addition, goods and merchandise are a fairly valuable collateral, which can be liquidated or seized.	Petersen & Rajan (1997); García-Teruel & Martínez-Solano (2010)
	Vehicle for bank financing	High volumes of trade credit can be a signal of creditworthiness to financial institutions.	Biais & Gollier (1997)
	Type of insurance	It may be cheaper for a seller to insure or sell outstanding accounts receivable, rather than for a buyer to acquire appropriate external financing.	Schwartz (1974); Emery (1984); Petersen & Rajan (1997)

Source: Adopted from García-Teruel & Martínez-Solano (2010, p. 215-218), and author’s own analysis. **Notes:** \*Since the corresponding table provides mainly a synthesis of the original source, individual references within this table are not included in the reference list, and readers are advised to look up these references in the original paper by García-Teruel & Martínez-Solano (2010), and/or contact the authors of this paper directly.



In a recent review of the literature Huang, Shi & Zhang (2011, p. 1860) acknowledge that “*the available empirical evidence on relationship between trade and bank credits supports the above theoretical prediction [substitution] in most cases. However, such evidence comes mainly from [large and] developed economies such as the USA and the UK*”. In emerging market contexts empirical evidence remains not only scarce, but much more inconclusive, too. Thus, i.e. in their study of six emerging Asian and South American markets, Love, Preve & Sarria-Allende (2007) found support for substitution effect in the initial phases of country-level financial crises (in the 1990s). However, their empirical evidence failed to support this effect within the subsequent deepening of the financial crisis, when “*the entire economy enters a credit trap which drains the sources of banking credit*” (Huang, Shi & Zhang, 2011, p. 1860). Supported by Love, Preve & Sarria-Allende’s (2007), our first hypothesis is thus as follows:

*Hypothesis 1: Overall, the counter-cyclical substitution effect between trade and bank credit will be more prevalent (strong) during the initial phases of the current economic crisis, but not in the subsequent deepening and bottoming of the crisis.*

Other empirical evidence, which has unfortunately received less attention in the literature, seems to challenge the counter-cyclical substitution effect, altogether. Thus, i.e. Cook’s (1999) results on a sample of small Russian companies actually establish a *complementary relationship* between trade and bank credit, not a *substitution relationship*; albeit in a setting of “*extreme financial chaos*” in Russia (Huang, Shi & Zhang, 2011, p. 1861). A similar empirical observation was outlined for manufacturing companies in Japan (Ono, 2001), and small companies in the US (Alphonse, Ducret & Severin, 2006). Most recently, Huang, Shi & Zhang’s (2011) study on a small sample of 284 listed Chinese companies proposes a modifying relationship between trade and bank credit, which tends to be more close to *substitution*, but can alter into a more *complementary* relationship under certain conditions. Thus, their results show that “*when production efficiency crosses a low threshold value, trade credit and bank credit tend to be substitutes. Otherwise, they are complementary, but this rarely occurs*” (*ibid.* p. 1877).

## 2.1. The counter-cyclical substitution effect and company size

In general, Mörec & Rašković (2011) outline the following key *firm-specific* characteristics of SMEs, which should be considered when analyzing any type of financing patterns of SMEs as they importantly contribute to the existence of the proverbial SME financing gap,<sup>2</sup> and suboptimal capital structures of SMEs:

- Lack of economies of scale in SMEs’ operations (Tether, 1998);
- Lack of collateral (Fraser, 2004);
- Inseparability of the owner’s and company’s financial position (Berger & Udell, 2006);
- Lack of experience and know-how (Berger & Udell, 2006; Atherton, 2009);
- Limited human resources (Rašković et al., 2011);
- Higher personal involvement and desire for control (Hamelin, 2011);
- Pecking order theory and the entrepreneurs’ unwillingness to accept external financiers and/or investors (Hussain, Millman & Matlay, 2006);
- Lack of information and knowledge about existing financing sources (Fraser, 2004);
- Lower involvement in various social networks (Vos et al., 2007; Atherton, 2009);
- Different business objectives, compared to large profit and growth-driven companies (Vos et al., 2007; and
- Different preferences and demand for finance (Howorth, 2001).

Furthermore, as pointed out by Park, Lim & Koo (2008) there are conflicting views regarding the main reason for the existence of the SME suboptimal capital structures and different patterns of financing, where certain studies emphasize more the supply-of-funds side, and other more the issues on the demand-for-funds side (i.e. Howorth, 2001). However, one thing is for sure: company size does play an issue and SMEs’ capital structures and financing patterns are different compared to those of large companies. With this in mind our second hypothesis is thus:

<sup>2</sup> We think SME financing gap perspective is important for counter-cyclical trade credit substitution, since we believe different company size segments can differently effective tap into trade vs. bank credit substitution.

*Hypothesis 2: Overall, the counter-cyclical substitution effect between trade and bank credit will differ across company size groups in the current crisis, and will be in general less strong among SMEs, compared to large companies.*

The overall logic of Meltzer's (1960) and Schwartz's (1974) theory is based on some kind of "solidarity" between large companies (with better access to external bank financing) and SMEs. It assumes the existence of a certain liquidity "surplus" can be "split between suppliers and customers" (Cuñat, 2007, p. 491). If a crisis is indeed just a liquidity crisis, this may hold. However, if the crisis deepens and becomes more than just a liquidity crisis – i.e. a general longer-term credit crunch - large companies will no longer be able to access appropriate bank financing, as the evidence by Huang, Shi & Zhang (2011, p. 1861) on the bottoming phase of the crisis context suggests. Consequently, large companies will not only be unable to grant (additional) trade credit to their buyers, but will actually use their size and market power to extend their own accounts payable. This will in turn force their SME suppliers to become their source of funding (Mörec & Rašković, 2011). This perspective is supported by Petersen & Rajan's empirical results (1997, p. 669), also. It is also linked to the work of Fisman & Love (2003) and to Mateut, Bougheas & Mizen (2006). The recent analysis of supply chain risk management practices during the current economic crisis and an extensive review of the supply chain management literature by Blome & Schoenherr (2011) seem to be most actively concerned with this perspective.

### 3. DATA AND METHODOLOGY

#### 3.1 Data

The data for our analysis comes from the Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES), to which all companies in Slovenia have to report annual financial statements by law for tax and statistical purposes. Our analysis includes all Slovenian non-financial companies (micro, small, medium-sized and large <sup>3</sup>) with positive equity capital for the period between 2007 and 2010. We also have to stress that, apart from company equity value being above zero, no other criteria was used to exclude potential "outliers" within our studied sample. Namely, quite often large sample heterogeneity is not addressed through robust statistics, but rather by an *a priori* classification and exclusion of outliers (i.e. companies with 01). Thus, an *a priori* classification and exclusion of outliers was also employed i.e. by Črnigoj & Mramor (2009) in the analysis of the determinants of capital structure of Slovenian SMEs, as well as in the García-Teruel & Martínez-Solano (2010) study of the determinants of trade credit.

<sup>3</sup> Following the Slovenian Companies' Act we adopt the following classification of company size: *Micro company*: average number of employees does not exceed 10, revenue does not exceed 2 million (mil) EUR, and value of assets does not exceed 2 mil EUR. *Small company*: employees < 50; revenues < 8.8 mil EUR; assets < 4.4 mil EUR. *Medium-sized company*: employees < 250; revenues < 35 mn EUR; assets < 17.5 mil EUR. *Large company*: all other.



### 3.2 Operationalization of the variables

Table 2 summarizes the operationalized variables in our research, which are directly linked to the motives for trade credit outlined in Table 1, and are used in our model(s).

Table 2: Operationalization and background of the employed variables

Variable	Brief description	Impact	Reference
<i>PAYAB</i>	Share of accounts payable in total liabilities (share of assets financed by trade credit)	<i>Dependent variable</i>	Petersen & Rajan (1997); García-Teruel & Martínez-Solano (2010)
<i>RECEIV</i>	Share of accounts receivable in sales (liquidity reallocated to the customers)	+	Petersen & Rajan (1997); García-Teruel & Martínez-Solano (2010)
<i>lnAGE</i>	Logarithm of firm's age (+1) (reputation and evolution of customer-supplier relationship)	+	Petersen & Rajan (1997); García-Teruel & Martínez-Solano (2010), Ge & Qiu (2007); Cuñat (2007)
<i>CFLOW</i>	Operating cash flow to assets (firm's capacity to generate internal liquidity)	-	Love, Preve & Sarria-Allende (2007); García-Teruel & Martínez-Solano (2010); Huang Shi & Zhang (2011); Ge & Qiu (2007)
<i>STFIND</i>	Share of short-term financial debt in total liabilities (substitution effect)	-	Love, Preve & Sarria-Allende (2007); García-Teruel & Martínez-Solano (2010)
<i>LTDEBT</i>	Share of long-term debt in total liabilities (substitution effect)	-	García-Teruel & Martínez-Solano (2010)
<i>PURCH</i>	Share of material and service costs in total costs of a company (demand for material and services)	+	Earle, Pagano & Lesi (2006)
<i>Industry_D</i>	Dummies for industry specific effect: manufacturing (C), construction (F), trade (G), hotels and restaurants (I), transport (H), information and communication (J), professional, scientific and technical activities (M), and administrative and support service activities (N); other industries represent basic category.	+/-	Petersen & Rajan (1997); Deloof & Jegers (1999); Huang, Shi & Zhang, 2011; Ge & Qiu (2007)
<i>Size_D</i>	Dummies for micro (1), small (2) and medium-sized (3) companies; large companies represent basic category (bargaining power)	+/-	Mateut, Bougheas & Mizen (2006)
<i>Time_D</i>	Dummies for 2008, 2009 and 2010; year 2007 represent basic category (effect of financial and economic crisis)	+	Love, Preve & Sarria-Allende (2007)

Source: Authors' own summary; see specific references for specific variables.

Simultaneous correlation analysis of the employed variables importantly bridges the work of García-Teruel & Martínez-Solano (2010), with the work of Love, Preve & Sarria-Allende (2007). Additionally, we control for industry specific effects on level of trade credit, which the original work by García-Teruel & Martínez-Solano (2010) paid less attention to.

### 3.3 Model specification

As specified, our model was motivated by the recent work of García-Teruel & Martínez-Solano (2010) on the determinants of trade credit, published in the *International Small Business Journal*, and the recent work by Huang, Shi & Zhang (2011) on the counter-cyclical substitution effect between trade and bank credit in an emerging market context (China), published in the *Journal of Banking & Finance*. It also complements the determinants of capital structure of Slovenian SMEs research by Črnigoj & Mramor (2009), published in the *Emerging Markets Finance & Trade*. In terms of the model specification, our model extends the model by García-Teruel & Martínez-Solano (2010), and closely follows the *fixed-effects panel data model* by Love, Preve & Sarria-Allende (2007), in order to separate the *ex ante* and *ex post* crisis effects.

First, we test the aggregate behavior of Slovenian firms in the period between 2007 and 2010 with following basic regression model (detailed variable description is given in Table 2):

$$PAYAB_{it} = b_0 + b_1 RECEIV_{it} + b_2 lnAGE_{it} + b_3 CFLOW_{it} + b_4 STFIND_{it} + b_5 LTDEBT_{it} + b_6 PURCH_{it} + b_7 Industry\_D_{it} + e_i$$

Unlike Love, Preve & Sarria-Allende (2007) and García-Teruel & Martínez-Solano (2010), our sample contains all solvent companies (including the lowest and highest 1 percentile of companies with high parameter variability, which are usually treated as outliers). This significantly increases the heterogeneity of the studied sample, which prompted us to first apply a *robust regression cross-section*

analysis over time using a *iteratively reweighted least squares procedure*<sup>4</sup> (in Stata: *RReg procedure*), since traditional OLS regression is not suitable for high variability samples due to violation of its normality assumption (Alma, 2011). We first employ a robust cross-section regression model to get a general understanding of the impact of selected variables on trade credit, as well as to test the impact of company *size* and *time (years)* separately. Therefore, the basic regression model is extended by size dummy variables to determine the statistical significance of company's size on trade credit for each year respectively.

In the second part of our research we upgrade cross-section analysis with a panel regression analysis, which enables us to test the significance of the interaction of company *size* and *time (years)* simultaneously, in order to check the validity of our second hypothesis. Following Love, Preve & Sarria-Allende (2007) we add time dummy variables to capture changes of trade credit over time. Since the impact of company's size on the level of approved trade credit is the main focus of our study we include size dummies, as well (Mateut, Bougheas & Mizen, 2006). Combined with the time dummy variables, size dummy variables capture the impact of crisis on trade credit across individual size groups. Thus, the basic regression model is extended to:

$$PAYAB_{it} = \beta_0 + \beta_1 X_{it} + \beta_2 Time\_D_{it} + \beta_3 Size\_D_{it} + \beta_4 Time\_D_{it} * Size\_D_{it} + e_i$$

In the model  $X$  corresponds to a vector of control variables (*RECEIV*, *lnAGE*, *CFLOW*, *STFIND*, *LTDEBT*, *PURCH* and *Industry D*). With regards to our hypotheses testing, the direction and significance of regression coefficients on the interaction variables (year and size) are most relevant, since they simultaneously capture the crisis and size effects on trade credit level. We employ a fixed effects model, since the Hausman specification test rejected the hypothesis related to the non-systematic differences between coefficients of the fixed effects and random effects model (Hausman, 1978).

## 4. THE RESULTS

### 4.1 Descriptive statistics

Table 3 shows almost all companies (99%) in Slovenia are SMEs. In the period 2007-2010 the total number of companies increased by 14.2%, but only due to rapid establishment of new micro companies. On the other hand, and in the light of the current financial and economic crisis, the number of medium-sized and large companies decreased partly due to shrinking business volume (e.g. companies moved to lower size classes) or even bankruptcy.

Table 3: Basic Slovenian company data in the period 2007-2010

Size	Number of companies		Number of employees		Total assets (in million EUR)		Turnover (in million EUR)	
	2007	2010	2007	2010	2007	2010	2007	2010
<i>Micro</i>	45,232	51,805	135,059	129,706	20,265	20,199	13,417	12,427
<i>Small</i>	1,973	2,434	64,595	72,272	9,912	12,713	8,300	9,359
<i>Medium</i>	797	774	81,211	75,511	10,202	9,907	11,158	10,991
<i>Large</i>	779	721	218,599	185,154	55,231	57,464	40,041	38,574
<i>Total</i>	<b>48,781</b>	<b>55,734</b>	<b>499,464</b>	<b>462,643</b>	<b>95,609</b>	<b>100,283</b>	<b>72,916</b>	<b>71,350</b>

Source: AJPES and authors' own analysis.

As can be seen from Table 3 the number of employees in companies of all sizes decreased significantly with the deepening of economic and financial crisis. Despite a substantial increase in the number of micro and small companies, newly established, mostly micro companies were not able to replace the loss of jobs in medium-sized and large companies.

Table 4 shows the share of companies with bank debt, and the share of total liabilities to banks in total liabilities between 2007 and 2010. It should be noted, that the number of companies (not percentage!) with bank debt rose in the period from 2007 to 2010, primarily due to an increasing number of micro

<sup>4</sup> In order to achieve efficient estimation this procedure removes units with Cook's distance higher than 1 from estimation (see Hamilton, 1991), and uses Huber weights and biweights to reduce or even eliminate the impact of extreme observations on the regression estimation, thus solving the issue of sample heterogeneity.

companies with bank debt. However, this might be due to an increasing number of bank overdrafts and not systematic bank lending.

Lastly and most importantly, related to the counter-cyclical substitution effect between trade credit and bank debt, Table 5 shows micro and small companies increased their net working capital financing, while on the other hand medium-sized and large companies were able to decrease their net working capital.

Table 4: Overview of the share of companies with bank financing and liabilities to banks for 2007 and 2010

	2007		2008		2009		2010	
	%*	STBL**	%*	STBL**	%*	STBL**	%*	STBL**
<b>Micro</b>	29.1%	18.6%	28.1%	19.8%	29.1%	19.4%	28.7%	19.3%
<b>Small</b>	72.7%	21.2%	73.4%	22.3%	72.5%	23.1%	72.0%	24.0%
<b>Medium</b>	72.3%	21.9%	73.5%	23.2%	72.8%	24.9%	71.7%	25.6%
<b>Large</b>	76.1%	24.4%	78.2%	28.0%	75.7%	29.5%	74.6%	29.1%

Source: AJPES and authors' own analysis. Notes: %\* = percentage of companies that are using bank debt financing out of the whole population of sample companies in a given reference year; \*\*STBL= share of total liabilities to banks, relative to total liabilities.

Table 5 indicates how the burden of net working capital financing in 2008 was inversely proportional to the size of the company, as large and medium-sized companies were able to significantly reduce their inventories from 2007 to 2008. On the other hand, trade credit (accounts payable) decreased in micro and small companies.

Table 5: Shares of selected asset and liability components in total assets between 2007 and 2010 - only companies, which use bank financing (median values)

	INV		NWC		STL		LTL	
	2007	2008	2007	2008	2007	2008	2007	2008
<b>Micro</b>	2.3%	2.0%	10.7%	11.2%	49.6%	49.8%	12.1%	12.5%
<b>Small</b>	11.4%	10.7%	15.5%	15.7%	47.7%	46.9%	15.1%	15.9%
<b>Medium</b>	14.6%	14.4%	16.6%	17.2%	46.3%	46.3%	13.2%	13.4%
<b>Large</b>	8.0%	8.5%	8.4%	8.9%	40.0%	42.7%	10.8%	11.3%
	INV		NWC		STL		LTL	
	2009	2010	2009	2010	2009	2010	2009	2010
<b>Micro</b>	1.9%	1.9%	12.1%	12.1%	50.6%	49.9%	11.7%	11.2%
<b>Small</b>	10.5%	10.0%	16.5%	15.9%	43.8%	43.0%	17.5%	17.5%
<b>Medium</b>	12.5%	12.4%	17.1%	15.1%	43.4%	42.5%	14.4%	14.2%
<b>Large</b>	6.1%	6.5%	7.6%	7.1%	39.0%	38.8%	15.4%	15.8%

Source: AJPES and authors' own analysis. Notes: INV= share of inventories in total assets; NWC = share of net working capital in total assets (net working capital = accounts receivable + inventories - accounts payable); STL= share of short-term liabilities in total liabilities; LTL= share of long-term liabilities in total liabilities.

Finally, it is worth to highlight how medium-sized and large companies decreased their share of short-term liabilities, and sharply increased their share of long-term liabilities from 10.8% in 2007 to 15.4% in 2010.<sup>5</sup>

<sup>5</sup> Also, we have conducted an extensive analysis of the descriptive statistics related to our basic and extended regression model, which confirm high heterogeneity across the whole sample, as well as within individual company size groups. These quite extensive results are available upon request to the authors.

## 4.2. Model testing

The basic results of the cross-section robust regression analysis in Table 6 (Model 1) show the share of accounts receivable over total sales (*RECEIV*) seems to be highly statistically significant across the whole 2007 to 2010 period. However, it has an almost negligible *effect size*<sub>6</sub> on trade credit. On the other hand, the share of material and service costs over total costs (*PURCH*) is not only highly statistically significant, positive, and correlated with trade credit across the whole 2007 to 2010 period, but also has the highest effect size (relatively high coefficient values) on trade credit. Quite logically, trade credit depends on purchase volume, as was expected. Regarding the share of long-term debt over total liabilities (*LTDEBT*) – whose regression coefficient indicates the *substitution effect* between trade and bank credit – it is highly statistically significant across the whole 2007 to 2010 period, and negative as expected. More importantly though, the regressor's coefficient reached its smallest absolute value in 2009 with the bottoming of the crisis (and the biggest credit crunch), and consequently more than halved from 2007 to 2010. The decrease was much more dramatic with regards to the share of short-term debt over total liabilities (*STFIND*) – which measures the aforementioned substitution effect, as well. The corresponding regressor's coefficient is, not only highly statistically significant, but almost halved from 2007 to 2008 alone. It further decreased by more than three-fold between 2007 and 2009, while remaining constant between 2009 and 2010.

The relative decreases of both *LTDEBT* and *STFIND* regression coefficients between 2007 and 2010 shows a significant and consistent pattern of temporal change in the *substitution effect* between trade and bank credit, brought on by the crisis. Overall, the counter-cyclical substitution effect between trade and bank credit was more prevalent (strong) during the initial phases of the economic crisis (in 2007 and 2008), but not in the subsequent deepening and bottoming of the crisis (in 2009 and 2010). Therefore, overall strength of the substitution effect decreased with the length of the crisis situation. By including the effect of company's size on the trade credit level in our cross-section regression analysis (Model 2 in Table 6) we can see that micro, small and medium-sized companies are relatively more dependent on trade credit financing compared to large companies (our baseline category). Over time the coefficient on size dummy variable decreased for all company sizes, indicating large companies are no longer able to grant trade credit to their smaller suppliers.

Table 6: The results of the cross-section robust regression analysis

VARIABLES	Model 1 (robust regression)				Model 2 (robust regression)			
	2007	2008	2009	2010	2007	2008	2009	2010
Constant	-0.029*** [0.004]	-0.032*** [0.004]	-0.020*** [0.003]	-0.015*** [0.003]	-0.056*** [0.008]	-0.059*** [0.007]	-0.047*** [0.007]	-0.036*** [0.006]
RECEIV	-0.000** [0.000]	-0.000** [0.000]	-0.000** [0.000]	0.000*** [0.000]	-0.000** [0.000]	-0.000** [0.000]	-0.000** [0.000]	0.000*** [0.000]
CFLOW	-0.017*** [0.002]	-0.008*** [0.002]	-0.000 [0.000]	-0.002** [0.001]	-0.018*** [0.002]	-0.008*** [0.002]	-0.000 [0.000]	-0.002** [0.001]
lnAGE	0.002* [0.001]	0.007*** [0.001]	0.004*** [0.001]	0.004*** [0.001]	0.001 [0.001]	0.006*** [0.001]	0.003*** [0.001]	0.003*** [0.001]
PURCH	0.227*** [0.004]	0.192*** [0.003]	0.165*** [0.003]	0.154*** [0.003]	0.225*** [0.004]	0.190*** [0.003]	0.163*** [0.003]	0.151*** [0.003]
LTDEBT	-0.085*** [0.005]	-0.053*** [0.004]	-0.039*** [0.004]	-0.040*** [0.004]	-0.087*** [0.005]	-0.056*** [0.004]	-0.041*** [0.004]	-0.042*** [0.004]
STFIND	-0.072*** [0.005]	-0.048*** [0.004]	-0.022*** [0.004]	-0.022*** [0.004]	-0.072*** [0.005]	-0.048*** [0.004]	-0.021*** [0.004]	-0.022*** [0.004]
D_size_1					0.029*** [0.006]	0.028*** [0.006]	0.028*** [0.006]	0.022*** [0.006]
D_size_2					0.071*** [0.007]	0.070*** [0.007]	0.062*** [0.006]	0.056*** [0.006]
D_size_3					0.043*** [0.009]	0.038*** [0.008]	0.034*** [0.008]	0.043*** [0.007]
Industry dummies	yes	yes	yes	yes	yes	yes	yes	yes
R-squared	0.157	0.134	0.121	0.118	0.160	0.138	0.124	0.121
Adj R-Squared	0.157	0.133	0.120	0.118	0.160	0.137	0.123	0.120
N (observations)	35,710	39,104	39,585	40,569	35,710	39,104	39,585	40,569

Source: AJPES and own analysis. Notes: Standard errors in brackets; \*\*\* p<0.01, \*\* p<0.05, \* p<0.1. Variables descriptions are available in Table 2.

6 Cohen (1988, p. 9-10) describes effect size as “the degree to which the phenomenon is present in the population”. According to Breaugh (2003, p. 82) effect size measure are related to either “standardized measures of mean differences or measures of variance accounted for” between various compared groups or samples.

In order to test the statistical significance of differences across *time* and *company sizes*, we employed a fixed effects panel regression analysis (Table 7).

Table 7: Results from the fixed effects panel regression analysis

VARIABLES	Model 1	Model 2
Constant	0.083***	0.091***
	[0.007]	[0.009]
RECEIV	0.000	0.000
	[0.000]	[0.000]
CFLOW_2	-0.000***	-0.000**
	[0.000]	[0.000]
lnAGE	0.026***	0.025***
	[0.001]	[0.001]
PURCH	0.129***	0.129***
	[0.002]	[0.002]
LTDEBT	-0.255***	-0.255***
	[0.003]	[0.003]
STFIND	-0.223***	-0.224***
	[0.003]	[0.003]
D_year_2008	-0.010**	-0.010**
	[0.005]	[0.005]
D_year_2009	-0.022***	-0.021***
	[0.005]	[0.005]
D_year_2010	-0.021***	-0.021***
	[0.005]	[0.005]
D_size_1	0.032***	0.030***
	[0.007]	[0.007]
D_size_2	0.024***	0.022***
	[0.007]	[0.007]
D_size_3	0.021***	0.020***
	[0.007]	[0.007]
D_s_1_y_2008	-0.006	-0.006
	[0.005]	[0.005]
D_s_1_y_2009	-0.003	-0.003
	[0.005]	[0.005]
D_s_1_y_2010	-0.011**	-0.011**
	[0.005]	[0.005]
D_s_2_y_2008	-0.009	-0.008
	[0.006]	[0.006]
D_s_2_y_2009	-0.014**	-0.014**
	[0.006]	[0.006]
D_s_2_y_2010	-0.019***	-0.018***
	[0.006]	[0.006]
D_s_3_y_2008	-0.010	-0.010
	[0.007]	[0.007]
D_s_3_y_2009	-0.012	-0.011
	[0.007]	[0.007]
D_s_3_y_2010	-0.014*	-0.013*
	[0.007]	[0.007]
Industry dummies	no	yes
R-squared	0.810	0.809



Number of ms	53,481	51,426
Adj R-Squared	0.736	0.736
N (observations)	190,727	187,066

Source: AJPES and own analysis.

*Notes:* Standard errors in brackets; Baseline population are large companies in 2007

\*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$ . Variables descriptions are available in Table 2.

The results in Table 7 are quite robust, with or without the industry dummies. Overall, the results of the basic part of the regression model show companies with bank financing (either long-term or short-term) are less dependent on trade credit (negative and highly statistically significant regression coefficients for *LTDEBT* and *STFIND*). Over time (from 2007 to 2010) the statistical significance of the year dummies did not only increased (from  $p < 0.05$  to  $p < 0.01$ ), but the negative value of the regression coefficients doubled between 2008 and 2009, as well.

Overall, all companies (including large ones) had less trade credit in 2008, and considerably less in 2009 and 2010. However, although micro, small and medium-sized companies have relatively more trade credit compared to large companies (see highly significant and positive coefficients on size dummies), over time they suffered a stronger drop in trade credit (see statistically significant and negative coefficients on time and size interaction variables in 2009 for small companies and 2010 for all SMEs).

## 5. COMMENTARY AND IMPLICATIONS OF THE RESULTS

### 5.1. Results of hypotheses testing

With regards to the testing of our two hypotheses, we find support for the confirmation of *hypothesis 1*. This hypothesis relates to greater intensity of the counter-cyclical substitution effect between trade and bank credit in the initial phase of the current global economic crisis, compared to the subsequent deepening and bottoming of the crisis. As the results of our cross-section regression analysis shown (Table 6), both the shares of short-term debt (*STFIND*) and long-term debt (*LTDEBT*) over total liabilities have a highly statistically significant and negative impact on the share of accounts payable over total liabilities (*PAYAB*). This generally supports the substitution effect between trade and bank credit. More importantly however, the changes in size of the corresponding regressor's coefficients indicate at important changes between the initial and subsequent phases of the current global economic crisis. Generally speaking, there seems to be a considerable two- or three-fold decrease in the sizes of the regressors' coefficients between 2008 and 2009, corresponding with the bottoming of the crisis in 2009. While one could justly argue that there can be many underlying causes for the decrease of the aforementioned regressors' coefficients, a more detailed examination of the descriptive statistics (i.e. Table 4) provides support for this conclusion. Linking this to evidence by Love, Preve & Sarria-Allende (2007) the initial phase (year 2008) of the current global economic crisis seems to correspond to a typical liquidity crisis, where substitution was still possible. However, the steep decrease of this substitution effect in 2009, and its low level in 2010, supports evidence by Huang, Shi & Zhang (2011). Thus, when the crisis becomes more than just a liquidity crisis, it can result in a general "credit trap" which "drains the sources of bank credit" altogether (*ibid.* p. 1860).

The panel regression model in Table 7 provides an indirect testing of *hypothesis 2*, which relates to a varying strength of the counter-cyclical substitution effect between trade and bank credit across different company size groups. While the model tests the interaction between temporal change (years) and company size, it does not additionally address the issue of the level of bank credit across various company size groups as the same time (shown in Table 4). However, by building on the fact that the counter-cyclical substitution effect decreases with the deepening of the crisis (results of hypothesis 1), and by looking at the descriptive statistics related to *inventories* and *net working capital* in Table 5, we can indirectly provide support also for this hypothesis. Thus, while SMEs had a bigger share of trade credit before the crisis compared to large companies, they also suffered a much stronger drop and substitution decrease. On the other hand, large companies received certain soft-budget constraints in Slovenia, to an extent managed to restructure their bank credit, and apply additional pressure on their SME suppliers. This finding ironically supports Meltzer (1960) and Schwartz (1974), as well as Cuñat (2007), and Petersen & Rajan (1997). While Meltzer's and Schwartz's theory was implicitly built on the premise of large companies extending "solidarity" and passing off a certain kind of



financial *surplus* in the market (corresponding to a liquidity crisis), Cuñat (2007) shows how a lack of this surplus (corresponding to a more devastating credit crunch) terminates this solidarity. Moreover, as our evidence seems to suggest, large companies go even further, and actually apply additional pressure in their SME suppliers, using them as financing buffers themselves, and actually aggravating the situation in the market.

## 5.2. Discussion of the macroeconomic implications

In the most recent global competitiveness ranking by World Economic Forum (2011-2012) Slovenia's 12 place drop from 45<sup>th</sup> place to 57<sup>th</sup> place out of 142 compared countries is in many ways underpinned by the poor development of its financial market, where Slovenia ranks 102<sup>nd</sup> out of 142. In addition to this, the issue of *access to financing* remains as the most problematic factor for conducting business, as shown by WEF. This and similar information provided by the World Bank and its *Doing business in* survey shows how a microeconomic problem of a company's access to finance and issues of its capital structure can have also important macroeconomic implications; as emphasized by Biais & Gollier (1997).

Our analysis suggests that the counter-cyclical nature of trade credit vs. bank credit substitution is not as straightforward as thought of by Meltzer or Schwartz, and has different dimensions which come into play at various phases of the economic cycle. In terms of the macroeconomic implications of this issue it is very important to distinguish both between the different types of the economic crises, as well as their phases within the downturn cycle. Thus, the existing evidence by Love, Preve & Sarria-Allende (2007) on the substitution effect between trade and bank credit corresponds to a national-level, shorter-term (single-phase), liquidity crisis. We find support for their findings in the initial phase of the current global economic crisis, where liquidity was still an issue. As this crisis progressed however, substitution became less relevant, and market power in the form of company size became a bigger issue, raising a series of important macroeconomic policy issues. We see that in a full-blown and longer-term crisis bank-dominated financial systems prove to be relatively ill equipped to help the business sector, particularly SMEs. While not granting additional financing to large companies hurts all in the market, granting this financing usually only helps large companies. These in turn become "double victims" since on top of their existing access-to-finance problems; they are plagued additionally by large companies. This is in a way surprising, since the level of interest rates was fairly low within this crisis, and banks had the potential to inject much more liquidity into the market.

Our results also raise an important question of where do SMEs get their liquidity in a crisis like we are experiencing now? The answer seems to lie in a huge need to underinvest, which is especially troubling, since SMEs were the only segment to actually grow in number and importance within this crisis in Slovenia. We are thus talking about a unique paradox. On the one hand, large companies lay off volumes of their employees, which are to a certain extent absorbed by the SME sector. On the other hand, this sector becomes a "double victim" of the crisis and is additionally plagued by large companies. Can favorable financing terms extended to large companies be somehow tied to large companies being encouraged to translate this additional liquidity to more favorable trade credit to SMEs, as well? Or at least, can large companies be somehow prevented from aggravating the situation and extending much less favorable trade credit to SMEs?

Lastly, we need to distinguish between different types of SMEs. There is an urgent need to identify good and promising SMEs, which can even increase their business in a crisis, but must avoid being plagued by large companies or financing constraints. As the difference in results from traditional OLS and robust regression analysis has shown, there can be small sub-segments of SMEs which can drive the results for the whole SME population. This points to a need to avoid burdening the whole SME segment with high risk premiums, and better understand the various shades of gray within the SME population.

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**BUSINESS ANGELS: ISSUES, EVIDENCE, AND IMPLICATIONS FOR TRANSITION ECONOMIES****Christine Mitter**

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E-mail: [christine.mitter@fh-salzburg.ac.at](mailto:christine.mitter@fh-salzburg.ac.at)**Abstract**

Entrepreneurial ventures are considered of crucial importance for economic growth and development worldwide. However, these companies often lack sufficient availability and access to funding sources. This problem is extremely acute when banks are reluctant to lend money to these companies, and/or the formal venture capital market is not highly developed. Funding provided by business angels (BAs) could be a potential solution to this problem as they do not only provide capital but also value added contributions by means of their personal skills and networks.

By summarizing and structuring current research dealing with the characteristics of BAs, their relationship towards investees and the way they impact the companies they are funding as well as the influence of institutional settings, the paper presents a state-of-the-art picture of angel finance. The analysis reveals that the relationship between BAs and investees is less driven by formal contracts and monitoring but more by relational governance, resulting in mutual trust and an emphasis on mentoring. BAs' investment style is characterized by geographical proximity and – normally – active involvement. Thus, they support the entrepreneurial venture with industry expertise, entrepreneurial knowledge and management skills (know-how) as well as with their personal networks (know-who). The relationship between the entrepreneur and the BA as well as the impact of BA financing on the investee company are contingent on numerous factors including the characteristics of the BA, the entrepreneur, and the venture as well as institutional conditions.

Although BAs play an important role in closing funding gaps at early stages, can address regional gaps in the availability of finance and seem to be extremely well suited to deal with less developed institutional regimes, BAs' activity developed slowly or is still missing in transition economies. Consequently, insights into the role and function of BAs are not merely limited to general aspects, but also place a particular focus on the context of transition economies. Drawing on lessons from developed countries, the creation and advancement of business angel networks (BANs) as well as tax incentive schemes appear promising measures to stimulate BA investing. In the long run, however, other aspects of the institutional environment such as corporate governance, investor regulation, and capital market development, in particular the advancement of the stock market should be addressed as well in order to fully exploit this potential crucial funding source.

**Keywords:** Business Angel, Informal Venture Capital, Transition Economy, Entrepreneurial Finance

**1. INTRODUCTION**

Entrepreneurial ventures are considered of crucial importance for economic growth and development worldwide (Minniti, 2008). However, especially in Europe they often lack sufficient availability of and access to funding sources to set up, maintain, develop and grow their businesses (Lilischkis, 2011). This problem is extremely acute when banks are reluctant to lend money to these companies, and/or the formal venture capital (VC) market is not highly developed. Funding provided by business angels (BAs) could be a potential solution to this problem (Danson et al., 2007). Since they do not only provide capital at very early stages of company life but also offer their investees business skills (know-how) and personal networks (know-who), they play a significant role in the development and growth of entrepreneurial firms (Politis, 2008; Lahti, 2011a, 2011b).

While most research on entrepreneurial finance focused on venture capital, business angels are less widely recognized and researched (Ibrahim, 2008; Bruton et al., 2010), although they are at least equally (Wong et al., 2009) or even more important in the financing of entrepreneurial ventures (Riding, 2008; Collewaert et al., 2010). This paper therefore aims at tackling this research gap by addressing the following questions:

- What are the characteristics of BAs?
- What does the relationship between BAs and investees look like?
- How do BAs impact the companies they are funding?
- Do institutional settings affect angel finance and in what way?



By summarizing and structuring extant research concerning these questions and by linking them to theoretical perspectives, the paper provides a state-of-the-art picture on angel finance. However, insights into the role and function of business angels in the financing of start-ups should not be merely limited to general aspects, but should also place a particular focus on the context of transition economies. Evidence suggests that BAs' activity developed slowly or is still missing in many transition economies (see part 5), indicating that this potential crucial funding source has not been fully deployed yet or used at all. Consequently, current research and findings are analyzed in order to determine what lessons can be drawn for transition economies in terms of implications and public policy issues.

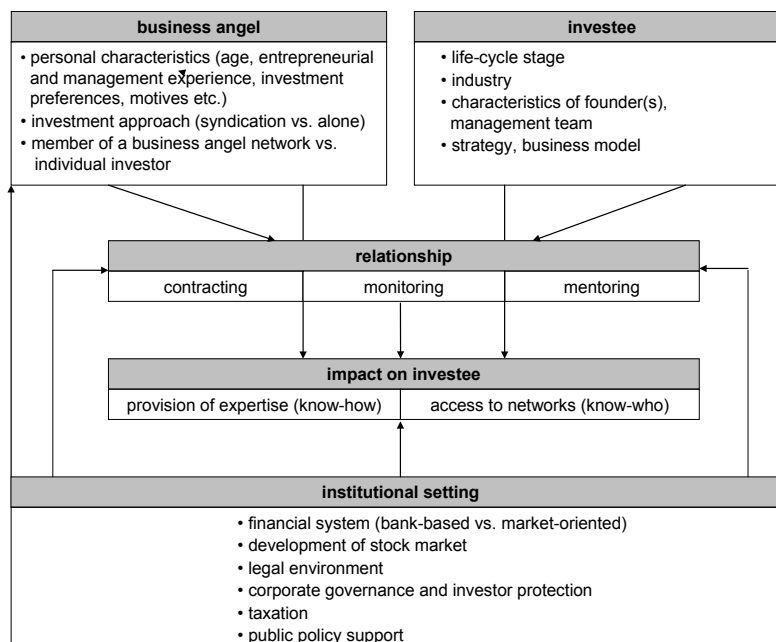
The reminder of the paper is structured as follows: The next part delineates the term “business angel” and develops a conceptual framework that serves in the following parts for structuring extant literature concerning the above mentioned research questions. Based on these empirical findings, implications for angel financing in transition economics are deducted. The paper concludes with a summary.

## 2. THEORETICAL BASIS AND CONCEPTUAL FRAMEWORK

BA research is characterized by a lack of a uniform definition (Avdeitchikova et al., 2008). Nonetheless, the key features that delineate BAs from other types of investors remain robust (Mason and Harrison, 2008). These include the description of BAs or angel investors as wealthy individuals who offer risk capital to unlisted firms in which they have no family connection. Contrary to institutional venture capitalists (VCs) who raise the capital to be invested from others, business angels invest their own money and at their own account. While some authors (e.g. Ramadani, 2009; Wong et al., 2009) use the terms “informal venture capital” and “BA” interchangeably, others (e.g. Szerb et al., 2007; Riding, 2008) segment the informal market into BAs (narrow definition of the informal VC) and love money investors (family and friends).

Although less researched than VC, there are a number of empirical studies on BAs from a wide range of countries in particular the USA and the UK (Politis, 2008; Lahti, 2011b). Empirical evidence, however, is scattered across various contexts with different levels of detail (Kelley, 2007; Politis, 2008). Therefore, a conceptual model (see figure 1) was developed that served as an organizing framework for the analysis and structuring of research on BAs. The paper's aim is to provide a systematic overview and state-of-the-art picture of BA research concerning the areas of inquiry contained in the conceptual framework; neither are these areas meant to be an exhaustive set of issues studied to date, nor is this paper meant to be an exhaustive survey of the literature on the issues listed in the framework.

Figure 1: Conceptual framework





### 3. BUSINESS ANGEL AND INVESTEE CHARACTERISTICS

According to the contingency approach (Donaldson, 2001) the design and outcome of the relationship between BAs and portfolio companies may be dependent on conditions in the internal and external environment of the BAs and the investees. Examples of internal influencing factors concerning BA characteristics are personal traits such as age, industry and entrepreneurial experience, investment motive and affiliation with a business angel network (BAN) or other institutions. Concerning the investee, a firm's life cycle stage, its industry, management/founder characteristics and the company's strategy may have an impact.

Although BAs exhibit great heterogeneity in personal characteristics (Wong et al., 2009), previous empirical studies have revealed a fairly robust description of the "typical" BA, who is a middle aged male often with a college or university degree that invests a relatively large amount of his personal wealth in entrepreneurial firms (see Morrisette, 2007; Politis, 2008; Ramadani, 2009 for reviews). Most BAs have an enterprise background stemming from previous entrepreneurial or management experience (see Morrisette, 2007 and Politis, 2008 for reviews; Lahti, 2011b). Another generality among BAs is their involvement with the investee (Mason and Harrison, 2008) as most of them do not only provide the entrepreneurial firms with equity but also with non-financial support (Wong et al., 2009; Mitter and Kraus, 2011). In order to find potential investment candidates, BAs rely on a network of business associates and friends (Kelley, 2007).

The bulk of angel investments are made informally and in secrecy, making it extremely difficult to measure the size of the market and/or the number of BAs (Mason, 2009). Since the mid- to late-1990s, however, there are tendencies to formalization by creating BANs (Berger and Udell, 1998; Ibrahim, 2008). Among the reasons for forming a BAN are a steadier stream of deal flow, increased opportunities for interactions with other BAs and VCs and the advantages from the pooling of resources such as the chance to fund larger deals (Ibrahim, 2008).

Contrary to VCs, monetary motives do not seem to be the only investment criterion for BAs. Although many, if not most, invest primarily for profit (Prowse, 1998; Lahti, 2011a), they appear to have significant non-economic motives as well deriving from the desire to actively participate in the entrepreneurial process (hedonistic motive) and/or the felt obligation to give something back to society (moral or altruistic motives) (Sullivan and Miller, 1996).

Concerning investees, BAs primarily focus on start-ups and early stage firms (Prowse, 1998). A study in the USA indicates that a majority of angel-backed firms have not earned revenues when they receive funding from BAs (Wong, 2002). Consequently, angel-backed ventures receive financing earlier in the lifecycle than VC-financed companies. Such early stages involve high informational risks (see below) for potential investors, so that "angels are more willing to finance firms with greater uncertainty about the prospects of success than venture capitalists" (Wong et al. 2009, p. 224) and are often the only financing source available at this stage (Denis, 2004; Ibrahim, 2008). For an optimal benefit of their enterprise background, BAs particularly invest in entrepreneurial ventures in their region (Prowse, 1998; Wong, 2002; Morrisette, 2007; Ramadani, 2009; Lahti, 2011b) and in industries they are familiar with (Wong et al., 2009). Most BAs focus on high-tech industries for investment (Månsson and Landström, 2006) and provide investees – compared to VCs – with relatively smaller amounts of funding (Wong et al., 2009). In order to mitigate risks, angels typically form syndicates and co-invest with others rather than alone (Kelley, 2007; Wong et al., 2009; Lahti, 2011b). Evidence from the US shows that companies that receive funding from BAs typically seek lower amounts of capital coupled with higher revenue and profit projections (Manolova et al., 2009).

### 4. RELATIONSHIP BETWEEN ANGEL INVESTOR AND ENTREPRENEURIAL FIRM

The essential criterion of young ventures is their opacity (Beck et al., 2006; Hyytinen and Pajarinen, 2008) concerning their relationship to suppliers, customers, employees and other stakeholders, the quality of their products as well as the founders' management skills and personal characteristics (Berger and Udell, 1998). Because the company has not yet been founded or has only existed for a very short time, there is no track record investors can rely on. This results in an entrepreneur-investor relationship which is characterized by large information asymmetries (Denis, 2004; Mitter and Kraus, 2011).

Agency theory (Jensen and Meckling, 1976) describes interactions, in which the better informed agent performs actions which are delegated by the principal. Agency problems or agency costs arise when agents make use of their superior knowledge in an opportunistic manner in order to maximize their own utility, which, due to divergent interests of the principal and the agent, simultaneously

limits the utility of the principal. In the case of entrepreneurial finance, the information asymmetry can prevent a financing relationship a priori (adverse selection problem) or lead to the phenomenon of moral hazard, that creates an incentive for entrepreneurs to misallocate the funds received from outside investors, e.g. BAs, by using them in a way that benefits themselves but not necessarily the BAs (Denis, 2004; Lahti, 2011a).

All corporate governance instruments in essence serve the purpose of decreasing the above mentioned agency costs by reducing the asymmetrical information or by aligning the interests of the principal and agent via an appropriate incentive structure. In the case of entrepreneurial finance, this can be done by designing the financing contract in a way that the interests of the entrepreneur and financier are harmonized and/or intensive monitoring rights are granted to the investor (Mitter and Kraus, 2011).

Instead of contracts (as proposed by agency theory), theories of relational governance and social capital stress the importance of social embeddedness and norm-driven definitions of proper behavior to regulate relationships between economic actors (Shepherd and Zacharakis, 2001; Shane and Cable, 2002; Sørheim, 2003). Therefore, mechanisms such as network ties, trust and a shared vision become a necessary and efficient complement to formal contracts (Politis, 2008).

Empirical evidence shows that compared to VCs (e.g. Kaplan and Strömberg, 2003) BAs rely to a much lower extent on contractual features such as board rights, staging, preferred stock or certain contractual clauses in order to deal with agency problems (Prowse, 1998; Wong, 2002). There are several reasons for this. First, designing and executing a complex contract is quite cost-intensive. Since BAs only invest small sums, the transaction costs outweigh the benefits (Ibrahim, 2008; Wong et al., 2009). Second, due to the small amount of funding, BAs typically own less than a quarter of the entrepreneurial firm while the founders' still hold a large residual claim. Consequently, the interests of the founders and BAs are aligned and the threat of expropriation is minimized (Wong et al., 2009). Even if this were not the case, protective clauses and control mechanisms would be of little benefit. At the early stages, much of the venture's value is embodied in the human capital of the founders, meaning that a replacement would not increase the value of the firm (Wong et al., 2009). As a result of these arguments, BAs use much more simple contracts and make less use of post-investment monitoring than VCs. Moreover, in the case of BAs gaining control through active involvement (see next part) seems to be a more effective form of monitoring than through contracts (Lahti, 2011a).

Theories of relational governance and social capital provide further explanations. By focusing on local and relationship-driven investments, BAs gain access to private information and can overcome the problems of information asymmetry (Shane and Cable, 2002). BAs rely on social capital in numerous ways. First, they generate deal flow from trusted referrals from their personal network (Ibrahim, 2008). Secondly, personal characteristics of the entrepreneur and/or management team, in particular their integrity and trustworthiness are among the most important investment decision-making criteria (e.g. Sudek, 2006; Manolova et al., 2009; Maxwell et al., 2011 for a review). Demanding comprehensive, protective terms would signal a lack of trust in entrepreneurs that does not fit with BAs' altruistic investment motives (Ibrahim, 2008). Moreover, due to their enterprise background BAs perceive themselves as entrepreneurs rather than as financiers, facilitating the establishment of a relationship characterized by a shared vision and mutual understanding (Politis, 2008). Investing in close geographic proximity might additionally create a localized bond of trust between the BA and the entrepreneur (Wong et al., 2009). In sum, these arguments manifest BAs' mentoring role which is about being a helpful, open and trustful partner (Politis, 2008).

BANs resemble VCs in a number of ways. They are characterized by a more arms-length relationship with their investees, higher investment amounts and non-financial motives that are less focused on the development of the individual venture. All these factors lead to a higher use of formal contracts including higher levels of monitoring (Ibrahim, 2008). A longitudinal study from Finland (Lahti, 2011b) indicates that BAs put more emphasis on formal control than previously. This might not only result from BANs but also syndication as best practices concerning contracting are likely to be shared in BA syndicates (Lahti, 2011b). In general, the extent to which BAs use several contract features and perform their monitoring and/or mentoring role is contingent on their individual characteristics, their investment style as well as the characteristics of the investee company (see e.g. the clusters identified in Lahti, 2011a).

## 5. IMPACT ON THE COMPANY FUNDED BY ANGEL FINANCE

Along with risk capital, BAs are assumed to provide the companies they fund with a number of different value added activities that nurture their development. Apart from the influence of these activities on the relationship between BAs and entrepreneurs through mentoring and monitoring as described above, they can also impact the company directly. In this regard, BAs' activities can be broadly categorized in two distinct roles (Politis, 2008): On the one hand, they directly participate in the management of the firm providing it with entrepreneurial knowledge, industry expertise and business skills (know-how). On the other hand, they support young companies with their network and personal relationships (know-who).

The first role can be linked to the resource-based view that assumes that a firm's comparative advantage is dependent on its access to resources (Barney, 1991). Given the lack of internal resources that characterizes entrepreneurial ventures, BAs and their specific knowledge can substantially broaden a firm's resource pool and might be of crucial importance in order to form a long-term competitive advantage. Ideally, entrepreneurial firms should search for BAs who provide the expertise they are lacking the most.

A firm's survival and long-term success, however, does not only depend on internal resources. Instead, it also hinges on a company's ability to link with its external environment as suggested by the resource dependency perspective (Pfeffer and Salancik, 1978). Consequently, BAs seem heavily involved in the provision of contacts through their personal networks (see Politis, 2008 for a review) in order to help entrepreneurial ventures initiate and form stable business relationships. In this respect, BAs act as certifying agents bringing legitimacy to start-ups and entrepreneurs that have no prior track record (Steier and Greenwood, 2000) by signalling the entrepreneurial venture's quality through their own reputation and standing. This accreditation role is extremely important in order to enhance further financing (Harrison and Mason, 2000; Madill et al., 2005; Sørheim, 2005).

Both roles, the provision of expertise and the access to networks are extremely value adding when BAs reside in geographical proximity (Prowse, 1998). On the one hand, empirical evidence from the USA suggests that local investors provide more help to new ventures as they are more involved (Wong, 2002). On the other hand, they can better rely on their network if they are from the same region. The same is true for industry backgrounds. BAs can better provide critical knowledge and contacts if the investee company is from an industry where they have gained specific expertise.

While empirical studies disagree on the extent to which BAs are active investors (Mitter and Kraus, 2011) and indicate that the degree of involvement varies by BA (Wong et al., 2009) and the development needs of the investee (Lahti, 2011a), a Canadian study (Madill et al., 2005) demonstrates that BAs' non financial contributions are valued either helpful or extremely helpful by the investees. However, recent evidence from longitudinal studies in Sweden (Månsson and Landström, 2006) and Finland (Lahti, 2011b) show a decrease in the BAs' active involvement. This decline might be the result of changes in the BAs' characteristics including lower levels of entrepreneurial experience (Lahti, 2011b) or syndication which allows BAs to be passive and benefit from an actively involved lead investor (Avdeitchikova et al., 2008; Lahti, 2011a).

## 6. INFLUENCE OF INSTITUTIONAL CONTEXT

Variations in BA activity that have been found in empirical studies conducted at different times (Månsson and Landström, 2006; Lahti, 2011b) and in different countries (Chahine et al., 2007) imply that the external environment influences angel financing, as suggested by contingency theory. By affecting the information, legal, judicial, bankruptcy, social, tax, and regulatory environments in which BAs operate, the prevalent institutional regime impacts the informal VC market and the BAs' roles in numerous ways. Consequently, institutional factors such as the financial system, the legal environment or public policy support for entrepreneurial ventures may stimulate or hamper angel investments.

The development of a country's stock market seems to be a crucial factor in determining BA activity as it defines whether and to what extent BAs can use IPOs as an exit route (Chahine et al., 2007; Lahti, 2011b). Even if it is argued that BAs due to their altruistic motives might not intend to take an investee firm public, they are usually followed by VCs and/or co-invest with VCs to whom the opportunity of an IPO is extremely important (Black and Gilson, 1998; Jeng and Wells, 2000).

Given the important role that BAs play in early stages when financing gaps are extremely severe, public policies are increasingly focusing on the promotion of angel investments (Mason, 2009). Among the



most common government interventions are tax incentive schemes and the establishment of BAs. Evidence suggests that BAs are extremely sensitive to taxation (Mason and Harrison, 2002; Lahti, 2011b). By increasing the rewards of investments in entrepreneurial firms, tax incentives compensate for the high uncertainty and risks involved and might lead to a higher supply of investors and capital (Mason, 2009; Lahti, 2011b). While empirical results reveal positive effects of tax incentives schemes (Månsson and Landström, 2006; see Mason, 2009 for a review), there are also drawbacks. Especially the counterproductive effect of encouraging “amateur” informal investors, leading to publicly subsidized ill-advised investments (Riding, 2008) must be tackled.

Due to the fragmented and invisible nature of the market, BAs (Prowse, 1998) as well as entrepreneurs (Collewaert et al., 2010) are encountering difficulties in information flow and the search for investment opportunities/investors. Therefore, the creation and further development of BAs as platforms where BAs and entrepreneurs can meet should be a promising stimulating measure (Lerner 1998). While BAs proved to decrease information and financing problems in Sweden (Månsson and Landström, 2006), Belgium (Collewaert et al., 2010) and Finland (Lahti, 2011b), evidence from the UK reports only a fairly limited impact (Mason and Harrison, 2002). In Finland, the increase in transparency and deal-flow also facilitated the syndication of investments (Lahti, 2011b).

Since not all BAs are financially sophisticated and experienced, they should be provided with the necessary skills to assess the risk of investment opportunities and to manage the process (Aernoudt, 2005). Entrepreneurs also lack skills in getting their business investment ready. Through actions classified as “investment readiness” programs and BAs training for BAs and entrepreneurs can be promoted (Heger et al., 2005; Mason, 2009; Collewaert et al., 2010).

## 7. IMPLICATIONS FOR TRANSITION ECONOMIES

Evidence from transition economies suggests that BAs’ activity developed slowly (e.g. in Poland, see Brzozowska, 2008; Danson et al., 2007, or in Croatia, Hungary and Slovenia, see Szerb et al., 2007) or is still missing in many transition economies (e.g. Ramadani, 2009 for the case of Macedonia; Vemić and Stamatović, 2010 for the case of Serbia), indicating that this potential crucial funding source has not been fully deployed yet or used at all. Among the reasons for this underdevelopment or non-existence are imperfections on the supply and demand side (Szerb et al., 2007). Concerning the supply side, individuals have in general accumulated less wealth as well as entrepreneurial experience and business skills than in more developed countries (Kosztopulosz, 2004; Szerb et al., 2007; Vemić and Stamatović, 2010). Entrepreneurial culture is still in its infancy. Consequently, local entrepreneurs lack entrepreneurial knowledge and market economy experience resulting in an insufficient number of high-quality investment opportunities (Szerb et al., 2007; Brzozowska, 2008). Moreover, entrepreneurs are often not aware of (Danson et al., 2007; Ramadani, 2009) and/or willing to use angel finance (Kosztopulosz, 2004). Concerning the institutional environment of transition economies, there have been tremendous improvements in governance, investor protection and the financial sector, however, they are still going through a catching-up period (Szerb et al., 2007; Groh and Liechtenstein, 2009). Evidence from a survey among institutional investors indicates that underdeveloped capital markets are considered as biggest investment obstacles in Central Eastern Europe, followed by bribery and corruption (Groh and Liechtenstein, 2009, see also Ramadani, 2009), making the environment for angel investing less favorable.

Since – apart from the sources quoted above – there is a paucity of research concerning BAs in transition economies, it seems rational to look for lessons in more mature markets and whether these lessons can be transferred to the context of transition economies (Danson, et al., 2007). Evidence suggests that BA characteristics (Kosztopulosz, 2004; Scheela and Isidro, 2009) as well as the drivers of informal investments (Szerb et al, 2007) are similar in transition and developed countries. Consequently, the following implications can be drawn for transition economies from the state-of-the-art picture developed through literature review.

First of all, BAs appear to be extremely well suited to close financing gaps in transition economies given their willingness to invest in early stages with greater uncertainty. Secondly, as they prefer to invest locally, they are able to close the regional gaps in the availability of funding (Mason, 2009). In particular they might solve financing gaps in the less developed rural regions of transition countries (Vemić and Stamatović, 2010). Thirdly, since BAs in general provide a high degree of involvement with their investee, they can compensate for a lack of resources and networks, which might be exacerbated in transition economies given their less developed entrepreneurial culture. Moreover, BAs prefer relational governance over formal contracts and monitoring and invest on the basis of

trust (Bruton et al., 2010). This leads to an emphasis on networking, which seems extremely effective in coping with a lack of formal institutions such as less developed legal and financial institutions, undersized IPO markets and intransparency (Scheela and Isidro, 2009).

These findings highlight the importance of BAs in transition economies. Thus, public policy issues that stimulate BA investments seem extremely expedient. Drawing on the findings from developed countries and the status quo in transition economies, the awareness of the existence and benefits of angel finance should be increased (Ramadani, 2009) and the lack of experience on the supply and demand side tackled. Since the literature review implies that the personal characteristics and skills of BAs as well as entrepreneurs are of crucial importance for a successful financing relationship and for positive effects on the investee companies, training BAs and entrepreneurs seems worthwhile. This would not only ensure that BAs have the experience and background to provide the portfolio companies with highly appreciated value added contributions, but would also help entrepreneurs to get their businesses “investment ready” in order to improve the number of investable opportunities. Evidence from developed countries (see above) indicates that BANs can be a valuable instrument to increase awareness as well as the skills of BAs and entrepreneurs. In this respect, the recent establishment of BANs in Eastern Europe (Mason, 2009) might be seen as an important first step.

Taxation is another important factor in increasing the BA market. However, it is important to stimulate wealthy *and experienced* individuals to become BAs. In order to avoid the negative aspects of tax incentives mentioned above, transition economies should be careful when drawing the qualifications for such incentives. Since investees appreciate BAs’ contributions in monitoring, mentoring, resource provision and networking, the decline in BAs’ involvement in Western countries seems undesirable. Given this trend as well as the fact that BANs and syndication contribute to such a trend, tax incentives should be designed to ensure that they enable a transfer of business knowledge from BAs to entrepreneurial ventures (Riding, 2008; Lahti, 2011a, 2011b).

Although, BAs’ can compensate – at least to a certain extent – for less developed institutional settings, approaches to enhance corporate governance, investor protection and the size and liquidity of the capital market appear warranted – at least in the long-run – given their central role (Groh and Liechtenstein, 2009). Especially the state of the stock market proved to be crucial for VCs and BAs and should therefore be focused on (Ramadani, 2009).

## 8. CONCLUSION

By summarizing and structuring extant research on BAs, a state-of-the-art picture of the characteristics, roles, functions and particularities of BAs in the financing of entrepreneurial firms is provided. The analysis reveals that the relationship between BAs and investees is less driven by formal contracts and monitoring but more by relational governance, resulting in mutual trust and an emphasis on mentoring. BAs’ investment style is characterized by geographical proximity and – normally – an active involvement. Thus, they support the entrepreneurial venture with industry expertise, entrepreneurial knowledge and management skills (know-how) as well as with their personal network (know-who). BAs’ activity and investment approach is contingent on numerous factors such as the characteristics of the BA, entrepreneur, and venture as well as institutional conditions. All of them appear less favorable in transition economies, providing proof for the slow or still missing BA development in these countries.

Since BAs, however, play an important role in closing funding gaps at the early stages and regional level and are better suited than many other financiers to deal with less favorable institutional settings, public policy in transition countries should focus on the enhancement of BA activity. Two promising stimulating approaches are the creation and advancement of BANs as well as tax incentive schemes. In the long run, however, other aspects of the institutional environment such as corporate governance, investor regulation, and capital market development, in particular the advancement of the stock market should be addressed in order to fully deploy this potential crucial funding source.



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## BUSINESS ANGELS IN MACEDONIA

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### Abstract

**Purpose:** This exploratory study aims to examine the effects of existence of business angel network on economy in Macedonia. More specifically, it aims to examine the influence of business angels in starting-up new business and entrepreneurship in our country.

**Design/methodology/approach:** Business angels network is examined in several way-the way of functioning and managing the network, the problems they have and the solutions they provide in the community, as well as which type of business angels they are. The survey was administered in the new developed business angel network in Republic of Macedonia.

**Findings:** The findings show strong positive relationship between influence of the business angel network and the amount of new entrepreneurship business that were developed. The empirical findings show support of the hypotheses.

**Research limitations/implications:** The study was conducted in the newly established business angel network in Republic of Macedonia, so the findings can't be generalized for all networks of this kind. Our recommendation is to replicate the research and compare the analyses with different countries.

**Originality value:** This study makes a significant contribution to the entrepreneurship literature and the practical knowledge of Macedonian entrepreneurs and business angels and also provides further evidence of the impact of business angel network on entrepreneurship.

**Keywords:** Entrepreneurship, Business Angels, Business Angel Network

### 1. INTRODUCTION

In all successful economies, entrepreneurs are viewed as essential factors for economic growth, as driving factors towards the creation of new jobs, and the advantages of small businesses are by now almost universally accepted. Entrepreneurs are small business managers who never rest, who create and introduce quality, demand and seek changes, innovations and idea realizations. They are competent in sensing the market needs and react quickly upon them, ready to take risk. Entrepreneurship, as an immeasurable factor of business development, manifests its prime through the growth of small businesses. The small business is oftentimes described as the backbone of entrepreneurship. It constitutes the ideal environment which enables the exposure of the entrepreneurs' real talents and the realization of envisioned ideas.

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1 Szabo A. (1995). The Rule of SMEs in Transition Economies and how to Promote them. ECE. UN. Geneva

## 2. ENTREPRENEURSHIP AND FINANCING NEW BUSINESSES

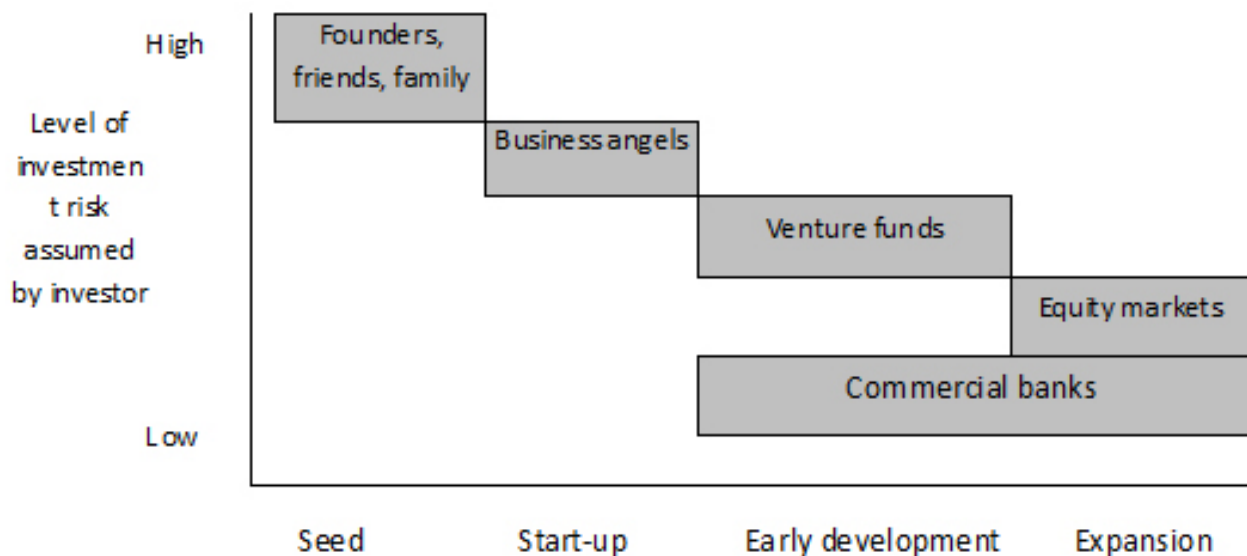
### 2.1. DEVELOPMENT OF NEW ENTREPRENEURSHIP BUSINESS

Development of new entrepreneurship business usually involves two main stages:<sup>2</sup>

- Early stage, with seed, start-up, and early stage development phases,
- Expansion stage.

The first stage is when the new business needs to be developed and proven. Then the products or services are developed and initial marketing takes place, which continues with producing more goods but often unprofitably. The second stage of expansion is when the business matures and goes public. Successful businesses have enough finances, no matter if it is a start-up finances or finances needed to be invested in its growth. Every business project needs a certain amount of money to be invested and if this sum is easily accessible the entrepreneur is much closer to his success. There are different ways to get the finances that the entrepreneurship needs—one is with the help of business angels. Depending on the stage of development various sources of finance can be involved (Figure 1).

Figure 1 Development and financing of entrepreneurial firms



Source: Mayer, C. (2001). *Investment and Growth: The Role of Corporate Governance, Economic growth and Government Policy*. HM, Treasury

In their earliest stages, start-up companies typically rely on own funds, such as their own credit cards, second mortgages or cash from close contacts. These sources, called by professional venture investors as three Fs' – founders, family, and friends, are limited, and are too small to bring to the market innovative ideas that can eventually turn into well-earned, prospective business.<sup>3</sup> Such gaps can be fulfilled by venture capitalists which put up their money in return for a stake in the enterprise. The main, complementary to each other, sources of early stage of venture projects are:<sup>4</sup>

- Business angels (informal venture capital): high net worth individuals, senior managers from large companies, or serial entrepreneurs, who invest (on their own or in groups) a small proportion of their own wealth in SMEs';
- Venture capital firms (formal venture capital): firms which manage fixed life venture capital funds of banks, pension funds and financial institutions, and other investors (wealthy families, corporations).

A market of venture capital is still growing and makes more ambitious. Business angels have long

<sup>2</sup> Mayer, C. (2001). *Investment and Growth: The Role of Corporate Governance, Economic growth and Government Policy*. HM, Treasury

<sup>3</sup> Kutsuna K. Honjo Y. (2005). *Start-up Financing and Post – Entry Performance: Evidence from Japan*, Discussion Paper Series. Kobe University. Kobe

<sup>4</sup> Harrison R.T. Mason C.M. (2001). *Venture capital market complementarities: the links between business angels and venture capital funds in the United Kingdom*. *Venture Capital*. Vol. 2, No. 3. p. 228



traditional track record as business investors, but their significance increased in sixties and seventies during Silicon Valley development, and a lot of pioneer investments had achieved financing from business angels.

## 2.2. Allocating financial resources for the entrepreneurs

The capital is one of the biggest issues that entrepreneurs meet, especially those whose business involves innovation. It often happens that the entrepreneurs have interesting idea that should be transformed into a business idea. In order to realize that idea the entrepreneurs need lots of resources, especially finances. Quite often do the entrepreneurs cannot allocate these resources from the banks or the other financial institutions, so they have to turn to friends or family, even though those resources will not suffice to fulfill the goal of the entrepreneur's initiative.

Allocating the financial resources to promote entrepreneurship is one of the most important factors of both qualitative and quantitative development, which in coordination with the other means of support (tax and custom reduction) enables optimal, desirable and necessary development of the business on the whole.

The basic characteristic of the financial support for the development of the entrepreneurship in Republic of Macedonia is the understanding of its importance as an accelerating and multiplicative effect in the development of the whole economy. For that cause, the state institutions in R. of Macedonia, through the instruments of economic policy allocate resources specifically directed towards forming specialized funds, associations, banks etc. The financial mechanism for support of the entrepreneurship should consist of:<sup>5</sup>

- Selective crediting of the small industries that produce for the big economies;
- Selective crediting of projects regarding the import substitution in highly rentable export products;
- Organizing assignment savings for the SME at specialized banks that finance highly profitable projects;
- Consortium financing of small and medium enterprises;
- Selective financing of new and deficit products;
- Financing family factories by large enterprises.

The reasons for dedicating such special attention on the entrepreneurship and the support of its development are rightfully questioned, knowing that the commercial banks are not always interested in financing new and risky business. The basic reasons are the following: the low amount of personal capital, larger credit risks than the average, high expenditures from crediting one by one, and the problems regarding discipline about payments of the credits. The newcomers find it hard to deal with the commercial banks, because of their strict conditions when approving credit, the high interest rates, the high percentage of personal share, the short term for paying back, the mortgages etc. Banks are not inclined to make any loans to small entrepreneurs mostly because of the distrust towards the new enterprises and the constant fear whether their resources will ever be paid off, since there is no way to check their creditworthiness coming from the little experience they got on the market. So the need for special guarantees is requested, which burdens the process of approving credits and loans to entrepreneurs.

## 3. WHAT IS A BUSINESS ANGEL?

Business angel is a high net-worth individual who invests his or her own money in start-up companies in exchange for an equity share of the businesses. Some important things to know about angels include:<sup>6</sup>

- Many angels are in most of the cases former entrepreneurs themselves. They bring both capital and mentoring/coaching to the start-up company.
- They make investments in order to gain a return on their money, to participate in the entrepreneurial process, and often to "give back" to their communities by catalyzing economic growth.

<sup>5</sup> Зарезанкова-Потевска, М. (2000). *Перспективите на малото стопанство*. Неол-Ристо-ДООЕЛ. Скопје

<sup>6</sup> Biznis\_Angeli, Panoptikum, [http://www.panoptikum.com.mk/old/images/stories/www.panoptikum.com.mk\\_-\\_biznis\\_angeli.pdf](http://www.panoptikum.com.mk/old/images/stories/www.panoptikum.com.mk_-_biznis_angeli.pdf) (accessed 21.08.2010)

- Angels make a return on their investment when the entrepreneur successfully grows the business and exits it, generally through a sale or merger
- It is estimated that angels invested: \$26 billion in 57,000 start-up businesses in 2007 in the United States and around €3 billion in 2007 in Europe Angels tend to invest in companies that are located near them regionally
- Angels tend to invest early and take a higher risk
- Angels invest in different sectors.
- Angels are generally more flexible and reactive than other investors
- Angels give access to networks and new potential customers
- Angels acts as an ambassador for the business, increasing the credibility and the chances to rise follow-on funding.

Business angels can act individually or in groups/networks. In North America angels groups are more frequent. In an angel group, individual angels join with other angels to invest collectively in entrepreneurial firms. In Europe angels tend to gather in networks, which can be more or less formalized up to the country and the nature of the association. Business angels networks are organizations which aim to facilitate the matching between entrepreneurs (looking for venture capital) and business angels (providing capital and mentorship). Business angels networks tend to remain neutral and generally refrain from formally evaluating business plans or angels, with the main function to make a market place for matching services.

Business angel investments are generally high risk, so the returns can be extremely good. But recent researches among existing business angels have shown that one in three investments resulted in the total amount being lost. However, one in five investments provided a cumulative return of 50% or more per annum. Business angels are actively involved in the company and will therefore need business skills in order to achieve the potential of the company in which they invest and accelerate the growth of the company. Angels are often entrepreneurs themselves or have a solid entrepreneurial experience, as their role is also to provide expertise to the company in its first stages. If the business angel's business experience is limited, the angel should consider aligning himself/herself with an experienced business angel in a syndicate. Generally speaking, the greater the percentage of shares business angels acquire, the greater their control; but business angels should seek professional advice before signing a contract.

Research shows that, on average, the business angel will spend about ten hours a week dealing with the company's affairs. The precise nature of their involvement, however, should be agreed in advance. If the business angels have specific skills to contribute, the company should welcome their involvement; on the other hand, some business angels have interfered too much and alienated the executives who are primarily responsible for the success.

### 3.1. Difference between business angels and venture capitalists

While both invest in entrepreneurial firms and take equity (ownership) in those businesses, there are some important differences:<sup>7</sup>

- Funding source – Angels invest their own funds directly in a business, while venture capitalists invest funds from other sources (e.g. pension funds, insurance companies, foundations);
- Stage of entrepreneur – In general, angels invest in seed, start-up and early-stage businesses, while venture capitalists invest in later-stage businesses (although there are exceptions);
- Size of investment – Venture capitalists generally invest \$2 million and up in a financing round, while individual angels make much smaller investments (\$5,000 to \$100,000). Angel groups can make investments in the mid-range, between most individual angels and VCs.

Business angels have a role in:<sup>8</sup>

- Filling the equity gap (50.000€ to 3 million €) in the start-up phase;
- Investing in companies at a stage where VCs are no longer active;

<sup>7</sup> Venture Support Systems Project: Angel Investors, MIT Entrepreneurship Center, Feb. 2000, <http://entrepreneurship.mit.edu/Downloads/AngelReport.pdf> (accessed 13.08.2010)

<sup>8</sup> [http://www.innovation.gov.au/Section/Innovation/Documents/Business\\_Angel\\_Report20070328092115.pdf](http://www.innovation.gov.au/Section/Innovation/Documents/Business_Angel_Report20070328092115.pdf) (accessed 12.08.2010)

- Being an integral part of the chain of integrated finance tools;
- Contributing to the culture of entrepreneurship in the region;
- Agglomerating the existing investment capital in the region.

As venture capitalists are moving up the ladder to higher amounts, business angels are increasingly active in the very early stage of companies, and are required to invest in several rounds of financing for the same company as there is a lack of follow-on investment. This new equity gap concerns amounts from 1 million to 3 million €, depending on the country.

#### 4. CURRENT SITUATION IN MACEDONIA – NEW BUSINESS ANGEL NETWORK

The Innovation Center has established the first Business Angel Network in Macedonia – i2BAN. The network is in close collaboration with the Slovenian Business Angel Network, Serbian Business Angel Network (SBAN) and the Croatia Business Angel Network (CRANE). The main goal of the network is to provide seed and growth capital to Macedonian companies, from established business-people in the country and abroad.

The Innovation Center is a spin-off of USAID's Competitiveness project. After a research that has been conducted on the R&D topic, it turned out that Macedonia has some serious lack of R&D in the business sector, thus there are not as many innovations in the country, especially not of the kind that get commercialized.

Center's main purpose is to help innovators/entrepreneurs select and implement their commercialization option. USAID's Competitiveness Project established The Innovation Center in April 2010 to assist innovators and innovative companies adopt innovations, create new products or services, or commercialize existing innovations. The Center is developing a pool of advisors, service providers and resources within and outside Macedonia that can assist entrepreneurial business ventures be successful. The Center will coach and guide entrepreneurs through every step it takes to realize business success from an innovation, linking innovators to specific knowledge, technology and financial resources needed.

The Innovation Center Macedonia, unleashes the potential of domestic innovators, links them to potential sources of capital, thus creating economic welfare in the country. The Innovation Center is a place for developing ideas and growing businesses. This is achieved by fostering an environment of innovation and providing a wealth of essential business resources to accelerate growth. The Innovation Center nurtures innovative and growth-minded businesses by developing the venture during start-up, early development, and the growth stages. The Innovation Center is all about growth. Growth in the economy, growth in jobs, and the growth of dynamic new companies with great new ideas! The Innovation Center seeks to create a way of thinking and acting that is opportunity obsessed, holistic in approach, market driven and leadership balanced.

The goals of the Innovation Center are:<sup>9</sup>

- Information sharing: IC actively works to promote and educate its members and non-members through events such as conferences, presentations, workshops, and informal gatherings;
- Relationship building: IC is promoting regional cooperation between its members and the business community;
- Entrepreneurship Awareness: IC is increasing awareness of the importance of young, small and medium-sized enterprises to economic development and the contribution of business support.

The main activities of the Innovation Center Macedonia are:<sup>10</sup>

- Matchmaking between domestic innovators and investors;
- Facilitating the commercialization of innovation;
- Analysis of the present situation relevant for innovations and their commercialization;
- Offering support to innovators for attracting potential investors;
- Training for innovators for commercialization of innovations;

<sup>9</sup> The Innovation Center. <http://www.mcp.org.mk/> (accessed 23.02.2011)

<sup>10</sup> i2BAN. <http://www.i2ban.mk/> (accessed 13.09.2011)

- Implementation of educational programs in business, attracting investors, structuring investment deals etc.;
- Support to investors in locating favorable opportunities to invest;
- Support in investment portfolio management including the opt in opt out possibilities from potential businesses;
- Establishing a framework for attracting capital for investment in early and risk phases when starting a business;
- Establishment of innovation fund (Investment fund for ideas/projects/businesses);
- Establishment of an eco-system of companies that will be specialized in providing services in technology commercialization, technology transfer, but also starting a business;
- Building capacities in these companies;
- Promoting innovations in the entire society;
- Promoting innovative thinking in the society, with special focus on the young population;

The Innovation Center serves innovators, entrepreneurs, business owners, and existing businesses that want to launch (or expand, or re-invent) a company based on innovative technology, product, or process in a high growth industry/sector. The Innovation Center assists access to all entrepreneurial services - e.g. business development, access to capital, product innovation and commercialization services, marketing, research, training, mentoring, and coaching - and it is committed to growing, building, or developing innovative businesses in Macedonia and the region.

## **5. CONCLUSION**

Startup companies usually do not have operational history, no steady cash-flow and no assets. Banks or other financial institutions are not willing to finance companies in early stages. The solution to this problem is often found in business angels and venture capital funds. In Republic of Macedonia, the financing gap has enhanced the need of immediate implementation of measurements in order to provide alternative financial resources for the seed and early stage of business development for start-ups.

Business angels are successful businesspeople who have usually built and/or manage one or several successful companies in the past. They are high net worth individuals and their financial position allows them to invest in highly risky investments such as young companies with potential for rapid growth and potential for high return. For the business angel, the investment presents sophisticated money refinement with influence on the investment. Being a business angel is an important status symbol, as it means sophisticated money refinement, as well as helping entrepreneurs to build and create a company. Being business angel in Macedonia is a new thing, a new opportunity for the rich people in our country. The fact that now in Macedonia there is a business angel network makes things much easier for the businessman, but also for the entrepreneurs. Hopefully, we can expect more new businesses to start-up very soon thanks to the business network and the Innovation Center.

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## THE ROLE OF FINANCIAL SUPPORT FOR SME DEVELOPMENT IN REPUBLIC OF MACEDONIA

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### Abstract

Considering the fact that many of the countries are passing through transitional period the leaders of development should be small and medium sized enterprises. This paper will include the meaning and the role of different forms of financial support for SME in start-up phases in function of processes of overcoming the causes of transition and recovering the competition, entrepreneurship and increasing the economy efficiency. In the end is the conclusion made to get information for perspectives and odds of financing the small and medium sized business in Republic of Macedonia.

**Keywords:** Financial Support, SMEs

### 1. INTRODUCTION

Considering the fact that many of the countries are passing through transitional period the leaders of development should be small and medium enterprises. The significant appearance in period of 70<sup>th</sup> years of 20 centuries was decreasing the rate of GDP, increasing the unemployment, decreasing the investment activities. The only way for enlarging the economics activities is bigger liberty on the market and decreasing the role of the state in the economy life. This is important for stimulating the competition, entrepreneurship and economy efficiently in the national economy. It helps for entrepreneurship's reconstitution, manifested by establishing the small and medium enterprises which lean on creativity, entrepreneurship spirit and individual innovation. The main goal of this paper is researching the importance of financial support for SMEs development in Republic of Macedonia and current actuality for financial support of MSP from the banking sector. An analysis of financial support for SMEs in Republic of Macedonia will be performed by using the statistical data from the banks.

### 2. SMES DEFINITION

Given that SMEs are a heterogeneous group there isn't single approach for their definition. According to national statistics of countries, most often used criterion is the number of employees that varies from one country to another. For example, in EU countries the limit is 250 employees in Japan to 300 employees in the U.S. and Canada that goes to 500 employees. Just for illustration in the following table is indicated classification of enterprises by number of employees.

Table 1: SME classification by number of employees

	micro	small	medium	SMEs	large
Countries of EU, Iceland, Norway and Switzerland	1-9	10-49	50-249	1-249	250+
Australia	0-9	10-49	50-199	0-199	200+
Canada	0-9	10-49	50-499	0-499	500+
Japan	4-9	10-49	50-249	1-249	250+
Korea	5-9	10-49	50-199	5-199	200+

Mexico	0-10	11-50	51-250	1-250	251+
New Zealand	1-9	10-49	50-99	0-99	100+
Turkey	1-19	20-49	50-249	1-249	250+
USA	1-9	10-99	100-499	1-499	500+

Resource: OECD Studies on SME and Entrepreneurship, 2010 ([www.oecd.org/publishing/corrigenda](http://www.oecd.org/publishing/corrigenda))

Besides the number of employees there are in use other criteria that vary in different countries. As a result of the small and medium enterprises operation on a single market without internal borders, there is a need to initiate application of a uniform definition of their operational efficiency and consistency. The European Commission in 2003 made a modification of the definition of small and medium enterprises and that definition is used in all strategies, programs and measures relating to the small and medium enterprises. The definition is an important instrument for implementation of effective measures and programs for support of the development and success of the small and medium enterprises (<http://ec.europa.eu/> The definition of SMEs according to the European Commission recommendation 2003/361/EC)

Table 2: Criteria's for SME definition

Criteria's	Dimension of enterprises		
	small	medium	large
average number of employees	to 50 employees	to 250 employees	more than 250 employees
average incomes	< of 8.000 wages	< of 40.000 wages	> of 40.000 wages
average of assets	< of 6.000 wages	< of 30.000 wages	> of 30.000 wages

SMEs have a huge contribution for economics activities in the country and usually are appointing the question: What are the reasons and advantages of SMEs and why are they so important for country development?

SMEs are expected to boost efficiency and growth and they lead the economy development because:

- SMEs constitute the most dynamic segment of many transition and developing economies
- They are engine of job creation
- SMEs boost the innovations, entrepreneurship , competition and flexibility
- Important role in promoting growth and development

The other advantages of SMEs establishment are:

- Direct control of the costs;
- Easier and cheaper function control;
- More liberal and free lows for entering a foreign capital;
- Faster noticing of the direction for more successful investments, innovations and market participation;
- Team work;
- Bigger responsibilities in work organization, etc.

In most economies, SMEs are much greater in number than big enterprises. In the EU, SMEs comprise approximately 99% of all firms and employ about 65 million people. In many sectors, SMEs are also responsible for setting up innovation and competition. Globally SMEs account for 99% of business numbers and 40% to 50% of GDP.

### 3. SMES IN REPUBLIC OF MACEDONIA

Private sector development in Republic of Macedonia has started since 1990. According to the data of the State Statistical Office the number of active business entities in the Republic of Macedonia in 2010 was 75497. The sectors with the highest share in the structure of business entities were: Wholesale and retail trade; repair of motor vehicles and motorcycles with 28326 entities or 37.5% and Manufacturing with 8263 entities or 11.0%, whereas the least represented were the sectors Electricity, gas, steam and air conditioning supply with 107 entities or 0.1% and Mining and quarrying with 164 entities or 0.2%. The data on the structure of active business entities according to the number of persons employed show that the highest share of 78.5% belongs to business entities with 1-9 persons employed, followed by business entities with no persons employed (or the entities did not provide information about persons employed) with 14.2%, and entities with 10-19 persons employed with 3.3%. The share of entities with 20-49 persons employed was 2.1%, those with 50-249 persons employed participated with 1.6%, while entities with 250 or more persons employed had a share of only 0.3%.

SMEs have a huge role for economy development actually for creating GDP, decreasing the unemployment and increasing the export. A lot of measure should be taken in order to encourage the SME sector.

Business climate has the main role for economics activities and for boosting the economy at all and also for incresing the SME sector. According to the Doing business report 2011 Republic of Macedonia has done a lot of improvements in business climate.

An analyses of business climate in R. Macedonia is given in the table according to the dates from Doing business report 2011. That reports include the following criteria's:

- Starting a business;
- Dealing with construction permits;
- Employing workers;
- Registering property;
- Getting credit;
- Protecting investors;
- Paying taxes;
- Trading across borders;
- Enforcing contracts;
- Closing a business.

Table 3: Doing business ranking

Macedonia	
Easy of doing business (rank)	38
Starting a business	5
Procedures (number)	3
Time (days)	3
Cost (% of income per capita)	2.5
Minimum capital (% of income per capita)	0.0
Dealing with licenses	136
Procedures (number)	21
Time (days)	146
Cost (% of income per capita)	1,601.4
Registering property	69
Procedures (number)	5
Time (days)	58
Cost ( % of property value)	3.2
Getting credit	46
Strength of legal rights index (0-10)	7
Depth of credit information index (0-6)	4

Public registry coverage (% of adults)	39.4
Private bureau coverage(% of adults)	0.0
Protecting investors	20
Extent of disclosure index (0-10)	9
Extent of director liability index (0-10)	7
Ease of shareholder suits index (0-10)	4
Strength of investor protection index (0-10)	6.7
Paying taxes	33
Payments (number)	40
Time (hours per year)	119
Total tax payable (% of gross profit)	10.6
Trading across borders	66
Documents for export (number)	6
Signatures for export (number)	12
Time for export (days)	1,376
Documents for import (number)	6
Signatures for import (number)	11
Time for import (days)	1,380
Enforcing contracts	65
Procedures (number)	37
Time (days)	370
Cost (% of debt)	33.1
Closing a business	116
Time (year)	2.9
Cost (% of estate)	28
Recovery rate (cents on the dollar)	20,7

As we can see from the dates R. Macedonia has huge progress in starting a business (today you can start a business for 7 days thanks to involving the one stop shop system) and paying taxes thanks to the tax reliefs.

The most important condition for SMEs establishing is macroeconomic stability. The economic performance of the Macedonian economy is expressed through stable GDP growth of around 4%, a low rate inflation rate of 3% on average, fiscal discipline confirmed by the international financial institutions and a well- functioning coordination between fiscal and monetary policy

#### 4. FINANCIAL SUPPORT FOR SMES IN REPUBLIC OF MACEDONIA

Considering the current situation and the needs for provision of faster and more symmetrical development of the small businesses in the Republic of Macedonia, with a goal to emphasize the advantages of that process, it comes to an effort in building an appropriate environment and to take adequate measures and activities. Mainly all these activities were aimed on providing of the necessary financial and other kind of support to the development of small and medium enterprises in the country. Such measures are especially necessary in the starting stages of the SMEs development, when those entities are characterized by a high level of risk and the impact of a numerous constraining factors - the inability to use the stock exchange market, underdeveloped institutions and restraint of the banks for their financing.

In conditions of low level of development of the financial market as an alternative form of financing of its ongoing and investment projects, the companies are primarily directed towards traditional banking products. In that direction the loans from banks represent the single source of an external financing, of: investment projects, permanent working capital and financing of the current assets in form of short-term loans or revolving credit lines.

1 Apart from the banks own funds, for the SMEs there are also at disposal a numerous credit lines: Credit line through the International Finance Corporation (IFC); Credit program for the development of small and medium enterprises through the Macedonian Bank for Support of Development; Credit line through the Agricultural Credit Discount Fund; European Investment Bank; MBSD credit line for export financing; Italian credit line through MBSD; Credit line through the European Fund for Southeast Europe (EFSE); Credit line through the Macedonian Enterprise Development Foundation; Credit program by EIB implemented through the MBSD - for permanent working capital; Credit program by EIB implemented through the MBSD - Investment Loans; Credit line for energy efficiency and renewable energy sources, EBRD (WeBSECLF).

In the pre-crisis period we have witnessed the credit expansion, when the banks tended to increase the credit support, and thus to secure greater market share. In particular, at the end of 2008, the total loans to nonfinancial persons remarked an annual growth of 34.4% (despite the slowdown in the second half of 2008) and in 2007 the annual rate of credit growth was 39.1%. ([www.nbrm.gov.mk](http://www.nbrm.gov.mk))

In the last two years, the banks have been directed towards maintenance of their quality loan portfolio, and therefore, it is evident that the lending to the companies by the banks unrolls gradually. The support by the banking sector to companies in 2010 illustrates a recovery compared to the previous 2009 (see figures 1 and 2). The total loans granted to non-financial entities at the end of 2010 rose to 7.4%, representing almost double increased intensity of acceleration with respect to previous 2009, when the realized growth of credits was 3.35%. The rate of growth continued in 2011 when on an annual basis (April 2011 / April 2010) it was observed a rate of growth of 7.8%, by which in the contribution of growth of the total bank loans, the contribution of loans offered to the companies is participating with 66.3% of the total increase, or expressed at an annual rate of growth of loans to companies in accordance with data until April 2011, it accounts 8.6%, with a remark that an important structural component are the exchange currency loans, together with the rapid trend of increase of contribution of the Denar loans, as well as that a significant contribution to the annual rate of growth have the long-term loans, while the short-term loans have an annual contribution in the last three months of 2011 with a negative indication.

Despite the progressive dynamics with low intensity, the annual growth rate of loans in the Republic of Macedonia in 2010 (including Albania and Croatia) is above the annual growth rates of a number of countries, except Turkey and Serbia, which in this period had far higher rates of credit growth. The increase of credit growth goes in parallel with the raise of the quality to the ability for financing of the companies in terms of what it means spending of borrowed money, or, evident is the gradual decrease of the interest rate of the loans, in particular to loans in domestic currency by 10.8% in June 2010 to 8.1% in April 2011.

Table 4: Financial support for SMEs -loans

In million denars

Date	Description	Total	Total			Enterprises			
			MKD	MKD with clause	Foreign	MKD	MKD with clause	Foreign	Total
31.12.2009	Past due loans	2.414	1.586	501	327	620	363	309	1.293
	Short-term loans	39.229	23.441	7.555	8.233	18.493	7.365	8.221	34.079
	Long-term loans	116.290	38.795	51.135	26.360	11.400	25.514	22.851	59.764
	Non-performing loans	15.777	8.315	3.141	4.321	4.649	1.596	3.889	10.133
	Total loans	173.710	72.137	62.332	39.242	35.162	34.838	35.270	105.269
	Impairment	-16.054							
	Accumulated amortization	-528							
	Total net loans	157.128							



31.12.2010	Past due loans	2.968	1.549	496	922	578	369	910	1.857
	Short-term loans	39.172	23.293	8.525	7.354	18.090	8.365	7.336	33.791
	Long-term loans	127.117	42.534	48.951	35.632	12.882	23.296	31.057	67.235
	Non-performing loans	17.289	9.466	3.563	4.260	5.775	1.931	3.672	11.378
	Total loans	186.545	76.842	61.534	48.169	37.325	33.961	42.975	114.261
	Impairment	-17.491							
	Accumulated amortization	-708							
	Total net loans	168.346							
Increase 31.12.2010/ 31.12.2009	The absolute increase in loans	12.835	4.706	-798	8.927	2.163	-877	7.706	8.992
	Increase in %	7,4%	6,5%	-1,3%	22,7%	6,2%	-2,5%	21,8%	8,5%
	Structure of increase		36,7%	-6,2%	69,6%	16,9%	-6,8%	60,0%	70,1%

Table 5 Newly approved loans in the period

Activities	Number of credit parties				Average interest rate			
	First quarter 2010	Second quarter 2010	Third quarter 2010	Fourth quarter 2010	First quarter 2010	Second quarter 2010	Third quarter 2010	Fourth quarter 2010
Enterprises	4.946	5.278	4.527	5.508	8,9%	8,5%	8,5%	8,3%

## 5. CONCLUSION

The general conclusion about the financial support to the SMEs persistence in this so called post-crisis period as well as additional impulse for their development is that most of the offered financial support remains unused. The reasons for this situation the various stakeholders are detecting it differently. The owners of small and medium businesses accent that the criteria for obtaining loans are strained and at the same, the interest rates are quite high, while the banks emphasize that there is a low interest among SMEs for borrowing, and there are not enough profitable projects of creditworthy companies that could be funded.

Therefore, future development and future support of SME development in the Republic of Macedonia should be directed to the following:

- Development of the financial system especially the capital markets and its special forms faimed for small and medium enterprises;
- Greater awareness of the owners of SMEs on opportunities to finance their businesses and use the pre-accession funds of EU;
- Developing a system of insurance of loans in terms of security does not rely only on the mortgage;
- More liberal credit policy of banks;
- Decreasing the required reserves of banks;
- Greater awareness of SMEs on the owners of the essence and meaning of their financial statements, significant qualitative content based on which banks carry the financing decision.

This paper will contribute to determining the problems which are facing SMEs in the provision of finances. Also we will suggest measures and instruments for improving the financial support for SME sector.

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## **THE HARMONIZATION OF ACCOUNTING REGULATIONS OF CROATIAN SMALL ENTERPRISES WITH ACCOUNTING REGULATIONS OF THE EU**

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### **Abstract**

The modern economy is characterized by small enterprises which constitute the fundamental drivers of economic development and contribute to the dynamic economic trends. Transition countries prior entering to the global market have to create conditions which will ensure equal participation of their small enterprises in competition with small enterprises of developed countries from the European Union. As one precondition is harmonization of accounting regulations for small enterprises. Ignoring the harmonization of accounting regulations would result in an unfavorable position of small enterprises of transition countries, and thus the overall economy of transition countries.

**Keywords:** Small Enterprises, Accounting Regulations, Transition Countries

### **1. INTRODUCTION**

The first records of small enterprises appear before 4000 years. From its beginnings the small enterprises play a major role in the development of ancient cultures (Egyptians, Jews, Romans, Babylonians ...) as well as the spread of civilization across the unexplored regions of the world. During the second half of 20th century markets globalization resulting in frequent turbulence on the market, what pushing forefront the flexibility, dynamism and innovation as a necessary precondition for a successful business life, and the aforementioned characteristics represent the fundamental characteristics of small enterprises. The life expectancy of 4 000 years indicates the importance tradition and achievements of small enterprises. Therefore, the goal of this paper is to point to the need to create a favorable legislative conditions using regulatory accounting standards that would achieve equality between small enterprises of transition countries and small enterprises of EU Member States.

### **2. CONCEPTUALIZATION OF SMALL FIRMS IN MODERN CONDITIONS**

Entrepreneurship has always been very important both for development and the restructuring of the market economy, which was confirmed during the great transitional period like the transition from agrarian to industrial civilization in the 15th and 16 century, and the transition from industrial to postindustrial civilization in the late 20th century. Entrepreneurship has played a decisive role in development of the U.S., Japan, South Korea, Singapore and Hongkong, also crucial was for Europe and for the former socialist states within which represented a major lever of reform. Regarding the criteria for defining the small enterprises on a theoretical level we have a big mess, because there are no uniform criteria for the theoretical definition of small enterprises. Therefore, in the world, we find significant differences in the definitions of small businesses due to the different criteria for defining the enterprises. In literature the often used criteria<sup>1</sup> are the total asset value, the value of the share capital, the amount of sales, the value of fixed assets, , the size of necessary investments, the volume of energy resources and the total number of employees. Most often as a separate or combined criteria apply "Total number of employees" because the same easily accessible, transparent, fair and comparable. Taking into account the total number of employees as the most common criterion, we have a very vivid picture of small businesses:

- In the United States under a small enterprises belong the company which have up to 1500 employees,
- In Austria, Belgium, Netherlands and UK small enterprises are counted up to 100 employees.
- In France, small enterprises are those which employing between 10-500 employees.

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<sup>1</sup> Kuvačić, N.: Počela poduzetništva, Ekonomski fakultet Split, Split, 1999, str. 93-94.

- In Japan, small enterprises, depending on the branch of industry employs up to 300 jobs in wholesale and retail to 100 to 50 employees.
- In Sweden, small enterprises employing up to 200 employees
- In Switzerland, small enterprises employing up to 49 employees.

Until now in the Croatia as a criterion for classifying enterprises to small, medium and large used the total number of employees in combination with following as shown in the table:

Table 1: Criteria for classifying enterprises

Parameters	ZOR /1992	ZOR / 2005	ZOR / 2008
Total assets	2.000.000,00 DEM	27.000.000,00 HRK	32.500.000,00 HRK
Annual income	4.000.000,00 DEM	54.000.000,00 HRK	65.000.000,00 HRK
Number of employees	50	50	50

Currently the Croatian Law of Accounting (01.01.2008) classificate the enterprises to small, medium and large regarding the following<sup>2</sup>. Small enterprises are those that do not exceed two of the three following criteria:

- Total assets to 32,500,000.00 HRK;
- Annual income is 65,000,000.00 HRK;
- They have 50 employees.

Medium enterprises are those that exceed two of the three aforementioned criteria and not exceed two of the three following criteria:

- Total assets 108,000,000.00 HRK;
- Annual income 216,000,000.00 HRK;
- They have 250 employees.

Large enterprises are those that exceed two of the three aforementioned criteria.

### 3. THE ROLE AND IMPORTANCE OF SMALL BUSINESSES IN THE MODERN ECONOMY

Small businesses are at the heart of contemporary society, supplying with their products and services the overall environment. In support of the role and importance of small businesses in the modern economy tell us the following information:

- Austrian small enterprises represent (excluding companies in the field of agriculture) between 98% and 99%, 55% and provide jobs and generate 50% of the total social product;
- Belgium small enterprises represent 98% of all companies;
- France small enterprises represent (up to 500 employees) 99.90% of all companies, employing 66.80% of all employees in total investment accounted for 55.10%;
- Switzerland small enterprises represent the 97.10% of the total number of enterprises;
- U.S. small enterprises with up to 10 employees participate with 88.90%, to 20 employees participate with 91.30%, to 100 employees with 99.10% and up to 500 employees with as much as 99.80% of the total number of enterprises;

The above data indicates a change in the structure of the company as a core business entities. The increase of significance and the role of small businesses and their numerical dominance in the structure of the company are due to changes in the following conditions:

- Extreme uncertainty of contemporary changes in the economic field requires extraordinary economic dynamism;
- Time becomes a central factor in the field of competitive struggle, because of uncertainty

<sup>2</sup> Zakon o računovodstvu, Narodne Novine br. 109/07, Zagreb, 2007. čl. 17.

requires speed, flexibility and adaptability on the basis of information and technological change;

- Quality, design and service remain the most important comparative advantages of producers of new products;
- Restructuring of large companies based on quality, design and service, organizational and technological flexibility and adaptability of the market;
- Individual organization becomes part of cooperative networks;
- Internationalization of economic processes means that all agents have become interconnected and dependent on world market.

Due to its specific characteristics, the small enterprises along with medium have the chance to survive in today's complex business conditions. One of the important role of small business is to increase total employment. Increasing employment by small enterprises is understandable when we know that for the establishment of small businesses require a relatively small amount of capital than to establish a medium or large enterprises. Furthermore, new technologies will enable for small enterprises a successful business with a certain minimum level of production. The relatively small volume of production is a consequence of changes in consumption trends from the mass consumption of these goods to the individually consumption goods. Due to the increasing influence of international competition and the inability of the isolated effect all companies have develop their organization, management, production, marketing, finance and other skills to perfection, what is simpler to small than to large enterprises. For all these reasons it is assumed that the small business more dynamic and more flexible than large companies. Overall, small businesses play a significant role in the modern economy.

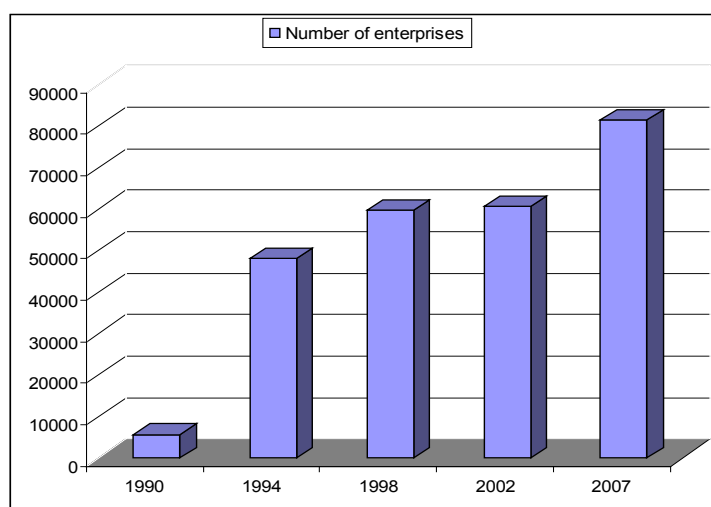
#### 4. SMALL ENTERPRISES IN CROATIA

From the examples of the developed economies the Republic of Croatia following the politics where small businesses are the engines of economic development. In support of this tells us the following table and chart:

Table 2: Development of small enterprises per year

Year	Number of enterprises
1990	5651
1994	48021
1998	59718
2002	60562
2007	81467

Chart 1: Number of small enterprises



Based on the above table and chart we can see a significant increasing of small enterprises during

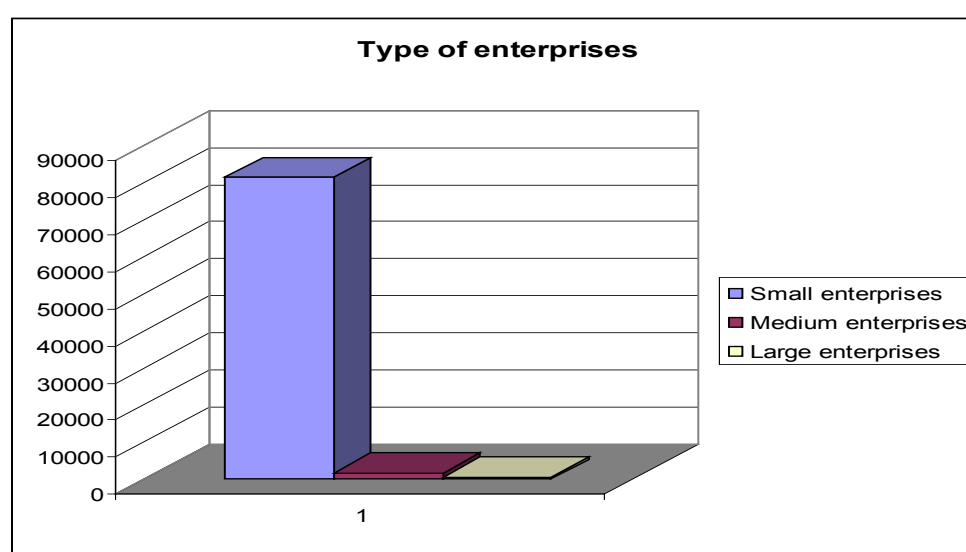


the period from 1990. to 2007., what represent the trend of the developed world economies, in which small businesses are the engines of economic development. Thus we can see that the the appropriate political and economic developments of the 90-year led to a significant increasing in the number of small enterprises from 5651 to th even 81 467 small enterprises. The importance of small enterprises in the overall economic development tells us all the more pronounced role of small enterprises, which is reflected in share of overall companies structure as shown in the following table and chart:

Table 3: Share of enterprises in the overall structure

Type of enterprises	Number of enterprises	%
Small enterprises	81467	97,5
Medium enterprises	1590	1,9
Large enterprises	475	0,6
Ukupno	83532	100

Chart 2: Share of enterprises in the overall structure



From table and chart above we can see that even 97,5% of overall enterprises in the economy of the Republic of Croatia. At the same time the importance of small firms is confirmed and the number of employees, where they employ 48% of the total number of employees in the Croatian economy, apropos 460 856 workers. This indicates that small enterprises represent generator of employment, what is essential for further economic development. Small enterprises are the most flexible part of the economy, because with the least committed capital achieved positive results despite a challenging market conditions.

## 5. THE HARMONIZATION OF CROATIAN ACCOUNTING REGULATIONS WITH ACCOUNTING REQUIREMENTS OF THE EUROPEAN UNION

The establishment and development of small enterprises requires the appropriate measures of economic policy and support of government bodies and business institutions. Recognizing the importance of small enterprises, government and others business bodies have taken significant steps in promoting small enterprises with the goal of economic development and approximation to EU standards. The fundamental step was the adoption of Croatian Financial Reporting Standards (01.01.2008.), because previous Accounting Act from 1993. and from 2006. practically not taking care of small enterprises. Previous standards were related to all companies equally, regardless of size, which indicated that they were too broad, too general and with more alternatives. Only makes the financial statements for small businesses differ from large firms was the number and shortening scheme of financial statements which are supposed to prepare. Croatian Financial Reporting Standards have been adopted in accordance with the existing Accounting Law<sup>3</sup> and apply to small businesses since 01.01.2008. They were adopted with the aim of harmonizing Croatian legislation with the legislative framework

<sup>3</sup> Zakon o računovodstvu, Narodne Novine br. 109/07, Zagreb, 2007.

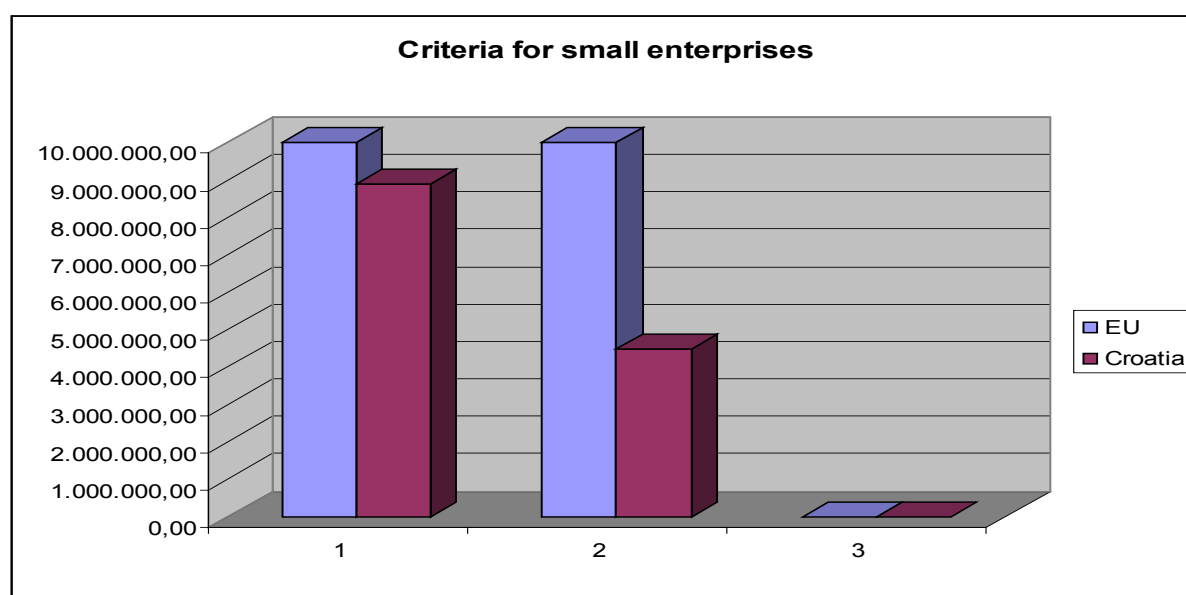
of the European Union. But here we have doubt between the harmonization of accounting regulations versus equality of small businesses in transition countries (like Croatia) with small businesses in EU countries. Based on the criteria for classifying companies by size, which is shown by the following table:

Table 4: Criteria for Small Businesses

Parameters	EU	Hrvatska
Total assets	$\leq 10.000.000,00$ E	$\leq 8.900.000,00$ E
Annual income	$\leq 10.000.000,00$ E	$\leq 4.500.000,00$ E
Number of employees	$< 50$	$\leq 50$

Croatian conversion of the exchange rate criterion is 7.3 HRK / E

Chart 3: Criteria for small enterprises



We can see obvious differences in the criteria to be met by small enterprises in the EU against the criteria of small enterprises in Croatia. Threshold amounts of total assets and annual income are higher in the EU compared to the Republic of Croatia. These difference represent disadvantage to croatian small enterprises which have to carry on the European market with more powerful companies from the EU. Apropos EU small enterprisess thanks to EU criteria, larger total assets and higher annual incomes were able to overcome the croatian small enterprises. In addition, in determining the categories of enterprises in the EU's mandatory criteria is the number of employees and one of the remaining criteria, whereas in the Republic of Croatia condition set is two of the three criteria. Regarding the number of employees required by the EU to 49 employees, while the RH frame is allowed 50 employees. Also, classification of enterprises in the EU includes micro enterprises to 9 employees, as well as the criterion of independence of other companies. All of the above places in an unequal relationship between croatian small enterprises with EU small enterprises, because the assumption of major credit and business capacity of small enterprises in the EU we can expect competition problems of croatian smaller enterprises. If we take into account the current economic and political developments in which republic of Croatia is the first candidate to enter the EU to assume that it will face similar problems and other transition countries in the field of ex-Yugoslavia. Therefore, the intention of this paper is to show the necessary reclassification criteria for classifying companies by size, or increasing thresholds of total assets and annual income with which to acquire a more equitable conditions of competition and the conditions for the use of incentives by the EU for small enterprises of transition states.

## 6. CONCLUSION

Contemporary market conditions forced on us such a dynamic environment that business must constantly adapt to new conditions, but just small enterprises thanks to its characteristics are active participants in these business environments. Small enterprises represent crucial factors for economic development. It is necessary to establish accounting and legislative framework to improve the credit and business capacity of small enterprises. To achieve the above it is necessary to harmonize the criteria for the classification of enterprises by size and change the threshold value based on which we distinguish between businesses. By changing the thresholds would contribute to equalizing the conditions of competition between firms of underdeveloped countries in transition and the company of the European Union.

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**THE ORGANIZATION OF MANAGEMENT ACCOUNTING IN SLOVAKIAN SMALL AND MEDIUM SIZED ENTERPRISES****Stefan Mayr**

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E-mail: [stefan.mayr@jku.at](mailto:stefan.mayr@jku.at)**Abstract**

The paper surveys the organization of management accounting in Slovakian small and medium sized enterprises. Since Slovakia is facing a lot of social and economic changes, the question arises, to which extend the process of transition influences the organization of management accounting and the use of operational plans and strategic instruments. Existing studies regarding management accounting in transition countries show that management accounting has become an important field of research. However the organization of management accounting and the use of management accounting instruments can be determined at a very low level of institutionalization.

The contingency theory as a theoretical frame is used in order to explore the effect of the stratifying variables size and structure (family firm versus non family firm). In conclusion, the analyses will reveal that the organization of management accounting in Slovakian enterprises measured by the institutionalization of an appropriate sub-unit is at a very low level. Regarding the used operational plans the survey shows that some plans are used frequently, but the financial budget can be found rarely. Strategic instruments are used for control and documentation but not for governance.

**Keywords:** Management Accounting, Small And Medium Sized Enterprises, Process of Transition

**1. INTRODUCTION**

Like many other countries in Eastern Europe, Slovakia is currently facing a lot of social and economic changes. Slovakia has reached the highest average economic growth in the European Union from 2000 to 2010. Slovakia, like all European countries, is dominated by small and medium sized enterprises (SME) – 98.8% of all enterprises in Slovakia are SME. The fact that Slovakia has a very small proportion of micro sized enterprises (Schmiemann, 2008) allows to conclude, that the structure of the Slovakian economy is relatively high developed.

Regarding the management of these small and medium sized enterprises in Slovakia, the question arises, to which extend the process of transition from a primary centrally planned economy towards an international oriented free market system is already completed. Economic reforms, the access to the European Union (EU) and globalization of transition economies in Central and Eastern Europe in general and in Slovakia in particular have dramatically changed the economic preconditions. Regarding these dramatic changes the management of SME in Slovakia is facing a big challenge.

In general, SME are confronted with limited resources of capital, staff (including management) and time. Exactly this lack of resources is often the reason for reducing their concentration on management activities. Management accounting must support the management to reach operational and strategic objectives. According to a traditional definition, management accounting can be defined as the process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of financial information used by management to plan, evaluate, and control within an organization (Kaplan, 1984). Firms in transitional and merging economies have realized that they need effective management accounting techniques to provide management with relevant, timely and accurate information to improve enterprise performance. However, few findings have been published on the progress that firms in these economies have made toward this goal (Jaruga/Ho, 2002).

The paper deals with the organization of management accounting and influencing context factors in small and medium sized enterprises in Slovakia. The topic has been a neglected field both in management accounting research as well as in small and medium sized enterprise research (national and international) so far. It is of great interest, how management accounting as a concept of planning and control is organized in a transition economy like Slovakia. The accounting law has been changed in Slovakia in 1993. The accounting system is based now on the principle of providing appropriate information to financial managers of a company (Schroll, 1995).

The few existing investigations into management accounting in transition countries in Eastern Europe have mainly been conceptual, descriptive, or otherwise qualitative. Shama and McMahan (1990) have reviewed the historical development in the nature of management accounting in the

Soviet Union subject to the command economic (a context referring and explanatory approach) in the years before 1990. They sum up that it is necessary to look at management accounting from the perspective of the context. Stevens (1991) has made an analysis of fundamental, conceptual differences between management accounting principles and objectives and the derived differences in market and commercial language in the USA and the Central and East European transition economies, respectively. He points out the differences in the understanding of profitability and success criteria. Vamosi (2000) examines in his case study how the interpretation of new concepts and ideas affects management accounting in a Hungarian, previously government-owned enterprise. He focuses on how economic matters and management accounting are constituted between 'cargoes of thoughts' and a new 'reality of everyday life'. Interesting perspectives of the case are the practiced instruments of management accounting and the experiences made by the management and the management accountants during the process of transition. According to his results calculation practice technically is almost unchanged, whereas cash management is a quite new discipline. Daniel, Suranova and De Beelde (2001) focus on analyzing the development and role of accounting and auditing in Slovakia. They resume that after the political changes of 1989, the accounting system was adapted to meet the economic changes in the country. The innovations in (management) accounting were strongly influenced by continental European accounting models. The role of accounting has moved from an instrument of central planning to a tool to manage enterprises and report to third parties (e.g. foreign owners). Szychta (2002) analyzed in her empirical work the scope of application of management accounting methods in Polish enterprises. According to the results the majority of Polish enterprises use the traditional full costing system based on actual costs. Annual operating financial budgets for the whole enterprises are prepared by a considerable proportion of the companies studied. In large enterprises management accounting methods are used to a greater extent than in smaller ones.

International researchers (e.g. Matthews/Scott 1992, Reid/Smith 2000) as well as german-speaking ones (Ossadnik/Barklage/Lengerich, 2004, Berens/Püthe/Siemes, 2005, Schachner/Speckbacher/Wentges, 2006, Feldbauer-Durstmüller/Wimmer/Duller, 2007, Becker/Ulrich, 2009, Becker/Staffel/Ulrich, 2010) have published several descriptive studies on the implementation status of management accounting and investigations on the contingency factors of management accounting. Summing up contingency factors "firm size" and "firm type" (family versus non family firm) were identified as the most important ones (Flacke, 2007).

In conclusion, the above studies indicate that research of management accounting has become and is still to focus on transition countries. Following the research gap, the paper, which exclusively focuses on Slovakian small and medium sized enterprises, explores the research questions below:

- How is the management accounting organized in Slovakian enterprises (internal/external, sub-unit for management accounting)?
- Which operational plans and strategic instruments are used in Slovakian enterprises?
- What are the dominating effects on the organization of management accounting: legal form, size, family firm/non family firm, internationalization?

To tackle these research questions, the paper is structured as follows: Section 2 presents the theoretical background. Small and medium sized enterprises are defined and the contingency theory as the basic reference theory is explained. Section 3 provides information on the data collection process, samples structure and the different types of the organisation of management accounting. Crucial results are presented in Section 4, which focuses in particular on the answering of the research questions. In section 5, the findings are discussed.

Based on the empirical findings of the research, implications for the practice, in particular for the organization of management accounting in Slovakia and other transition economies, are derived. In addition, findings are discussed in detail and compared to other researches. The paper also provides directions for further research.



## 2. THEORETICAL BACKGROUND

### 2.1. Definition of small and medium sized enterprises

Attempts to define SME are most likely in combination with different size categories like number of employees, turnover, total assets, value added or equity. These figures separate the different sizes of enterprises. Medium sized enterprises are defined by the European Commission (suggestion 2003/361/EG) as follows: not more than 249 employees and less than 50 million Euros turnover per year and/or total assets of less than 43 million Euros and (mainly) independent.

This study uses the criterion “number of employees” for its definition. The distinction by firm size was chosen because a certain minimum size is required to measure the suspected interactions. For defining SME quantitative and qualitative attributes are used (Pfohl, 1997, pp.1-25).

Specific characteristics of this type of firm are: lack of specialist input (Belz/Travella, 1999, p.7), more focus on production oriented than management oriented knowledge, limited time budget for management tasks of the entrepreneur, limited use of costly planning and management instruments, neglect of strategic management and decision-making on a daily basis with regards to personnel resources and priorities. Especially qualitative attributes like ownership or management rights and quantitative features like firm size define SME according to the literature.

### 2.2. Contingency theory and hypothesis

The contingency theory (Burns/Stalker 1961, Laurence/Lorsch 1967, Thompson 1967) is used in order to explore the effect of the stratifying variables mentioned above. This theory is a very prominent approach when it comes to the investigation of management accounting practices. According to Luft and Shields (2007, p.35) the contingency theory is the most common theoretical base for empirical studies on planning and control. Among the frequently investigated variables are size and organizational structure.

According to international literature about SME the firm size is one of the most outstanding influential on the organization of management accounting. With regards to the contingency theory this is most likely because of a growing organizational differentiation at bigger companies. This leads to hypothesis number one:

*H1: Medium sized enterprises are more likely to have established a separate management accounting department than small sized enterprises.*

Furthermore, firm type (family versus non-family companies, operationalization according to the concept of substantial family influence (concept of SFI, Klein, 2000) is expected to influence the organization and structure of management accounting: companies managed by family members do not get back to institutionalized management accountants so often compared to one controlled by external managers (Davila, 2005). This leads to hypothesis number two:

*H2: Non-family firms are more likely to have established a separate management accounting department than family firms.*

The extent to which companies operate internationally is seen as a further contingency factor. Internationally operating enterprises are confronted with more and intense competition and therefore modern management instruments like qualitative price calculations are required. This leads to hypothesis number three:

*H3: Internationally operating enterprises are more likely to have established a separate management department than not or just little internationally operating ones.*

Another contingency factor for the organization of management accounting is the legal form of the enterprises. Due to the strict and comprehensive guidelines of the Slovakian commercial law there are special implications for accounting and management accounting in corporations. It is most likely that this circumstance influences the organization and structure of management accounting. This leads to hypothesis number four:

*H4: Corporations are more likely to have established a separate management accounting department than sole proprietorships or partnerships.*

### 3. RESEARCH DESIGN

#### 3.1. Sample

In order to answer the research questions and to prove these hypotheses a study was carried out in Slovakia within the framework of a bigger research project in Austria, Germany and Slovakia. For this empirical research data was collected in Slovakia by the Catholic University of Ruzomberku. This institution acted as a partner of the Johannes Kepler University in Linz (Austria) in this joint research project. In November and December 2010 the chief executive officers of more than 5.400 small and medium sized enterprises in Slovakia were contacted. The questionnaire was answered by 484 enterprises, 397 of those could be used for the survey (response rate of 7.4 %). The survey instrument employed was a standardized online questionnaire, which had already undergone a pretest. To control for a non-response bias, the representativeness was tested by comparing the first third of the data set with the last third. As no differences were detected, the representativeness of the study was confirmed. Of the participating firms 92% are small sized enterprises (between 0-50 employees).

Since there is no clear-cut definition of the term ‘family firm’, the operationalization of the concept is not a simple task. The decision of which definition of family firm should be adopted will crucially affect the results of the empirical study (Villalonga/Amit, 2006; Rutherford et al., 2008). A approach to delineating the concept can be found in the dimension of power which, according to the F-PEC scale, focuses on the fact that the family will exert substantial influence on the firm; this method of distinguishing a family firm from a non-family firm (SFI – substantial family influence) was used in order to enable a comparison between our results and the results of other empirical studies based on the F-PEC definition of ‘family firm’. SFI measures the strength of family influence, construed as the family’s share of equity in the firm as well its influence through governance boards and management. Moreover, some shares must be held by the family in order for the firm to be considered a family business. Following this classification the sample of the research included 67.2 % family enterprises and 32.8 % non-family-businesses.

#### 3.2. Methodology

In addition to descriptive statistics also classical statistical testing for our data analysis was employed. To test the hypotheses either the chi-squared test or Fisher’s exact test at a significance level of  $\alpha = 0.05$  was applied. The usual as well as special assumptions (for the chi-squared test expected cell count is 5 or more in at least 80 % of cells and the minimum expected count is 1 or more) were always fulfilled. Prior to the mailing of the questionnaire a pre-test was conducted with enterprises in Slovakia.

### 4. RESULTS AND IMPLICATIONS

*Research question 1:* How is the management accounting organized in Slovakian enterprises (internal/ external, sub-unit for management accounting)?

With respect to the institutionalization of management accounting only 4.3% of the participating firms (in relation to those enterprises, which have implemented management accounting) had a specialized sub-unit for management accounting. Table 1 shows the result for small and medium sized enterprises:

Table 1: Institutionalization of management accounting sub-units in small and medium sized firms (source: author’s compilation)

Institutionalization of Management Accounting	Small sized enterprises (n = 210)	Medium sized enterprises (n = 21)	Total (n = 231)
with sub-unit	4.29%	4.76%	4.33%
without sub-unit	95.71%	95.24%	95.67%

Only a minor part of all SME examined has a separate sub-unit for management accounting, the rest gets the relevant information from the management (39%), the financial or accounting department (36%) or from an external consultant (20%). With respect to these results it is most likely that management accounting is not very much formally institutionalized in Slovakia. Around 27% of all enterprises examined have not installed any active management accounting (28% of small sized enterprises, 5% of medium sized enterprises).

*Research question 2:* Which operational plans and strategic instruments are used in Slovakian enterprises?

With regards to operative plans it is to say that especially sales and marketing plans are the dominating instruments (44.10%), followed by budget balance sheets, procurement and purchasing plans, inventory plans and production plans which are used by nearly a fifth of all enterprises examined. Surprisingly, liquidity planning seems to be less important. Only 11% of the sample uses that instrument.

Table two shows the results.

Table 2: Implementation of operational instruments (source: author's compilation)

Type of instrument	Small sized enterprises	Medium sized enterprises	Total
sales/marketing plan	45.10%	35.00%	44.10%
product portfolio plan	10.90%	10.00%	10.80%
procurement/purchasing plan	17.60%	55.00%	21.10%
profit and loss forecast/ fiscal plan	5.20%	30.00%	7.50%
budget balance sheet	22.30%	30.00%	23.00%
liquidity plan	10.40%	15.00%	10.80%
production plan	16.10%	50.00%	19.20%
inventory plan	22.30%	20.00%	22.10%
personnel plan	8.30%	20.00%	9.40%
R&D plan	2.10%	0.00%	1.90%

Results on usage of strategic instruments in Slovakian enterprises show: performance measurement systems, SWOT analysis and competitor analysis are very common (nearly 40% of interviewed enterprises). The implementation of other strategic instruments like capital budgeting, balanced scorecard or shareholder value analysis could not be observed very often. Table three shows the results:

Table 3: Implementation of (selected) strategic instruments (source: author's compilation)

Type of instrument	Small sized enterprises	Medium sized enterprises	Total
performance measurement system	41.50%	50.00%	42.20%
SWOT analysis	40.10%	40.00%	40.10%
competitor analysis	39.60%	25.00%	38.40%
benchmarking	6.90%	5.00%	6.80%
cost-benefit analysis	11.50%	20.00%	12.20%
balanced scorecard	2.80%	5.00%	2.90%
shareholder value analysis	4.10%	0.00%	3.80%
target costing	5.50%	10.00%	5.90%
capital budgeting	0.90%	0.00%	0.80%
portfolio analysis	5.00%	5.00%	5.00%

*Research question 3:* What are the dominating effects on the organization of management accounting: legal form, size, family firm/non family firm, internationalization?

In order to answer the research question 3, three hypotheses were stated.

*Hypothesis 1:*

With respect to the effects of size on the institutionalization of management accounting table one can be taken into consideration. Surprisingly, there is no significant difference between small and medium sized companies with respect to building up a separate management accounting department (Fisher's Exact Test at a level of 95%). Hypothesis 1 cannot be confirmed.

*Hypothesis 2:*

For evaluating Hypothesis 2 the impact of the firm structure (family firm versus non family firm) on building up a separate management accounting department was measured:

Surprisingly, significantly more family firms have installed a separate management accounting department than non-family firms (table four): Hypothesis 2 cannot be confirmed as well.

Table 4: Institutionalization of management accounting sub-units in family firms and non-family firms (source: author's compilation)

Institutionalization of Management Accounting	Family firms (n = 144)	Non family firms (n = 80)	Total (n = 224)
With sub-unit	6.25%	1.25%	4.46%
without sub-unit	93.75%	98.75%	95.67%

*Hypothesis 3:*

For details about Hypothesis 3 please refer to table five. Interestingly, fewer internationally operating enterprises have built up a separate management accounting department (3.33%) compared to locally operating ones (4.73%). On the other hand it has to be stated that approximately a fifth of internationally operating enterprises examined (21.10%) has no active management accounting at all (local enterprises 28.70%). That means even predominantly internationally operating enterprises in Slovakia hardly have a separate sub-unit for management accounting. Therefore Hypothesis 3 cannot be confirmed as well.

Table 5: Institutionalization of management accounting sub-units in international and local enterprises (source: author's compilation)

Institutionalization of Management Accounting	Substantial internationally active (n = 60)	Predominant local active (n = 169)	Total (n = 229)
With sub-unit	3.33%	4.73%	4.37%
without sub-unit	96.67%	95.27%	95.67%

*Hypothesis 4:*

For evaluating Hypothesis 4 the influence of the legal form on building up a separate sub-unit for management accounting was investigated. Table six summarizes all corporations and compares it to sole proprietorships and partnerships. Unexpectedly, more partnerships have installed a separate management accounting department than strictly regulated corporations. There is a significantly higher rate at partnerships (Fisher's Exact Test at a level of 95%).

Table 6: Institutionalization of management accounting sub-units in corporate enterprises and private companies (source: author's compilation)

Institutionalization of Management Accounting	corporate enterprises (n = 219)	private enterprises (n = 9)	Total (n = 228)
with sub-unit	3.20%	33.33%	4.59%
without sub-unit	96.80%	66.67%	95.67%

## 5. CONCLUSION

Summing up results are surprising: on the one hand the study identifies that operational plans like turnover or sales plans are very common in Slovakian enterprises (around 44% of interviewed companies), on the other hand instruments like liquidity plans are used seldom (just around 11% of examined companies). These results are confirmed by the study of Vamosi (2000) who shows that cash management and liquidity planning are new and innovative instruments in Slovakia. The heavy use of performance measurement systems, which are doubtlessly past- or control-oriented instruments, could mean that management accounting is more likely to be seen as control- rather than management-oriented. A major limitation in this context is that only the use of the instruments itself was queried, but not the way of its use. The fact that such a few Slovakian enterprises have built up a separate management accounting department and that the management itself is often responsible for the management accounting activities (around 40% of all enterprises which have installed management accounting) shows that there is a very indefinite understanding of what means and implies management accounting exactly in Slovakia. The cultural context and meaning of management accounting in Slovakia seems to be not clear and definite so far.

It has to be mentioned that previous studies and recent literature do not confirm with these investigations. Especially for the contingency factors "firm size" and "firm structure" (family firm versus non-family firm) which are investigated commonly, this study could not measure any influence on management accounting. Regarding operative plans and strategic instruments only the contingency factor firm size was analyzed: only purchasing plans, profit and loss forecasts, fiscal plans and production plans are more likely to be used in medium sized Slovakian enterprises than in small sized ones. With respect to strategic instruments there are no significant differences in use between medium and small sized companies.

Possible explanations for these results could be as follows: due to the fact that just a minor share of enterprises examined has installed a separate management accounting department (around 4.3%); a low institutionalization of management accounting in Slovakia is quite likely. As a result the evaluation of Hypothesis 1 to 4 is only of limited value.

Based on the above findings following implications can be derived for further research: with respect to the indefinite understanding of management accounting in Slovakia (which can be seen as evident after this study) it seems interesting to investigate what is understood by management accounting in Eastern European countries exactly and in which way organization and structure of management accounting are influenced by their culture (Shama/McMahahn, 1990). Furthermore research on the reasons of implementing or non-implementing a separate management accounting department would be interesting. Qualitative research methods like expert interviews or case studies could be appropriate tools in this case. Based on this study the way of use of the investigated instruments in Slovakia could be examined to eliminate one of its limitations.

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## DOING BUSINESS IN RUSSIA: LESSONS FOR MANAGEMENT ACCOUNTING

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### Abstract

Since the collapse of the Soviet Union, Russia is on the transition from a command economy to a market system. Having undergone fundamental political and economic changes in the last 20 years, Russia is considered to be a significant player in the world economy and an attractive location for foreign direct investments. As a result, Russia is also an important trading partner for Austrian companies that often maintain a Russian sales office, branch or subsidiary.

It is widely acknowledged and empirically tested that leadership and management theories developed in one culture cannot be easily exported to other cultures. This applies also to management accounting that contributes to the achievement of the company's objectives and thus takes on an important role in managing the organization. Since people react to situations and interpret information differently depending on the norms of their native culture, cultural differences impact management accounting activities. Despite the growing interest in management accounting in transition economies in general and in Russia in particular, there is still a significant lack of research concerning the influence of cultural factors on management accounting.

Drawing on interviews with Austrian companies operating on the Russian market, this paper investigates the influence of cultural differences between Austria and Russia on management accounting. Our study does not only aim to enhance the understanding of the needs and particularities of doing business in Russia but also places a particular focus on the context of management accounting by exploring how cultural differences impact management accounting functions such as information supply, planning and control.

Our results reveal that the access to management accounting information as well as the readiness to provide data is significantly lower in Russia than in Austria. Moreover, Austrian employees participate more actively in the planning process, develop more detailed and precise plans and are able to accept objective criticism to a greater extent than their Russian counterparts. Consequently, the study provides evidence that culture differences have a considerable effect on management accounting. This implies that companies entering or already serving the Russian market have to consider these differences in order to design an effective management accounting system.

**Keywords:** Management Accounting, Russia, Austria, Cross-Cultural Study

### 1. INTRODUCTION

During the last 20 years, since the collapse of the Soviet Union, Russia has undergone fundamental political and economic changes in its transition from a command economy to a market system. Today, Russia belongs to the group of eight (G8) and represents one of the world's major economies. Consequently, it has become an attractive location for investors, amongst others Austrian companies. With a bilateral trade volume reaching the record level of €5 billion in 2008 (Statistik Austria, 2011) Russia is one of the most important trade partners of Austria. More than 1.200 Austrian companies operate on the Russian market, of which approximately 400 maintain a subsidiary or a branch in 50 Russian regions (Pfeffer, 2008).

The successful operation of foreign sales offices, plants, branches or subsidiaries requires – amongst other management tools – the implementation of a management accounting system in the host country to ensure that managers receive the information necessary for planning, control and decision-making. However, it is widely acknowledged and empirically investigated that leadership and management theories developed in one culture cannot be easily exported to other cultures (Hofstede, 1980; Newman and Nollen, 1996; Paik et al., 2002; Thang et al., 2007). This applies also to management accounting.

With the aim of advancing the understanding of the needs and particularities of doing business with Russian companies, this paper makes the following contributions: First of all, it provides insights how cultural differences between Austria and Russia affect the management accounting functions

information supply, planning and control. Secondly, it develops recommendations for the design of an effective management accounting system for firms entering or already serving the Russian market.

The reminder of the paper is organized as follows. In the next section an overview of the theoretical background is provided and the relationship between culture and management accounting described. The third part focuses on the results of previous studies devoted to the influence of cultural factors on management accounting, followed by the development of hypotheses. Next, the data collection and methodology used as well as the empirical results are presented. The paper concludes with a summary of our findings, implications for management accounting and possible avenues for future research.

## 2. CULTURE AND MANAGEMENT ACCOUNTING

Hofstede (2001, p. 9), one of the most influential researchers in intercultural management, defines culture as “the collective programming of the mind that distinguishes the members of one group or category of people from another.” Put differently, culture describes a set of shared attitudes, values and behaviors that allows people to successfully adapt to their environment.

There are a number of approaches to operationalize the concept of culture and to develop a set of criteria on the basis of which national cultures can be compared. In his seminal study of cultural differences, Hofstede (1983a) extracted four dimensions of national culture, namely power distance, uncertainty avoidance, individualism vs. collectivism and masculinity vs. femininity.

The most recent study of cross-cultural differences that extended Hofstede’s cultural dimensions was conducted as a part of the large-scale research program GLOBE in 62 countries (House and Javidan, 2004). Researchers identified nine cultural dimensions: power distance, uncertainty avoidance, institutional and in-group collectivism, gender egalitarianism, assertiveness, future, performance and humane orientation.

Power distance and uncertainty avoidance are defined as direct extensions of Hofstede’s work. Power distance describes the degree to which an unequal distribution of power is accepted and expected. In high power-distance cultures people are more likely to approve inequalities, be comfortable with hierarchic organization structures and overestimate authority and seniority. People from low power-distance countries demand more equality in social relations, easy access to superiors and open channels of communication (O’Clock and Devine, 2003). Uncertainty avoidance represents the preference of a society to avoid ambiguous or risky situations. In strong uncertainty avoidance countries rules and norms are important in order to generate stability and pseudo-security, while weak uncertainty avoidance cultures prefer less structure and standardization (Hofstede, 2001; O’Clock and Devine, 2003).

Individualism vs. collectivism describes the tendency of society members to perceive themselves as individuals rather than members of a group. In individualistic cultures individuals tend to place their own goals and interests above those of other members and are concerned with the recognition of personal achievement and independence (Van der Stede, 2003). On the contrary, people from collectivistic cultures attach great importance to social connections, group harmony and dependencies and postpone their own interests to the welfare of the group (Kraus et al., 2008). The GLOBE study split the concept of individualism/collectivism into two distinct dimensions. While in-group collectivism refers to the extent, to which individuals express pride, loyalty and cohesiveness in their families and organizations, institutional collectivism describes how society encourages and rewards collective action and distribution of resources (House and Javidan, 2004).

Gender egalitarianism and assertiveness have their origins in Hofstede’s dimension of masculinity/femininity. While gender egalitarianism describes the extent to which society minimizes gender role differences and gender discrimination, assertiveness is the degree to which individuals are assertive, confrontational, and aggressive in social relationships (House and Javidan, 2004).

GLOBE’s new dimension of “future orientation” relates to the degree to which people engage in future-oriented behaviors such as planning, investing in the future and delaying gratification (House and Javidan, 2004). Countries with a high score on this dimension (e.g. Japan) are more willing to sacrifice current success in favor of future development (O’Clock and Devine, 2003). The dimension of “performance orientation” shows how society members are encouraged and rewarded for performance improvement and excellence (Javidan, 2004). Humane orientation relates to the extent to which individuals are encouraged and rewarded for being fair, altruistic, friendly, generous, caring, and kind to others.

Table 1 shows the scores of Austria and Russia on the GLOBE-study's dimensions. It illustrates that Austria is characterized by low power distance, a rather individualistic orientation, a low score on gender egalitarianism and a high score on assertiveness reflecting a masculine culture, strong uncertainty avoidance, a rather higher extent of future orientation and a high performance orientation. Russia exhibits high levels of power distance and collectivism, in particular in-group collectivism, but a rather low performance orientation. Russia scores lowest on uncertainty avoidance and future orientation among all participating countries. It is very gender egalitarian but rather assertive, however to a far lower extent than Austria. Thus, Russia is regarded as a rather feminine culture. Since Austria's and Russia's score on humane orientation are relatively similar, it is not considered as relevant for our study and examined further.

Table 1: Cultural dimension scores of Austria and Russia according to the GLOBE-study (Sources: Grachev et al., 2007; Szabo and Reber, 2007)

Cultural dimensions	Austria	Russia	Difference	Mean
Power Distance	4.95	5.52	0.57	5.17
Uncertainty Avoidance	5.16	2.88	2.28	4.16
Institutional Collectivism	4.30	4.50	0.20	4.25
In-Group Collectivism	4.85	5.63	0.78	5.13
Gender Egalitarianism	3.09	4.07	0.98	3.37
Assertiveness	4.62	3.68	0.94	4.14
Future Orientation	4.46	2.88	1.58	3.85
Performance Orientation	4.44	3.39	1.05	4.10
Humane Orientation	3.72	3.94	0.22	4.09

Two other surveys have identified additional dimensions that seem relevant for our study. In Hall's cultural framework (Hall and Reed Hall, 1990) communication styles are central. It distinguishes between high-context and low-context cultures. Low-context cultures (e.g. Austria) communicate predominantly through explicit, detailed, direct and precise statements. On the contrary, communication in high-context cultures (e.g. Russia) occurs not only through the spoken words. Messages include other communication cues such as body language, eye movement and the use of silence. For this reason, verbal communication in high-context cultures is regarded to be indirect, implicit and vague. A second cultural dimension describes the way cultures perceive and manage time. In monochronic cultures (e.g. Austria) all tasks are arranged and completed one after another, and detailed time schedules and punctuality play an essential role. In contrast, people from polychronic cultures (e.g. Russia) are usually involved in many projects at the same time. Meeting deadlines seems to be secondary as priority is given to the human being and not to tasks.

In a broad-based survey of cultural differences Trompenaars (1993) extracted seven cultural dimensions that are labeled universalism vs. pluralism, individualism vs. collectivism, neutral vs. affective, specific vs. diffuse, achievement vs. ascription, time and environment are proposed. Since they are similar to some extent to the earlier described dimensions of the GLOBE study or Hall's framework, only one of them (neutral vs. affective) is of primary interest for our study. This dimension illustrates how people display their emotions. While affective cultures (e.g. Russia) do not deem necessary to hide feelings, representatives of neutral cultures (e.g. Austria) are taught not to display their feelings overtly.

Since accounting systems are developed and implemented within a cultural setting, culture affects management accounting practices. The effectiveness of an accounting system ultimately depends on how accounting information is used by people or influences people's behavior (Hopwood, 1974) and this is shaped to a considerable extent by culture. Hence, management accounting tools acknowledged to be highly effective in one culture could be less effective or even dysfunctional in another environment (Chow et al., 1996). For this reason the design of an efficient management accounting system requires an understanding of the cultural aspects of a particular country (MacArthur, 2006).



### 3. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Concerning the impact of cultural differences on management accounting, the attention of scholars focuses primarily on the function of management control in the intercultural context (e.g. Chow et al., 1994, 1999; Van der Stede, 2003). The majority of studies conclude that control procedures cannot be designed without considering the underlying patterns of culture (Scheytt, 2003). Several other surveys (e.g. Rauch et al., 2000; Choe and Langfield-Smith, 2004; Hoffjan and Boucoiran, 2008) investigate the impact of cultural differences on planning, budgeting and information supply and reveal that the national culture influences the behavior and attitudes of managers towards planning and the precision of plans to a great extent.

Most previous studies focus on cultural differences between the USA, Japan and Germany. Although there is a growing interest in studying management accounting in Russia (Morrison and Abrosimova, 1993; Enthoven, 1999; Taylor and Osipenkova, 2003) and investigating the impact of Russian culture on management activities (Michailova, 2000; Naumov and Puffer, 2000; Grachev, 2001; Grachev and Bobina, 2006), there is still a significant lack of research concerning the influence of cultural factors on Russian management accounting practices.

As a result of this paucity it was not always possible to deduce hypotheses on the relationship between Russian culture and management accounting from previous research. Instead, we had to rely on general assumptions and interpretations associated with the cultural dimensions presented before and on research conducted in other countries that exhibit similar scores on a particular dimension.

One of the major tasks of management accounting is to provide managers with the necessary information for decision making, planning, control and performance evaluation (Scarbrough et al., 1991). Considering the process of information supply, cultural differences can affect the types and amount of management accounting information. Managers in masculine low-context cultures (such as Austria) prefer an explicit communication style and are more willing to provide management accounting information. The majority of management accounting information is available in written form (e.g. protocols and records). Feminine high-context cultures (such as Russia), on the other hand, replace open communication by implicit information. Thus, less data is provided and verbal information plays a more important role. Personal contacts, networking and informal information exchange are crucial for management accountants. In order to get access to the necessary data, management accountants are expected to cultivate social relationships within a company and constantly expand their network (Hoffjan and Boucoiran, 2008). Moreover, the level of power distance in a culture has a strong influence on the access to management accounting information. In cultures with high power distance (e.g. Russia) the access to information is based on hierarchical positions of users and therefore is more limited than in societies with low power distance (e.g. Austria) (Komlodi and Carlin, 2004). Based upon these arguments, the following hypothesis can be proposed:

*H1: Concerning information supply, verbal information is less important, access to information easier and the management accountants more willing to provide decision-relevant information in Austria than in Russia.*

The planning process substantiates what activities and resources are necessary for the achievement of the objectives defined. Four dimensions appear especially influential in planning. A culture's power distance and individualistic orientation determine the degree of participation and centralization that is desired by employees. While participation of subordinates in planning is encouraged in individualistic cultures with low power distance (e.g. Austria), collectivist cultures with high power distance (e.g. Russia) emphasize centralized authority and hierarchical structures. The desire for being part of the decision-making process is less important for individuals from collectivistic cultures (Meindl et al., 1989; Frucot and Shearon, 1991). The ability of a culture to accept uncertainty is probably the most relevant dimension for planning (Rauch et al., 2000). Austria is characterized by strong uncertainty avoidance. Such cultures tend to invest significant resources in planning "trying to beat the future" (Hofstede, 1983b) with the help of very detailed and precise plans (MacArthur, 2006). In contrast, Russia bears the most uncertainty of all countries. In such a regime, detailed and precise planning may even seem dysfunctional because it requires investments and reduces flexibility needed for the successful adoption to the constantly altering business environment (Rauch et al., 2000). Finally, a culture's time orientation has a significant influence on the attitude towards planning. Polychronic cultures (e.g. Russia) tend to have more tolerance for unplanned behavior and less respect for plans (Rauch et al., 2000). Plans and deadlines are considered as reference points that can be easily changed or postponed. In contrast, people from monochronic cultures (e.g. Austria) attach great importance to meeting deadlines. As a result, they are inclined to stick to their plans and perceive changes of plans threatening (Nonis et al., 2005). The above arguments lead to our second hypothesis:



*H2: Planning is characterized by a higher degree of employee participation, detailedness and precision in Austria than in Russia.*

The control function appears to be affected by the dimensions of individualism/collectivism, masculinity (especially assertiveness), performance orientation and neutrality. As masculine performance-oriented cultures like Austria give a high priority to meeting budget targets and performance evaluation, it is likely that the acceptance of performance-based rewards and sanctions is high. Focusing on performance-based rewards and sanctions without taking into account the interpersonal relationships is less accepted by feminine cultures with low performance orientation such as Russia (Van der Stede, 2003).

Besides, collectivism and the desire for harmony in social relationships associated with the Russian culture result in the avoidance of conflicts that alienate the group. Consequently, conflicts are not directly addressed, but rather solved through compromises or just ignored. In individualistic masculine cultures (e.g. Austria) coping with conflicts is considered to be an inevitable part of social life. Direct confrontations are perceived natural and conflicts are approached constructively (Ohbuchi et al., 1999).

Feedback seems to be influenced by culture as well. Especially in collectivistic, affective cultures like Russia, positive feedback is usually considered to be of higher quality and more relevant than negative one (Van de Vliert et al., 2004). For this reason, criticism is considered rather as an offence in Russia than as a chance for improvement (Schwarzenbach, 2009). Due to this reluctance to criticism, Russians might have stronger emotional reactions to negative feedback while representatives of the individualistic neutral Austrian culture seek for feedback and are ready to accept it (Kurman et al., 2003). Based on this reasoning, the following is expected:

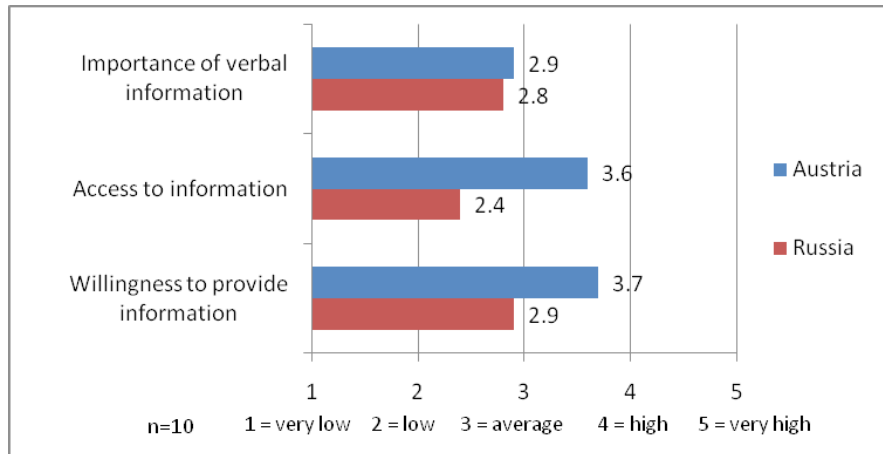
*H3: Concerning control activities, Austrian management accountants avoid conflicts to a lower extent and exhibit a higher acceptance of sanctions and criticism than their Russian counterparts.*

#### 4. RESEARCH METHOD AND RESULTS

To test our hypotheses, interviews based on the case study research approach (Yin, 1984) were conducted. Data was collected in 2010 by personal in-depth interviews with management accountants of ten Austrian manufacturing companies. In order to be included in our survey, a firm had to be active on the Russian market with a joint venture or subsidiary and familiar with management accounting. Each interview took approximately one hour and was based on a semi-structured questionnaire enabling the replication of the study. To examine the impact of cultural differences on information supply, planning and control, management accountants had to indicate their perceived agreement with different management accounting practices in Austria and Russia on a scale from 1 (very low) to 5 (very high).

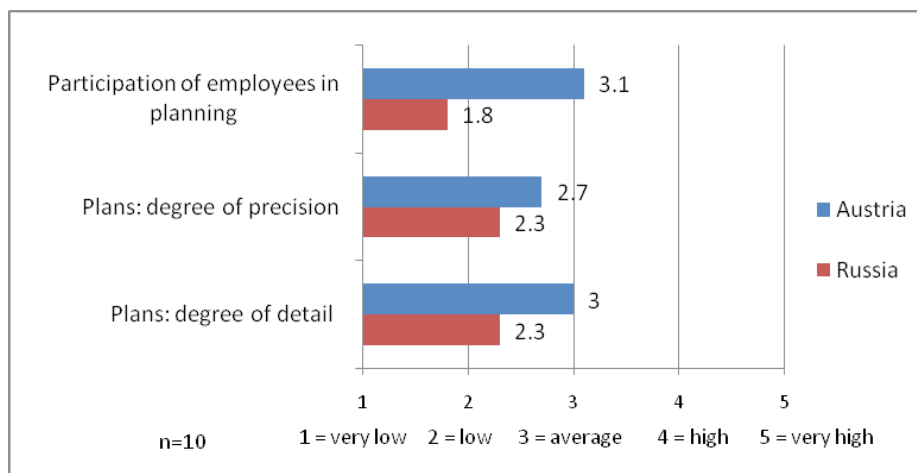
As shown in figure 1, both Austrian and Russian management accountants attach almost equal importance to verbal information, which is in contrast to our assumption. As hypothesized, the access to management accounting information is easier in Austria than in Russia and Austrian management accountants reflect a higher willingness to provide decision-relevant information than their Russian counterparts. Consequently, hypothesis 1 can only be partially confirmed.

Figure 1: Impact of cultural differences on information supply



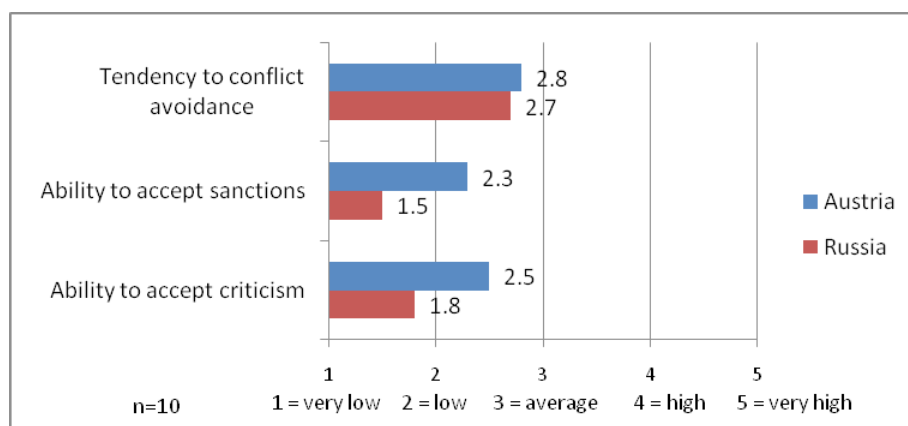
Concerning planning, the findings of the study support hypothesis 2 and illustrate that Austrians participate more actively in planning and use more detailed and precise plans than their Russian counterparts (see figure 2). One of the interview partners described the planning process in Russia in the following way: “Planning means in Russia the definition of objectives. Nobody is concerned about if and how these objectives can be achieved”.

Figure 2: Impact of cultural differences on planning



In contrast to hypothesis 3, Austrian management accountants seem to avoid conflict even to a slightly higher extent than their Russian counterparts. Concerning the ability to accept sanctions and constructive criticism, however, the data collected confirm our assumptions that Russian management accountants have more difficulties in accepting sanctions and are less open to criticism than Austrians (see figure 3). Several respondents pointed out that objective criticism was frequently regarded as personal criticism by Russian employees and consequently caused frustration and discouragement by the persons concerned.

Figure 3: Impact of cultural differences on control



## 5. CONCLUSION

Our study affirms the impact of a country's national culture on management accounting. Comparing Austria and Russia, the access to management accounting information and the willingness to provide decision-relevant data are significantly lower in Russia. Moreover, Russians participate less in the planning process, develop less detailed and precise plans and accept criticism and sanctions to a lower extent.

The contributions of our study are twofold. First of all, it provides empirical evidence on management accounting practices in Austria and Russia, two countries that have been scarcely researched. A deeper understanding of the particularities of the Russian culture and how it influences management accounting seems extremely warranted given the potential of the Russian market for international investors and the rapid increase of multinational business activities in Russia in the last years. The comparison of Austrian and Russian management accounting practices contributes to a better understanding of the influence of cultural differences on information supply, planning and control and a further exploration of the differences in management accounting between Western and Eastern Europe. Secondly, for multinational companies that already serve or plan to enter the Russian market the study's findings provide helpful insights into Russian management accounting practices.

Based on our results, the following recommendations for designing an effective management accounting system can be developed. In order to increase the willingness of Russian management accountants to provide information, personal contacts should be intensified. This can be done by modern communication technologies like videoconferencing that enable the exchange of verbal information. The implementation of appropriate incentive systems that encourage Russian employees to participate in the planning process could enhance the overall importance of planning in Russia. In order to increase Russian employees' ability to accept criticism, an organizational culture that tolerates mistakes and allows fruitful discussions should be established. Generally, companies doing business in Russia should be aware of cultural distances and should enhance their employees' awareness of differences in thinking and behavior patterns.

In interpreting the results of this study and the recommendations for designing an effective management accounting system, certain limitations should be acknowledged. Due to the small sample size, the generalization of the results has to be viewed with caution. Furthermore, since interviews were only conducted with Austrian management accountants, our findings might be biased, reflecting an Austrian perception of Russian management accounting.

In terms of future research, there is a need to study the impact of cultural differences on management accounting activities in more depth. To verify the results of this study, future research could use large-scale surveys and explore the self-reflection of Russian employees in performing management accounting activities.

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# FOSTERING ENTREPRENEURSHIP AND INNOVATIONS THROUGH THE INTERNATIONAL ACCOUNTING STANDARDS - RECOMMENDATIONS FOR SMES AND POLICY MAKERS IN B&H

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## Abstract

The importance of entrepreneurship and innovations for sustainable development and growth has been proven beyond any doubt a thousand times over. In the field, especially in emerging economies, questions regarding financial treatment of innovative activities in SMEs very often occur and as a result produce different effects on financial performance of given enterprise, sector, economy, etc. From the other side, transitional countries such as Bosnia and Herzegovina are determined to raise entrepreneurship and encourage SMEs development. In line with this, innovations friendly accounting frameworks may additionally stimulate entrepreneurs to set up new or improve current activities in terms to be more innovative and as results to have greater added value. As Bosnia and Herzegovina admitted International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) for its accounting framework, this paper will examine relevant IAS and IFRS, especially IAS 38 – Intangible Assets, in order to find out “positive” or “negative” effects which arise from given accounting treatment of innovative activities of SMEs. The aim is to answer: Are the IAS and IFRS entrepreneurship friendly? Additionally, concrete accounting models will be proposed, in order to maximise/minimise effects of financial treatment of innovative activities in SMEs given by IAS and IFRS. Those models shall be used by SMEs and policy makers equally, in order to rise up current level of investments in innovative activities (RS is cca 0.1% of GDP and on the level of B&H about 0.07% of GDP).

**Keywords:** Innovations Friendly Accounting Framework, Accounting Treatment of Entrepreneurial Activities, Financial Treatment of Innovative Activities, Financial Effects of Innovative Activities on SMEs

## 1. DEFINITION AND POSITION OF ENTREPRENEURIAL AND INNOVATIVE ACTIVITIES IN RELEVANT IAS AND IFRS

In literature, by Entrepreneurship is usually considered a start up of new business or enterprise in new, original way. That originality is manifested through an innovation that presents new technological, economic or organizational solution. Every change has innovative character when a company first uses a new idea in given place and time. Development of entrepreneurship and innovativeness interact: capable entrepreneurs are creating conditions for the innovators and successful innovators help entrepreneurs to create and modify new products and services that bring them above average profits. By modifying and adjusting products to current market needs they are and innovators at the same time. Therefore, in the era of commercialization and by looking from commercial aspect solely, entrepreneurship and innovativeness are different words but with the same meaning.

Entrepreneurial capacity on individual and institutional level is the most important source of proactivity and innovativeness in any country and therefore it is of interest to everyone, from policy makers to businesses, universities and research centres. As enterprises as well as policy makers draw decisions based on data in enterprises financial statements, accurate accounting-financial treatment of those activities is of significant importance for enterprises as well as policy makers and Governments and therefore it is essential to analyse those activities from the aspect of IAS and IFRS.

By analysis of IAS and IFRS, it seems that the most relevant accounting standard for innovative and entrepreneurial activities is IAS 38 – Intangible Assets. Even the name of this standard highlights “just” type of assets its coverage and usage is much wider. IAS 38, paragraph 5, points out that although the result of these activities can be assets with dominant physical substance (for example, the prototype) the physical element of the asset is of secondary importance compared to its intangible component, what is the knowledge embodied in it. Therefore, regardless of the result of innovation activities and form it takes (physical or intangible), enterprise’s innovation process and corresponding financial outlays are defined and determined by IAS 38 - Intangibles.

When enterprise internally develops a patent, a technology solution or innovates business processes, different kinds of costs and/or investments occur and its accounting and financial treatment is given by IAS 38. Specifically, this is the case of internally generated Intangibles<sup>1</sup>, and activities undertaken in order to develop such asset, in accounting terms, are known as research and development (R&D) activities. Therefore, from the aspect of enterprise and management theory those activities are known as innovative activities but in accounting and financial terms those are known as R&D activities. In both cases it is about the knowledge application and incorporation in daily business and processes but is called with different names – innovative or R&D activities.

IAS 38 recognizes a situation when an enterprise hires another enterprise, institute, research center or agency to develop a new technology, product, service or business process and then buys resulting study, patent, know-how or machine from that subject. According to IAS 38 this is the case of externally acquired knowledge – intangibles. Therefore, in this case enterprise buys “knowledge” from other subject instead to develop it internally, and as a matter of contrast those activities refer as entrepreneurial activities.

When enterprise externally acquires knowledge - buys an asset (either tangible or intangible but improved – with knowledge incorporated), in the amount of the purchased value corporate assets, in enterprise's Balance Statements, will be increased. In the future, given asset is subject to depreciation, and by time it will be fully transferred to Income Statement. By depreciation, enterprise's cost of depreciation will be higher and as a result net profit will be lower for the amount of higher depreciation costs as well as corresponding corporate tax. Therefore, the company realizes so-called tax savings from the investments in intangible and its use in the production process and many countries nowadays very often use depreciation expenditures to indirectly stimulate innovative (R&D) and entrepreneurial activities in private sector. One of the examples is recognition of depreciation costs in higher amount than real costs in order to additionally decrease the amount of corporate tax paid based on the type and character of business that enterprise does.

## 2. ACCOUNTING TREATMENT OF ENTERPRISE' INNOVATIVE ACTIVITIES

In previous chapter we could clearly conclude that innovative activities of enterprises are defined by IAS 38 and comes under the category of “internally generated intangible assets”. In order to estimate whether an internally generated intangible asset meets the criteria for recognition, an enterprise classifies the generation of property on:

- Research phase;
- Development phase.<sup>2</sup>

By research, according to IAS 38, is considered original and planned research undertaken with the aim to acquire new scientific or technical knowledge and understanding. As research always has a new knowledge but not a product or service as a consequence, future inflows of economic benefits to the enterprises are blurred and not possible to be capitalized and found in Balance Statement. As a result, all research outlays are recognized as expenditures when occurred.<sup>3</sup>

On the other hand, in the development phase, a new product or service, organizational solution or innovative market approach is possible to predict and as a result outlays in this phase can be capitalized. Development activities means the application of scientific - research results or production design of significantly improved materials, devices, products, processes, systems or services before commercial production or usage.<sup>4</sup> Given that inflow of future economic benefits (if and only if this is possible) is certain all expenses incurred during this phase of innovation development is recognized

1 International Accounting Standard 38 – Intangible Assets, translation, Ministry of Finance of Republic of Serbia, <http://www.mfin.gov.rs>

2 International Accounting Standard 38 – Intangible Assets, translation, Ministry of Finance of Republic of Serbia, <http://www.mfin.gov.rs>

3 Examples of research activities, according to IAS 38 are: (a) activities aimed at acquiring new knowledge, (b) search for the application of research findings and other knowledge, their evaluation and final selection (v) the search for alternatives for materials, devices, products, processes, systems or services, and (d) the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services. Source: IAS 38 - Intangible assets, translation, Ministry of Finance of the Republic of Serbia, <http://www.mfin.gov.rs>

4 Examples of development activities, according to IAS 38 are: (a) designing, building and testing prototypes and models of pre-production and before use, (b) design tools, assembly equipment, molds and dies, which means the new technology, (v) the design, construction and pilot plant work, which in size is not economically feasible for commercial production, and (g) the design, construction and testing of the chosen alternative for new or improved materials, devices, products, processes, systems or services. These examples are taken from IAS 38, whereby it should be stressed that any national body in charge of this activity can be defined more narrow or broaden their scope depending on the situations that arise in practice.

as an asset<sup>5</sup>.

Availability of resources for innovation completion and successful usage in business purpose can be proved, for example, with a business plan in which the present technical, financial and other necessary resources are shown and the ability of enterprise to provide those resources. In some cases, an enterprise demonstrates the availability to provide desirable resources with external financier's indication-willingness to finance given innovation development.

In order to precisely and in adequate way divide outlays incurred in the phase of research and in the phase of innovation development, beside those essential factor, it is necessary to ensure some technical conditions. One of them is existence of adequate cost accounting system in enterprise in order to reliably measure the value of internally generated intangible assets, such as salaries and other expenses incurred in securing copyrights or licenses or developing computer software.

### 3. HOW INNOVATION PROCESS IMPACTS ENTERPRISE'S FINANCIAL STABILITY

For an enterprise is said to be financially stable if there is balance (both in value and in terms of time) between the available sources of financing and assets immobilization of a given enterprise. In practice, the financial stability of the company is measured by the coefficient of financial stability (CFS) that shows which part of the enterprise's fixed assets is financed from long-term financial sources and which part of the short-term sources. The optimal situation is when the entire fixed assets are financed by long-term sources of financing, and then the coefficient is equal to 1, because we have an optimal effect on the profitability of the company. Financial stability performance is even better as the coefficient is closer to zero (then a part of current asset-s is-are financed from long-term financial sources and worse as the value of the coefficient is higher - above 1.

$$CFS = \frac{\text{Permanent current assets + Inventories + Loss denominated in asset}}{\text{Capital + Long-term provisions + long-term liabilities}} \quad (1)$$

In order to assess the influence of enterprise's innovative activities (R&D activities) on financial stability of the company, it is necessary to bear in mind the above mentioned levels of innovation's completion. In the research phase, each outlay is treated as an expense and as such has no impact on financial stability, but has on the profitability of the enterprise as it will be shown below.

In the development stage, when incurred outlays meet the above mentioned requirements to be recognized in Balance Statement, long-term assets will increase and thus the coefficient of financial stability will increase too. This negative effect on the ratio will decrease by amortization of these assets continuously through the useful life of innovation. Also, in order to minimize negative impact on financial stability performance, and taking into account factors that affect the same, it is necessary to take care of the sources of financing - denominator of the CFS. Given the long-term effects of the development stage and maturity of innovation, outlays in this stage need to be financed by long-term financial sources (from its own capital – by the issue of additional equities, “stronger” allocations from net profit on account of “retained earnings”, issuing own bonds or through long-term borrowing). Given the experience of other countries and current situation in our country in terms of available external financial resources, our recommendation relates to the formation of long-term provisions, which in accounting terms will favorably impact CFS and will allow greater allocation from the enterprise's net profit to additionally focus on improvement and development of innovations and innovative products, processes and services. Previously mentioned option is even more important and useful for companies that already have background in innovating – innovation active enterprises and thus can meet the condition for the formation of provisions, such as Provisions for Investment Maintenance, the Provisions for Costs of Restructuring and other types of provisions that will meet the criteria for its formation according to IAS 37 - Provisions, Contingent Liabilities and Contingent Assets.

5 Necessary conditions that need to substantiate the fact of recognition are: a) the technical feasibility of completing the intangible asset so that it will be available for use or sale (feasibility); b) its intention to complete the intangible asset and use or sell it (the end of intent); v) our ability to use or sale of intangible property (possession); g) intangible asset will generate probable future economic benefits - the existence of markets for the product of an intangible asset or intangible asset itself (commercialization)

#### 4. HOW INNOVATION PROCESS IMPACTS ENTERPRISE'S PROFITABILITY

The accounting treatment of outlays in the phase of research as operative expenditures will imply smaller amount of net profit from regular business activities, smaller amount of total gross and net profit and therefore smaller amount of tax paid for profit. Therefore, by investing in research, company accomplishes positive tax savings in the following amount:

the R expenditures x tax rate for profit (2)

which leads us to the fact that

the real amount of costs for research = R expenditures (1-tax rate for profit) (3)

Considering that, according to the current Accounting framework in Republic of Srpska and Bosnia and Herzegovina, the expenditures appeared in the phase of research are treated as operative costs, at the moment when they appear, will burden the business gain and thus affect the increase of the business risk. As a result it will affect the fading of financial image of company during deliberation about credit application etc. However, we have two effects or embedded automatism present in MRS 38. To clarify the first effect it is necessary to make the difference between innovation active and inactive companies. At innovation active companies, which have successful innovation results behind them, the impact on the business risk growth or leverage will not be that significant because of the fact that this kind of companies have very high business incomes. It is unlikely that companies, which are just starting with their innovative activities, will have enough resources for financing innovative projects from the beginning till the end, which means from the phase of research to the new product, service, process, etc. Also, there is a very big risk of, so called, deadweight loss, if, for example, during the phase of research it turns out that this kind of project is unenforceable. On the other hand, through this kind of treatment of research and development activities, the commercial basis of that researches or, for example, engagement of other, more experienced business subjects (institutes, centers of excellence, universities etc) is forced to carry out the research for the companies' needs because the risk of irreparable costs or failure of innovation undertaking is not so big.



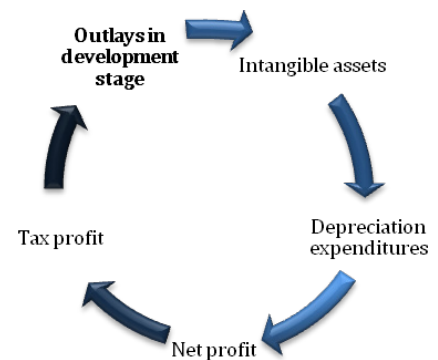
The treatment of expenditure in the phase of development as capital costs, affects the increase of value of total assets of companies and, in the amortization period, it affects reductions of gross and net gain and the amount of gain tax. If the company, at the same time, has active research projects, gross gain of the period will be additionally burdened, which leads us to the total tax savings in the following amount:

(Depreciation expenditures + R expenditures) x tax profit (4)

which opens the space for "internal financing" of expenses for research and development activities. Real expenses of investment in R&D activities are:

R expenditures - (4)

We cannot forget the income aspect of balance of success of innovation companies. For sure, changed product or service, specialized process or improved approach to the market will affect the realization of higher incomes when compared with the previous period or with the competition. Observing from the aspect of innovation companies, burdening such high incomes with above mentioned expenses of research, amortization of material and non-material property (results of research and development activities), then with the expenses of booking and expenses of interest on long-term sources of financing, in synergy, will have even more positive effects on company's tax savings. On the other hand, that will provide the company with the base for the long-term growth and development, but only provided that companies continuously invest in development and research activities. Also, the amount of expenses of research should not have big impact on the amount of gain from regular business activities because of the high incomes that innovative product or service brings to the company, and therefore also the height of business risk that it brings.





## 5. ACCOUNTING TREATMENT OF THE EXTERNALLY OBTAINED INNOVATIONS – COMPANY'S ENTREPRENEURIAL ACTIVITIES

When a company buys some kind of a non-material good, the value of company's property will increase for the amount of the purchase value<sup>6</sup> of that good. In the next period, the non-material good amortizes and that is how it transfers its value on the expenses, in order to show all the expenses that occurred in the observed period due to the generated incomes. Consequently, net gain of the period, as a result of increased expenses of amortizations based on the amortization of non-material property, will be smaller and therefore even the amount of paid gain tax will be smaller. Based on that fact, the company achieves, so - called, tax saves from the investment in non – material goods and their use in the process of production.

## 6. CONCLUSION

In this paper, we tried to present the advantages and disadvantages that appear when investing in non – material forms of property. At the same time, we proposed potential solutions for the reduction of potential negative effects on the financial stability and profitability of a company. Also, we noticed that IAC 38 covers all the innovative activities of the company, which means research and development activities, regardless of the form in which it will result.

Appreciating the fact that, in this paper, we fulfilled the aim of the research, and for the sake of further promotion of potential “internally generated” advantages of investing in the research activities, development and the utilization of the positive “hidden” mechanisms through IAS 38, in the next period, we propose the partition of all legal persons according to their innovative intensity, in Republic of Srpska and Bosnia and Herzegovina. In order to achieve that, it is necessary to raise the current level of the quality of financial reporting in Republic of Srpska and Bosnia and Herzegovina, for example through education of professional accountants, company managers and entrepreneurs in order to give them the conceptual and technical classification, accounting – financial treatment of research and development activities and the advantages of that investments. That would be the way to provide the quality base for the legislator and the executive authority in Republic of Srpska and Bosnia and Herzegovina for further, significantly efficient and more effective measures of incitement of innovative activities of companies, which is done by other, more developed countries in our closer and wider surrounding.

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<sup>6</sup> The purchase value of some good is the amount of cash or cash equivalent paid, or fair value of other compensation given for the acquisition of that mean.



## CORRUPTION AS AN OBSTACLE FOR DOING BUSINESS IN WESTERN BALKANS: A BUSINESS SECTOR PERSPECTIVE

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### Abstract

This paper investigates businessmen perceptions on corruption as obstacle for business and their attitudes towards corruption. The research is based on the survey conducted on the sample of over 1800 business owners and managers in Western Balkans region. Using the original survey data<sup>7</sup>, collected from February to June 2010 for seven countries – Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia, the paper explores businessmen views on how business sector is facing with corruption, and on the role of private and government agents to combat corruption.

The empirical analysis based on data obtained from businessmen opinion survey is performed in several steps. The data are analyzed using descriptive statistics, exploratory factor analysis, and analysis of variance (ANOVA).

The factor analysis has been performed at nine selected items from the questionnaire, each in the form of statement. Businessmen rated each statement on a 11-point Likert-type scale anchored by strongly disagree (0) and strongly agree (10). Three distinct factors were extracted: (1) Understanding corruption as a “greasing wheel”, (2) Self-initiative to combat corruption needed, (3) Corruption is a government-related issue. The main research question was if there were differences in factor means related to the: i) country of origin, ii) perceptions on corruption being an obstacle for business, iii) corruption experience, and iv) opinions on corruption trends in the past decade.

The results of the analysis of variance showed that the country of origin strongly determines businessmen attitudes on corruption as measured on all three factors, probably due to the different social and economic set-up and heritage. Businessmen with corruption experience tend to justify corruption as greasing wheel more than “clean” respondents with no corruption experience. Generally businessmen that see corruption rising in their country would attribute this problem exclusively to the government. This group of respondents accordingly expect government authorities to take the anti-corruption lead. Government response to the corruption issue rather than strengthening individual or private anti-corruption initiative is a prevalent opinion of businessmen who consider corruption as big or enormous obstacle for their business.

Country-specifics, business corruption experience, and different opinions on selected corruption-related issues showed to have influenced businessmen attitudes towards corruption. Since the large majority of companies in the survey sample are young and small enterprises up to 50 employees, results of this research study provide useful policy recommendations. Findings could help countries in Western Balkans region to design more entrepreneurship-friendly environment.

**Keywords:** Corruption, Businessmen Attitudes, Perceptions, Corruption Experience, Western Balkans

<sup>7</sup> The survey was conducted within the project Responsible youth entrepreneurship: creating a culture of anti-corruption in the private sector, [www.yes.org.mk](http://www.yes.org.mk). Authors would like to thank YES Foundation, Macedonia and Partnership for social development, Croatia for supplying us with the original database for this research.

## 1. INTRODUCTION

The extensive research in last decade or two has brought to the common understanding of negative effects of corruption.<sup>8</sup> Corruption has multiple adverse impacts on entrepreneurship and business in general (Kaufmann and Wei, 2000; Méon and Sekkat, 2005). Hellman et al. (2000) based their analysis on the Business Environment and Enterprise performance Survey (BEEPS) results and argued that governance, corruption, and state capture shape business environment in transition countries. Despite various anti-corruption initiatives to combat political and administrative corruption that had been put in place both internationally and locally, in many countries corruption still stands as an obstacle for doing business. One could assume that modest results are related to the lack of country-specific measures to eliminate corruption. The motif of this research study is to assess the business sector attitudes and opinions on corruption and to better understand factors associated to these attitudes. The approach applied in this study should help policy-makers to better target measures to fight corruption as an obstacle for doing business.

The paper investigates corruption as an obstacle for doing business in Western Balkans. Besides the research covers one historical and geographical region, it offers a multi-national comparative perspective among seven countries: Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro and Serbia. The issue of corruption hindering the development of business sector is explored by surveying local businessmen views on how business sector is facing with corruption, and on the perceived role of private and government agents to combat corruption. Our main research question is whether different business opinions and attitudes are related to the country of origin, individual corruption experience and perceptions, and opinions on past corruption trends. This study adds to the existing literature by providing results that could help countries in Western Balkans region to create corruption-free business environment.

The next section elaborates the rationale background and conceptual framework used in this research. The survey methodology and data are presented in section three, and the results of empirical analysis are provided in section four. The concluding section offers preliminary policy recommendations and indicates lines of future research.

## 2. RATIONALE BACKGROUND

Corruption is broadly defined as “a misuse of public power for the private gain” (The World Bank, 1997) that distorts resource allocation by shifting them to private elite. Corruption hampers social and economic development by increasing inequality and poverty (Hassan, 2004), yet the main negative impacts are seen in the poor performance of public sector (Tanzi, 1998; Mauro, 1995). Corruption rent-seeking decrease state revenues and leave less funds for public services such as health, education, and infrastructure (Tanzi and Davoodi, 1997; Shleifer and Vishny, 1993). Driven by personal benefits corrupt public officials make decisions opposite to the public interest they should serve. Instead of the development criteria the policy priorities chosen by individual rent-seeking opportunities make economic policy inefficient (Kaufman and Wei, 2000). Growing bureaucracy and malfunctioning institutions (North, 1990) go hand in hand with corruption thus affecting all aspects of citizens’ daily life, as well as business sector prospectives.

In the corrupt environment costs of doing business increase significantly in terms of resources needed to cope with expenses and risks. Corruption rent works as a tax imposed arbitrarily to business agents. Corruption fee is required to enter the market, to ensure compliance with regulations, to cope with the excessive bureaucracy, or to get political protection. The modalities of corrupt transactions include bribery, influence peddling, embezzlement, fraud and extortion, cronyism and patronage (Amundsen, 1999). Entry to new markets for example may be subject to corruption if export or import quotas are to be obtained. Firms may confront with corrupt pressure at global market because of unfair competitive advantage gained by other companies that offer corruption deals to third party. Respectively, public procurement is especially sensitive to corruption (Ateljević and Budak, 2010; Grødeland and Aasland, 2011).

Besides bribery and similar rather simple modalities of corrupt rent-seeking, more sophisticated corruption deals may include political financing arrangements, conflict of interests and lobbying, nepotism and cronyism such as hiring personnel or loyal partners to insure institutional or political support needed. Grand corruption is associated with shadow economy, tax evasion, money laundering, and even international crime and terrorism. Illegal corruption transactions require complex financing schemes and networking. Whether it consists of “small” or “big” deals, corruption increases transaction

<sup>8</sup> For review of corruption studies, see Jain (2001).

costs of doing business. Indeed this arguments against theories of justifying corruption as a greasing wheel that helps firms to get things done when public administration is inefficient (e.g. Leff, 1964; Dreher and Grassgebner, 2007). Instead of doing core business and keeping focus to innovation and development, in the corrupt business environment firms need to allocate significant human, financial and time resources to handle corrupt pressures. Large companies have more capacities to cope with corruption and to protect their business interests (Tanzi, 1998). Corruption therefore more strongly affects new and small and medium enterprises.

Table 1: Corruption Perceptions Index for Western Balkans countries, 2003-2010

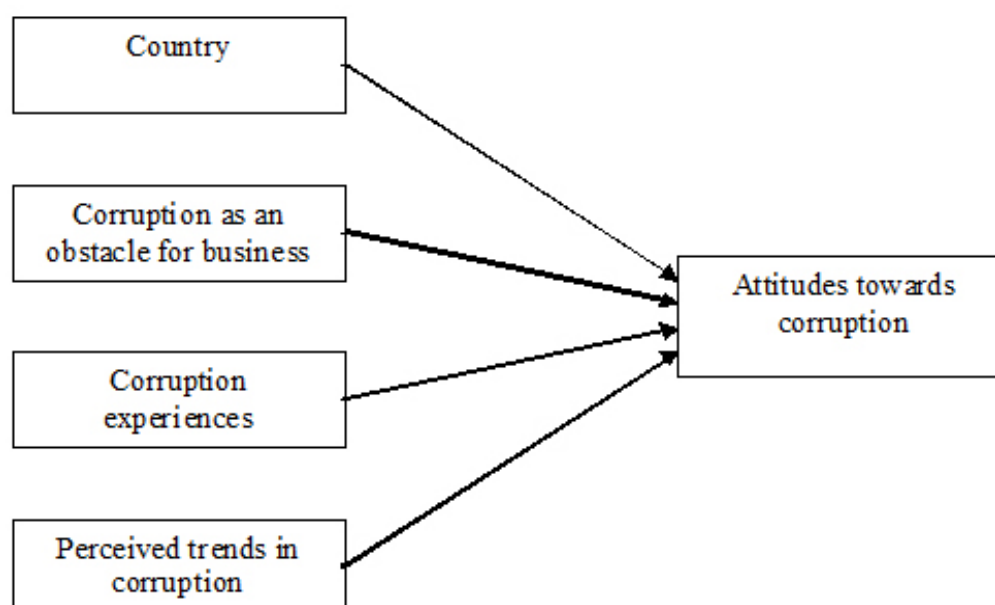
Country	2003	2004	2005	2006	2007	2008	2009	2010
Albania	2.5	2.5	2.4	2.6	2.9	3.4	3.2	3.3
Bosnia and Herzegovina	3.3	3.1	2.9	2.9	3.3	3.2	3.0	3.2
Croatia	3.7	3.5	3.4	3.4	4.1	4.4	4.1	4.1
Kosovo	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2.8
Macedonia, FYR	2.3	2.7	2.7	2.7	3.3	3.6	3.8	4.1
Montenegro*	2.3	2.7	2.8	3.0	3.3	3.4	3.9	3.7
Serbia*	2.3	2.7	2.8	3.0	3.4	3.4	3.5	3.5

Source: Transparency International.

Note: CPI at the scale from 0-highly corrupt to 10-highly clean. \*Data for 2003 to 2006 are for Serbia and Montenegro.

Western Balkans is considered a region of high corruption prevalence (Table 1). Despite slight differences in Corruption Perceptions Index (CPI) scores for particular countries, the corruption problem is common to the entire Western Balkans region (UNODC, 2011). Corruption is as well perceived as a major hurdle to investing in the region and doing business efficiently (EUROCHAMBRES, 2009). National studies also point out the corruption creates considerable difficulties for doing business (e.g. see Džafić et al., 2011 for Bosnia and Herzegovina; Budak, 2006 for Croatia). Although there is a common view on regional prevalence of corruption and its adverse impacts to business sector development, there are many outstanding research and policy issues to explore corruption and business climate nexus. Our approach is to assess businessmen attitudes towards corruption using the conceptual model developed and presented by Figure 1.

Figure 1. Conceptual framework to assess business sector attitudes towards corruption



The empirical analysis that follows will explore what different business attitudes exist, and if they are related to the country of business origin, expressed views on corruption as an obstacle for doing business, eventual real corruption experience and businessmen perceptions on corruption prevalence trends. Survey data and methodology used for the empirical analysis are presented in details below.

### 3. DATA AND METHODOLOGY

This quantitative research is based on the survey conducted on the sample of 1849 business owners and managers in Western Balkans region. The original survey data<sup>9</sup> were collected by conducting the telephone survey in the period from February to June 2010 in seven Western Balkans countries. The share of respondents per country reflects the size of the economies, with two largest economies representing about 20 percent of sampled respondents each: Croatia (22 percent of respondents) and Serbia (20 percent). The characteristics of survey sample are presented in Table 2.

Table 2. Summary statistics of sampled respondents, n = 1,849

Respondent profile	%
1. Gender	
1.1. Male	65.7
1.2. Female	34.3
2. Country	
2.1. Albania	10.7
2.2. Bosnia and Herzegovina	15.6
2.3. Croatia	22.2
2.4. Kosovo	8.6
2.5. Macedonia	15.1
2.6. Montenegro	7.8
2.7. Serbia	20.0
3. Respondent age	
3.1. 18 to 30 years	20.4
3.2. 31 to 40 years	33.6
3.3. 41 to 50 years	24.7
3.4. 51 to 60 years	17.0
3.5. 61 years or older	4.3
4. Company size	
4.1. 1 to 9 employees	61.3
4.2. 10 to 49 employees	28.7
4.3. 50 to 249 employees	7.9
4.4. 250 or more employees	2.2
5. Company age	
5.1. 1 to 5 years	20.6
5.2. 6 to 10 years	24.1
5.3. 11 to 20 years	45.0
5.4. 21 years or older	10.2

Respondents are 66 percent males and 34 percent females, which is in line with the male gender prevalence in the business sector in the region. Over half of the respondents are businessmen under the age of 40. Younger businessmen opinions represented in the sample are valuable to the findings of the survey research. That part of the business sector would be the most affected by the future developments in creating corruption-free business environment. Over 98 percent of the firms represented in the survey sample are small and medium enterprises (SMEs). This share as well as the large subset of micro companies (up to 10 employees) corresponds to the national business sectors

<sup>9</sup> The survey was conducted within the project Responsible youth entrepreneurship: creating a culture of anti-corruption in the private sector, [www.yes.org.mk](http://www.yes.org.mk). Authors would like to thank YES Foundation, Macedonia and Partnership for social development, Croatia for supplying us with the original database for this research.

structure. Regarding the company age, 20 percent of firms in the surveyed sample are young companies established five years ago or less. The largest share (45 percent of respondents) is associated to the firms with longer experience of doing business in these business environments (companies established 11 to 20 years ago). Businessmen from established companies might have broader past experience to estimate how corruption affects business, the effectiveness of anti-corruption initiatives and past developments. Finally the large size of the sample in our survey provides reliable database to conduct empirical analysis. The empirical analysis based on data obtained from businessmen opinion survey is performed in several steps. The data are analyzed using descriptive statistics, exploratory factor analysis, and analysis of variance (ANOVA).

The measurement instrument for measuring attitudes towards corruption included nine questions. Respondents were asked about corruption pressures faced by private companies and the potential efficiency of corrupt means in their business operations. Further we have collected their opinion on the perceived role of private sector and/or government agents to combat corruption, as well as general opinions on roots of corruption (Table 3).

Table 3. Mean values, n=1,849

Items	Means
i1 The private (business) sector is helpless before corruption, because corruption derives from the government	6.9
i2 Private companies can refuse to get involved in corruption without consequences to their operation	5.1
i3 Private companies are the ones which initiate corruption by offering bribe to get benefits they don't deserve	4.5
i4 A certain (small) degree of corruption is useful for business	3.4
i5 Corruption is rooted in our culture; people believe they should "grease" to get the job done	6.8
i6 The basic instrument in the fight against corruption is the effective policy for its identification and punishment	8.1
i7 The fight against corruption is primarily an obligation of the authorities	8.5
i8 The fight against corruption is primarily an obligation of citizens	7.3
i9 Each individual and organization can make a strong contribution in the fight against corruption	8.2

Businessmen rated each statement on the 11-point Likert-type scale anchored by strongly disagree (0) and strongly agree (10). The mean values (Table 3) provide first insight into businessmen opinions. Business people most strongly agree (mean value over 8) that fighting corruption is primarily the responsibility of the government who should implement effective anti-corruption measures (including more repressive actions); yet, each individual and organization can contribute to these efforts. On the other side, respondents most strongly disagree on corruption effectiveness as a greasing wheel (mean value 3.4). At the first sight, expressed opinions reflect encouraging business sector attitudes towards corruption as a negative phenomenon. Next we proceed to more detailed factor analysis.

#### 4. RESULTS

The factor analysis has been performed at nine selected items from the questionnaire, each in the form of statement. Two items (i2 and i6) were removed from further analysis as they had significant cross-loadings. Three distinct factors were extracted, with 58.4 percent of explained variance (Table 4).

Table 4. Factor analysis results, factor loadings

Items	Factor 1	Factor 2	Factor 3
i1	0.18	-0.16	0.71
i3	0.68	0.01	0.06
i4	0.73	0.03	-0.12
i5	0.63	-0.05	0.35
i7	-0.10	0.23	0.73
i8	-0.02	0.81	0.21
i9	0.02	0.82	-0.14

As presented in Table 5, description of factors corresponds to the items attributed to each factor: (1) Understanding corruption as a "greasing wheel", (2) Self-initiative to combat corruption needed, (3) Corruption is a government-related issue (Table 5).

Table 5. Description of factors



Factor 1: Understanding corruption as a “greasing wheel”	Means
i3 Private companies are the ones which initiate corruption by offering bribe to get benefits they don’t deserve	4.5
i4 A certain (small) degree of corruption is useful for business	3.4
i5 Corruption is rooted in our culture; people believe they should “grease” to get the job done	6.8

Factor 2: Self-initiative to combat corruption needed	
i8 The fight against corruption is primarily an obligation of citizens	7.3
i9 Each individual and organization can make a strong contribution in the fight against corruption	8.2

Factor 3: Corruption is a government-related issue	
i1 The private (business) sector is helpless before corruption, because corruption derives from the government	6.9
i7 The fight against corruption is primarily an obligation of the authorities	8.5

Statements related to understanding corruption as a “greasing wheel” (items i3, i4 and i5) form factor 1. Factor 2 contains statements on the potentially significant individual contribution to the success of anti-corruption initiatives (items i8 and i9). Finally, statements reflecting opinions on corruption as an exclusive responsibility of government authorities (items i1 and i7) are grouped in factor 3.

In the next step, the analysis of variance has been performed to test the effects of country of origin, perceptions on corruption being an obstacle for business, corruption experience, and opinions on corruption trends in the past decade on factor means (Table 6).

Analysis of variance indicate that attitude on corruption as a “greasing wheel” was affected by country of origin ( $F=22.56$ ,  $p=0.000$ ), by perceptions on corruption being an obstacle for business ( $F=4.23$ ,  $p=0.005$ ), by corruption experience ( $F=46.11$ ,  $p=0.000$ ), and by opinions on corruption trends in the past decade ( $F=4.53$ ,  $p=0.000$ ). Furthermore, attitude that self-initiative is needed to combat corruption was affected only by country of origin ( $F=6.22$ ,  $p=0.000$ ), while attitude that corruption is a government-related issue was affected by country of origin ( $F=10.48$ ,  $p=0.000$ ), by perceptions on corruption being an obstacle for business ( $F=37.78$ ,  $p=0.000$ ), and by opinions on corruption trends in the past decade ( $F=47.33$ ,  $p=0.000$ ).

Table 6. ANOVA results

Independent variables	Dependent variables		
	Understanding corruption as a “greasing wheel”	Self-initiative to combat corruption needed	Corruption is a government-related issue
Macedonia (n=279)	5.0	7.5	7.2
Serbia (n=370)	5.3	7.5	7.8
Croatia (n=410)	4.9	7.9	8.1
Montenegro (n=144)	4.6	8.6	6.9
Kosovo (n=159)	3.1	8.3	7.7
Bosnia and Herzegovina (n=289)	5.6	7.8	8.1
Albania (n=198)	4.4	7.3	7.2
All groups (n=1,849)	4.9	7.8	7.7
ANOVA	$F=22.56$ $p=0.000$	$F=6.22$ $p=0.000$	$F=10.48$ $p=0.000$

In your opinion, is corruption an obstacle for your business?	Understanding corruption as a “greasing wheel”	Self-initiative to combat corruption needed	Corruption is a government-related issue
It is not an obstacle at all (n=409)	4.6	7.8	6.9
It is a small obstacle (n=660)	5.1	7.8	7.6
It is a big obstacle (n=497)	4.9	7.7	8.1
It is an enormous obstacle (n=283)	4.7	7.8	8.5
All groups (n=1,849)	4.9	7.8	7.7

ANOVA	F=4.23 p=0.005	F=0.04 p=0.988	F=37.78 p=0.000
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In the last year, have you or anyone in your company paid bribes in any form?	Understanding corruption as a “greasing wheel”	Self-initiative to combat corruption needed	Corruption is a government-related issue
Yes (n=347)	5.7	7.5	7.8
No (n=1491)	4.7	7.8	7.7
All groups (n=1,838)	4.9	7.8	7.7
ANOVA	F=46.11 p=0.000	F=3.29 p=0.070	F=1.66 p=0.198

Do you think corruption in your country in the past decade has:	Understanding corruption as a “greasing wheel”	Self-initiative to combat corruption needed	Corruption is a government-related issue
been growing (n=809)	5.1	7.8	8.2
been declining (n=279)	4.6	7.9	6.6
remained unchanged (n=642)	4.9	7.7	7.6
doesn’t know/refuses to answer (n=119)	4.4	7.9	6.8
All groups (n=1,849)	4.9	7.8	7.7
ANOVA	F=4.53 p=0.004	F=0.412 p=0.744	F=47.33 p=0.000

Results presented in Table 6 enable comparative analysis of respondents attributes. Businessmen from Montenegro, Kosovo, Macedonia and Albania expressed their firm opinion on more individual efforts needed to combat corruption. The prevalent opinion of respondents from other countries in the survey (Croatia, Bosnia and Herzegovina and Serbia) is that corruption problem derives from government and therefore should be solved by official authorities.

Corruption is primarily a government-related issue for businessmen who consider corruption big and enormous obstacle for business, and for those who had recent corruption experience in doing business. An interesting finding is that businessmen who believe corruption has been declining in the past decade, have more firm and positive attitudes on strengthening self-initiative to combat corruption. This group of respondents would not blame only the government for corruption prevalence.

## 5 CONCLUSION

The analysis based on the business-sector survey showed there are three distinct factors of attitudes towards corruption: (1) Understanding corruption as a “greasing wheel”, (2) Self-initiative to combat corruption needed, (3) Corruption is a government-related issue. Country-specifics, business corruption experience, and different opinions on selected corruption-related issues showed to have influenced businessmen attitudes towards corruption.

Country of origin strongly determines businessmen attitudes on corruption as measured on all three factors, probably due to the different social and economic set-up and heritage. Businessmen with corruption experience tend to justify corruption as greasing wheel more than “clean” respondents with no corruption experience. Generally businessmen that see corruption rising in their country would attribute this problem exclusively to the government. This group of respondents accordingly expect government authorities to take the anti-corruption lead. Government response to the corruption issue rather than strengthening individual or private anti-corruption initiative is a prevalent opinion of businessmen who consider corruption as big or enormous obstacle for their business. The results of this research study provide useful policy recommendations, especially having in mind that the large majority of companies in the survey sample are young and small enterprises up to 50 employees who should generate the economic development in the coming years.

In Western Balkans countries where businessmen expressed firm opinion that more individual efforts are needed in combating corruption, the key component of seizing corruption activities should be raising public anti-corruption awareness. In countries where business sector mostly understands corruption as a government-related issue, “clean” official practises of government institutions would raise trust in the institutions and are considered a good starting point for anti-corruption activities.

Business sector recognizes efforts in combating corruption. This is supported with an important finding: businessmen perceptions on decreasing corruption are related to their (lower) expectations from the government to take an exclusive responsibility in seizing corruption.

Conclusively, policy measures to remove corruption as an obstacle for doing business in Western Balkans should be focused to strengthen anti-corruption awareness and to promote transparency and openness of public services to business. Increased transparency of for example public procurement procedures or issuing licences would increase transaction costs of manipulation so the misuse of public power would not pay off. Governments have to prove their commitment in combating corruption; however, the results would be visible at the longer run. Probably the fastest results could be achieved in increasing trust in institutions and encouraging businessmen and public employees to report on corruption incidence. Findings could help countries in Western Balkans region to design more entrepreneurship-friendly environment. In this respect, more detailed business survey on corruption modalities and bribery experience would provide useful basis for the future research.

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## THE IMPORTANCE OF CORRUPTION SUPPRESSION FOR APPROACHING BOSNIA AND HERZEGOVINA TO EUROPEAN UNION

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### Abstract

Historically, the corruption phenomenon was observed in all human societies from the time immemorial, but economic science has recently begun to deal with this problem seriously. Corruption exists if there is a deliberate distortion of the impartiality principle in decision making process in order to appropriate some benefits. In other words, corruption can be defined as abuse of public power for private gains realization. Corruption is not crucially related to the character of the people in certain region, but it is primarily system creation. Economic system based on greater economic freedom and lower degree of economic activity control is followed by lower level of corruption. Greater interventionism in economy results in higher level of corruption. Therefore, developing countries should establish liberalization of the economy, in order to approach the corruption level that exists in European Union.

According to the mechanisms of corruption and its economic consequences, it is possible to identify several types of corruption:

- Corruption that enables the application of regulations (laws), so-called corruption without theft;
- Corruption that allows circumvention or violation of regulations (laws), so-called corruption with theft;
- Corruption that brings modifications in the existing and creates new regulation (law) or political corruption.

An important issue when considering problem of corruption is difference between centralised and decentralised corruption. It is often considered that decentralised corruption (basic concept: honest government and several corrupted officers) is represented in democratic and developed market economies. More pernicious centralised corruption implies a monopoly in the market of corruption. This type of corruption is a limiting characteristic and particularly difficult problem in developing countries.

Obviously, corruption will never be completely eradicated. A certain level of corruption is inevitable in any society. In order to eliminate sources of this negative activity in developing countries, such as Bosnia and Herzegovina, it is necessary to revitalize assumptions of market economy: private property, economic freedom, individual entrepreneurship, open market and competition. New legal and institutional framework based on mentioned conditions including principle of transparency, is the best way to prevent and suppress corruption to the minimal level.

**Keywords:** Corruption, Economic Freedom, Corruption Suppression, Centralised and Decentralised Corruption.

### 1. INTRODUCTION

The corruption phenomenon has existed since the very beginnings of the human society and is associated with the essence of human nature, which is why it is very difficult to eradicate. The word corruption originates from the Latin word *corumpere* which means to break something in parts. Even Plato, Aristotle and Cicero's writings testify about existence of corruption. Modern meaning of corruption from 1283. is attracting with promises and gifts certain person who has authority and power to act contrary to their duty. Corruption destroys the community, reverses the role of legal and moral standards and threatens public goods and existence of most people.

This paper focuses on the influence of corruption and corruption suppression to the developing countries' socio-economic position and factors affecting the spread of this negative phenomenon in society. In the article we claim that strengthening of market economy assumptions such as liberalization and economic freedom, private property, open market, competition and transparency with new legal and institutional framework, is the best way to prevent and reduce corruption to the lowest possible level. In order to confirm this conclusion, we turn to theoretical considerations of the term and types of corruption, then we consider the factors leading to corruption and its consequences for society, and finally in the last section we explain ways to prevent and limit corruption in developing countries.



## 2. THE TERMS AND TYPES OF CORRUPTION

Regardless of the obvious corruption subsistence, social sciences, especially economic science has recently begun to seriously address this problem. Functionalist's and liberal theories in the USA (60's and 70's of XX century) argued that corruption's ethical aspect is secondary, because it is inherent in human nature; it is necessary product of social development and facilitates its progress, therefore corruption will disappear when development process is completed. Critics of this theory point out the ineffectiveness of most corruption forms, because it encourages the adoption of non-productive behaviors (investing in the purchase of decision makers, not in the quality of the decisions); corruption is a conservative element that attempts to preserve the acquired situations. The European authors approach to corruption problem from the standpoint of universal human rights and social contract. Corruption attacks the foundation of the social contract and civil liberties. The inefficiency of the law and the possibility to rise above the law through corruption practice hurt fundamental principles of democracy: equality and justice. Corruption can be divided into (Hayek, 1997):

- *Black* – the most dangerous form of expression which fall under the impact of criminal law;
- *Gray* – condemnation of public opinion, but tolerated by governing elite;
- *White* – in the public it is considered benign and generally seen as acceptable behavior.

Hayek also claims that corruption is pursuit of the private at the expense of public interest. On the other hand, corruption could be seen as putting public things in service of private interest, while OUN's definition is: "The concept of corruption includes any act or omission done by responsible person when performing duties or in connection with duty, and as compensation, solicit or accept a gift, a promise or a benefit". World Bank and Transparency International talk about corruption as abuse of public power for private gain.

Corruption is the abandonment of the impartiality principle while making decisions that may be intentional or motivated by acquiring material gain. So far, the most comprehensive definition is: "Corruption exists in case of willful violation of the impartiality principle in decision making in order to appropriate certain benefits. Accidental distortion of impartiality (e.g. due to imperfect information) or discrimination for other reasons (e.g. racism) is not a corruption" (Tanzi, 1998).

According to the mechanisms of corruption and its consequences, we distinguish several types of corruption (Mappes-Niedek, 2004).

- Administrative corruption is divided into:
  - Corruption which enables the application of regulation for the implementation or acceleration of rights based on laws, where the employee is motivated to work efficiently or deliberately delays to obtain a bribe. This is so-called corruption without theft.
  - Corruption which allows a violation or circumvention of regulations (enables implementation of illegal rights or fulfillment avoidance of legal obligations or sanctions). This is so-called corruption with theft.
- *Political corruption* - which leads to change or adoption of new regulation or laws (enables partial interests of groups or individuals establish themselves as general);
- *Centralized corruption* – where powerful individuals are trying to control the state. If the product's import requires just one licence from one public officer, there is a monopoly in the market of corruption. In case the permit is issued by more officers, it is assumed they are colluding to form perfect (full) cartel. As there is no difference between the monopoly equilibrium and balance in the case of a perfect cartel, this market structure is called centralised corruption. This type of corruption is particularly difficult problem in developing countries.
- *Decentralized corruption* – carried out in the individual interest (an individual or few related individuals perform the corruption). Let's assume, the import may take several licences, each representing necessary, but not sufficient condition for import of the observed product. Every licence is issued by different incoherent department of public administration and different public officers who are not in collusion. This market structure or industrial organization of corruption is known as decentralised corruption.

Different types of corruption could give different effects on economic efficiency. One of important questions is whether it is worse for a country to have decentralized or centralized corruption. Centralized corruption is much more difficult to eradicate; it permeates the whole system. Decentralized corruption is better researched section because it's basic concept: honest government and several corrupted

officers is more suitable for democratic and developed market economies, with delaborated economic theory.

### 3. INFLUENCE OF THE ECONOMIC SYSTEM'S TYPE ON THE CORRUPTION LEVEL

Greater interventionism in economy and increasing role of the state leads to the higher corruption level. On other words, economic system based on greater economic freedom implies a lower degree of corruption in society. If the government has more resources to regulate the economy, there are more conditions for corruption and bribery. Rule of the law means the government is restricted in all proceedings with determined and proclaimed rules – rules which make it possible to predict with fair certainty how the government will use its power of coercion in given circumstances (Hayek, 1997). Hayek is against so-called arbitrary rule, which involves the situation where the government directs the use of production's resources for specific use. In order to avoid this, regulations should be made in advance in form of formal rules that do not target the needs and desires of individuals.

However, state interventionism is the opposite of this approach. The state agency which acts according to plan, cannot limit on the opportunity provision and conditions creation for individuals. The authority such as this one solves problems case by case and does not use established rules, but entries specificities of the moment and subjective ratings. This immediately creates a suitable environment for abuse of positions for their own purposes. Analysis of intervention would not be completed if corruption phenomenon was not mentioned (Von Mises, 1966). Any system that has the ideal of distributive justice threatens the rule of rules and produce convenient ambient for corruption. Distributive justice is not based on fundamental rights, but on specific orders and decrees adapted to circumstances and/or certain people and groups.

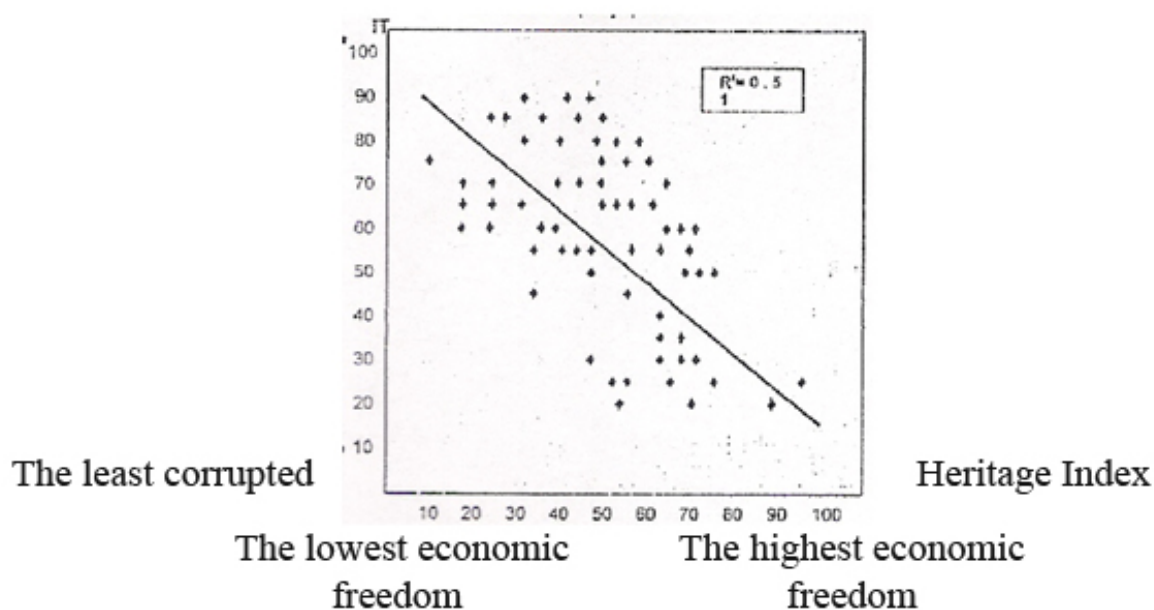
From the point of corruption it is very important to found an institutional system in which the state will be limited on establishing the rules related to the general types of situation (not on case by case) and where individual freedom will be allowed. Freedom of the individuals means creating conditions for corruption, but also for the control of every government's action (Douglas, 1990). Different analyses show corruption is very present in areas that lack economic freedom.

The interdependence between economic freedom and corruption has been empirically measured within research carried out by Heritage Foundation from Washington. The Index of Economic Freedom and TI Index (Transparency International Index) are constructed by their methodology. Though measurements are error-prone, statistic data are relevant and confirm the logical analysis of state interventionism combined with the weakness of human nature opens up the possibility for corruption. Economic freedom in this model is measured by index which gave three independent organizations: Heritage Foundation, Fraser Institute and Freedom House. The first index (Heritage Foundation) includes 140 countries, the second (Economic Freedom of the World) - 95 and the third (Survey of Economic Freedom) – 69 countries. Index of Economic Freedom ranges from 1 (the lowest) to 100 (the highest level of freedom). Corruption is measured by TI Index, ranged from 0 (the most corrupted country) to 10 (the cleanest country). The following graph shows the correlation between economic freedom (Index of Economic Freedom) and corruption (TI Index).

Graph 1: High level of economic freedom is correlated with lower level of corruption,

All indexes of economic freedom have a high negative correlation with the index of corruption: the higher the index of economic freedom - the lower corruption index. This correlation is high and it amounts  $R^2 = 0.51$ . Therefore, 1% increases in the Index of Economic Freedom causes reduction of more than 1% in the level of corruption.

### The most corrupted IT Index



True economic freedom is only possible in a system with great power of government and strong legal norms. Hence, the rule of law system, which means the system of limited state powers, constitutes the essence of a just society that protects individual rights and individuals are free to realize their desires and actions.

It should be noted corruption will not automatically disappear with introducing of economic freedom and minimizing government intervention. In countries with the same degree of economic freedom may be found different level and types of corruption. Increase of corruption is especially observed in developing countries, such as Bosnia and Herzegovina. In these countries, corruption becomes a particular problem in the following situations:

- Certain groups and political allies have obtained favorable positions and monopolies (e.g. during privatization process);
- Change in the structure of government intervention has occurred in the economy;
- Globalization in the economy affects increasing importance of economic power.

During the XX century, state interventionism was easily concealed by claims that these activities served the common good or the execution of social obligations. Import restrictions gave opportunity to civil servants to charge their signature on import permit. However, with globalization and expansion of international trade, listed phenomena are becoming hard to maintain and the hiding costs are growing. In terms of globalization, facilitated import and lower prices, there are fewer people seeking the "other way", so diffusion of economic power and easier access to information affects reduction opportunities for corruption. Preservation of closed economy is very hard in modern times. If the import of quality products from abroad is restricted and its domestic substitute is costly, it increases expenses that were previously covered through loans and assistance from foreign countries or lower standard. Globalization definitely breaks down closed systems. Certainly, changes in corruption do not automatically correspond to changes in economic freedom. This process requires time and even countries with low level of corruption take time to reach that level. Corruption requires a period

1 Source: <http://www.transparency.de/Veranstaltungen-zum-Thema-Korr.1181.0.html> (accessed 29.08.2011.)

of time only for discovering and then the time for institutional changes that will stand up against corruption.

#### 4. CORRUPTION IN MARKET ECONOMIES

Even in market economies, corruption is successfully working. However, in comparison to developing countries, we are mainly talking about decentralized corruption. Corruption is seen in connection with the creation and operation of the black market. Black market appears in situations where there is consumer interest in certain types of products and services whose market transactions are disabled. Thus it appears in both market and non-market environments. Revenue's realization from large transactions on black markets creates a strong financial potential for the initiation and maintenance of corruption. Like any market phenomenon, it is possible to identify carriers of supply and demand for a given type of service. Interested players engaged in this type of transaction tend to reduce external constraints that the system sets them. They realize their aim by corrupting civil servants. Consequently, it is possible to involve bribery in standard analytical framework of the market equilibrium concept. Theoretically speaking, entrepreneurs in the black market could perform openly the same way as on the free market, which make it possible, with defined supply, to establish level of equilibrium bribe. This bribe should be calculated with costs and passed on the equilibrium price (Becker, 1993). However, it is a theoretical assumption, because in reality entrepreneurs tend to crowd out their potential competitors and establish a classical monopoly, often by all means necessary and without any regard to moral norms.

This type of behavior has broad implications. The bribery process leads to creating a parallel system of bribery regulation, apropos illegal private taxation which actors on black market pay to public employees. Tax burden caused by bribery is transferred to final consumers, who pay higher price. If we compare the black market without regulation and the state of corruption and regulation, two effects can be observed: allocation and distribution (Mijatović, 2001). The allocation effect is caused by changing the price level and therefore conditions of equilibrium and distribution effect is the fact that part of income is directed to government officers.

In the situation where government agencies appear on the market either as a buyer or as a seller, there is a whole range of opportunities for corruption (Rand, 1994). Major incentives for corruption are public sales (e.g. privatization or sale of national wealth) and functioning of public services sector which is in the regime of controlled prices. Controlled prices lead to emergence of excess demand and lack of supply, and the balance is established by long waiting at services. On the supply side is civil servant – monopolist. Interested actors on demand side offer funds through informal auctions to reduce the time of waiting (so-called ways of pressure) and the winner is the highest bribe bidder. This type of corruption in public sector provides additional social problem and generates social inertia. On the other hand it creates powerful and influential lobbies that prevent or oppose any kind of liberalization, in order to keep their positions.

So, source of corruption is always the same: existence of state which distributes welfare to different social groups. Any regulation, law or legal program creates space for manipulating in the interest of certain social groups (Becker, 1993). If the state has the power of economic control, it attracts legislators and politicians who are prone to bribery. They will work in favor of incompetent entrepreneurs and hinder economic efficiency based on ongoing initiatives and activities, which means long-term destroying vital prerequisites for economic development in society. This is also the most serious negative effect of corruption.

The 2009 Global Corruption Barometer research asked more than 73,000 individuals around the world to perceive corruption in six key sectors and institutions. Political parties were perceived to be corrupt by 68% of respondents, followed closely by the civil service and parliament: 63% and 60% respectively. The private sector and judiciary are also seen as corrupted by half of respondents. Around 43% of interviewees also believed that the media is affected by corruption. When asked which of the six sectors/institutions they considered to be the most corrupted, the general public frequently identified political parties and the civil service, with 29% and 26% respectively. The media and the judiciary, with 6% and 9% of respondents, were seen as the least corrupted institutions.

Table 1: Single institution/sector perceived to be most affected by corruption, by countries

Institution/Sector	Country/Territory
Political Parties	Argentina, Austria, Bolivia, Bosnia and Herzegovina, Chile, Colombia, El Salvador, Finland, Greece, Hungary, India, Israel, Italy, Lebanon, Malaysia, Nigeria, Serbia, South Korea, Thailand, United Kingdom, Venezuela.
Parliament/Legislature	Indonesia, Panama, Romania, United States.
Business/Private Sector	Brunei Darussalam, Canada, Denmark, Hong Kong, Iceland, Luxembourg, Moldova, Netherlands, Norway, Portugal, Singapore, Spain, Switzerland.
Public officials/Civil Servant	Azerbaijan, Belarus, Cameroon, Czech Republic, Ghana, Iraq, Japan, Kenya, Kuwait, Lithuania, Morocco, Pakistan, Philippines, Poland, Russia, Senegal, Turkey, Ukraine, Zambia
Judiciary	Armenia, Bulgaria, Cambodia, Croatia, FYR Macedonia, Georgia, Kosovo, Mongolia, Peru, Senegal, Uganda

Source: [http://ti-bih.org/wp-content/uploads/2011/02/Global\\_Corruption\\_Barometer.pdf](http://ti-bih.org/wp-content/uploads/2011/02/Global_Corruption_Barometer.pdf) (accessed 05.09.2011.)  
Percentages are weighted.

Table 1 shows the institution or sector that was identified in each country as the most corrupted. When looking at people's perceptions of corruption in key sectors over time, the results show little change between 2004 and 2009. Analysis of individual assessments in 41 countries and territories covered by all editions of the Barometer since 2004, indicate that the views of the general public on political parties, parliaments, the judiciary and the media have not changed notably. Table 2 groups countries based on reported bribery.

Table 2: Countries reported to be most affected by bribery

% of respondents reporting that they had paid a bribe in the previous 12 months		Country/Territory
	<b>Group 1:</b> More than 50 %	Cameroon, Liberia, Sierra Leone, Uganda
	<b>Group 2:</b> Between 23 and 49%	Armenia, Azerbaijan, Bolivia, Cambodia, Ghana, Indonesia, Iraq, Kenya, Lithuania, Moldova, Mongolia, Russia, Senegal, Venezuela
	<b>Group 3:</b> Between 13 and 22%	Belarus, Greece, Hungary, Kosovo, Kuwait, Lebanon, Nigeria, Pakistan, Peru, Romania, Serbia, Ukraine
	<b>Group 4:</b> Between 7 and 12%	Bosnia and Herzegovina, Chile, Colombia, Czech Republic, Hong Kong, India, Malaysia, Philippines, Thailand
	<b>Group 5:</b> 6% or less	Argentina, Austria, Brunei Darussalam, Bulgaria, Canada, Croatia, Denmark, Finland, FYR Macedonia, Georgia, Iceland, Israel, Japan, Luxembourg, Netherlands, Norway, Panama, Poland, Portugal, Singapore, South Korea, Spain, Switzerland, Turkey, United Kingdom, United States.

Source: [http://ti-bih.org/wp-content/uploads/2011/02/Global\\_Corruption\\_Barometer.pdf](http://ti-bih.org/wp-content/uploads/2011/02/Global_Corruption_Barometer.pdf) (accessed 05.09.2011.). Figures exclude 'Don't know' answers. Groups were defined using cluster analysis.



## 5. STIMULATING FACTORS FOR THE APPEARANCE OF CORRUPTION

When it comes to corruption, it is necessary to explain the factors that stimulate corruption and answer the question what are the suitable conditions for the flourishing of the same. Corruption in developing countries is particularly affected by economic factors, such as structure and transformation of the ownership (privatization), excessive state intervention in the economy, non-observance of market principles, poverty, etc. In these conditions, one institutional system is destroyed and has not been established an alternative, which is why the society lost its landmark. The market economy is formally introduced, but the production and allocation of resources is directed by administrative activities of the state. Due to the lack of market verification of business, political mediation creates a privileged position of individuals and groups. Directors of state owned enterprises are in favor of excessive state regulation of economic activity, import and other licenses and price control, resulting in a hypertrophy of the institutions (Čupić, 2002). Regulation and price control is a key tool for the development of corruption in the history of civilization. An example of corruption's implementation is granting loans at interest rates lower than market ones by some of the banks, thus certain groups; the most politically convenient draw their advantage. Do not forget the weak local currency which restricts political and economic freedom. High inflation and weak currency induce people to protect their own interest in different ways through speculation, which is the opportunity for corruption.

Furthermore, political factors may also be initiators of corruption and the most important ones are: an inadequate institutional framework, functioning mode of the political parties, uncertain legal status, long-term international isolation, informal power centers and the lack of consensus on strategic state goals (Nikolić, 2005). Government guarantees for the loans, intermediations and government procurement, always of high volume, represent a very suitable environment for the corruption development. In developing countries the state often has a monopoly over the information, which is used to create unfair competition among the potential competitors.

The legal factors which may increase corruption include: failure or selective application of regulation, the existence of legal gaps and inconsistency of regulations (Vukotić, 2000). Conversely, institutional factors that encourage corruption are: missing or dysfunction of institutions, unqualified staff, lack of material equipment and incompetent institutions. Corruption can also have historical background, e.g. rapid change of social values, consequences of the wars in former Yugoslavia, tradition, the lack of professionalism. Abundance of natural resources, high level of corruption in neighboring countries and long distance from the world's leading trading centers are factors that instigate corruption. Studies show countries with high level of general trust; a lot of Protestants and low acceptance of hierarchy are less exposed to the corruption risk. Further, the social structure dominated by men adversely affects corruption. Gender's influence on corruption significantly decreases when variables such as rule of law, press freedom and democracy are valued and kept under the control.

## 6. CONSEQUENCES OF CORRUPTION

The incentive factors of corruption are related to a number of negative consequences of this phenomenon. The direct economic consequences include high transaction costs shifted on citizens (in this case, citizens are not subjects of judicial corruption protection, so a lot of resources and time have been spent unnecessarily). Long-term economic consequences are following:

- Corruption and organized crimes are not productive but redistributive activities so they redistribute in the society;
- The diversion of direct foreign investments, not only because of the amount to be paid, but also by instigating uncertainty and risk during the lifetime of the investment project;
- Increasing risk of placing loans in listed country and thus increasing interest rates;
- The interest of organized crime to increase corruption, because it allows taking control in the state.

At the end, corruption leaves serious social consequences: decreasing living standard, destruction of the earlier value systems, increasing social stratification, cutting the budget and thus the social rights of the poor (poverty is one of the causes of corruption and vice versa).

## 7. HOW TO SUPPRESS CORRUPTION

How we saw in previous chapters nor market economies are exempt from corruption problems. However, developing countries have much more trouble with this phenomenon. So how to fight corruption back? It is necessary to establish not only market competition, but also democratic political system. Free competition in the democracy context is of the same importance as in free enterprise. In an ideal democratic atmosphere no one could stay long in power if they did not respect the will of voters. This would reduce potential for abuse of official position. The more government is constrained; the incentives for corruption are minor. In order to restrain civil servants from abusing public functions, there have been suggested different measures. One proposal is to shorten the term of individual functions and, but it can lead to a counter effect. Another suggestion is the decentralization of powers (Tullock, 1992). Voters should raise questions of their vital interest and exert pressure towards the authorities. Enabling citizens to choose their institutions and carry out the democratic control decreases opportunities for corruption. In smaller communities, the interdependence is greater and any criminal activity or corruption would put in question survival of the community.

Liberal doctrine holds the point any institutional restraint, especially economic freedom limiting, as a rule leads to corruption. Economic freedom has much deeper implications that it could be assumed at first. "Economic control is not only a control of human life that can be separated from the rest, it is the control of resources necessary for our goals" (Hayek, 1997). It is important to have in mind the fact there is strong interdependence between economic and political freedom. Without the existence of economic freedom, legal freedom itself is not able to prevent corruption.

## 8. CONCLUSION

After all it is said, how can we cut down and suppress corruption? First, the type of economic system definitely affect the level of corruption in society. Numerous studies confirm economic systems with less interventionism and more freedom indicate a lower degree of corruption. Not only that: even in the same society corruption representation is much higher in the fields controlled by state and lacking economic freedom. So the first goal in the fight against corruption is to limit often very harmful regulation. Since the corruption occurs as a result of privilege that only the government can legally authorize, Index of economic freedom in the country includes corruption as one of the variables (using the indicators of corruption in bureaucracy and judiciary and existence of black markets).

Therefore, corruption can be suppressed by reducing the public sector. However, there is another problem. Private enterprises can also be exposed to corruption, e.g. massive corruption during the privatization. The stumbling block is not the size of the public sector, but bad regulation and erroneously targeted state intervention. Corruption is a reflection of the lacking competition, although competition can sometimes increase corruption. The officials' obligation to inform public about their work, transparency and increasing salaries of civil servants, career development system and development of ethical standards can significantly reduce corruption. In particular, anti-corruption mechanisms can be divided into:

- *Prevention* – transparency, decision making and access to the information, limiting monopoly in decision making, restriction of discretionary powers, reducing the number of prohibitions and restrictions, strengthening public ethics.
- *Repressive measures* – annulment of corrupt activities, discovery of actors, efficiency of the procedure and adequacy of imposing sanctions, seizure of the property acquired through corruption, etc.

Democracy limit corruption by increasing competition for political mandates. Researches show the parliamentary systems are followed by lower levels of corruption, while the strong presidential systems tend to be more corrupted. Smaller electoral units increase corruption, also corruption is greater when the deputies have been elected from party lists rather than as independent candidates. Furthermore, decentralization is a way to reduce corruption, because the government becomes closer to citizens (the problem is that local authority can be weak, but local players strong.) Corruption in developing countries is a systemic and systematic phenomenon and such should be the struggle against it. The most important test is preventing corruption in the tops of power by introduction of anti-corruption system laws. The power within the government can be controlled by decentralization, distribution of power, demonopolisation and rule of the law. In this regard it is necessary to separate the judiciary from legislative power since functioning, effectiveness and independence of the judicial system affects all political institutions. These institutions are using judicial system to protect themselves against political tyranny and criminalization. Only with institutional (economic, legal

and political) arrangements that protect economic and political freedom based on it, it is possible to achieve the necessary conditions for combating corruption.

We conclude that any loss of economic freedom creates the conditions for the emergence and expansion of corruption with all its negative consequences. Developing countries need less interventionism and more free space to strengthen the mechanisms of market economy, with transparent, protected and strictly followed rules and laws. Building a system based on private property, individual entrepreneurship, competition and open market, and promoting transparency and public opinion in society represents the possibility to combat corruption and improve the economic position of developing countries.

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Part Two:  
Entrepreneurship, Innovation, Creativity

# LOCATING ENTREPRENEURIAL CREATIVITY AND KNOWLEDGE TO FOSTER GROWTH OF EUROPEAN CITIES<sup>1</sup>

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## Abstract

By exploring the attitudes and preferences of managers and entrepreneurs from creative and knowledge-based sectors, this paper aims to contribute to the ongoing discussion of the factors fostering the flow of entrepreneurs to particular cities and regions in Central and Eastern Europe and Western Europe. The cases of five metropolitan regions – Sofia, Riga, Budapest, Helsinki and Toulouse are used for this purpose. Among other things, our data suggests that, although very useful, the distinction between “hard” and “soft” factors is not a sufficient theoretical basis to explain the location patterns of creatives. In this light, the influential role of additional drivers, such as the “individual trajectory” considerations that overwhelmingly dominated in all studied groups in our sample, was identified by this study.

**Keywords:** Entrepreneurship, Creativity, Europe, Cities

## 1. INTRODUCTION

Recent literature emphasizes the role of the constant supply of creative energy from citizens in fostering the development of places, cities in particular (e.g. Florida, 2002). In this light, globalization and new technologies have significantly decreased the impact of distances which in turn has facilitated the flow of the creative population between various cities and regions (e.g. Lucas, 1988; Karlsson, Johansson and Stough 2008), widely acknowledged as having a positive impact on productivity, (Amabile, 1983; Audretsch and Feldman, 1996). Attempting to explain why economic activity and creative people group in one place and not another, literature emphasizes the role of supply and demand conditions.

The supply side refers to the personality and cognitive characteristics of individuals living in cities - their ability to generate new ideas and spot new opportunities and their willingness to implement these opportunities (e.g. Amabile, 1996). Furthermore the role of the context in which people live and make everyday decisions has been highlighted as having considerable impact on the level of individuals' creativity (Florida, 2002; Rasulzada, 2007). In this light, literature highlights the importance of the demand side of cities, referring to the “overall quality of the city”. Factors such as the level of education institutions, tolerance towards minorities, city size and the size of the market as well as networking possibilities and the ability to generate spillovers have been mentioned among other factors of influence (e.g. Jacobs, 1961; Florida, 2002; Glaeser, et al., 2001; Fujita and Thisse, 2002).

In spite of considerable efforts to address the questions of why and how cities and regions attract people and stimulate creativity, there is still a lack of sufficiently robust empirical evidence in this regard. By exploring the attitudes and preferences of managers and entrepreneurs from creative and knowledge-based sectors, this paper aims to contribute to the ongoing discussion of the factors fostering the flow of entrepreneurs to particular cities and regions in Europe. The cases of five metropolitan regions – Sofia, Riga, Budapest (East European capitals), Helsinki (a West European capital city) and Toulouse,

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2 Although it is generally believed that creativity has a positive effect on productivity and general well-being, it should be emphasized that there are also costs which the process of creativity can involve. For example, due to the uncertainty of the outcome, creative people are met with scepticism and resistance from society and are also at risk for failure and increased stress (Boden, 1997; Kanter, 1988).



a classic West European “second city” operating in the shadow of the national capital – are used for this purpose. The rest of the paper is structured as follows: Section 2 highlights the major challenges in the existing conceptual framework. Section 3 presents methodology. The main results are presented in Section 4 and the paper closes with conclusions and implications in Section 5.

## 2. CITIES AND THE CREATIVE CLASS: MAJOR CONCEPTUAL CHALLENGES

An influential position within the debate on the determinants of creative population flow between cities is, of course, the conceptual construct of the “creative class” developed by Richard Florida (2002). There are three major points in Florida’s theory. The first is that the highest value added is produced by “creative industries” such as IT, design and arts and cities should thus focus on these industries. Florida’s second point is that, in creative industries it is no longer the case that employees follow the company. On the contrary, creative companies tend to be located in places where the “creative class” (“creatives” for short) congregates.

The third point is most directly linked to policymaking and planning, highlighting that “creatives” are highly mobile, nomadic individuals who choose their location for reasons other than the classic “hard”-factor considerations, such as rent levels, availability of office space, accessibility and transport. Instead, “soft” factors, e.g. urban “buzz”, varied (sub)cultural life, ethnic diversity, availability of greenery and open water, bicycle-friendliness, friendly spaces for interpersonal communication and high levels of tolerance are of major importance when location decisions are made. The simplified policy-related outcome arising from this framework is obvious: a city which intends to have creative industries should first put together the right mix of “soft” and “hard” factors to attract the nomadic “creatives”. The development of the city should then follow as they move in.

In light of this discussion, it should be emphasized, however, that a multitude of critical objections have arisen regarding the Florida brand of “creative class” theory and its policy ramifications. Steven Malanga, the editor of *City Journal*, for example, pointed out that over a longer term horizon the “most creative” US cities on Florida’s list are the worst performers economically (Malanga, 2004). According to Malanga’s estimates, the top ten most “creative” cities, for instance, experienced 17.5 % job growth from 1993-2003, while “Florida’s least creative cities” saw their job numbers grow by 19.4 %. Furthermore, over a 20-year period, the “least creative” cities have been the USA’s powerhouses, expanding 60% faster than creative cities.

Next, in line with Florida (2002), some US-based empirical evidence has indeed indicated that amenities do matter and play a role in individuals’ location decisions. The trouble here, however, is that existing empirical evidence suggests that almost every group of the population, not only “creatives”, are attracted by amenities (Clark, 2004). Furthermore, “pipes, pavements and policing” seem, even in the USA, to remain very important in making cities attractive places. If that is the case, an over-simplified Florida-derived development plan may badly misfire by misdirecting resources, for example.

These are only a few examples of criticism of Florida (2002) to be found in the literature, of course. The major caveat in this discussion is that getting policy-oriented decisions wrong can have a negative impact on the future of each city. This is why the assumptions behind location theories of the “creative class” must be constantly re-assessed. Consequently, it is reasonable to argue that updated and diversified conceptual and empirical packages are needed in order to inform policy decisions. The next sections of this paper aim to contribute in this regard by providing empirical evidence from Sofia, Riga, Toulouse, Budapest and Helsinki, drawing on data from a survey of managers in creative and knowledge-intensive industries.

## 3. METHODOLOGY

21 to 24 semi-structured interviews were conducted from February-April of 2008 in each city, i.e. Sofia, Riga, Toulouse, Budapest and Helsinki. The respondents were all “managers” – where “manager” was defined as the person being the leading decision maker of the company. Following sectors were covered: business and management consultancy; computer games and electronic publishing, motion picture and video activities, radio and TV activities, research and development. All interviews were in depth face-to-face interviews lasting for about one hour.

The main aim of the interviews was to address the reasoning behind the location decisions of the managers and entrepreneurs from creative and knowledge intensive industries. Thus, interviews were

conducted based on a semi-standardised guideline which comprised open-ended questions structured around the following themes<sup>3</sup>:

- The company's business model and markets;
- Labour processes and recruitment;
- Networks (formal and informal) and their importance;
- Choice of location;
- Public support;
- Prospects at the current location.

#### 4. TESTING FLORIDA: ON THE LOCATION OF THE CREATIVE CLASS

##### 4.1. Location Decisions: the Role of “Individual Trajectory” Considerations and “Hard” Factors

The results from all cities in our sample suggest that the main drivers for settlement of entrepreneurs and managers from creative and knowledge-intensive industries are linked not to “hard” or “soft” factors but to “*individual trajectory*”. In *Toulouse*, for instance, as much as 75% of the interviewed managers had an anterior link with the city, either through family networks or networking established during their studies. Moreover, 55 % of the managers were born in or near the Toulouse region and 60% studied in Toulouse. Very similar findings to those are also reported in the case of the Helsinki Metropolitan Area, whereas in Sofia, Budapest and Riga “individual trajectory” seemed to have an even more significant impact.

To be more specific, respondents from the knowledge-intensive industries in *Sofia* and *Budapest* reported location decisions related to “individual trajectory” factors virtually without exception. Also, in *Riga* the majority of managers mentioned that their company is located in the city mainly because they were born there, have lived there in the past, or have studied there, thus having relatives and friends in the city. Overall, these findings are in line with Krugman (1991) and Markussen (1996), who emphasized the place-dependency of entrepreneurial activities, arguing that entrepreneurs tend to stick to the places they know and where they have networking opportunities – very often these are the places they originally come from.

As for the influence of “hard” factors, managers and entrepreneurs of creative companies in Toulouse cited “market opportunity” reasons rather than “soft” factors as having an influence on their location decisions. Opportunities to recruit skilled workers, the presence of good universities as well as size of the city seemed to affect the location choices of both local and incoming managers considerably. Furthermore, the rapid demographic growth of the UAT (about 17,000 extra inhabitants per year since 1999) is seen as a favourable factor by companies, especially those having a link with the real estate sector. Overall, these findings reflect previous empirical evidence highlighting the role of density within cities in generating knowledge spillovers, achieved through the interaction and networking of the (creative) population and furthermore positively influencing the growth of the region (Lucas, 1988; Johansson and Karlsson, 2008). It should be emphasized, however, that according to our data, “hard” factor deficiencies are also seen, in Toulouse, as a significant stumbling block. Respondents from Toulouse, for instance, mentioned that the city is at a disadvantage due to the lack of cheap high-speed train connections to the capital and other strategic nodes in France and Europe. In managers’ and entrepreneurs’ opinion, the concentration of power and resources in Paris means that the majority of managers have to travel regularly to the capital city to meet and socialize with decision-makers.

“Hard” factors outweigh “soft” considerations in the case of *Helsinki* as well. More specifically, apart from “individual trajectory” considerations, the major drivers of entrepreneurs’ and managers’ location here are the presence of specialized skilled labour and the concentration of customers. Furthermore, many entrepreneurs stated that nearly the whole industry is located in Metropolitan Helsinki; thus, they simply have to be there. Such claims are well justified by available statistics, e.g. similarly to other industries, the business and management consulting industry, for example, is strongly concentrated in the Helsinki area, with approximately 60% of the entire sector’s employment positions in Finland (Kepsu and Vaattovaara, 2008). Interestingly enough, however, none of the entrepreneurs or managers interviewed in Helsinki mentioned any “soft” factors as important location drivers for their location to the city.

<sup>3</sup> Please see <http://www2.fmg.uva.nl/ACRE/results/reports.html> (reports 6) for a more detailed description of methodology.

As in the case of Helsinki, “hard” factors, just after “individual trajectories”, play a decisive role in the site selection of entrepreneurs and managers and their companies in *Budapest*. The availability of the labour force, especially in financial and business activities, stands out as a crucial issue in this regard. That is, according to respondents, Budapest, as the centre of business life and also of higher education, is an “ideal place” to recruit. As in the other cities in our sample, however, several “hard” factors, such as the poor state of public transportation, were mentioned as causing major dissatisfaction. Overall, the same picture with regard to the importance of “hard factors” is reproduced by interviewed entrepreneurs and managers in *Riga* and *Sofia*, where beyond the dominant “individual trajectory” issues, factors such as access to a qualified workforce, the concentration of the relevant industry in the city, proximity of customers, access to government institutions and networking possibilities were highlighted as having a positive role in the location decision.

#### 4.2. Location Decisions: the Role of “Soft” Factors

The main conclusion with regard to the influence of “soft” factors on the location decisions of managers and entrepreneurs of creative and knowledge-intensive industries in Sofia, Riga, Toulouse, Budapest and Helsinki is that our sample falls almost entirely outside of Florida’s theoretical model. More specifically, “soft” factors were mentioned very rarely and were emphasized as the drivers behind location decisions by isolated individuals only. Still, drawing on our results, an analytical sub-division between “location” and “retention” decisions has to be introduced as even though the location decisions of managers in the sample are nearly free of “soft” considerations, the decision to stay in the city is often significantly influenced by satisfaction with the “soft” factors in place.

For example, in the case of *Toulouse*, not a single respondent has made a *location decision* based significantly on “soft” considerations. Overall, the most mobile turned out to be managers in the business and management consultancy sector, over half of whom had no prior link to Toulouse, whereas web designers and managers from the games industry showed the least mobility in our sample, all of them being locals. A number of managers, however, reflected a strong affective attachment to the region by saying that they are not willing to leave the city at all. Arguably, this pattern may result from the “individual trajectory”. However, the influence of “soft” considerations, such as the proximity of the sea and mountains, the sunny climate, and the specific atmosphere and mindset of the South of France, could be another explanation in this regard, pointing to the comparably large role of “soft factors” with regard to managers’ and entrepreneurs’ *retention decision*.

Contrary to Toulouse, some evidence that “soft” factor considerations inform at least a few location decisions in *Helsinki* emerged from the data set. The major considerations include the nearness to high-quality residential space and safety issues. Furthermore, in line with the findings of a previous sub-study on creative knowledge workers in Helsinki (Kepsu and Vaattovaara, 2008) our data from Helsinki, as well as from other cities in the sample, suggest that managers appear to value “soft” factors, such as the ambience or “buzz” of the city. More specifically, according to managers various *networking related factors*, such as hanging out in theatre cafés, going to movie premiers and being inspired by urban life are of increasing importance to people, e.g. potential and existing employees from the managers’ and entrepreneurs’ viewpoint, in the whole industry. Overall, however, the mentioned “soft” factors seem to have a greater weight in entrepreneurs’ and managers’ *retention*, rather than in *location decisions*.

The situation regarding the influence of “soft” factors is not very different in the ex-socialist cities covered by the survey. In *Budapest and Riga*, for example, managers mentioned “soft” factors rarely and largely by chance, suggesting that as far as location decisions go, “soft” factors play no appreciable role. According to managers, “soft” factors emerge during site selection primarily when the residence (cottage) is also the seat of the company and in the agglomeration zone, where due to the lower rental fees and real estate prices the business managers have better opportunities to consider “soft” factors in decision-making. Of such factors, the importance of a calm and quiet environment was mentioned by the managers as most important. A neighbourhood with very poor outer appearance and social composition could be an excluding circumstance in a few cases.

The fact that very few managers from Budapest and especially from Riga explicitly discussed the role of the “soft” factors in the location decision might support the view that “soft” factors are not important. However, since people usually find it easier to complain than to give credit, the reason for not mentioning problems with “soft” factors could also be due to the fact that Riga, for instance, does quite well in this regard. This notion, however, again appears to be more relevant for employees than for managers. Furthermore, as in the case of other cities, managers’ and entrepreneurs’ decisions to *retain* in Riga are more likely to be motivated by “soft” factors than decisions to *move in*.

As regards *Sofia*, almost uniformly companies do not see emblematic “soft” factors, such as amenities, leisure and nightlife, or diversity as having any significance in their location decision. Of particular interest in this regard is the lack of sensitivity to the factor of cultural tolerance, which Florida (2002) finds to be of particular significance – i.e. the importance of low barriers for entry, such as barriers for self expression (often related to tolerance towards gays and bohemians), in order to facilitate the flow of creatives to the city. In this light, according to the available statistics, Sofia seems to be one of Europe’s most cosmopolitan and tolerant cities, with more than 17% of its population being some sort of ethnic, religious or national minority (Dainov and Nachev, 2008). Yet, according to our data, in no case did a single respondent see tolerance and diversity as a factor in location decisions. It is not, therefore, surprising that in cities more homogenous than Sofia, tolerance of diversity also plays no role in location decisions.

Finally, according to our data, the importance of “soft” considerations, especially in Helsinki, Budapest and Sofia, varies across the industries. In this light, respondents having at least some sensitivity to “soft” factors in these cities can be found at broadcasting companies. It could be argued in this regard that while representatives of other industries, such as consultants and computer-related businesses, are almost entirely oblivious to this problem, broadcasters are capable of discussing and evaluating the role of “soft” factors. One of the explanations for this phenomenon could be related to the maturity of the companies, since consultancies and computer-related businesses are at an age of infancy compared to broadcasters. Thus, the reasoning that “individual trajectory” issues and “hard” factors dominate when you start a business, whereas sensitivity for “soft” factors is developed when a business matures and stabilizes, could make at least some sense. This is, however, something previous empirical studies have not captured to a sufficient extent, suggesting that further research is needed on the issue.

#### 4.3. In-City Location Decisions

Different types of creatives tend to congregate in different locations within the urban area. While “cultural creatives”, such as artists, media and entertainment workers, scientists, teachers, designers and advertisers, usually prefer an inner-city location, managers and entrepreneurs seem to be spread much more evenly across the city (e.g. Musterd, 2004). Such differences in location decisions within the “creative class”, often influenced by “soft” considerations, have also been pointed out by Florida (2002), especially with regard to, as labelled by the author, “bohemians” and “nerds” in the U.S.. Whether the location preferences of creatives within the city centre or suburbs are influenced by “soft” factors, however, is a very problematic issue in the European context. According to our findings, for example, “soft” factor considerations play a strikingly insignificant role with regard to in-city location decisions as compared with the case of the U.S., being mostly related to classic “hard” factors, such as rent, access, and closeness to client base. Moreover, it looks like such profiling, for whatever reason, should be expected of settled “Western” cities, rather than of the more turbulent and as yet unsettled ex-socialist newcomers to capitalism.

To be more specific, in *Toulouse*, for example, in-city location profiling does exist, but evidence points away from the overwhelming dominance of “soft” factor considerations. Self-employed creatives as well as small companies,<sup>4</sup> for instance, tend to settle more frequently in the periphery, where rent is lower, whereas the largest companies exclusively choose the city centre of Toulouse.<sup>5</sup> However, companies involved in, arguably, the most creative activities, such as video, animation movie, 3D web design, and computer games, seem to favour the historic core and show the most sensitivity to “soft” factors. Here, the managers mention accessibility and flexible working hours, but location choice also relates to the image given to clients, whereas “soft” factors are linked to atmosphere, including architecture, density of boutiques, cafés and restaurants in the neighbourhood.

Entrepreneurs and managers whose companies are located in the centre of Toulouse usually justified their choice by proximity to their own place of residence and by the fact that employees tend to live in the area. The parking difficulties and the congestion problems in the centre, however, often come up as explanations for choosing a location in the peripheral business parks. According to the survey data, the computer industry also benefits from a large density of already-existing clustered establishments, such as the aeronautics clusters in the northwest, electronic and computer clusters in the southwest as well as space, computer and biotechnology clusters in the southeast and the multi-nodal logistic platform in the north of the city. Among influential factors regardless of the sector in Toulouse, however, the importance of informal social networks linked to “individual trajectory” factors and to the role of the anterior social insertion of the respondents in the city region was mentioned by entrepreneurs and managers.

<sup>4</sup> 1-9 employees.

<sup>5</sup> E.g. according to our findings, no companies with 50 employees or more are located in the periphery.



In the case of *Helsinki*, and to some extent also *Budapest*, in general “individual trajectories” play a decisive role with regard to the in-city location patterns of entrepreneurs and managers located outside the city centre (most companies not located in the city centre are established close to where the founding manager lives). This trend, however, is less obvious for companies who have chosen to be located in the city centre. According to our data, the main driver for the entrepreneurs and managers of these firms is the high prestige of the city centre, with the predominant influence of “hard” factors shaping the location decision instead. It should be mentioned, however, that being located in business parks is considered to provide a good image to the company as well. Overall, as in the case of *Toulouse*, all managers in the sample stress the importance of being within easy reach of the place of work and customers. The factor that came up as the most decisive for all firms, however, was the need for a supply of a specialized and skilled labour force, whereas clustering is particularly valued in the film and TV industries.

In light of previous discussion, it is perhaps no surprise that “hard” factors dominate in-city location decisions in the case of *Budapest* and *Riga* as well, where office price or rent seem to be of overriding importance. Furthermore problems with the availability of parking space in the centre have a significant impact, especially in the case of *Riga*. In this light, most of the managers claimed that the reasons mentioned prevent them from being located in the city centre, where desirable “hard” factors, such as proximity to clients, would come into play. It should be emphasized however, that at least in the case of *Budapest* the issue of distance from the clients has been losing significance for particular sectors, such as the ICT sector and the software consultancy sub-sector. Furthermore, the proximity to other research institutes rather than to customers is mentioned among the managers of companies involved in research and development in *Riga*.

*Transport–accessibility–availability* forms the next set of the most important “hard” factors of influence in *Budapest*, just after the cost of office space. It should be mentioned here that entrepreneurs and managers seem to employ various strategies in order to overcome the influence of such factors. In the case of *Budapest* as well as *Toulouse*, for example, it is common for a company to have its headquarters in an office owned by the director, thus saving on the rent, for example. Despite such efforts, “hard” factors still often play a decisive role. To illustrate this: most of the companies in *Riga* located in the suburbs, for example, do not intend to move into the centre mainly due to high rent and parking problems. The companies located in the centre, on the other hand, were in general happy with their location, but concerned about the cost of office space and the poor infrastructure: some thought that eventually this might force them to leave the centre.

Finally, our data suggests that managers in *Sofia* are taking deliberate in-city location decisions, in contrast with the chaotic pattern of domestic settlement of the various types of “creatives”. As in the cases of other cities in the sample, managerial location decisions are dominated by “hard” factors virtually to the exclusion of all other considerations, with only one company reported being at the periphery not because it is cheaper, but because it is a nicer place than the centre. Furthermore, some differences with regard to inner location decisions exist across various industries in *Sofia*. Managers of consultancy firms, for example, generally prefer the city because of the proximity to client government institutions, whereas financial and IT consultancy companies choose the sub-centre area, near to central traffic roads for rapid movement around the city and better access for clients from outside *Sofia*. Moreover, for computer-related companies prices and rent are a crucial location factor, just as they are for the ITC and software sector, where companies are young and small in size.

#### 4.4. Capital City vs. Provincial City Location Decisions

A major – overwhelming, in effect – location decision determinant, which has little to do with the “soft”/ “hard” debate, is whether the city in question is the national capital of a small nation (thereby attracting the bulk of its resources, qualified workforce and development potential), or a non-capital city of a big nation. According to our findings at least, the main trend emerging from the capital cities covered in our sample seems to be that creative and knowledge industry managers simply find it difficult to envisage not being in the capital city.

More specifically, in the case of *Helsinki*, for instance, all interviewed managers were unequivocal on the issue of capital vs. province, usually stating that operating from other parts of the country aside from the capital city is simply not an option. According to them, the main motives for this are related to the proximity of both customers and the skilled labour force in *Helsinki*. The case of *Budapest*, where the country’s creative and knowledge industries are concentrated, is very similar. In fact, the whole “critical mass” of Hungary, in the social and economic sense, seems to be concentrated in the metropolitan region of *Budapest*, with branches of cultural industries being overrepresented



in the Budapest area. The setting in Budapest is also favourable from the aspect of financing, as firms are better off here than in the provincial towns of Budapest. Besides, as voiced by one of the interviewed managers, tax and financial auditing is not so frequent in Budapest due to the large number of enterprises in the area, thus making life easier for the entrepreneurs. Overall, all respondents in Budapest agreed that it is absolutely necessary to be in or near the capital city to be able to take part in specific “creative activities”, such as motion picture productions, for example.

In *Riga* we find the same situation. Being the capital and by far the largest city not only in Latvia but also in the region (e.g. Estonia, Latvia and Lithuania), Riga is Latvia’s main attractor of investment and generator of employment. Furthermore, Riga is the main educational and scientific centre of Latvia. To be located outside Riga is thus to not be considered as an option by any of the companies interviewed. As mentioned by many, within Latvia, there is simply no competition from any other city.

As in the case of Riga, *Sofia* enjoys the benefits of being the capital city by concentrating the major resources of the country, including the “power of decision-making” and labour. It is obvious that many industries, almost without exception, depend on the presence and quality of these institutions; thus, it is of no surprise that managers and entrepreneurs choose to be located there. Furthermore, especially for companies that work entirely in the local market, the market size is of major importance. In this light, it should be emphasized that Sofia is several times larger than the next largest city in Bulgaria, which is of major influence on the location decisions of many entrepreneurs and managers.

In contrast to the cities explored previously, *Toulouse* is clearly a “second” city, living in the shadow of the capital of France, Paris. As a result, Toulouse might seem to be attractive primarily to the industries and branches already developed in the capital city and “moved down” to Toulouse as a consequence of the government’s de-concentration policy. Otherwise, Paris is as dominant for the creative industries in France as Sofia for Bulgaria or Budapest for Hungary. For instance, 74.5% of cinema, picture and video production activities are gathered in Île-de-France, 59% in the only commune of Paris. Over 62% of motion picture, video and television programme production activities are concentrated in Paris and its adjacent western *département* of Hauts-de-Seine, which comes in second in most of the audiovisual sub-sectors. From these numbers it is quite clear that Toulouse’s chances of directly competing with Paris are very limited.

#### 4.5. Policymaking: “Soft”, “Hard” or “Other”?

As expected, the “Western” cities in the sample, which didn’t undergo the severe dislocations of the 1940s as well as the 1990s, are much more prone to sustained planning and policy efforts than the ex-socialist cities. Differences, however, also exist if “Western” cities are compared among themselves, mostly arising from the fact that one of the cities in our sample, e.g. Helsinki, is the capital city, whereas Toulouse is not.

More specifically, *Toulouse*, for example, whose “knowledge-intensive” profile is the outcome of national-level policies in France, seems to be lacking the local capacity to provide policy-based support for the creative sector. Here, sector managers report lack of interest and misunderstanding about new creative industries from the local policymakers as well as administrative heaviness and complications in entering local markets. Entrepreneurs and managers’ demands from policymakers, however, have little to do with “soft” factors. Instead, “hard”-factor-related policies are requested such as improvement of transport and infrastructure, development of the business climate and easing of cumbersome administrative procedures. Furthermore, audiovisual companies claimed the need for easier access to financing. Interestingly enough, however, managers in general claimed they would like to see policy improvement at the national rather than local level.

Being a capital city, *Helsinki*, on the other hand, boasts a good bottom-up policy track record. During the economic crisis of the early 1990s, government, municipalities, universities and business community joined together to revive the economy. The key principle of the authorities has been to mobilise and join the resources of the business community, the academic community and the administrative sector. The emphasis in policymaking has been on education, research and knowledge. As a result, there is strong enthusiasm in Finland among politicians and civil servants to work on creative knowledge strategies to foster national development.

As for “Eastern” cities, *Budapest*, although for various reasons less “Eastern” than Riga or Sofia, demonstrates a lack of effective municipal-level policy, as usually expected from non-“Western” cities. In this light, the research found, for example, that at least according to the viewpoint of entrepreneurs and managers, local government virtually has no role in fostering the creative sector, and that only

the national government can influence the development of any creative activity. As for more specific wishes, entrepreneurs and managers highlighted the need for a more business-friendly climate on the national level. On the local level, however, “hard”-factor-related demands were expressed, including the improvement of transport, noise, pollution, top-heavy bureaucracy in the issuing of business permits and similar areas.

When analyzing policymaking practices in Riga, it should be noted that the whole concept of planning was historically discredited because of its association with the central planning of the former Soviet system. It is still symptomatic, however, that when asked about collaboration with the public sector, only one respondent out of the 21 interviewed mentioned having received support from Riga City. However, when the issue of public support or support from the European Union was brought up during the interviews, again, all but one manager in our sample claimed that no support had been received either from Latvian or from European Union sources. However, there is a variety of demands from entrepreneurs and managers in Riga, primarily targeted at the central government and concerned with “hard” factors. These include facilitation of tax administration, lowering of taxes, battling corruption, facilitation of the administration of EU projects, making education more practical and improving the business climate as such.

In the case of *Sofia*, the path of the city’s development had much less to do with planning than application of the Aristotelian-Habermasian model, under which civic energies and habits, once awoken, spread beyond issues of governance (the end of communism, in this case) and infuse the daily lives of citizens. As a result, political initiative turned into economic entrepreneurship and established Sofia as the locomotive of the new national economy. Confirming this “self-regulating pattern”, all respondents reported an absence of municipal-level policies for their sectors. Strikingly enough, and uniquely for the five cities studied, the lack of policy initiatives was confirmed by the city planners themselves. To illustrate the extent of the problem: officials of Sofia Municipality refused to be involved in the survey on the grounds that the Municipality had no policies whatsoever aimed at knowledge-intensive and creative industries.

National level policies, however, such as the government’s package of policies lowering taxation, are found to be of much greater help by entrepreneurs and managers in Sofia. Regarding the wished for municipal policies, as with other cities in the sample, “hard” factors, such as infrastructure, transportation, access to social and educational centres, security and also initiation events and happenings in the cultural life of the capital, were highlighted by respondents. Sadly, most of the entrepreneurs and managers seemed to be sceptical about the Municipality’s capacity to deliver those factors. At best, respondents expressed hopes that the various administrations would simply stop getting in their way.

## 5. CONCLUSIONS AND IMPLICATIONS

According to the data compiled from five European cities, it seems that considerable differences in creative entrepreneurs’ and managers’ location patterns exist in Europe as compared with the U.S. (e.g. Florida, 2002). More specifically, the survey suggests that in Europe, cultures are much less individualistic and individuals are less geographically mobile than in the U.S., from where “creative class” theories originate. Location decisions, therefore, include factors less visible in America, such as family ties, traditions, national identities and the like. These findings alone in turn lead to the conclusion that, in Europe’s case at least, the analytical picture as developed by Florida (2002) needs elaboration and, to a certain extent, redefinition.

Among other things, the data from Europe suggests that, although very useful, the distinction between “hard” and “soft” factors is not a sufficient theoretical basis to explain the location patterns of creatives. In this light, the influential role of additional drivers, such as the “individual trajectory” considerations that overwhelmingly dominated in all studied groups in our sample, was identified by this study. However, considering location decisions through the “hard” and “soft” dichotomy in the five cities of our sample makes sense mostly on the level of decisions to be located in a particular area *inside the city*. In these decisions, as far as the managerial sample is concerned, traditional “hard” factors reign supreme.

There are areas, however, in which European “creatives” reveal sensitivity to “soft” factors. The vast majority of respondents from all cities in our sample, for instance, reported significant levels of job satisfaction, with emphasis placed on workplace-related factors, including a sense of achievement gained from work, the scope for innovation in the workplace and the level of influence individuals have in directing their work. Furthermore, high satisfaction with “soft” factors, such as the living

environment in their district and the cultural life of the city, were often mentioned by entrepreneurs and managers from creative sectors.

In light of this discussion, it should be noted, however, that the sensitivity of respondents in creative and knowledge-intensive industries to “soft” issues did not turn out to drive their *location decisions*. These respondents simply did not behave as Florida’s “happy nomads”. A complex package of location motivations emerged instead, having to do greatly with the influence of “individual trajectory issues”. More specifically, for most of the entrepreneurs and managers, the reason for being located in a particular city had much more to do with the fact that the respondents were born in the region, had family there, had studied in the city, or had moved there to join a spouse or to be in the proximity of friends than with various “soft” considerations. Community-related rather than “nomadic” considerations thus play a more significant role in this regard.

Beyond that, entrepreneurs and managers in all five cities strongly follow a “hard” factor path of location decision making. Costs, nearness to clients, access issues and availability of labour outweigh “soft” factor considerations. Only a handful of isolated individuals interviewed have gone in the opposite Florida-type direction. At the same time, dissatisfaction is most frequently voiced with the “hard” factors of a city – costs, taxes, transportation issues. This in itself means that city planners should start by concentrating on the development of “hard”-factor-related policies, if *attracting* creative managers and entrepreneurs to the city is at least one of the priorities of their work. Our data, however, suggest that “soft”-factor-related policies also can not be ignored, as these considerations play a significant role in *retention decisions* of creatives.

According to our data, the theoretical model of city development needs to be re-drafted so as to differentiate between capital and non-capital cities. This is particularly the case with regard to less populated European countries (such as Finland, Hungary, Latvia and Bulgaria), where up to one-third of the entire population lives in the capital area and up to 100% of all the nation’s knowledge-intensive and (particularly) creative industries may be concentrated. The capital, being the administrative, economic, educational, political, cultural, commercial and tourist hub of a small country, can almost by default step onto the path of “creative city”. Any city that is not a capital, therefore, would be facing an uphill battle if it decided to persuade creatives to re-locate from their nation’s capital. Finally, as suggested by our study, an appreciable difference between “Western” and “Eastern” cities exist.

To conclude, it would be premature to “dismiss” Florida’s conceptual construct as a useful tool in explaining location patterns of entrepreneurs and managers from creative and knowledge-based sectors in Europe. After all, if individual energy and creativity can compensate for structural deficiencies and push cities forward and onto the creative path, the duty of city planners is to create the optimal, favourable conditions for citizens to develop and harness their energy and creativity productively. This notion brings the discussion back, at least to some degree, to classic Florida “soft” themes, such as the importance of the availability of friendly public and semi-public spaces for personal intercourse and networking, urban “buzz” among other things.

Ultimately, however, it may turn out that Florida-type constructs have more relevance during “good” times and fall by the wayside during “bad” times. In this light critics of Florida (2002) have long pointed out that, in the end, wages matter more than amenities, particularly during an economic recession. As managers are forced to employ “hard” factor survival mechanisms by cutting costs and dismissing labour, even creatives see their incomes disappear or decline. The policy measures that can address the current crisis in Europe and the U.S., on either a global or national level, should thus concentrate on “hard” factors first, such as getting the financial systems kick-started and finding ways of reviving the economies of the world. Only once these issues are resolved can policymakers again enjoy the luxury of debating the relative merits of “soft” factors.

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## A COMPARATIVE ANALYSIS OF THE NATIONAL INNOVATION PERFORMANCE: R.MACEDONIA AND SELECTED BALKAN COUNTRIES IN CONTEXT OF EUROPA 2020 STRATEGY

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### Abstract

Contemporary predictions of future economic concepts are that societies in essence will be innovative, based on information and knowledge. The characteristics of a modern society can be analyzed in terms of dominance of innovation, knowledge and information. Knowledge and ability for creating, available and effective use of knowledge for a long period of time represent an instrument of innovation, competition and economic progress and leading power of wider economic and social development. Nonmaterial investments in research and development, education, professional development and upgrading the software, increasing the efficiency of management processes and communication of information, become crucial indicators of opportunities for future development of the economy and society as a whole.

The Lisbon Summit held in 2000 expressed the attitude that innovation supposed to be a fundamental mechanism for transition towards a knowledge society. Innovation policy therefore become a major strategic tool for achieving the competitiveness of industry and thus to stimulate sustainable economic growth. The European Council in March 2005 redefined the broad goals of the Lisbon focus the priorities on economic growth and employment, and confirm that knowledge, innovation and human capital are key to social development. Shift away barriers to free movement of knowledge, encouraging innovation through border cooperation and flexibility of R&D facilities and the creation of conditions for wider application of ICT become essential priorities of the EU.

The new strategy entitled "Europe 2020", adopted by Member States in June 2010, confirming the continuity of the previous strategy. The European Council defines innovation as a top priority and a pillar of economic growth in the EU in the next decade. Strategy determines the future development of the union as "smart, sustainable and inclusive growth." Innovative Union is one of seven flagship initiatives or directions of action within the Strategy. It means improving conditions and access to finance for R&D and innovation in order to ensure that innovation to be converted in products and services that will enable creation of new jobs.

As a basis for comparative analysis and evaluation of innovative performance of countries in this paper, data will be used by the IUS (Innovation Union Scoreboard 2010). Normalized values of selected indicators for countries of the Balkans were obtained by graphical calculation schedules for each indicator separately, which are published in the report (Innovation Union Scoreboard 2010 - Methodology report, 2011). Graphical comparisons are made between countries in order to identify comparative advantages and delays, what should emerge future directions of action to improve performance indicators.

The current position of R.Macedonia represents lagging behind and away from the innovative performance of countries in the Balkans. If in the coming period policies are not be promoted in direction to improve the performances of the indicators for detected weaknesses in terms of dynamic processes of development of innovative performance, R.Macedonia will have a wider gap shared by Member States and candidate countries for EU membership.

**Keywords:** Knowledge-Based Economy, Competitiveness, Innovation, National Innovation System, Innovation Performance

### 1. INTRODUCTION

Modern economic reality characterized accelerated creation and emergence of new technologies, globalization and regional economic connection. In these circumstances the search for new forms of economic activity need to be adopted by a new paradigm called *knowledge-based economy*. Policy makers in the transition countries are increasingly emphasizing the importance of building knowledge-based economies, where capacity to innovate is the basic competition factor (Masso & Vahter, 2008; Roper, 2009). The ability to create economic value is the basis for gaining competitive advantage and growth of enterprises, industry and society at large (Fagerberg 1988, 1996, Fagerberg, Knell and Srholec 2004).

At the time of the informational revolution created opportunities for quick access to and use of knowledge by any subject of the global community. This knowledge can be used in the creation of their own innovations as part of the world treasure of new ideas, and through which firms can upgrade



their innovation capabilities through organisational learning (Nelson and Winter 1982). Companies starting from directions of global changes and the criteria governing the world market, are increasingly pressured to invest in knowledge, or in technology-intensive production and through innovation to fight at the market with its competitors. There are important differences among industries or technological fields in the operation of processes characterized by entry (and exit) of firms, continuous innovation, gradual development of standards, the adaptation or creation of institutions, etc. (Pavitt 1984, Carlsson and Stankiewicz 1991, Malerba 2004).

SMEs were likely to be the source of most innovation (Schumpeter, 1934). Subsequently, he claimed that large established firms possessing some degree of monopoly power were likely to be the driving force behind technical progress (Schumpeter, 1950). The ability and innovative capacity of SMEs varies significantly, depending on their sector, size, focus, resources, and the business environment in which they operate (Burrone and Jaiya 2005). A recently proposed and popularized model for the management of innovation, known as *open innovation*, is based on the need for companies (especially SMEs) to open up their innovation processes and combine internally and externally developed technologies to create business value. (Chesbrough 2003a; 2003b).

The basic question that arises for the purpose of future development of the transition economies, is “new” way to organize and re-structuring limited resources in order to enable the creation, diffusion and use of innovation to create higher value-added products and services. Previous course is based on increased investment in science and technology, R&D, the system of knowledge and developing skills for the technological development with the ultimate aim of increasing the welfare of citizens and improving the standard of living.

## 2. THE DEVELOPMENT OF INNOVATIVE PERFORMANCE AS THE BASIS FOR ECONOMIC GROWTH

The creation of innovations, their diffusion and transfer of modern technology and knowledge as a basis for increased economic activity and performance of companies on the open market, have the role of carriers of economic growth (Fagerberg and Godinho 2004; Fagerberg 2006). The empirical analysis suggests that a well developed innovation system is essential for countries that wish to succeed in catch-up. There is a strong statistical relationship between level and change of GDP per capita on the one hand, and the innovation system on the other. Historical and analytical evidence also suggests that countries that have succeeded in catch-up are given a high priority to this dimension of development (Fagerberg & Srholec, 2008).

Innovation covers the entire process from creation of a new idea to its implementation, in order to develop or enhance new or existing products, services, methods, processes. According to *Joseph Schumpeter*, innovations are classified into two major categories: *product innovation and innovation process*. Product Innovation covers “..... creating a new product that meets adequate existing or previously satisfactory needs “, thus allowing the inventor a monopoly position. Innovation process replaces “.... production or consumption of one thing with another that serves to satisfy the same need, but is cheaper.” Thus the innovation process involves the implementation of new repro-materials that have the potential to allow production of cheaper product.<sub>1</sub>

*“Innovation is the implementation of new or significantly improved product (good or service) or process, a new marketing method or a new organizational method in business practice in the workplace or enterprise in external relations. The minimum requirement for innovation is a product, process or organizational method to be new (or significantly improved) in terms of enterprise.”<sub>2</sub>*

The major factor determining the overall innovation performance is not the performance of the individual organisations, but the intensity and quality of linkages and co-operation among them (Fagerberg (2005); Lundvall (2002); Niosi (2002). Several authors note the growing importance of network-type innovation interactions among firms, and private and public research institutions (Lundvall, 1992; Nelson, 1993; Etzkowitz & Leydersdorff, 2000; Charles, 2003). Therefore innovation process is not isolated and because of his interactive nature interest of the analysis is replaced from initial interest to R&D towards National Innovation System (NIS).

The (NIS) concept first appeared in work by (Freeman 1987), (Lundvall 1992), (Nelson 1993) and Edquist (1997). According to one of his biggest advocates Christopher Freeman is defined as “a

1 Bilge Mutlu, Alpay Er, (2003), *Design Innovation: Historical and Theoretical Perspectives on Product Innovation by Design*, 5th European Academy of Design Conference, Barcelona, p.5

2 Rajnish Tiwari, (2008), *Defining Innovation*, (Based on “Oslo Manual”, 3rd edition, 2005) Hamburg University of Technology (TUHH), p.1

*network of institutions of public and private sector who interact, initiate, import, modify and diffused innovation.*"<sup>3</sup> National innovation system refers to the network institutions, rules and procedures that affect the way that the country acquires, creates, expands and uses knowledge. The universities, public and private research centers are included in the institutions of the innovation system. NGOs and government are also part of the innovation system. An effective innovation system is one that provides a setting that encourages research and development, resulting in new products, new processes and new knowledge and therefore the main source for the development of innovative performance of countries.

### 3. EUROPEAN STRATEGY FOR SMART, SUSTAINABLE AND INCLUSIVE GROWTH EUROPE 2020

The challenge of finding solutions to the Global financial crisis and preventing the tendency of economic processes to take place with the dynamics and the way in the period before the crisis, there is a huge challenge for policy makers to promote a new strategy for economic growth and development of the EU. These processes occur in a time period of waning importance of the Lisbon strategy and that the EU should develop a new strategy for economic growth in the next ten year period. The new strategy was adopted in June 2010 by the European Council entitled Europe 2020, which determined the future economic development of the union as: "smart, sustainable and inclusive growth." The strategy sets priorities and objectives through the realization of which should provide greater economic growth and job creation, social cohesion, higher levels of education, dealing with social challenges (climate change, health care, energy supply, demographic changes, limited resources, lack of food and clean drinking water, etc.). The answer to these challenges leads through the exercise of seven flagship initiatives. One of them is Innovative Union, where innovations are the main driver of the processes for achieving the objectives of the Strategy.

*"At a time of public budget constraints, major demographic changes and increasing global competition, Europe's competitiveness, our capacity to create millions of new jobs to replace those lost in the crisis and, overall, our future standard of living depends on our ability to drive innovation in products, services, business and social processes and models. This is why innovation has been placed at the heart of the Europe 2020 strategy."*<sup>4</sup>

Implementation of the Strategy will take place at the national level and EU level. The European Commission will monitor progress towards achieving the objectives, to mediate and facilitate the exchange of policies and practices in processes and make suggestions for encouraging leading initiatives. The European Parliament is a driving force for mobilizing citizens and initiate the necessary legislative changes. This partnership approach will include the European commission, national parliaments, local and regional authorities and all citizens and social partners from civil society to include all factors towards achieving the strategy Europe 2020.

### 3. THE INNOVATIVE PERFORMANCE OF R. MACEDONIA AND THE BALKAN COUNTRIES SELECTED IN THE CONTEXT OF THE EUROPE 2020

In this paper the analysis of innovation performance in the Balkan countries in which would be included Macedonia, Serbia, Croatia, Bulgaria and Slovenia are based on the latest methodology in 2011, *Innovation Union Scoreboard 2010 (IUS)*. The choice of group is made by a common historical aspect of the model economy by 1990, the regional association, the traditional economies of cooperation and common agenda, EU membership (Bulgaria and Slovenia are already members). Countries of Europe by the values of its innovative performance are grouped into four groups:

- *Innovation leaders* - include Germany, Finland, Denmark, Sweden and Switzerland, countries that show much higher performance than the EU27 average
- *Innovative followers* - Slovenia, Iceland, Cyprus, France, Luxembourg, Ireland, Netherlands, Austria, Belgium and United Kingdom, countries that demonstrate performance similar to the EU27 average
- *Moderate innovators* - Slovakia, Poland, Croatia, Hungary, Malta, Greece, Spain, Czech Republic, Italy, Portugal, Norway, Estonia, countries whose performance is slightly below the

<sup>3</sup> OECD, (1997), *National Innovation Systems*, Paris, France, p.10

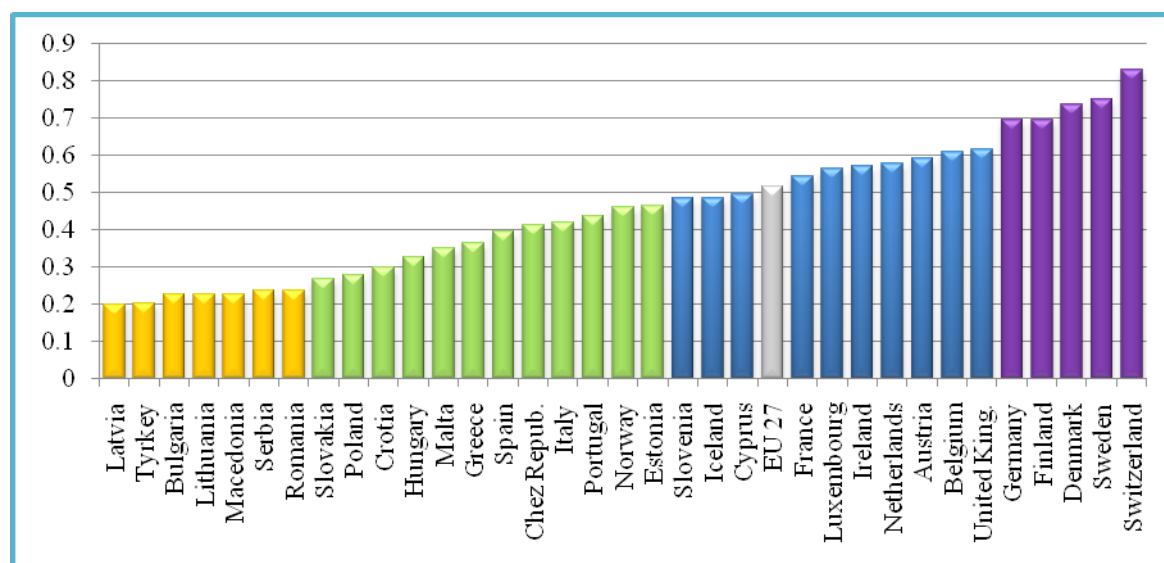
<sup>4</sup> European Commission, (2010), Communication From The Commission To The European Parliament, The Council, The European Economic and Social Committee and The Committee of The Regions, *Europe 2020 Flagship Initiative Innovation Union*, Brussels, p.2

## EU27 average

- *Modest innovators* - Latvia, Turkey, Bulgaria, Lithuania, Macedonia, Serbia and Romania, countries whose performance is well below the EU27 average

The total index for innovative recipient countries of Europe is shown in Graph 1

Graph. 1 Innovative performance of European countries



Modest innovators Moderate innovators

Innovative followers Innovative leaders

Source: "Innovation Union Scoreboard 2010", Inno metrics, 2011, page. 15

The current state of the innovative performance of selected countries from the Balkans for the group of **Enablers** and the three dimensions of innovation in this group are shown in the following:

Table 1. Current state of the innovative performance - group of Enablers

	EU27	BG	SI	HR	RS	MK
<b>ENABLERS</b>						
<b>Human Resources</b>						
1.1.1 New doctorate graduates aged (25 – 34)	1.4	0.5	1.3	0.8	0.5	0.3
1.1.2 Population completed tertiary education aged (30 – 34)	32.3	27.9	31.6	20.5	19.2	14.3
1.1.3 Youth with upper secondary level education aged (20-24)	78.6	83.7	89.4	95.1	84.7	81.9
<b>Open, excellent and attractive research systems</b>						
1.2.1 International scientific co-publications	266	190	750	---	---	---
1.2.2 Scientific publications among top 10% most cited	0.11	0.03	0.07	0.03	---	---
1.2.3 Non – EU doctorate students	19.5	3.97	4.64	2.55	8.50	3.36
<b>Finance and support</b>						
1.3.1 Public R&D expenditure	0.75	0.36	0.66	0.50	0.38	0.14
1.3.2 Venture capital	0.11	0.03	---	---	---	---

Source: "Innovation Union Scoreboard 2010", Inno metrics 2011, Annex A, p.62-63

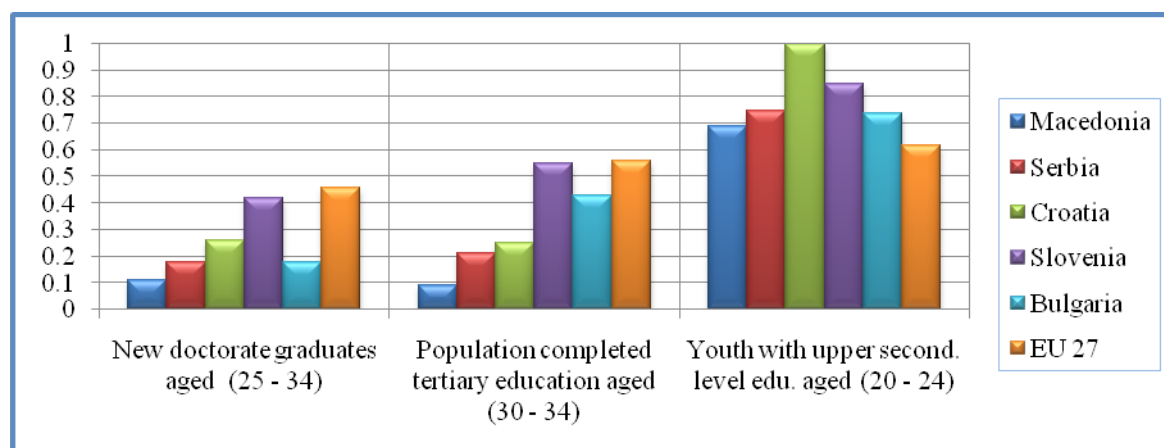
Graphical display of innovation indicators in separate dimensions, expressed in *normalized values*, of indicators are shown in the following charts. For the purposes of this paper normalized values of

1 Hugo Hollanders – MERIT (Maastricht University), Stefano Tarantola – Joint Research Centre, (2011), *Innovation Union Scoreboard 2010 – Methodology report*, Unit G3. p.15-24 Normalized values of the indicators presented in the report obtained by the method of (min-max) values. The maximum value is the largest score for each indicator in the period (2005 – 2010) reviewed by all countries. The minimum value is the lowest score for each indicator throughout the period considered for all countries. Normalized value is obtained when each of the minimum value is subtracted and the result is divided by the difference between the maximum and minimum value. The highest normalized value is equal to 1 and the smallest to 0. For more see: Stefano, Tarantola, S., (2008), "European Innovation Scoreboard: strategies to measure country progress over time", Joint Research Centre, p.3 - 7

selected indicators for countries of the Balkans were obtained by graphical calculation schedules for each indicator separately, which are published in the report. Possible inaccuracies of standardized values of indicators should not depreciate the analysis, which aims to show the current state of indicators to detect weaknesses in terms of dynamic changes in innovative performance. Graphical comparisons are made between countries in order to identify comparative advantages and delays, what should emerge future directions of action to improve performance indicators.

The innovative dimension of **Human resources** in Macedonia all indicators showing the weakest performance in relation to other selected countries. Weaknesses are observed in the acquisition of new doctoral degrees, offering higher education workforce in all areas and scientific disciplines as well as the level of qualifications of the young population (20-24), discussed in terms of supply of human capital for that age and as output of the education system through a number of diplomas. Completed secondary education is considered as a minimum level of education that can successfully participate in a knowledge-based economy.<sup>2</sup>

Graph. 2 Human resources - comparative data using normalized values of indicators



Source: "Innovation Union Scoreboard 2010 – Methodology report", 2011, p.25-30

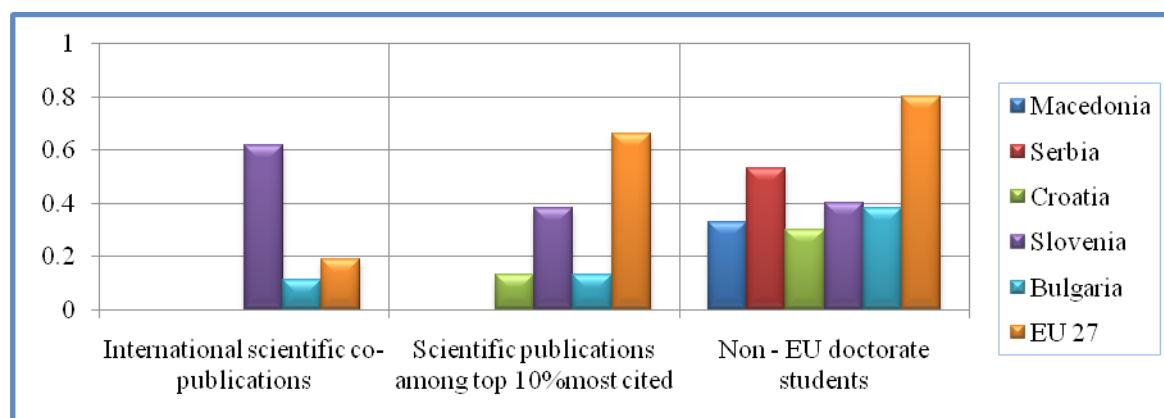
R. Macedonia needs to stimulate higher education, graduate and doctoral studies to ensure quality supply of human capital, but certainly the number and percentages may not be lifted only as a quantity to a higher quotation schedules and analysis, but also need to be raised the quality of education. It is the only way the labor force to possess the necessary knowledge, skills and acquire the "acquired need" to constantly up graded in the process of lifelong learning.

The innovative dimension of **Open, attractive and excellent research systems**, lack of data on both indicators makes the analysis a bit more uncertain in this section. The statistical databases in Macedonia are supposed to be improved in this area in order to:

- Through analyzing the number of international scientific publications, to assess the quality of research and international cooperation.
- Through a number of scientific publications published in the top 10% of the world most prestigious scientific journals, to assess the effectiveness of R&D system and its quality.
- Through a number of PhD students from non-recipient countries of the EU, to assess the mobility of students as an effective way of diffusion of knowledge.

<sup>2</sup> In the previous methodology (EIS 2009) higher educated were calculated only in technical and natural sciences, but today is widely accepted view that the absorption and creation of innovations in many areas especially in the service sector are directly dependent on the existence of a wide range of knowledge and skills.

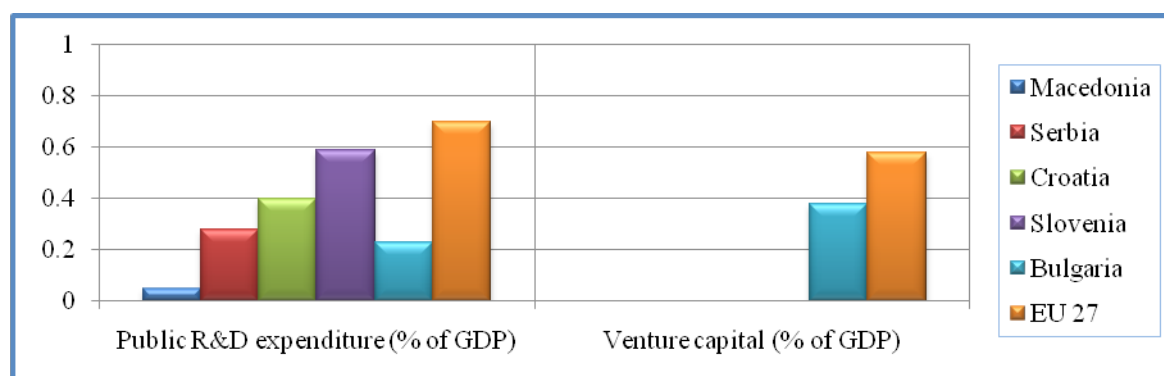
Graph. 3 Open, attractive and excellent research systems - comparative data using normalized values of indicators



Source: "Innovation Union Scoreboard 2010 – Methodology report", 2011, p.31-33

Analysis of the performance of the innovative dimension **Financing and support** separately for each indicator points to the need for R.Macedonia to make greater efforts to increase R&D costs which are the main promoters of economic growth in modern economies based on knowledge.

Graph. 4 Financing and support - through comparative data normalized values of indicators



Source: "Innovation Union Scoreboard 2010 – Methodology report", 2011, p.34-35

Costs for R&D investments are actually needed for the transition to knowledge-based economy by stimulating technological development. In this respect, the availability of capital to finance risky business, *venture capital* (expansion, use of new technology, developing new businesses, etc.) becomes a necessity to support the innovative performance of enterprises and the economy as a whole.

The current state of the innovative performance of selected countries from the Balkans to the group **Firm Activities** and innovative three dimensions in this group are shown in the following:

Table 2. Current state of the innovative performance - group Firm Activities

	EU27	BG	SI	HR	RS	MK
FIRM ACTIVITIES						
Firm investments						
2.1.1 Business R&D expenditure	1.25	0.16	1.20	0.34	0.10	0.04
2.1.2 Non – R&D innovation expenditure	0.71	0.95	0.79	0.86	0.80	0.90
Linkages and entrepreneurship						
2.2.1 SMEs innovating in-house	30.3	17.1	---	25.6	27.8	11.3
2.2.2 Innovative SMEs collaborating with others	11.2	3.50	14.2	11.9	3.50	9.6
2.2.3 Public – private co-publications	36.2	2.3	51.0	17.7	4.2	---
Intellectual Assets						

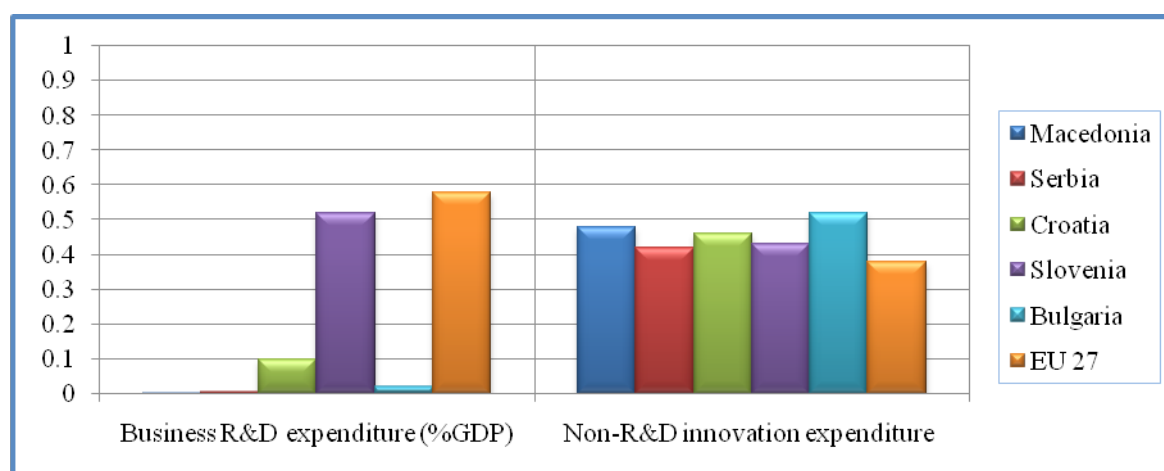


2.3.1 PCT patent applications	4.00	0.38	2.56	0.88	---	0.13
2.3.2 PCT patent applications in societal challenges	0.64	0.04	0.65	0.03	---	---
2.3.3 Community trademarks	5.41	3.97	3.80	0.52	0.50	0.06
2.3.4 Community designs	4.75	1.78	2.45	0.23	0.00	0.06

Source: “Innovation Union Scoreboard 2010”, Inno metrics 2011, Annex A, p.62-63

From the analysis of the performance of innovation dimension **Firm Investments** for each indicator separately derived conclusion that Macedonian efforts to reach innovative performance of the developed countries of Europe need to allocate more funds for R&D that will enable the creation of new knowledge and its diffusion among enterprises. Investments in equipment and machinery, costs of patents and licenses, measure the diffusion of new production technologies and ideas, represent the basis for technological development and improved competitiveness among enterprises.

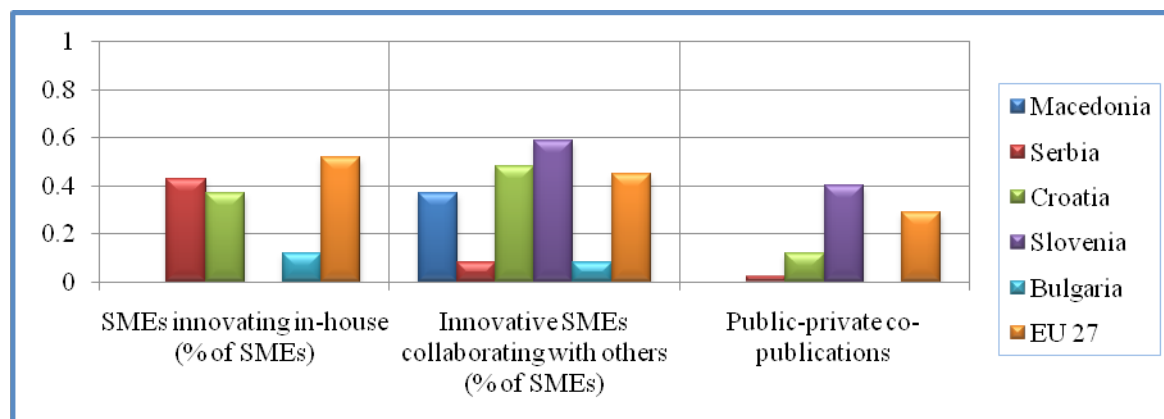
Graph. 5 Firm Investments – comparative data using normalized values of indicators



Source: “Innovation Union Scoreboard 2010 – Methodology report”, 2011, p.36-37

The second dimension of innovation **Linkages and entrepreneurship** shows that Macedonia has a very poor record in the field of SMEs presented their own market innovation, while better position (closer to the European average), has in the field of SMEs with innovation common with other SMEs which shows a higher level of cooperation between SMEs and a better flow of knowledge between research institutions and SMEs and between themselves. It should be stressed the need for active cooperation between researchers from both public and private sector that will result in an increased number of co-publications that raise the quality of creation and diffusion of knowledge.

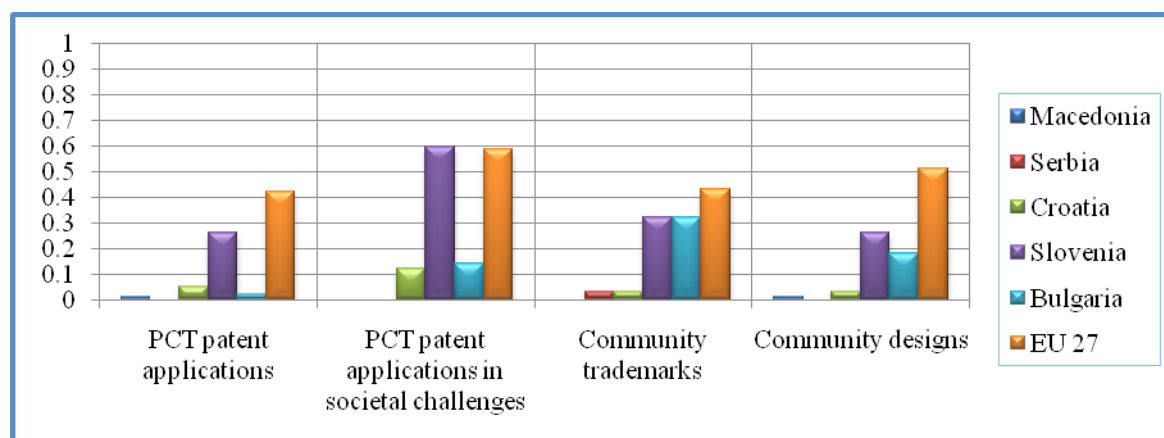
Graph. 6 Linkages and entrepreneurship - comparative data using normalized values of indicators



Source: “Innovation Union Scoreboard 2010 – Methodology report”, 2011, p.37-41

R. Macedonia in the third innovative dimension of **Intellectual assets** shows the weakest performance in respect of all countries analyzed on all indicators. Macedonia shows the weakest results in the field of protection of intellectual property and the output of innovative activity in patents, trademarks and design marks. This confirms the low capacity of enterprises to develop new products and processes which basically determines their competitive advantage. The need for an increased number of patent applications in the field of social challenges (climate change mitigation and health care), is in direct correlation with the strategy for ensuring long-term and sustainable economic development as a high priority for the EU and the R.Macedonia as a candidate for EU membership.

Graph. 7 Intellectual assets - comparative data using normalized values of indicators



Source: "Innovation Union Scoreboard 2010 – Methodology report", 2011, p.42-45

The current state of the innovative performance of selected countries from the Balkans to the group **Outputs** both innovative dimensions in this group are shown in the following:

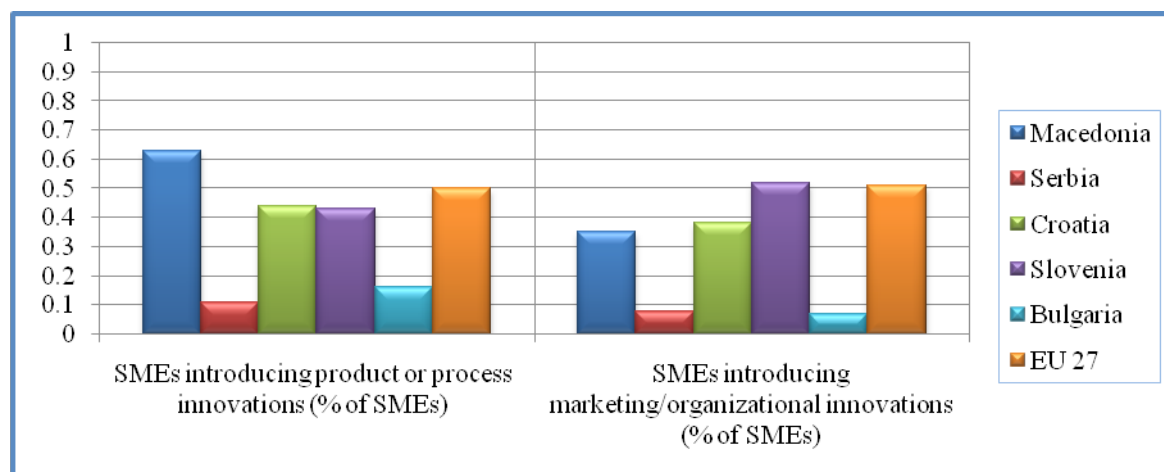
Table 3. Current state of the innovative performance - group Outputs

	EU27	BG	SI	HR	RS	MK
<b>OUTPUTS</b>						
<b>Innovators</b>						
3.1.1 SMEs introducing product or process innovations (% of SMEs)	34.2	20.7	31.0	31.5	18.3	39.2
3.1.2 SMEs introducing marketing/organizational innovations (% of SMEs)	39.1	17.4	39.4	32.5	18.1	30.8
<b>Economic effects</b>						
3.2.1 Employment in knowledge-intensive activities	13.0	8.49	12.9	9.43	---	---
3.2.2 Medium and high-tech product exports	47.4	26.2	58.5	41.6	27.4	30.5
3.2.3 Knowledge-intensive services exports	49.4	21.5	27.2	16.1	34.4	28.7
3.2.4 Sales of new to market and new to firm innovations	13.3	14.2	16.3	14.4	10.0	9.90
3.2.5 License and patent revenues from abroad	0.21	0.02	0.08	0.06	0.10	0.06

Source: "Innovation Union Scoreboard 2010", Inno metrics 2011, Annex A, crp.62-63

The situation in the first dimension of the innovative group **Outputs, Innovators** shows that Macedonia produces good results in technological innovation (products and services) and in the forms of innovation that are not technological (marketing and organizational innovation). However, diffusion of innovation is also very important segment in the direction of propagation and absorption of innovations and achieve higher commercial effects, which should pay more attention to this innovative activity.

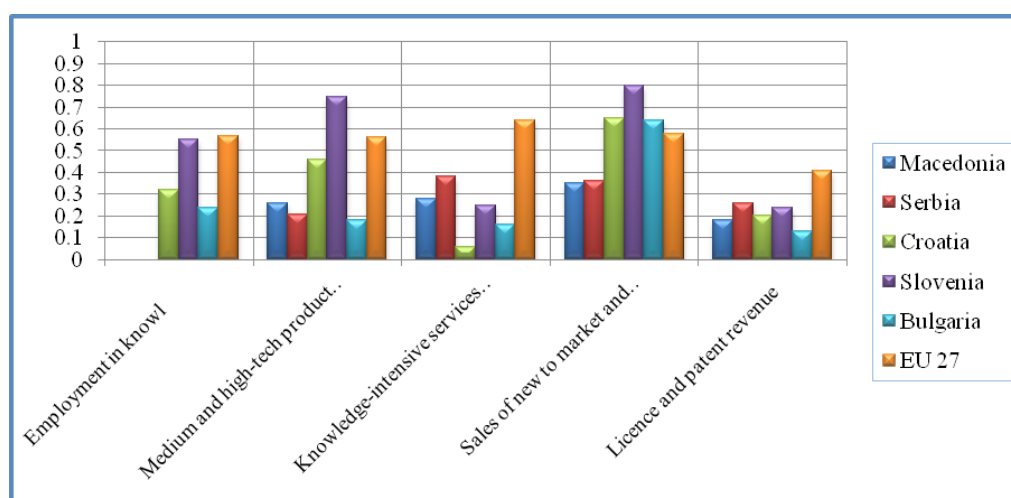
Graph. 8 Innovators - comparative data using normalized values of indicators



Source: "Innovation Union Scoreboard 2010 – Methodology report", 2011, p.46-47

The innovative dimension of **Economic effects**, R.Macedonia separately through indicators show results higher than half the EU27 average. Lack of indicator values for employees in knowledge-intensive activities in (manufacturing and services) emphasized the need for statistical engagement in this field. Regarding the export of intermediate and high-tech products as measured by the competitiveness of the EU market and the ability for commercial exploitation of the results of R&D activities, R.Macedonia is a higher rank than half the EU27 average. Intermediate and high-tech products are key promoters of economic growth due to high value added products that contribute to higher paid employees in those sectors. The export of services sectors based on knowledge intensive value indicates better results than many advanced countries. In the area of creation of new technologies in terms of new market and in terms of enterprise and their diffusion, R.Macedonia is showing the weakest analyzed results from all Balkan countries. In the area of revenue from licenses and patents from abroad all Balkan countries have a low rank in terms of the EU27 average, which is higher more than doubled.

Graph. 9 Economic effects - comparative data using normalized values of indicators



Source: "Innovation Union Scoreboard 2010 – Methodology report", 2011, p.46-47

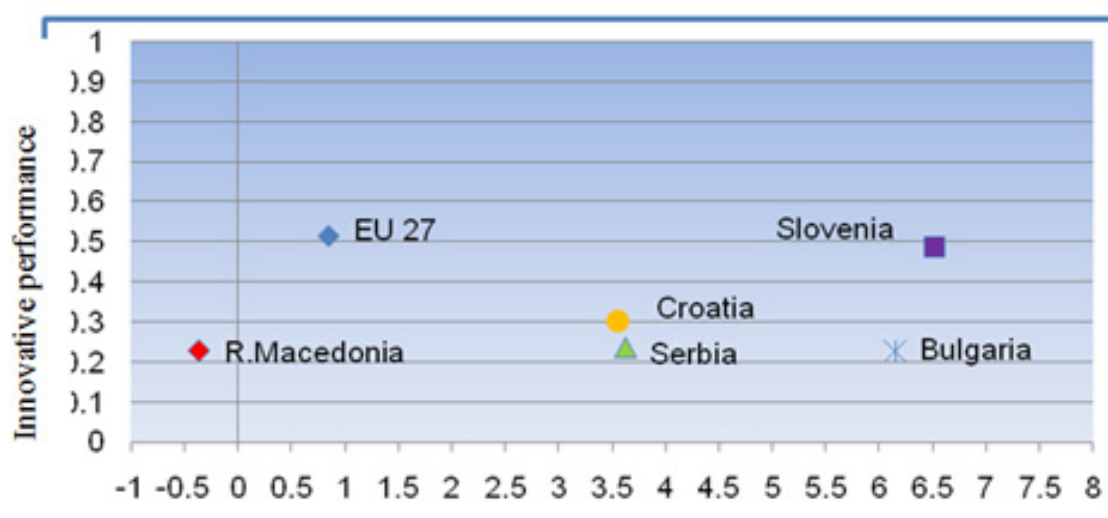
#### 4. GROWTH RATE OF INNOVATION PERFORMANCE

The rate of growth of the innovative performance of the considered countries is calculated for five-year period (2005-2010) according to the methodology of the generalized approach.<sup>3</sup> The construction of the following graph 10. which shows the average growth rates of innovative performance of countries data are used from Annex F of the (IUS) 2010.

According to the graph with respect to the total value of the innovation index, almost equal results have R. Macedonia 0.228, Serbia 0.237 and Bulgaria 0.226, while Croatia 0.301 has a higher innovation performance. Slovenia with an average of 0.487 is very close to the EU27 average with 0.516.

But in terms of average growth rate of innovative performance, R.Macedonia with -0.36% is the only country with negative growth rate in relation to comparable countries and far behind Croatia with 3.55% and Serbia 3.63%. Bulgaria 6.15% and Slovenia with 6.52% showed extremely high rates of growth compared to the EU27 average of 0.85%.

Graph. 10 Convergence in innovation performance of countries in the Balkans



Average growth rate of innovative performance

Source: "Innovation Union Scoreboard 2010", Inno metrics2011, Annex F, p.72

If we analyze the growth rates of innovative performance in the innovative dimensions of R.Macedonia, the following summary is:<sup>4</sup>

Rates of growth in innovative dimensions Human Resource, Firm investment and Economic effects are above average in the EU27, while the innovative dimension Finance and support and Intellectual assets are below the EU27 average.

The values of the separate indicators show the following condition: Positive and high rates of growth observed in the indicator Number of new PhDs 10.7%, a percentage of the population aged (30-34) who have completed higher education 5.4%, expenditures for R&D by business sector 7.5%, Medium and high-tech product exports 9.7%, exports of knowledge-intensive services 17.8%, licenses and patents revenue from abroad 11.8%.

Negative growth rates are observed in the indicators Public R&D expenditure -9.6%, PCT patent applications -19.8% and Community trademarks -29.9%.

The overall average annual growth rate of the innovative performance of R.Macedonia for the period (2005-2010) is -0.36%, and only worse ranked than it in terms of all EU27 member states and selected countries in the Balkans is Lithuania, with an average annual growth rate of innovative performance -0.70%.

<sup>3</sup> Stefano, Tarantola, S. (2008). *European Innovation Scoreboard: Strategies to measure country progress over time*. Joint Research Centre, p.13 - 14

<sup>4</sup> INNO METRICKS, (2011), *Innovation Union Scoreboard 2010*, The Innovation Union's performance scoreboard for Research and Innovation, <http://www.proinno-europe.eu/metrics>, p.65

## 5. CONCLUSION

According to the results achieved by groups, innovative dimensions and indicators of innovative performance of R. Macedonia, the weaknesses and strengths are detected for each indicator separately. Thus the following conclusions and recommendations can be drawn towards enhancing their values:

- Stimulating higher education, post-graduate and doctoral studies that should provide better quality supply of human capital;
- Fostering a lifelong education that will qualify people with knowledge and skills through training and education, to enable better adaptation of the workforce of the new economic conditions and potential changes in the workplace;
- Improving the statistical database on the number of internationally published scientific publications through which one can evaluate the quality of scientific research and international cooperation and to evaluate the performance of IR system and its quality;
- Increasing mobility of students as an effective way of diffusion of knowledge;
- Increasing costs of R&D by the public sector;
- Improving access to capital to finance risky business which is necessary to support the innovative performance of enterprises and the economy as a whole;
- More funds for R&D by business sector which will enable the creation of new knowledge and its diffusion among companies;
- Increasing investment in equipment and machinery, increasing the cost of patents and licenses, the cost of measuring the diffusion of new production technologies and ideas and so on;
- Fostering entrepreneurship and stimulate innovation activities of SMEs;
- Active collaboration between researchers from both public and private sector that will result in an increased number of co-publications that raise the quality of creation and diffusion of knowledge;
- Greater protection of intellectual property;
- Increasing the output of innovative activity in patents, trademarks, marks and designs;
- Increasing the number of patent applications in the field of social challenges (climate change mitigation and health protection, energy supply);
- Improving the diffusion of innovation which is a very important segment in the direction of propagation and absorption of innovations and achieve higher commercial effects;
- Increasing exports of intermediate and high-tech products;
- Increasing exports of services sectors based on intensive knowledge;
- Improving conditions for creation of new technologies in terms of new market and in terms of enterprise and their diffusion;
- Increasing revenue from licenses and patents from abroad.

Greater priority in R. Macedonia should be given to the commercialization of innovation in the business sector and the faster spread of their innovations, knowledge and import advanced technologies in economic and non-economic activities. EU membership will inevitably require adaptation of the economy in terms of acceptance and achievement of the objectives of development strategy, the EU Member States. In this context the promotion and development of innovative performance are crucial for the restructuring of production, its growth and development, oriented towards foreign markets, increasing competitiveness of products and services and increasing the number of jobs. It will be possible only through achieving higher growth rates of innovative performance of the country which will ensure sustainable GDP growth and overall economic development.



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## INNOVATION AND ECONOMIC DEVELOPMENT – CORRELATIONS AND CONDITIONS

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E-mail: [s.abduli@seeu.edu.mk](mailto:s.abduli@seeu.edu.mk)**Abstract**

Innovation is not a new phenomenon. Arguably, it is old as mankind itself. There seems to be something inherently “human” about the tendency to think about new and better ways of doing things and to try them out in practice. Innovation is essential for sustainable growth and development. In the modern economy, innovation is crucial factor for value creation, growth and employment. Innovation will lead to new businesses as well as to the increased competitiveness of existing enterprises.

As a country where EU integration is among the top priorities considering the Innovation Union Scoarboard (IUS) indicators, Republic of Macedonia belongs to the modest innovators, with performance well below the EU27. Republic of Macedonia is a full-fledged partner in the Programme for Competition and Innovations of the European Union. The Programme for Competition and Innovation is especially important for the small and medium sized enterprises in our country, because it will provide them with internationalization, as well as an easier access to the financial assets, more appropriate use of information and communication technologies, development of the IT society and promotion of the importance of new renewable resources of energy and energy efficiency.

There are several core conditions which enable innovation and encourage economic growth and development. According to OECD the most important are: strong standards and effective enforcement of intellectual property protection; dynamic competition and contestable markets; a strong and sustainable fundamental research and development infrastructure; encouraging information and technology communication developments and a strong emphasis on education at all levels.

This paper specifically elaborates the proper way of using terms such as innovation, invention, creativity and science, because in daily conversations they are often used interchangeably. The paper also addresses the meaning of innovation, innovation sources, types of innovation etc.

**Keywords:** Innovation, Invention, Competition, Economic Growth, Development

**1. INTRUCTION**

Enterprises today act under a big pressure by other enterprises, which offer the same or similar production or service, or they are under the pressure of the customers who expect more and more from the product they consume. In order to face with the new conditions and situations, enterprises are made to continuously search for new ways of production, namely offering new products or enhancing existing ones. In other words, they should continuously introduce innovations. But, what in fact do innovations represent?

Innovation is a process of transforming the new ideas, new knowledge into new products and services. Joseph Schumpeter defines innovation as an activity which leads to new producing function, new product. He divides this activity in several steps, as follows (McDaniel, 2002, p.57-58): a) *Introducing a new product*: the entrepreneur should produce, namely introduce a new product which can be easily sold and which is not offered in the market; b) *Introducing a new method of production*: innovation should offer a new scheme of production which through existing inputs can lead to an increased output, decrease of costs per 2unit product, introduction of new inputs and change of existing ones; c) *Opening new markets*: innovations can increase the sell in new regions, and also increase the number of customers; d) *Finding of appropriate sources of raw materials*: The raw material supplier can often lower raw materials' quality or increase their price and this directly influences over the quality and the selling price of the new product. Therefore, the entrepreneur should find an appropriate source of

inputs, which are needed for production of new products; e) *Establishing a new organization in the industry*: Schumpeter describes this step as an entrance of the entrepreneur in the monopoly market, where there has been no competition previously; or creating conditions through which the entrepreneur would take the monopoly position in the market. Lionnet (2003, p. 6) defines innovation as a process by which a novel idea is brought to the stage where it eventually produces money. It is a dynamic technical, economic and social process involving the interaction of people coming from different horizons, with different perspectives and different motivations. Ramadani and Gerguri (2011, p.102) define innovations as a process of creating a new product or service, new technologic process, new organization, or enhancement of existing product or service, existing technologic process and existing organization. UK Department of Trade and Industry (2003, p.18) defines innovation as the successful exploitation of new ideas and it is central to meeting this challenge; it involves investments in new products, processes or services and in new ways of doing business.

According to the given definitions, if we analyze their separate elements, we can say that we classify: innovations in production – development or enhancement of a specific product; innovations in services – offering new or enhancing of existing services; innovations in process – finding of new ways of organizing and combining inputs in the process of production of specific products or services; and innovations in management – creating new ways of organizing business resources.

The importance and definition of innovations can be explained from several aspects. From the aspect of *customers*, innovation means products with better quality and better services, which together mean a better way of life. From the aspect of *businesses*, innovation means sustainable growth and development, realization of great profit. For the *employees*, innovation means new and more interesting job, which requires more mental faculty, which results in higher salaries. From the aspect of *whole economy*, innovation represents a bigger productivity and development for all (Ramadani and Gerguri, 2011, p. 102).

In daily conversation, terms like *innovation*, *invention*, *creativity* and *science* are often used interchangeably. But, for academics, researchers and policymakers there are important distinctions between these terms and these distinctions give each term a unique, specific meaning. Invention is the first occurrence of an idea for a new product or process, while innovation is the first attempt to carry it out into practice (Fagerberg et al, 2004, p.4). Creativity is thinking about new things, while innovation is making new things. Creativity is an ability to develop new ideas and ways of facing problems and possibilities, while innovation is an ability to perform creative solutions in order to enhance people's life. Hence, enterprises can be successful only if they invent and make new things, or if they make the old ones in a new way (Zimmerer and Scarborough, 2002, p. 37). According to Cannon (1991, p.17), the distinction between these terms is as follow: *Creativity* represents an opportunity to create new appearance, content or process by combining existing inputs or factors of production; *Inventiveness* is a process of creating something new, which assigns a contribution to the level of overall mankind knowledge; and *innovation* is linked to the definitive marketing of the new product, service or technologic process, which is a result of the inventiveness.

Also, very important issue is that where do innovation come from? Which are the innovation sources or ideas for potential successful innovations? IBM made a study about the potential sources of innovations, which was based on phone interviews with over 750 CEOs and business leaders. This study found “that 76% of CEOs ranked business partner and customer collaboration as top sources for new ideas. This greatly contrasts with internal R&D, which ranked eighth as a source for new ideas — cited by only 14% of CEOs”. The top sources can be considered sources outside of the company (De Ridder, 2008). There are the IBM's top sources of innovation: Employees, Business partners, Customers directly, Consultants, Competitors, Associations, Internal Sales & Service Unites, Internal R&D, Academia, Think-tanks and Labs or other institutions. Another research shows that innovation s come from the inside of company (28.4%), suppliers (26.4 %), customers (25.8 %), competitors (24.9 %), and exhibitions (24.6 %). Such innovation sources as universities and other non-profit R&D institutions scored just 3.7 % and 2.9 %, respectively (Ukrainski and Varblane, 2005, p. 20-21).

Innovation is a major factor of economic growth and performance in the globalised economy. The relationship between innovation and economic growth and development has been well studied. However, that is not to say that it is well understood. Innovation brings new technologies and new products that help address global challenges, new ways of producing goods and delivering services boost productivity, create jobs and can help improve citizens' quality of life.

Innovation is the throbbing heart of the twenty-first century economy, consistently pumping new revitalizing activity through the system. The opposing force is commoditization—probably the single most powerful force in business today—which rapidly takes what was distinctive and profitable and

rapidly makes it commonplace and marginal, sucking out the vitality and profitability (Torun and Çiçekci, 2007).

## 2. THE CORRELATIONS BETWEEN INNOVATION AND ECONOMIC GROWTH AND DEVELOPMENT

Federal Reserve Board Vice Chairman Roger W. Ferguson, Jr. says that innovation benefits consumers through the development of new and improved goods, services, and processes, an economy's capacity for invention and innovation helps drive its economic growth and the degree to which standards of living increase (Federal Trade Commission, 2003, p.4). The capacity and the ability to create economic value are critical to competitive advantage and growth for firms, industries and countries. The question then becomes how to best organize resources to create, diffuse and sustain innovation and, moreover, how to leverage investments made in science and technology, research and development and related capabilities with the ultimate goal of reaping rewards in terms of wealth creation and increased standards of living.

Table 1. Innovation Union Scorecard indicators

Main type / innovation dimension / indicator	Data source	Reference year	No data available for
<b>ENABLERS</b>			
<b>Human resources</b>			
1.1.1 New doctorate graduates (ISCED 6) per 1000 population aged 25-34	OECD / Eurostat	2008	CN, IN
1.1.2 Percentage population aged 25-64 having completed tertiary education	OECD / Eurostat / national sources	2008	
<b>Open, excellent and attractive research systems</b>			
1.2.1 International scientific co-publications per million population	Science Metrix / Scopus	2008	BR, IN, RU
1.2.2 Scientific publications among the top 10% most cited publications worldwide as % of total scientific publications of the country	Science Metrix / Scopus	2007	
<b>Finance and support</b>			
1.3.1 Public R&D expenditures as % of GDP	OECD / Eurostat / national sources	2008	
<b>FIRM ACTIVITIES</b>			
<b>Firm investments</b>			
2.1.1 Business R&D expenditures as % of GDP	OECD / Eurostat / national sources	2008	
<b>Linkages &amp; entrepreneurship</b>			
2.2.3 Public-private co-publications per million population	CWTS / Thomson Reuters	2008	
<b>Intellectual assets</b>			
2.3.1 PCT patents applications per billion GDP (in PPSC)	OECD / Eurostat	2007	
2.3.2 PCT patent applications in societal challenges per billion GDP (in PPSC) (climate change mitigation; health)	OECD / Eurostat	2007	
<b>OUTPUTS</b>			
<b>Innovators</b>			
<b>Economic effects</b>			
3.2.2 Medium and high-tech product exports as % total product exports	UN / Eurostat	2008	
3.2.3 Knowledge-intensive services exports as % total service exports	UN / Eurostat	2008	
3.2.5 License and patent revenues from abroad as % of GDP	WorldBank / Eurostat	2008	

Source: Inno Metrics, 2011

According to the main findings of the Innovation Union Scorecard 2010 on their average innovation performance across 24 indicators presented in Table 1, the countries can be divided into four groups: Innovation leaders, innovation followers, moderate innovators and modest innovators (Inno Metrics, 2011).

- *Innovation leaders* show a performance well above that of the EU27. In this group belong Denmark, Finland, Germany and Sweden.
- *Innovation followers* show a performance close to that of the EU27 such as Austria, Belgium, Cyprus, Estonia, France, Ireland, Luxembourg, Netherlands, Slovenia and the UK.
- *Moderate Innovations* show a performance below that of EU27. In this group belong Czech Republic, Greece, Hungary, Italy, Malta, Poland, Portugal, Slovakia and Spain.

- *Modest innovators* show a performance well below that of EU27 such as Bulgaria, Latvia, Lithuania and Romania.

In all countries, indicators used in these analyses show an absolute improvement in the innovation performance over time, except Lithuania. The report shows that within the Innovation leaders, Finland and Germany are the growth leaders. Table 3 presents the annual growth rate for the rest of EU27 countries (Inno Metrics, 2011, p.11).

Table 2. Innovation Growth Leaders

Group	Growth rate	Growth leaders	Moderate growers	Slow growers
Innovation leaders	1.6%	Finland (FI), Germany (DE)		Denmark (DK), Sweden (SE)
Innovation followers	2.6%	Estonia (EE), Slovenia (SI)	Austria (AT), Belgium (BE), France (FR), Ireland (IE), Luxembourg (LU), Netherlands (NL)	Cyprus (CY), United Kingdom (UK)
Moderate innovators	3.5%	Malta (MT), Portugal (PT)	Czech Republic (CZ), Greece (GR), Hungary (HU), Italy (IT), Poland (PL), Slovakia (SK), Spain (ES)	
Modest innovators	3.3%	Bulgaria (BG), Romania (RO)	Latvia (LV)	Lithuania (LT)

\* Average annual growth rates as calculated over a five-year period

Source: Inno Metrics, 2011, p.11

According to the Fourth Community Innovation Survey in collaboration with the European Commission of the European Innovation Scoreboard, Frunză (2010, p.10-11) observed that among the EU27 Member States the highest proportion of companies with innovation activity in 2002-2007 period was recorded in Germany (65% of enterprises), Austria (53%), Denmark, Ireland and Luxembourg (52% each), Belgium (51%) and Sweden (50%), while the lowest rates were observed in Bulgaria (16%), Latvia (18%), Romania (20%), Hungary and Malta (both 21%).

As a core conditions which enable innovation and encourage economic growth are: strong standards and effective enforcement of intellectual property protection; dynamic competition and contestable markets; a strong and sustainable fundamental research and development infrastructure; encouraging information and technology communication developments, a strong emphasis on education at all levels (OECD, 2004).



## 2.1. The strong protection of intellectual property

Innovation and intellectual property increasingly dominate the economy. As technology advances, no firm has the resources to stand alone, and collaboration with others is becoming essential. This means that new business models are needed for developing intellectual property and sharing in its value. In 1421 the Government of Florence awarded the world's first patent to Filippo Brunelleschi for a means of bringing goods up the usually unnavigable river Arno to the city. He demanded and was duly awarded legal protection for his invention, being given the right for three years to burn any competitor's ship that incorporated his design (Dawson, 2002).

Intellectual Property Rights such as patents, trademarks copyrights, registered industrial designs, integrated circuit topographies ect, are known as key factors promoting innovation and growth in today's economy. Designing an effective and appropriate system of IPRs is complex for any country. The mechanisms by which IPRs operate vary across functional areas such as mentioned above and their importance differs across sectors. The nature and the purposes of these mechanisms are distinctive, although they share certain fundamental characteristics that bring them under the IPRs Umbrella. The strength of IPRs depends on the demand characteristics, market structure and other forms of business and competition regulation. Intellectual property helped make possible the conditions for innovation, entrepreneurship and market-oriented economic growth that shaped the 20<sup>th</sup> Century. In the 21<sup>st</sup> Century, IPRs increasingly will define these conditions, and will dictate the pace and direction of innovation, investment and economic growth around the world (Torun and Cicekci, 2007, p. 11).

Since the 1995 Green Paper on Innovation, the European Commission and the Governments of several Member States have emphasized the role of Intellectual Property Rights (IPR) as an incentive to firms to invest in innovation and as a means of appropriating their investments in innovation. If we look at one of mechanisms of IPR such as patenting, one of the main concerns over time has been a lower rate of patenting by European firms compared to American firms, as identified in several editions of the EIS (European Comisson, 2005). The difference in patenting rates between the US and Europe is partly due to a difference in industrial structures. For example, compared to the US, a higher percentage of European value added and employment is from manufacturing sectors with low to moderate background patent rates<sup>1</sup>, such as transportation equipment. The US, conversely, has a higher concentration of firms active in high-technology sectors with high background patent rates such as pharmaceuticals, biotechnology and IT equipment.

Table 3. The equivalent subsidy rates of patents by industries

	USA	FRANCE	GERMANY
Pharmaceutical	22%	4.1%	15.2%
Industrial Chemicals	14%	7.2%	
Food, kindred and tobacco products	2%		
Semi-conductors	23%		
Electronic Components	13%		
Communication Equipment	39%		12.5%
Computer	8%		
Metals	23%		
Rubber Products	19%		
Aircraft and Missiles	4%		
Instruments	16%		
Medical Instruments	21%		

Source: Lévêque and Ménière, 2006, p. 10

From the Table 3 we can see different studies carried out at different periods of time in different countries and with different methodologies. In the table we can see the importance of patents to recover investments and their effects on innovation depends on industrial sectors. Unsurprisingly, for pharmaceuticals patent protection is a key mechanism (drugs can easily be imitated) whereas it is not for missiles manufacturers (purchaser of weapons do not want the invention being public). We must always keep in mind that patent stimulates innovation differently from one sector or one technology to another. There is not a universal effect of patents (Lévêque and Ménière, 2006, p. 10).

<sup>1</sup> The *background patent rate* is defined as the number of patents per employee or unit of value added or sales

## 2.2. Dynamic competition and contestable markets

Competition is the critical driver of performance and innovation. It benefits everyone by enabling to choose from an array of excellent products at affordable prices. Competition encourages the adoption of innovation as companies evolve and offer new ideas in order to flourish in the marketplace.

Products should compete on their own merits, and consumers everywhere should have the ability to easily choose the best products available for purchase. Fair and open competition dictates that the best product wins, and market forces prevail. Competition among firms generally works best to achieve optimum prices, quantity, and quality of goods and services for consumers. Competition can stimulate innovation. Competition among firms can spur the invention of new or better products or more efficient processes. Firms may race to be the first to market an innovative technology. Companies may invent lower cost manufacturing processes, thereby increasing their profits and enhancing their ability to compete. Competition can prompt firms to identify consumers' unmet needs and develop new products or services to satisfy them.

## 2.3. Research and development infrastructure

Research and development (R&D), resulting in new goods, new processes and new knowledge is a major source of technical change. R&D is a fundamental input into the innovation process and innovation is an important factor that influences productivity growth and competitiveness. As defined by the Frascati Manual (OECD, 1993, p. 29) "R&D comprises creative work under-taken on a systematic basis in order to increase the stock of knowledge and the use of this stock of knowledge to devise new applications". The relationship between R&D and innovation is a complex, non-linear one. However, it is recognized also that it is difficult for substantial advances in technology to occur without work undertaken on a systematic basis (even serendipity tends to develop in such a context), and R&D is a good indicator of this broader phenomenon.

## 2.4. Development of information and technology communication

In the last two decades, the information technology sector has been responsible for more economic activity, more wealth creation, more productivity and more worldwide economic growth than any other sector in the economy. Economies, consumers, businesses and governments reap the benefits of technological innovations. R&D is not the only source of new technology: in modern, industrial economies, other activities, such as learning by doing or design are conducted in most cases on the basis of new technology coming out of R&D (*e.g.* changes in the organisation of business related to the use of information and communication technology).

Technological change is the rate at which new knowledge is put into physical forms and diffused for use in the economy. Major technological advances, such as the steam engine or microprocessors are known as *general purpose technology* as they have broad applications and productivity-enhancing effects in a number of different sectors. As a result, general purpose technologies induce dramatic economic changes by creating innovation that rejuvenates existing sectors and, in the process, create new industries and services. A historical example is the steam engine, the Internet is a more recent example. The Dot-Com bubble notwithstanding, the Internet has fundamentally changed the way business transactions take place, creating efficiencies and productivity growth for existing firms as well as new opportunities for entrepreneurs (Feldman, 2004, p. 7).

According to a study done regarding ICT (Information and communication technologies) Innovation and Economic Growth in Transition Economies, suggest that ICT is already playing a significant role in the transition economies, with ensuing economic benefits. However, it is also evident that the introduction of new technologies must be accompanied by a range of complementing factors for ICT to be effectively utilized and to contribute to productivity gains and economic growth. In particular, firms must develop appropriate and new marketing strategies, invest in equipment, and undertake processes of organizational change. This raises a critical question of whether the reason for some firms having yet to experience economic benefits from ICT lie with their failure to undertake the complementary efforts, or if it is due to some limitations inherent in ICT itself (ECORYS, 2007).

## **2.5. Impact of education on the economic growth and development**

Education represent very important determinant of economic growth and development (Barro, 2001). Sandberg (1982) showed for 21 European countries that there exists a relationship between the literacy rates in 1850 and per capita income in 1970, but not between literacy and income in 1850, suggesting that literacy affects economic well-being in the very long-run. This finding is further supported by Nunez (1990) for 49 Spanish provinces. Unfortunately, in most of these studies it is unclear how literacy translates into better economic outcomes.

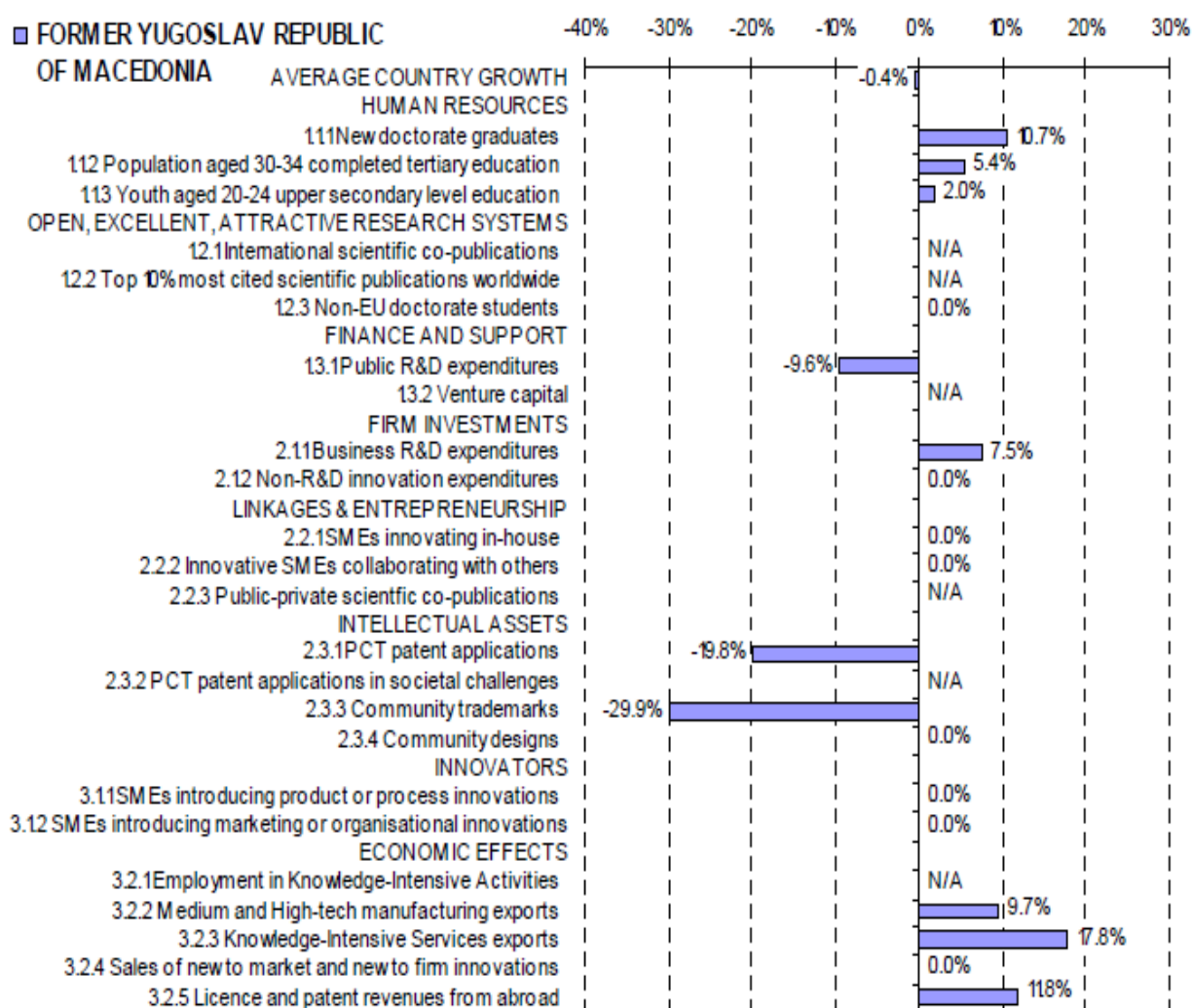
Innovation driven economic growth is a process of continual transformation. The economy expands into new materials, new sources of energy, new processes and new products, and it contracts from old ones requires a mobile labour force. People have to be ready to move from one occupational position to another maybe several times within a generation. This is not possible without the support of a system of education and training, which provides both general purpose and learning skills and diversified specialization possibilities as the national educational systems supervised by the state, has done for years. There are some tendencies towards international integration of education, but this is mainly on the post graduate level and as a supplement to national systems.

A large number of literatures suggest that education's contribution to economic growth has been variable across countries over time, and it is proven to have made a substantial contribution to growth. Education accounts for between 15 percent and 25 percent of growth in the U.S. national income per employee. Its contribution to economic growth has tended to increase over time (Becker and Lewis, 1993). As coverage of primary education has expanded rapidly in the developing world, higher education has gained importance. Thus, countries which have invested heavily in creating a well-developed infrastructure for tertiary education have reaped enormous benefits in terms of growth. Education has been a particularly important driver in the development of the capacity for technological innovation, as the experience of Finland, Korea, Taiwan, and Israel clearly shows (Lopez-Carlos and Mia, 2006, p. 89-105).

### 3. INNOVATION AND REPUBLIC OF MACEDONIA

As a country where EU integration is among the top priorities considering the IUS indicators presented in figure 1 and the group division, Republic of Macedonia belongs to the modest innovators, with performance well below the EU27. Considering the IUS Report “*relative strengths are in innovators relative, weaknesses are in open, excellent and attractive research systems, finance and support and intellectual assets. High growth is observed for new doctorate graduates, knowledge-intensive services exports and license and patent revenues from abroad. A strong decline is observed for pct patent applications and community trademarks. Growth performance in human resources, firm investments and outputs is above average, growth performance in finance and support and intellectual assets is below average*” (Inno Matrics, 2011, p.57).

Figure 1. Annual average growth per indicator and average country growth



Source: Inno Matrics, 2011, p.57

Growing role of innovation in economic and social development, and how governments can help ensure that innovation is translated into new products and techniques that can help society meet the global challenges of the 21st century. Therefore, significant efforts are invested in preparing the country for EU membership – national legislation is being adapted to EU legislation in all areas covered by EU law, EU standards are adopted in economic, political and social areas and comprehensive horizontal reforms of the public administration are conducted. Government officials and commentators have recognized this reality and have called for a variety of different substantive incentives for stimulating innovation (Analytica, 2007).

In 2006, the Government of the Republic of Macedonia adopted the Programme for Scientific Research, Technology and Technological Development which along with the newly developed draft Laws on Higher Education and on Scientific and Research Activity, regulate research activities and set priorities in this area (Analytica, 2007, p.5). Since Republic of Macedonia signed the above mentioned programme, in the area of Information Society, the government launched several initiatives with ‘e’

prefix: E-Citizens, E-Education, E-Business, E-Government, and E-Infrastructure, and IT is now an integral component of every government policy.

Republic of Macedonia is a full-fledged partner in *the Programme for Competition and Innovations of the European Union (CIP)*. Starting from January 1<sup>st</sup> 2008, Republic of Macedonia officially started with the implementation of this programme for the period 2007-2013, and in this way, it became the second country after Croatia which is not a member of EU, but has joined this Programme. Through this programme, the European Commission gives an impulse to the entrepreneurship, innovations and the development of small and medium sized enterprises, which in EU are considered a backbone for the national economies. The aim is to encourage the competition and innovations in the European Union, bearing in mind that this could lead to an increase in the economic growth in the member-countries and candidate-countries for membership in EU.

The Programme for Competition and Innovation is especially important for the small and medium sized enterprises in our country, because it will provide them with internationalization, as well as an easier access to the financial assets, more appropriate use of information and communication technologies, development of the IT society and promotion of the importance of new renewable resources of energy and energy efficiency.

The Programme for Competition and Innovation of the European Commission is planned for the 2007-2013 period and it has a *budget of 3.6 million Euros*, and it is divided into three basic programmes: Entrepreneurship and Innovation Framework Programme (EIP), Information and Communication Technologies Policy Support Programme (ICTPSP) and Intelligent Energy Europe Programme (IEE).

Entrepreneurship and Innovation Framework Programme (EIP) has several defined goals:

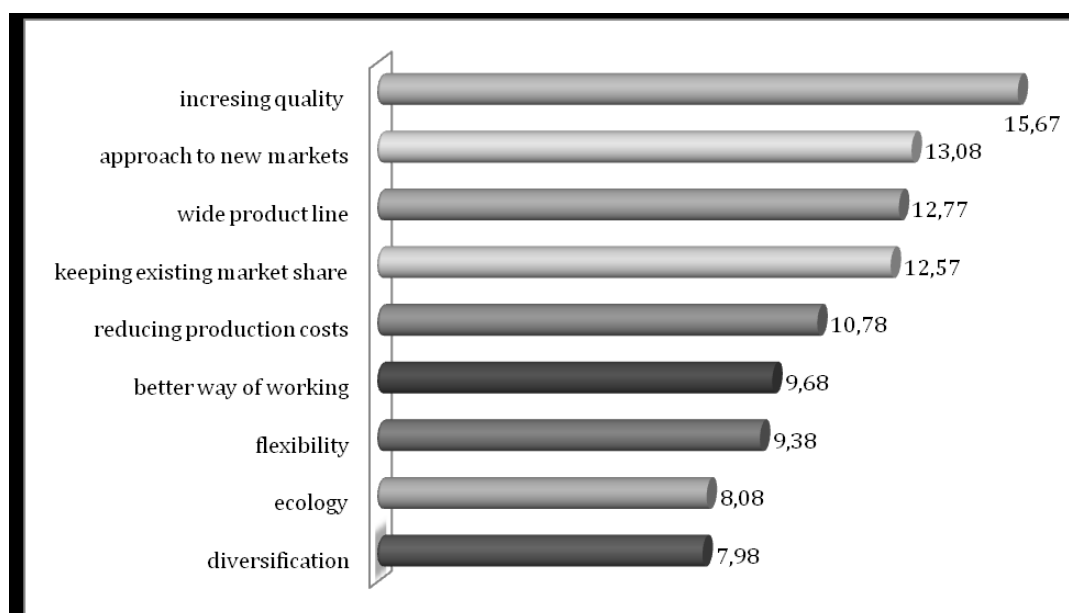
- Providing more efficient access to financial resources for the small and medium sized enterprises (SMEs) by co-guarantees and co-investments of the local banks and funds for the capital venture;
- Ensuring business and innovation services through a developed network of regional centres;
- Supporting and promoting entrepreneurship and innovation;
- Supporting ECO – Innovations.

The Programme for Competition and Innovation of the European Commission foresees cooperation among owners of the small and medium sized enterprises, state institutions and organizations, organizations of the civil society. It is specific that co-financing of the projects is conditioned with cooperation through the consortium or network of co-operators.

Regarding to the innovations in the Republic of Macedonia, the Bureau for protection of the intellectual property conveyed a research in order to find out the reasons of undertaking innovative activities by the enterprises. The results of this research are shown in Figure 2.



Figure 2. Reasons for undertaking innovative activities



Source: APERM, 2004, p. 49

To reveal the types of benefits that innovation brings to companies, we will use the empirical data from our research, which was carried out during January–April 2010 in 119 small and medium sized enterprises from different cities of the Republic of Macedonia. The data shows that improving the quality of products and services offered to customers is the first ranked benefit from innovation. This benefit was mentioned from 27% of respondents. Further benefits are ranked as follows: creating better conditions at work (by 18% of respondents), maintaining the existing position in the market (17%), entering new markets (13%), creating flexibility at work (9%), improving the ecological environment (5%) and diversification of product range (2%).

#### 4. CONCLUSION

Innovations represent an activity of creating a new product or service, new technologic process, new organization, or enhancement of existing product or service, existing technologic process and existing organization. According to the given definition, if we analyze its separate elements, we can say that we classify: innovations in production – development or enhancement of a specific product; innovations in services – offering new or enhancing of existing services; innovations in process – finding of new ways of organizing and combining inputs in the process of production of specific products or services; and innovations in management – creating new ways of organizing business resources.

The importance and definition of innovations can be explained from several aspects. From the aspect of customers, innovation means products with better quality and better services, which together mean a better way of life. From the aspect of businesses, innovation means sustainable growth and development, realization of great profit. For the employees, innovation means new and more interesting job, which requires more mental faculty, which results in higher salaries. From the aspect of whole economy, innovation represents a bigger productivity and development for all.

Growing role of innovation in economic growth and development, how governments can help ensure that innovation is translated into new products and techniques that can help society meet the global challenges of the 21st century. EU integration is among the top priorities of Macedonia. Therefore, significant efforts are invested in preparing the country for EU membership – national legislation is being adapted to EU legislation in all areas covered by EU law, EU standards are adopted in economic, political and social areas and comprehensive horizontal reforms of the public administration are conducted. Government officials and commentators have recognized this reality and have called for a variety of different substantive incentives for stimulating innovation. Several core conditions enable innovation and encourage economic growth: strong standards and effective enforcement of intellectual property protection, vigorous competition and contestable markets, a strong and sustainable fundamental research and development infrastructure, encouraging information and technology communication developments, a strong emphasis on education at all levels, etc.

As a country where EU integration is among the top priorities considering the IUS indicators presented in table and the group division, Republic of Macedonia belongs to the modest innovators, with performance well below the EU27. From January 1<sup>st</sup> 2008 Republic of Macedonia officially started the implementation of the European Union CI Programme for the period of 2007 – 2013, which became the second country after Croatia, which is not part of the EU but is part of this programme. Competitiveness and Innovation Programme (CIP) is particularly important for small and medium enterprise in Republic of Macedonia, which would make them become international, and have a better access to financial resources, better usage of information and communication technologies and development of the technological society.

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**ENTREPRENEURIAL PROPENSITY AS A GENERATOR OF TOURISM SUPPLY****Tomislav Klarin**

University of Zadar, Department of Tourism and Communication Studies, Croatia

E-mail: [tklarin@unizd.hr](mailto:tklarin@unizd.hr)**Abstract**

Innovation is a key success factor in today's market and, consequently, innovative entrepreneurship in the modern economy is the very driving force that positively affects the development of technology and knowledge, encourages new jobs and ultimately leads to the general stability of society. A particularly important segment of entrepreneurship is small and medium-sized enterprises, which makes up the majority of the total number of companies in developed economies.

Croatia is one of the countries going through the transitional process of changing their social system from socialism to capitalism. Socialism in its essence involved job security and uniformity and was not an incentive setting for the exercise of individual creativity, innovation and entrepreneurial productivity. Therefore, the process of transition inevitably requires from individuals to change their perception in favour of larger entrepreneurial initiative. Researches suggest that this process has not been fully accomplished. Its objectives must ultimately result in competitive and dynamic economy based on knowledge and technology, capable of sustainable development, creation of more quality jobs and a stronger social integration.

Despite the instability of the market, Croatia by means of various measures and incentives is trying to encourage entrepreneurial development and catch up with more developed European countries. Tourism is a fundamental activity in Croatian economy and accounts for the most important element in its GDP and is constantly evolving and improving. Tourism and entrepreneurship are in strong interaction, because fresh ideas and changes are a prerequisite for the survival of a destination in the tourist market.

Due to the transition trends and the global crisis which led to dramatic changes in the labour market, new young generations are in a highly disadvantaged position. The positive shift is possible through their entrepreneurial involvement, based on knowledge, innovation, strength and willingness to contribute to the development of the economy, especially tourism, as the only sector recording positive results.

The aim of this paper is to explore attitudes about employment or, in other words, the willingness of the new generation of young people to work for others or to start their own business, to examine their entrepreneurial potential and the motives and reasons for (not) starting-up their own business. In particular, it discusses their entrepreneurial propensity to participate in the tourism supply. The assumption is that students of tourism are more inclined to entrepreneurial ventures. A survey was carried out through a structured questionnaire on a sample of students of the University of Zadar. The collected data were analyzed by methods of descriptive statistics and the research results were presented as workable solutions for the development of a model meant to encourage entrepreneurship among the student population.

**Keywords:** Entrepreneurship, Tourism, Students, Education, Croatia

**1. INTRODUCTION**

Many of the current developed countries were forced to transform their economies and accept concept of small and medium enterprises as a response to turbulent and demanding environment. Modern economy based on flexible, innovative and penetrating enterprises gave positive results, not only in economical, but also in political and social development. Entrepreneurship had influence on all levels of human living generating value added and general prosperity.

Transition countries recognized the power of entrepreneurship, but still try to find solid framework for making positive entrepreneurial climate. Global crisis makes the situation worse. Croatia is one of countries with the same problem. Strongly oriented on entrepreneurship, has noticed its weakness that wanted to remove, but also noticed its advantages that wanted to exploit. Advantages graded in tourism, only sector with positive trend in previous years. A positive trend follows also young population expecting opportunity for progress and development as a participant of modern concept of entrepreneurship.

## 2. TRANSITION AND ENTREPRENEURSHIP

Democratic changes in transition countries have created new economic and social order. Economies of the social countries were based on large and indolent companies and believing that economic success and wealth creation depended only on these companies. Under these conditions worker's existence was assured but also possibility and freedom of entrepreneurial ventures was limited. Abandoning the economy of scale concept and state control, processing market liberalization and reaching open economies, many large companies could not find solution in hard situation, gradually have reduced business activities and ultimately, many of them have ceased to operate. Some of those large companies have managed to restructure and adapt to changes and still work successfully. Mostly, they have transformed into many small enterprises, which have applied knowledge and new technologies much easier. According to data from research (Kandzija, Biljan-August and Lovric, 1997) in Croatia in 1989 were 4,109 small and medium enterprises, and up to 1995 that number raised on 59,407. At the same time, number of large companies reduced from 1.403 to 515.

Developed countries have realized on time fact that Small and Medium Enterprises (SME) were precondition of local and regional economy development, competitive creation and overall social prosperity. Their example followed transition countries. The experience of developed countries and those in transition has identified entrepreneurship as an important accelerator of economic and social development, although, flexibility, adaptability and creativity of SMEs continuously recorded positive results in all socio-economical levels.

Development of an entrepreneurial climate requires primarily freedom, expressed through free and competitive marketplace, the right and safety of capital, the right of establishing companies, investment freedom, the possibility of making profit etc. Assumption of higher freedom degree is well functioning of government, market and other institutions and transparent legal and statutory regulations. In addition, a socio-political environment must be achieved to make a positive entrepreneurial climate. It involves stimulating state policy with aim to ensure the existence and development of SMEs economy and to create cultural, moral and ethical society that will make entrepreneurial behaviour acceptable and positive. Securing property rights, stable monetary policy, good regulation, low taxes and free trade presume increasing entrepreneurial activity and economic prosperity (Gwartney & Lawson, 1996).

In order to make a positive business climate and entrepreneurial economy, numerous political and economics programs have been created to encourage entrepreneurship at all levels. Programs of encouraging and developing SMEs include three basic strategic documents and actions of the European Union: 1) The Lisbon Strategy, 2) The European Charter for Small Enterprises and 3) Action plan for entrepreneurship, (Croatian Chamber of Economy, 2009). Some of the activities of encouraging and developing SMEs are following: removing and reducing administrative cost and barriers, appropriate sources of corporate financing, export orientation, constructing enterprise zones and business incubators, developing consulting educational programs, researches and development of new technologies etc. All actions are aimed to promote the establishment of new companies, encouraging development and innovation capability of enterprises through the creation of dynamic and stable business environment, strengthening of internal market and accessing to other markets.

Entrepreneurial motives are determined by entrepreneurial climate and entrepreneurial environment depends on the degree of development of certain country. Data show a different representation of SMEs in the European Union and transition countries. According to the Croatian Chamber of Economy in Croatian economy in year 2009 SMEs made 99.5% of the total number of enterprises, in which worked 66.01% of total employees and where achieved 57.72% of the total profits made by all enterprises. The share of SMEs in Croatian export in 2009 was 44% (Croatian Chamber of Economy, 2011). Data for EU-27, estimated from European Commission in year 2008 were similar: 99.8% of the total numbers of enterprises with 67.4% of whole employees and 57.9% of all value added. In non European countries like Serbia was almost similar situation. It was estimated 99.4% SMEs in total number of enterprises, where worked 57.3% of whole employees and realized 51.5% of whole value added (European Commission, 2009).



## 2.1. MODERN CONCEPT OF ENTREPRENEURSHIP

Economic freedom and market liberalization significantly influenced on development of modern enterprises, a higher degree of economic freedom has increased the opportunity for entrepreneurial activity. Although, entrepreneurial activities are different between countries, its role in shaping economic and social environment is unquestionable. The positive effect of entrepreneurship is: the creation of new companies and new markets, liberalization of closed sectors, the expansion of technology and knowledge, creation of new products and services, higher level of employment and labour mobility, development and expansion of industry and production, better education and higher technological level – thereby generates economic growth and raises general welfare of society.

Economic theory has developed different definitions of entrepreneurship, but they all contain the same essential elements. Entrepreneurship is ability to initiate specific actions, to undertake activities with purpose to struggle against obstacles in achieving desired aim, taking over the risk and uncertainty of outcomes together (Deakins & Freel, 2003), where the entrepreneur must be prepared to identify business opportunities, to collect and invest resources, to start a business and achieved planned value (Cengic, 1995). Therefore, it could be concluded that entrepreneurship is behavioural phenomenon, talent or skill that includes specific management of various resources and undertakes business activities in order to achieve positive economic results, while taking risk.

The establishment of new SMEs increases competitive pressure on existing companies, pushing them to enhance their effectiveness, while stimulating changes. Modern entrepreneurship increasingly emphasizes the role of innovation, knowledge and technology, while reducing the importance of material resources (land, raw material, energy), because these elements affect the efficiency of business and enable competitiveness and productivity of economy.

As a participant of entrepreneurship, entrepreneur is a person who creates new business activities, identifying market opportunities and ensuring resources, necessary to exploit recognized opportunities, taking uncertainty of profit and development of the enterprise (Leburic & Krneta, 2004).

Entrepreneur implements four dimensions – *economic, managerial, innovative and socio-ethical dimension* (Cingula, 1995).

*Economic dimension* of entrepreneurship manifests through the creation of profit and achieving greater income. That act makes him aware of possible risk, and possibility of loosing invested assets and financial capital, so he must necessarily identify business opportunity and distinguish chance from the threat.

*Control dimension* refers to the duties and responsibilities of management – planning, managing and realization of strategic plans, organizing and controlling financial, material and human resources, coordinating all process and business activities etc. Managerial skill is very important, because this dimension requires entrepreneur to be rational, rightful and wise leader in optimizing all resource and business activities in order to achieve sustainable development and prosperity of enterprise.

*Innovative business* reflects in reproduction and generation of new, different and creative ideas. According to Schumpeter, ideas include five innovations (Vujic, 2010): 1) initiation of a new product and service, 2) initiation of new method or production process, 3) opening and conquering new markets, 4) conquering new source of supply or raw materials and 5) creating new organization in certain industry. In that context Peter Drucker find innovation as function and special instrument of entrepreneur – doing something in a different way, not doing something better than what already exists (Drucker, 1992).

*Socio-ethical or moral dimension* combines other three dimensions, whose realization is possible if the socio-ethical responsibility minimum is satisfied. That responsibility reflects through respecting economic and legal framework of national laws and international standards. It reflects also through behaviour according to moral principles and rules and respect for human rights. Although, moral and ethical values of modern world brought to a crisis, ethical should not be left to entrepreneur as a free choice. It should be settled as an obligation and any contempt and deviant behaviour should be sanctioned. For this reason, importance of socio-ethical dimension stresses more and more, while gradually transformed into a special form of entrepreneurship, so-called *social entrepreneurship* (Cingula, Veselica & Cingula, 2010).

All of the above states that entrepreneur must be versatile and govern the economic, legal and socio-ethical skills. Therefore, some experts call them part of the “*economic elite*” of modern societies (Cengic, 2005), while some authors consider them as “*elite controlling most resources*” according to order they have created in some countries in recent years (Kutsenko, 2004).

### 3. TYPOLOGY OF ENTREPRENEURS AND ENTREPRENEURIAL MOTIVATIONS

Various authors give different typologies of entrepreneurs (Earle & Sakova, 2000; Smith, Norman & Miner, 1983) connected with status, entrepreneurial tradition, working experience, due the work purpose it considers only certain.

Typology and entrepreneurial motives relates to social and professional status, and specific situation potential entrepreneur is found. Abstracting, it is possible to distinguish “*entrepreneur of necessity*” and “*opportunity entrepreneur*” (Aidis, 2005). Entrepreneurs of necessity are appropriate to developing countries, where limited alternatives encourage or even push in realization of entrepreneurial ventures. Contrary to them, opportunity entrepreneurs are driven by market conditions entering in entrepreneurship by a desire to exploit business opportunity in a way to accomplish their idea and demonstrate their ability. The same classification states global Entrepreneurship monitor (GEM - Global Entrepreneurship Monitor, 2010) in the global report about business activities of enterprises in year 2010.

Social factors interacting with each other helps to create positive a positive entrepreneurial climate – quality of life, moral and ethical socially acceptable norms, representation of social strata in certain society, family structures, social roles within society, the strength of gender role in society, social status of entrepreneurs are such factor that de/stimulate entrepreneurial climate. If values of these variables concentrate around the mean average within a slight tendency to increase, stimulating influence on the creation of positive entrepreneurial climate. Contiguity with extreme values, discourage positive entrepreneurial climate. There is also a contrary interpretation of the so-called *marginalization theory* concerning the role that individuals presently achieve in society. Dissatisfaction with role or status in society or current work encourages individuals to make some changes. This situation creates a critical mass of individuals and potential entrepreneurial base.

### 4. ENTREPRENEURSHIP IN TOURISM

Considering the historical facts of the development of modern tourism is obvious that entrepreneurial factors (knowledge, technology and innovation) have played an important role in developing tourism and improving quality of tourist destinations. It is hard to measure the efficiency of transport technology in approaching tourist destinations or facility of communication and doing business installing ICT technology, but all these changes improved tourist supply with purpose to satisfy growing consumer’s needs.

Entrepreneurship figures complex economic activity represented and determinate differently in certain industry sector. Concerning the interdisciplinary nature of tourism, entrepreneurship takes place in all activities of tourism sector but also exceeds its limits, because of tight links with activities of other sectors. It proceeds in SMEs and large enterprises, in private and public sectors. Economic principles used in tourism are the same as in other economic sectors, however, the difference reflects in specific resources and market, product and service complexity, regarding tourism supply which is trying to valorise.

Entering the tourism market enterprises must consider their possibilities and market conditions. Facilitating the entry of enterprise is possible through adjusting supply to market conditions and needs. In conditions where is necessary to ensure long-term survival in the market, SMEs must find mode of constant adaptation to market demand. In order to succeed, it is necessary to maintain competitiveness and innovation. Innovation should not be a static dimension of onetime creation of making product and services uniqueness, but requires long term process of continuous maintaining and innovation offer. Therefore, the long term of enterprise’s survival and competitiveness presumes constant innovation.

### 5. METHODOLOGY

Within the framework, a research was conducted on a random sample of students at University of Zadar, Department of Tourism and Communication Studies. The research was realized electronically by anonymous questionnaire appointed by link on social network Facebook or sent by email to personal email addresses in period 15<sup>th</sup> of July to 15<sup>th</sup> of June 2011. The questionnaire approached 69 students, representing 15% of the total population of the Department. The questionnaire tried to investigate student’s opinions and attitudes about work and entrepreneurship, their entrepreneurial potential and propensity of entrepreneurial venture.

A structured questionnaire was composed of primary part and seven others parts. Primary part requested personal information about students, their study, work experience and entrepreneurial tradition in family. The first and second parts were related on their assessment of the current entrepreneurial climate and incentives in Croatia. In the third section it has been examined student's attitude about job opportunities and mobility inside and outside the country. Motives and factors of starting-up own business was evaluated in fourth and fifth part of questionnaire. Sixth part had the intention to explore their preferences of working for employer. Finally, in the seventh section students gave their answers to open question which kind of business would they deal with, if they have started their own business.

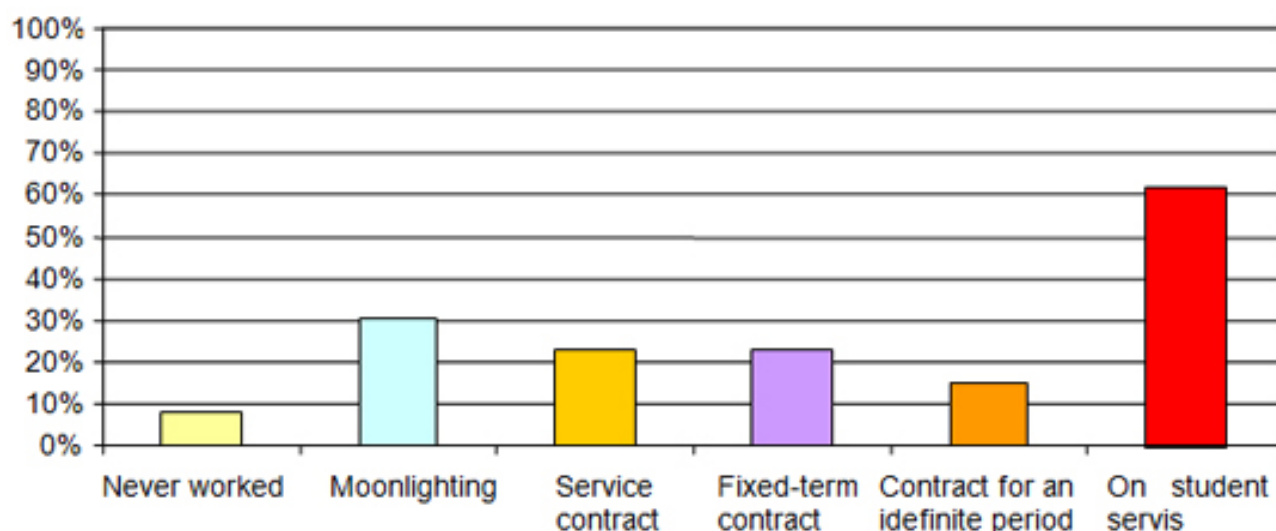
The research results are explained by methods of descriptive statistic graphically and tabular illustrated. Interpretation is settled in the theoretical framework and assumption that tourism students are more disposed to start their own business.

## 6. RESEARCH RESULTS

In a random sample of respondents were represented 87% of women and 13% of men, aged 18-25 years (91.3%) or older than 26 years (8.7%).

Information about working experience, with multiple choice answer is showed in Graph 1, where is obvious variety of working experience. Only small part of students never worked and more then 60% worked through student service – both index are positive and show working experience starts in earlier age, but also indicate difficult financial situation where students are forced to work to cover their student costs. Concerning data is that 32.4% students worked on moonlight (black market) – indicates the problem still exists in Croatian economy, despite the State struggle. It requires more actions from the State and behavioural changes of employers.

Graph 1: Working experience



Source: own research

The information was also obtained about working experience considering certain business sector. From all students with working experience, 26.9% of them worked in public sector, 82.1% in private sector and only 4.5% independently as an entrepreneur. Data correspond to actual data because, even the largest number of employees is concentrated in private sector still, more than 20% of employees work in the big state apparatus.

Within the questionnaire it was investigated family relatives and entrepreneurial tradition in family. Results showed that even 70.6% of examined students had someone from close relatives (father, mother, brothers, grandfather etc.) working as an entrepreneur, and only 29.4% without entrepreneur in family. According to data from Croatian Financial Agency (Croatian Financial agency, 2011) in year 2010 in Croatia was 96,383 SMEs, so, comparing to the latest population list (Croatian Bureau of Statistic, 2011), there was 22.5 enterprises per 1,000 inhabitants. Countries like Germany had only 20 enterprises, while Italy had 65 or Portugal even 80 enterprises per 1,000 inhabitants.

Entrepreneurial climate and relevant elements were examined through the assigned marks based on Likert scale from 1 to 5. Table 1 shows student's assessment of entrepreneurial climate, stated in

percentage accordingly to representation of their marks. Mostly, students had bad judgement. Even exists, (Government program for encouraging entrepreneurship, 2008), 40% of students knew nothing about Government program of encouraging entrepreneurship, so is understandable the negative opinion about encouraging entrepreneurial ventures. Government tries to achieve entrepreneurial climate and program of encouraging entrepreneurship exists, but still not transparent enough and recognized as successful. Perception of low level of economic freedom indicates inappropriate functioning of government, market and other institutions and non transparent legal and statutory regulations.

Table 1: Assessment of Entrepreneurial climate

Marks (%)	1 - very bad	2 – bad	3 – neither good no bad	4 - well	5 – very well
Economic freedom	4.4%	27.9%	52.9%	13.2%	1.5%
Entrepreneurial climate	10.3%	50.0%	33.8%	5.9%	0.0%
Encouraging entrepreneurship	11.8%	48.5%	35.3%	4.4%	0.0%
Current situation for starting-up business	23.5%	54.5%	20.6%	1.5%	0.0%

Source: own research

Table 2 is also connected with they marginalized thinking and behaviour, but shows they still don't have enough courage and experience to make a certain step in their life. They also don't show enough entrepreneurial propensities. Even they are pushed up by negative conditions on the labour market, they try to find chance working in safety and lower stress public sector. Certainly, alternative is not only entrepreneurship, even 30.9% of them found interesting perhaps, do to higher benefits, working simultaneously as entrepreneur and as employee.

Table 2: Intensions and desires after finishing study

After finishing study,					
I would like to	Work as employee in private sector	Work as employee in public sector	Try to start-up own business, If can't find adequate job	Work only as entrepreneur	Work simultaneously, as entrepreneur and as employee
	4.4%	35.3%	22.1%	7.4%	30.9%

Source: own research

It was also tried to investigate relation between sex (man & woman) and entrepreneurial propensity. 44% of all men declared they would like to work only as entrepreneur and simultaneously, as entrepreneur and as employee. Women had stronger entrepreneurial propensity participating with 50% of all examined women. In Efficiency-driven countries, where Croatia is also classified, men and women ratio oscillates from 1:3 to even 1:1, so this case of women's entrepreneurial propensity confirms the fact from GEM report 2010 (GEM, 2010).

Between the motives assessed in the research, results presented in Table 3 found interesting. Obviously, in entrepreneurship students saw the major opportunities missing in Croatian economy and society. According to low standard and low salaries, they want to be independent and increase profit. Also, through entrepreneurship they found possibility of development and progress aware of current situation, where small part of companies invests in their workers. Croatian people spend only app. 15 years in continuing whole life education, while some of Scandinavian countries have average of app. 23 years.

Table 3: Motives of starting-up own business

Motives for starting-up own business	1 – not at all important	2 – not important	3 – yes and not important	4 – important	5 – very important
Independence and increased profit	0.0%	0.0%	9.1%	54.5%	36.4%
Possibility of own development and progress	0.0%	0.0%	6.1%	45.5%	48.5%
Desire to use an opportunity	0.0%	3.0%	13.6%	53.0%	30.3%
Continuing and developing family business	15.4%	26.2%	15.4%	36.9%	6.2%
Insuring job to other family members	6.2%	15.4%	29.2%	38.5%	10.8%
Fear of unemployment	1.5%	4.5%	24.2%	42.4%	27.3%

Source: own research

Assessing features and factors for starting-up own business showed variety of perception, but most student have agreed that major elements for starting-up own business are quality and competitive product in correlation with innovation and creativity. They also concluded that for being entrepreneur and having own enterprise it's necessary to work hard and be persistent. Table 4 indicates student's perception.

Comparing students with entrepreneur in close family and desire of working, it could be conclude that 50% of students with entrepreneur in close family wanted to work only as entrepreneur or simultaneously, as entrepreneur and employee. 34% of them wanted to work in public sector. It's obvious that entrepreneurship is bipolar – it could give some benefits but still could be too risky and hard. Most of them indicated the same motives of starting-up own business (independence, increased profit, possibility of development and progress), but very few possibility of insuring tradition of family business and job to other family members.

Table 4: Features and factors necessary for starting-up own business

Features and factors necessary for starting-up own business	1 – not at all important	2 – not important	3 – yes and not important	4 – important	5 – very important
Good manager skills	0.0%	0.0%	4.5%	40.9%	54.5%
Human, social features and honesty	0.0%	4.5%	9.1%	31.8%	54.5%
Education and experience	0.0%	1.5%	18.2%	40.9%	39,4%
Innovation and creativity	0.0%	0.0%	0.0%	37.9%	62.1%
Initial capital	1.5%	0.0%	3.0%	34.8%	60.6%
Having quality and competitive product/ service	0.0%	0.0%	1.5%	22.7%	75.8%
Be persistent and work hard	0.0%	0.0%	3.0%	28.8%	68.2%



Positive entrepreneurial climate and market conditions	1.5%	0.0%	6.8%	50.0%	58.3%
Political and private connections	9.1%	9.1%	28.8%	30.3%	22.7%

Source: own resource

Contrary to the entrepreneurial motives and factors of starting-up business, students also gave their attitudes about relevant elements of working as an employee with the employer. If they had chance to work for employers most important factor was pleasant working environment, relation with superiors, then salary and personal development and lifelong earning. The least important was monotony of job, working hours and stress at work.

Last part of the questionnaire asked for open student responses on question of which activities would they dealt with if they have started their own business. 40% of students stated some of the tourism activities, while remaining 60% would involve in some other business.

## 7. CONCLUSION

Abstracting many anomalies and deviant behaviour raised from transition process, it is possible to conclude that relation to entrepreneurship in Croatia slowly going better. Perception of entrepreneur changed, but still connects entrepreneur with behaviour not in accordance with government measures and social awareness. Perhaps, the entrepreneurs are considered as some kind of elite, but certainly they are considered as elite according to new order of power and control they have established.

Development of entrepreneurship is possible if three conditions are provided: economical, political and sociological. Neither of them is completely insured. Indeed, some of activities from fundamental European documents of encouraging entrepreneurship are conducting, but European and Croatian socio-financial crises indicate really difficult and unpromising time for entrepreneurship.

Problem of encouraging entrepreneurship is also lack of coordination of government policies in creating and enabling environment for entrepreneurial activity. Large number of institutions and large public sector on central and regional level encourage entrepreneurship, without coordination and efficiency measurement of incentive programs and implementation of policies consistent with regional development needs.

Some positive improvements made in tourism, but still it's not enough without production and export. Students of tourism also showed their low entrepreneurial propensity and interests for starting-up own business. There are neither entrepreneurs of necessity nor opportunity entrepreneurs. They recognized all positive benefits entrepreneurship is offering, but they are also aware of current hard situation, alluding with their attitudes and perception on past times, living in socio-democracy, job security and lower stress life.

Creation of an effective social entrepreneurship is possible by engaging legal, economical and social institutions and political power in order to construct basic framework of social actions and equitable society. Healthy socio-economical environment encourages and reinforces entrepreneur's standing, while venture-oriented economy provides entrepreneur and entrepreneurship a central position in economic activities and achieving economic and social development.

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## FACTORS CONTRIBUTING TO THE MOBILITY OF INTELLECTUAL CAPITAL EXAMPLE FROM BOSNIA AND HERZEGOVINA

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### Abstract

Economic development based on creativity and knowledge or human capital in general, has become the leading growth strategy for both developed and developing economies. Those countries able to attract and retain educated, creative and entrepreneurial people build a sustainable competitive advantage in an increasingly interdependent global economy. Despite a growing amount of research into the phenomenon in developed economies, a detailed review of the literature revealed that there is a lack empirical research dealing with human capital and its mobility in transitional countries. Our research reports on a comprehensive survey of 420 creative and with knowledge-equipped people in Bosnia and Herzegovina (BiH). This study suggests that for those ties with family and friends are the most important factor in choosing their place of residence, while culture, place amenities, social diversity, and environmental quality are less important in this regard. The results have also been compared with findings of similar surveys conducted across developed part of the EU. We have also found that less than a quarter of the respondents are almost definitely or very likely to leave the country, mostly targeting larger EU cities, which is not as much as it was previously believed.

**Keywords:** Human capital mobility, urban environment, knowledge economy, creative industry, transitional countries.

### 1. INTRODUCTION

In an open global economy intellectual capital (Miller, 1999) has increasingly become sought after resource for economic and business development. Public availability of knowledge and decreasing communication costs propelled growth of knowledge-based products and services. Development of the Internet and related technologies boosted demand for innovative ideas, creative solutions, and custom made products. Companies, whose primary sources of profit are knowledge and creativity, nourish cooperation and wellbeing of their teams to support generation of new knowledge. Information and Communication Technologies (ICT) revolutionized methods of knowledge sharing and creation (Z. Acs & Varga, 2004; Jensen, Johnson, Lorenz, & Lundvall, 2007). Although the Internet and social mobility, knowledge networks span across the Globe, yet innovation is still very much a local phenomenon. Urban places with varied and complementing industries, founded on the diversified knowledge base, have been at the core of economic growth (The World Economic Forum, 2011), as people depend on personal contact and physical proximity to disseminate and develop ideas. In recent decades, a handful of metropolitan areas have experienced growth of knowledge and creative industries, while many other cities have experienced depletion of their stock of human capital. Thus as, Florida (2005) observes, the world economy is increasingly divided between thriving urban areas and the rest of the world. In fact, the majority of the world population, most key patents, and majority of the most-cited scientists are concentrated in several metropolitan regions. Development of the knowledge and creative economy increases the gap between rich and poor, not only on the global, but even more so, on the regional and local level (Weiming, 2000). In such an environment, the availability of local talents is the key precondition for growth of the knowledge and creative economy.

Talented and highly educated workers are increasingly mobile, those originating from other countries, make 2% of the European labour market, 4,5% in the United States, 8% in Australia and over 10% in Canada. Even countries like China and Brazil will long-term face the problem of labour shortages, especially highly educated professionals and entrepreneurs. Companies and countries struggle to attract the best and the brightest innovative and creative people, advertising quality of the environment to lure the top talent. Creating entertainment component of the city living has become a part of the long term strategic planning (Clark, 2003a). Knowledge enterprises work in the complex multicultural environment, what brings issues of tolerance into the fore of the research in economics (Florida, 2002). Creative and knowledge workers, with original ideas, non-conforming personal beliefs, attitudes, and different lifestyles want to feel welcomed among their peers (Amabile, 1998; Long & Fahey, 2000).

Same goes for non-domicile knowledge and creative workers, who need to be accepted and tolerated in the society they live in, regardless of their ethnicity, race, or sexual orientation. Contrary to the argument of Florida (2002), that the key factors of human capital mobility are community's tolerance to differences, amenities, and bohemian-like lifestyle opportunities, there is a finding of the ACRE research (Musterd, Brown, Lutz, Gibney, & Murie, 2010) that human capital in the EU is more likely to stay in their place of birth or study, close to their family and friends. Family and social networks are also the key factor on choosing the place of residence for human capital in Dublin (Murphy, Redmond, & McKnight, 2008). A possible explanation for this discrepancy could be related to lower general population mobility in Europe than in the USA.

Countries in transition are lagging behind in terms of development of economy based on knowledge and creativity. Bosnia and Herzegovina (hereafter, "BiH") is the case in point, the country's larger cities unable to create appropriate living and working conditions are in danger of losing their pool of talents. Global Competitiveness Report (2010) indicates that for the availability of scientists and engineers BiH occupies the 115<sup>th</sup> place amongst 139 countries covered by the survey. BiH is also one of the highest-ranked countries when comes to the number of educated and talented people leaving the country. In order to better understand the reasons contributing to such a situation in BiH, a typical transitional country, our research is set to analyze relationship between human capital mobility and societal and economic factors of the living and working environment in countries in transition. To the best of our knowledge similar research has not been conducted before. We also test whether the ACRE research findings (Musterd et al., 2010), that knowledge and creative workers in the EU are more likely to stay in their place of birth or study, hold true for knowledge and creative workers in BiH. The ultimate research question is to find out to how and to what extent *socio-economic conditions (factors) influence the choice of residence of knowledge and creative workers in BiH*. In order to deal with the main research problem the following questions are specified: What is the significance of traditional social networks, in regard to proximity of the family and friends on the choice of residence? What is the importance of economic factors on the likelihood of moving away from their city in BiH? What is the significance of city features on the likelihood of moving away?

The paper is structured as follows. After the introductory section, a comprehensive review of the literature gives us insight into development of theoretical and practical understanding of creative and knowledge economy (Section 2). Section 3 describes methodology and sample used for our research. Results of the survey are presented in Section 4, followed by the discussion in Section 5, and conclusion in Section 6.

## 2. LITERATURE REVIEW

Theoretical contest of the present research is rather broad as a number of topics are associated with the research problem, including knowledge economy, creative industry, innovation and entrepreneurship, the business/living environment and social mobility. The following discussion will focus on: knowledge dissemination, generation of knowledge, sources of innovation, human capital mobility, and factors that impact mobility of knowledge and creative workers.

Scholarly debate about the Knowledge and Creative industries has intensified in the past couple of decades (Hartley, 2005; Marcus, 2005; Musterd et al., 2010; UNCTAD & UNDP, 2008). Indeed, Knowledge and Creative industries significantly contribute to the economic growth, generating value by applying new knowledge to products, services and organizational processes. Profit comes from innovation of an entrepreneur who produces a commodity with lower costs than his competition, selling it for the prevailing market price, and keeping the entrepreneur's profit (Schumpeter, 1939). Idea that knowledge has a big impact on economic development is not new. Weber argued (2005, p. xxxvii) that utilization of *technical possibilities*, funded on "natural sciences based on mathematics and exact and rational experiment" had strong influence on development of capitalism. Breaking apart from neoclassical economic theory of the diminishing returns, in his study of data from 1909 to 1949, Solow (1957) argued that 7/8 of the rise in productivity is due to technological change, and only 1/8 of the growth was due to increased capital per man hour. In this sense, neoclassical theory becomes a special case of endogenous growth theory with margin of innovation converging to zero (Aghion & Howitt, 2007). Building on the model of Solow, Lucas (1988) incorporated human capital, identified as a production skill of a worker and its accumulation over time, marking human capital as the main source of rising productivity, both of labour and physical capital.

According to UNCTAD<sub>1</sub> & UNDP<sub>2</sub> report (2008), concept of creative industries is new and

1 United Nations Conference on Trade and Development

2 United Nations Development Programme



evolving, focused on their dynamics, without a single definition for creative economy, and with no consensus about activities based on knowledge that summarize sector of creative industries. These industries “constitute a set of knowledge-based activities”, using “creativity and intellectual capital as primary inputs”, not necessarily limited to arts but rich in creative content, being on the crossroads “among the artisan, services and industrial sectors” (UNCTAD & UNDP, 2008, pp. 12–18). Creative workers, as an agglomeration of a very large number of complementing professions, cover jobs such as: marketing and PR, advertising, architecture, trade with antiquities, ICT services, creative crafts, music, visual arts, theatre, newspapers – printed media/publishing/web portals, video, film, photography, music production, TV and radio, while knowledge-based work is usually found in legal and financial intermediaries and consulting services, science, R&D and engineering departments, and university faculty. Creative and knowledge workers bring prosperity to places where they work and live. Entrepreneurs create links and networks, serving as a medium for the transfer and creation of knowledge (Z. J. Acs, Audretsch, Braunerhjelm, & Carlsson, 2005). Examples of success, role models, famous creative and knowledge entrepreneurs, networks of support and knowledge spillovers, all constitute important environmental factors that increase success rate of new firms.

### 2.1. Innovation and knowledge

Innovators are creative and skilled people who “do things differently in the realm of economic life” (Schumpeter, 1939, p. 80). Creating something new, whether in a physical form or in a form of mental imagery, is regarded by Vygotsky (2004) to be an act of creativity or imagination, intrinsic to all human beings as their ability to process past knowledge and recombine it into innovations. Diversity and depth of available knowledge are crucial to new learning (Cohen & Levinthal, 1990). Economically relevant knowledge is idiosyncratic to innovative people, as there are able to recombine existing resources creating new products or services. Different forms of creativity are interconnected, they “not only do they share a common thought processes, they reinforce each other through cross-fertilization and mutual stimulation” (Florida, 2002, p. 33), creativity is “associated with a mind that exhibits a variety of interests and knowledge” (Simonton, 1999, p. 207).

Novelty ideas could come from convergence of random and varied stimuli, sometimes through collaboration of people from exceptionally different domains (Csikszentmihalyi & Sawyer, 1995; Nooteboom, 2000), if divergence of their cognitive processes is not too wide apart. Therefore, natural habitat for innovators is environment diverse in knowledge and rich in creative stimulus (Audretsch & Feldman, 2004). Polanyi argued that “we can know more than we can tell”, meaning that “tacit thought forms an indispensable part of all knowledge” (Polanyi, 1966, p. 20). Distribution of knowledge that can be codified (written and copied without substantial costs) depends on acquired tacit knowledge, which exists in a form of practical knowledge or knowledge that is still not completely developed (Z. Acs & Varga, 2004; Jensen et al., 2007).

### 2.2. Environmental aspects of knowledge and creativity

Concentration of knowledge and creative entrepreneurs bring competition, competence and dynamism into community. In a longitudinal survey (1977 to 2000), Glaeser *et al.* (2010) found that 10% increase in firms per worker in 1977 correlates with employment growth of 10% in that period. Agglomerating to certain places entrepreneurs not only increase their productivity by reducing transport costs and being closer to the natural resources and clients, but also by increasing access to ideas of their peers (Glaeser, 2007). Knowledge-creating networks spread far further than the boundaries of the workplace. People introduce information, personal contacts, specific experiences and personal insights from the outside world into their companies (Nooteboom, 2000). Cities with an abundance of business, educational, cultural and self-actualizing prospects are more likely to attract creative and knowledge workers than places where those opportunities are scarce (Clark, 2003b). A successful city is a “nucleus of an atom” (R. E. J. Lucas, 1988) that attracts increasing labour inflows. Glaeser et al. (2010) found a strong correlation between amenity index and level of employment in metropolitan areas, arguing that high amenity places attract human capital with college degrees; therefore, industries that employ them are also clustering in those cities.

Cities rich in amenities offer context for initial contact and friendship in a variety of situations; in art, sport, music events and venues, in clubs, art classes, lectures, bars, street performances, opera houses, libraries or galleries (Clark, 2003a; Clark, Lloyd, Wong, & Jain, 2003). Knowledge entrepreneurs are willing to pay more for living closer to the city centre (Glaeser, 2007). There are four key city amenities according to Glaeser *et al.*, (2004): range of available goods and services, aesthetic features of the city, quality and range of public services, and the quality and speed of transport and availability of jobs. The same researchers found that number of local amenities such as restaurants,

live performance theatres, attractive city dwellers, city architecture, superior schools, less crime, good local weather, well-organized transport connections, and availability of jobs are in positive correlation with an overall growth of a city. Research conducted in the EU found that there is no single city characteristic that is important to creative-knowledge workers (Musterd & Murie, 2010d), so we need to look into history of a place, quality and diversity of social and business networks, transport and communication infrastructure and quality and cost of housing. Musterd & Murie (2010a, p. 25) recognize “Soft conditions”, such as the quality of life, urban atmospheres, housing market situations, levels of tolerance, openness and the diversity of the population, while “hard conditions” relate to factors that are traditionally regarded as “playing the major role in explaining the development of firms in urban regions: availability of capital and of labour with adequate skills, proper institutional context, tax regimes, up-to-date infrastructure and accessibility” (Musterd & Murie, 2010b, p. 7). Contrary to this description, we consider proximity of family and friends, and other soft conditions that support social networks, as ‘societal factors’, while ‘economic factors’ are related to local hard conditions which depend on local funding and political decisions.

Proximity to friends or family most often determine where European creative-knowledge workers settle or move to (Musterd & Murie, 2010d). This differs from findings from the USA (Florida, 2002), that tolerance, openness and diversity are the key factors of human capital mobility. This discrepancy between Europe and USA could appear due to generally higher mobility of people in the USA, where knowledge and creative workers are less reliant on friendship and family networks and more on easier integration into local community and professional and business networks. Glaeser & Redlick (2008) found that declining areas might not experience weakening of social capital, keeping networks between family and friends strong, while being more likely to experience drop in number of skilled people. Furthermore, the existence of national boundaries within Europe, differences in citizenship rights and responsibilities, stronger interventionist traditions and the welfare state are also likely to affect the European human capital mobility (Musterd & Murie, 2010c).

Overall, available studies address issues of human capital mobility in developed countries in context of the living and working environment, while countries in transition are poorly represented in the literature on knowledge economy and human capital mobility. The existing research does not address differences between knowledge and creative workers who are more and those who are less likely to move away from their present place of residence in terms of their perception of their living environment. Also, there is a gap in the literature covering countries in transition, regarding the question of whether proximity to family and friends impacts knowledge and creative workers’ decision when choosing a place of residence, in spite of lower wages and poorer educational and career prospects in transitional economies. In the context of the Western Balkans countries, limited data suggest that over one fifth of the tertiary educated population from, for example BiH, Croatia, and FYR Macedonia are immigrants in the OECD countries only (R. Lucas & Martin, 2010), and still more highly educated people from these countries have settled in the USA, Canada and Australasia.

### 2.3. The knowledge and creative economy in Bosnia and Herzegovina

Countries in the SEE and CEE<sub>3</sub> regions went through a long period of the socialist planned economy, followed by a period of transition to the market economy. Some countries, like Czech Republic, Slovenia and Poland went through the transitional period more successfully, while others, such as Romania, Bulgaria, and most of the ex-SFRY<sub>4</sub> republics are struggling to consolidate their economies. Migration of younger and educated workers in BiH, from the periphery to urban centers and abroad, was exacerbated during the breakup of former Yugoslavia from 1991-1999. Anecdotal evidence suggests that high number of people with tertiary education want to leave the SEE countries. Glaeser and Redlick (2008) found that even in declining areas, with a net outbound human capital migration, people are more likely to return to schooling in order to raise their chances to migrate, adding in that way to accumulation of human capital in the area.

When it comes to youth, unemployment rates in the SEE countries are particularly high, with 60% percent in FYR Macedonia and BiH and 50% in Serbia (R. Lucas & Martin, 2010). In regard to mobility of human capital, high unemployment rates could propel outbound migration to more developed EU metropolitan areas as soon as administrative barriers are lifted. In BiH, research confirmed that around 70% of young people want to leave the country, mostly for economic or political reasons (United Nations WPAY – Youth UNIT, 2005). Commission of the European Communities (2007) acknowledged that obstacles for migration from BiH to the EU mainly relate to legal and administrative barriers, housing costs and availability, employment of spouses and partners, portability of pensions,

3 CEE – Central and Eastern Europe – countries of the former communist block

4 SFRY – The Socialist Federal Republic of Yugoslavia

linguistic barriers, and issues on the acceptance of qualifications.

### 3. RESEARCH DESIGN

The research process was conducted in phases. Firstly, focus group method was used to test validity and adjust a questionnaire we borrowed from the ACRE<sub>5</sub> research. The focus group filtered the most important factors of respondents' living environment.

In the second phase, we used the questionnaire to collect data on four aspects of working and living conditions, as well as demographics.

We use hypothesis testing to determine whether arguments from reviewed literature hold true for knowledge and creative workers in economies in transition:

*H1: Proximity to family and friends significantly influence the choice of place of residence,*

*H2: Cost of living significantly influence the decision of change of residence,*

*H3: City features do not significantly impact on human capital mobility.*

#### 3.1. The Survey

We use survey technique to test the hypotheses with. The questionnaire used for this research was borrowed from the EU research ACRE<sub>6</sub>. We use focus group interview to test the questionnaire. For the focus group we chose 11 people from the creative and knowledge economy<sub>7</sub>. We deliberately choose people with varied educational, professional and life backgrounds. Focus group was held on 9th of October 2010, Saturday, in a meeting room of the City Development Agency in Banja Luka (CIDEA). The questionnaire was then sent to a group of 25 respondents, who filled it online. They gave their comments on the clarity of the questions and technical issues.

The Sample and sampling techniques

We have determined the survey sample in accordance with the methodology and encountered difficulties. We follow argument of Fowler (1984), that there are five key issues related to sampling, including the sample frame, choice, size, design, collection of data, and the rate of response. The sample frame for our research consists of knowledge and creative workers living and working in larger BiH cities. Entrepreneurs are difficult to sample, since they are difficult to identify, their population is usually very small, and proprietary databases are either incomplete or non-existent, because of the populations' dynamics (Neergaard, 2008).

To determine the sample frame size we approached The Institute of Statistics and The Employment Bureau, who were not able to provide us with necessary information. Therefore, we decided to settle with the non-probability, snowball sampling method. We use every effort to reach population as wide as possible, but there is a large element of self-selection in the data collection process. We reduce selection bias by expanding the sample size. However, since we were not using probability sampling, we faced two sources of bias. The first one was our choice of initial subjects, and the second was volunteerism in responding (Heckathorn, 2002).

Our targeted population is fairly small in BiH and well interconnected. The initial group had 100 people including long-term friends, acquaintances from work, university, and leisure activities. It was assumed that older people were less likely to use the Internet, and people under the age of 30, who grew up with the web and ICT, are more likely to be overrepresented on the Internet (Sapsford & Jupp, 2006). Therefore, our sample frame consists of people from BiH under the age of 35, and people in managerial or other decision-making positions over 35 years old, who are found to be well represented on the Internet<sub>8</sub>. We used web platform Survey Monkey<sub>9</sub>, to distribute our questionnaire, and repeatedly reminded our initial group to send the link to their contacts via emails.

People we contacted directly or through friends' networks were highly responsive. This generated a

5 <http://www.acre.socsci.uva.nl/>

6 ACRE - Accommodating Creative Knowledge – Competitiveness of European Metropolitan Regions within the Enlarged Union, <http://acre.socsci.uva.nl/>

7 Economist, corporate banking, microcredit organization, Computer Programmer, Architect (senior architect in The Bureau for Civil engineering), Actress for The National Theatre, Graphic designer, the 3D design and animation studio.

8 „The GfK Group“ BiH: „A growing number of Internet users in BiH“: [http://www.gfk.ba/public\\_relations/press/press/004443/index.ba.html](http://www.gfk.ba/public_relations/press/press/004443/index.ba.html), 02.01.2011.

9 <http://www.surveymonkey.com/>

significant number of participants. The most active propagators were female friends who are holding managerial positions in web-based media houses. Our respondents work in the knowledge and creative economy, and they are in their twenties or older. Within the period of 3 months (February - May, 2011), the total number of people who followed the link from unique IP addresses was 684, while 464 people completed the questionnaire. The response rate was 67,8%. We deleted 42 responses that did not fulfil our specific requirements regarding the occupation. Therefore, the final response rate is 642 responses with 420 completed and useful questionnaires, so the final response rate is 65,42%.

We cannot claim population validity, because but there is a large element of self-selection in the data collection process. However, our sample is fairly large to minimize this bias, and number of completed questionnaires is sufficient, compared with number of visits to the web site (Sapsford & Jupp, 2006). We also introduced variables whose sole purpose is to exclude respondents who do not fit into our sample frame. In addition to our procedures to reduce bias and support validity and reliability, repeated research in the SEE countries could add to our analysis in this respect.

### 3.2. Data analysis techniques

To evaluate relationship for data acquired with the questionnaire, we use the non parametric Chi-square test and factor analysis in SPSS 17 software package. The Chi-square test was chosen because collected data are non-numerical; consisting in large part of nominal and ordinal data, and population distribution does not fit the normal distribution parameters. In addition to the Chi-square test, we use factor analysis and binary logistic regression, in order to determine which factors most significantly impact respondent's decision to move away from their city in the next three years.

To use binary logistic regression we modified dependent variable: "How likely are you to move away from their city in the next 3 years?", by reducing 5 options (almost definitely, very likely, somewhat likely, not too likely, and not at all likely) to 2 options (1 and 0), where option "1" = "YES" represents answers almost definitely and very likely, while option "0" = "NO" represents answers somewhat likely, not too likely, and not at all likely. This allows the calculation of equations expressing the relationship between binary outcome and impact of several factors, as predictors.

After conversion, our dependant variable (Likelihood of moving away from their city in the next 3 years) is dichotomous. Binary logistic regression analysis is used for one categorical dependent variable, and seven continuous independent variables - predictors (seven linear combinations that we get after the factor analysis). In this way, we are able to predict whether the probability of the dependent variable is the function of independent variables. Likelihood of moving away from the city is calculated by the equation for *odds*:

$$odds = \left( \frac{p}{1-p} \right)$$

Greater the *odds* of an event, the greater the probability that the event occurs, where,

$$\log(odds) = \log \left( \frac{p}{1-p} \right)$$

In the case of multiple predictors, as in our example, the equation for *p* is:

$$p = \frac{e^{b_0 + b_1x_1 + b_2x_2 + \dots}}{1 + e^{b_0 + b_1x_1 + b_2x_2 + \dots}}$$

$b_i$  – a measure of association between the predictors and the equation ( $\log(odds)$ ) for the occurrence of an event that interests us.

$b_i > 0$  – positive association

$b_i = 0$  – no association



## 4. THE RESULTS

In this section we present the empirical results. Results of the quantitative data are accompanied by tables in Appendix I. Analysis of the quantitative results start with descriptive analysis, which is followed by statistical methods of enquiry.

When asked the question: “How likely are you to move away from the city in the next 3 years?”, our findings show that respondents selected the following answers: 7,4% of our respondents selected *almost definitely*, 13,6% selected *very likely*, *somewhat likely* was selected by 22,9% of respondents, 43.6% choose *not very likely*, and *not likely at all* was selected by 12.6% of our respondents.

### 4.1. Demographics

When it comes to age, results show that 67% of the sample falls within 25-34 age group, 27,6% of respondents belong to 35-44 group, and fewer than 10% of respondents are less than 24 years old. Only 4,2% of respondents are older than 44. Our total sample is very close to being evenly distributed between female and male knowledge and creative workers. Female workers are better represented in the creative economy, but the difference is not statistically significant for our sample.

Although our selection criteria was primarily focused on occupation, and not on the highest achieved level of formal education, it is worth mentioning that 66,7% of respondents completed a degree, and 15,3% of respondents completed postgraduate studies. Respondents who completed one or more years of the university education comprise 15,2% of the sample, and 2,9% of respondents finished high school.

Results show that 12,9% of respondents receive net monthly income of less than BAM 500, and 21,2% of respondents have monthly income from BAM 500 to BAM 999.

It is notable that 41,7% of respondents receive net monthly salary/income between BAM 1,000 and BAM 1,999 (approx. EUR 500 – EUR 1.000), 8,3% of respondents have monthly income between BAM 2.000 and BAM 2.999, 1,9% have income between BAM 3.000 and BAM 3.999, and only 1,7% of respondents have monthly income above BAM 4,000 (2.050 EUR). There is no significant difference in income between male and female respondents.

### 4.2. Length of time lived in the city and neighbourhood

Survey data reveal that 86% of respondents lived in their city for 10 years or longer and 9,3% lived in their city between 5 and 10 years. It is worth mentioning that 50% of all respondents have spent their entire life in their city, that only 16,9% of people had a place of residence outside BiH, and only 0,2% respondents lived outside Europe. Results show that 21,4% of respondents have been living on the same address all their life, additional 29% of respondents lived on different address in their city, and 32,4% lived in another place in BiH.

### 4.3. Characteristics of respondents' households

Results for the household structure show that 17,9% of households are husband and wife (cohabiting couple), 26% are husband and wife (or cohabiting couple) with children, and single people living on their own represent 12,4% of the sample. Respondents in our sample who live with their parents make 25,7% of our sample, and those who live with their friends or relatives represent 6% of our respondents. Single parents make 1,4% of the sample. Our results show that 77% of respondents choose to live in central part of their city, less than 2 km from their city centre. Households are relatively modest in size, with only 8,3% of respondents living in households comprising of 5 or more members, 11,9% respondents live on their own, and 26,4% live in households of two people. Therefore, 38,3% of respondents live alone or with one more person, while 28,8% of respondents live in households of 3 people, and 24,5 of them live in households of 4.

### 4.4. Employment status

Because of high levels of unemployment in BiH, we introduced a category of unemployed creative and knowledge workers, i.e. respondents who are temporary out of work, but have experience in one of these sectors. 14.3% of our respondents are unemployed, 11,7% are self employed / freelance, and 74.0% are employed. Regarding the employer's category results show that 36,7% of respondents have the government as an employer, 32,7% work for a privately owned company, 12,8% of respondents work in NGO (non-governmental organizations), 8,5% are freelancers, 6,9% students, and 2,9% of respondents are owners/partners in their companies.



#### 4.5. Job sector

Data on surveyed knowledge and creative workers show that 63,8% of the total number of 420 surveyed knowledge and creative workers are employed by the knowledge sector, while 36,2% of respondents work in creative industries. Respondents who work in engineering, new technologies, and research and development (R&D) make 15,5% of the sample each, same as those working in management and consulting jobs. College, university and HE teaching professionals make 11,2% of the sample, workers in financial intermediaries 10,5%, legal and other business services 10,0%, marketing and PR, advertising 7,9%, design, applied arts 4,8%, arts: music, fine art, literature, theatre 4,5%, ICT – software 4,3%, architecture 3,3%, TV and radio 2,1%, new product development 0,7%, creative crafts 0,7%, newspapers, printed media / publishing, books, web 6,4%, video, film, photography 1,0% , music production 0,7%, and art dealers and ICT professionals working in the hardware sector represent 0,5% of the sample, each.

#### 4.6. Reasons for living in their city

Deciding on *four most important reasons for living in their city*, respondents gave the highest response to personal connections. In the questionnaire, reasons were ranked from 1 to 4, reason marked with number 1 being the most important, and reason 4 the least important. We converted values for our calculations, giving value 4 to previous value 1, value 3 to previous value 2, and so on.

According to results in Table 1(Appendix), the highest score has the variable 'the family lives here', 25,57% of the total sum of scores, 14,8% is score for 'born here', 12,68% for 'proximity of friends', and 11,6% for 'studied here'. Cumulatively, 64,65% of the total sum of scores belongs to: respondents having family in the city, being born in the city, proximity to friends and studied in the city. Apart from links to family and friends and employment, relatively high response rate of 7,71% of the total sum of scores was given to size of the city.

#### 4.7. Demographics and likelihood of moving away

Results in this section provide us with basic demographic characteristics of the sample in relation of how likely are respondents to move away in the next three years.

We use term 'mobility subgroups' to describe groups of respondents who are 'somewhat likely to almost definitely' to move away from their city in the next three years, therefore belonging to 'the more mobile subgroup', and respondents who are 'not too likely to not likely at all' to move away from their city in the next three years, therefore belonging to 'the less mobile subgroup'.

We found that significant variation exists in observed and expected values between mobility subgroups in terms of the respondents' age with  $\chi^2$  (3, n=420)=17,457,  $p < ,01$ . Respondents from the more mobile subgroup are in higher percentages younger than 34 years, and their age has a medium effect on the likelihood of them moving away from their city Cramer's V (3, n=420)=0,204,  $p < ,01$ , while their gender does not play a significant factor. A significant variation exists between mobility subgroups in relation to their monthly income, with  $\chi^2$  (3, n=420) = 10,713,  $p < ,05$ . It is noteworthy that 42,4% of respondent from the more mobile subgroup have wages below 999KM, and only 27,5% from the less mobile subgroup have wages in that bracket. The size of the respondent's household significantly affects likelihood of respondents moving away. Results demonstrate that 55,7% of respondents from the less mobile subgroup live in nuclear or single parent families. Data show that 16,5% of respondents from the more mobile subgroup live on their own (10,1% from the less mobile subgroup), 29% of them live with their parents (25% from the less mobile subgroup), and 16,5% live in extended families or with their friends or relatives (12,4% from the less mobile subgroup). Household size has a medium effect on the likelihood of respondents moving away from their city Cramer's V (4, n=420) = 0,194,  $p < ,01$ .

#### 4.8. City features and likelihood of moving away

This chapter provides an overview of the city features in relation to the sample breakdown in two mobility subgroups, as explained in demographics.

#### 4.9. Social activities and likelihood of moving away

Results in Table 2 (Appendix) show that the most popular social activities for more than half of all respondents, at least once a week, for both mobility subgroups are: going out to the pub/bar, visiting coffee shops (during the day), walking around city centre, going to city parks and visiting friends. Very popular in both groups is spending time with friends, what, at least once a week, practice 64,1%

respondents from the more mobile subgroup, and 66,9% from the less mobile subgroup.

Without statistically significant differences, results show that 74,5% of respondents from the more mobile, and 69,5% from the less mobile subgroup are going to movies, theatre and/or concerts at least once a month, while 63.1% of respondents from the more mobile subgroup, and 69,5% the less mobile subgroup visit restaurants once a month. Respondents from both mobility subgroups almost equally, with little over 78%, practice excursions in parks or peripheral green areas at least once a month.

The Chi-square test shows significant variations between mobility subgroups for observed and expected scores for variables: going to museum and/or art gallery, going to a night club, going to a festival (when happening in the city, participating in religious activities, and participating in community work. Respondents from the more mobile subgroups more often go to museum and/or art gallery, go to a night club, and go to a festival (when happening in the city), while respondents from the less mobile subgroup more often participate in religious activities, and participate in resident's associations. It strikes our attention that nearly 90% of respondents from both mobility subgroups never participate in political activities, and over 50% of all respondents almost never participate in religious activities or community work.

#### **4.10. Leisure amenities and likelihood of moving away**

In distributed questionnaire there were 13 independent variables relating to satisfaction with leisure amenities offered in the city, with a scale of five choices: very satisfied, satisfied, neither, dissatisfied, and very dissatisfied. For our analysis, we aggregated scores of five into three choices: very satisfied to satisfied, neither, dissatisfied to very dissatisfied. In that way we were able to use Chi-square to test significance of the relationship between mobility of respondents and their satisfaction with leisure amenities.

Results in Table 3 (Appendix) show that approximately more than 50% of all respondents are very satisfied or satisfied with quality of public spaces (plazas, parkas, etc), quality and range of restaurants, quality of bars and cafés, and quality of cinemas. Highest scores of very satisfied to satisfied respondents have variable quality of cinemas, 63.0% of respondents from the more mobile, and 74.2% from the less mobile subgroup, and for the variable quality of bars and cafés 46.7% of respondents from the more mobile, and 62.3% from the less mobile subgroup are very satisfied to satisfied.

The largest percentage of dissatisfaction is recorded for the city architecture/relevant monuments, with 60.3% respondents from the more mobile subgroup, and 39.8% respondents from the less mobile subgroup being dissatisfied to very dissatisfied.

Statistically confirmed differences between two mobility subgroups are identified for observed and expected values for variables: quality of public spaces (plazas, parkas, etc), quality and range of art galleries/ museums, quality of bars and cafés, quality of cinemas, quality of shopping areas, architecture of the city/relevant monuments, and quality and range of fitness centres, with more mobile subgroup being in larger percentages dissatisfied to very dissatisfied.

#### **4.11. Public services and likelihood of moving away**

When it comes to public services, results in Table 4 (Appendix) show the highest percentages of respondents, 85,9% from the more mobile, and 80.1% from the less mobile subgroup, are dissatisfied to very dissatisfied with a number of bicycle lanes, while 82.6% respondents from the first, and 72.5% from the second subgroup are dissatisfied to very dissatisfied with the quality of tourist attractions. High percentages of dissatisfied to very dissatisfied respondents are also recorded for social security (69.6% for the more, and 53.4% for the less mobile subgroup), quality of health services (65.8%, and 50.8%), quality of the university education (60.9%, and 45.3%), safety on the streets (56.0%, and 50.4%), police services (57.6%, and 43.2%), the quality of the high school and elementary school education (50.5%, and 39.4%), and municipal police services (46.7%, and 39.4%).

Statistical significance is confirmed by the Chi-square test for differences between the more mobile subgroup and the less mobile subgroup regarding quality of public transportation system, police services, number of bicycle lanes, quality of tourist attractions, social security, quality of health services, quality of the university education, and quality of the high school and elementary school education, with the more mobile subgroup being significantly more dissatisfied to very dissatisfied with public services offered in the city, than the less mobile subgroup.

#### 4.12. Environmental aspects and likelihood of moving away

Results in Table 5 (Appendix) show that the highest percentages of respondents, 75,5% from the more mobile, and 75,4% from the less mobile subgroup, are dissatisfied to very dissatisfied with levels of use of bicycles as a means of transport, while 64,7% respondents from the first, and 67,4% from the second subgroup are dissatisfied to very dissatisfied with tidiness and cleanliness of rivers and river banks.

Regarding environmental aspects of their city, high percentages of dissatisfied to very dissatisfied respondents are recorded for the recycling collection services (65,8% for the more, and 59,7% for the less mobile subgroup), traffic congestion (64,1% and 65,7%), availability of parking space (59,2%, and 62,7%), quality of children playgrounds (56,5%, and 56,8%), pavement condition of city streets and sidewalks (47,8%, and 44,9%), and air pollution (47,3%, and 38,1%). Statistically significant difference between mobility subgroups is recorded only for tidiness and cleanliness of rivers and river banks, where the less mobile subgroup is more dissatisfied with a state of riverbanks and cleanliness of rivers,  $\chi^2(2, n=420) = 5.841, p < .05$ .

#### 4.13. Issues of concern and likelihood of moving away

In distributed questionnaire, there were 26 independent variables relating to issues of concern related to the societal and economic factors of the living environment, with a scale of five choices: not worried at all, not worried, not particularly worried, somewhat worried, and very worried. For our analysis, in order to use the Chi-square test to determine significance of the relationship between mobility of respondents and their concern with the societal and economic factors of the living environment, we aggregated scores of five into three choices: not worried at all to not worried, not particularly worried, and somewhat worried to very worried.

Generally speaking, results in Table 6 (Appendix) show that respondents from both mobility subgroups are noticeably concerned about most of the issues of the living in their city. The highest rate of response in somewhat worried to very worried category respondents gave to availability of jobs, 94.6% from the more mobile, and 94.1% from the less mobile subgroup, while 84,8% respondents from the first, and 77,5% from the second subgroup are somewhat worried to very worried with the quality of university education.

Results show that, regarding issues of concern, high percentages of somewhat worried to very worried respondents are also recorded for the quality of medical services (85,9% for the more, and 77,1% for the less mobile subgroup), behaviour of traffic participants (81,5% for the more, and 78,4% for the less mobile subgroup), drug problems (81% and 76,3%), aggressive/anti-social behaviour (80,4%, and 76,3%), lack of bicycle lanes (81.5%, and 72.9%), the quality of secondary and elementary education (78.3%, and 69.1%), lack of sidewalks (76.1%, and 69.9%), homelessness (70.1%, and 61.0%), illegal construction (77.7%, and 55.9%), availability of recreation for children (67.4%, and 58.9%), the quality of kindergartens (62.5%, and 61.0%), and air pollution (60.3%, and 57.2%).

Statistical significance is confirmed by the Chi-square test for differences between the more mobile subgroup and the less mobile subgroup for issues of concern regarding: availability of recreation for teenagers, availability of affordable housing, availability of recreation for seniors, amount of graffiti, maintenance of trees and green areas, illegal construction, lack of sidewalks, quality of medical services, and appearance of building facades and shop window, with the more mobile subgroup being significantly more somewhat worried to very worried, than the less mobile subgroup.

#### 4.14. Cost of living and likelihood of moving away

In the questionnaire, there were 6 independent variables relating to cost of living in the city with a scale of five choices: very expensive, expensive, average, cheap, and very cheap. For our analysis, we aggregated scores of five choices into three: cheap to very cheap, average, and very expensive to expensive.

Results in table 7 (Appendix) show that the overall perception of all respondents is that their city is either very expensive or expensive city for all basic facilities and services listed. It is remarkable that for the variable general cost of living not a single one respondent from either mobility subgroups choose option cheap to very cheap.

The highest proportion of respondents, 97,3% from the more mobile, and 92,4% from the less mobile subgroup, perceives housing cost (mortgage, rent) to be very expensive to expensive, while 94% of respondents from the first, and 82,2% from the second mobility subgroup perceives general cost

of living to be very expensive to expensive. Other costs are also perceived to be very expensive to expensive: cost of food and beverages (basic consumables) (86,4% for the more, and 75% for the less mobile subgroup), cost of basic services related to the house (water, electricity) (84,2%, and 78%), cost of leisure activities (63%, and 53,8%), costs of education and training (59,8, and 47%), and transportation costs (54,3%, and 36,9%).

More mobile subgroup perceives certain costs of living higher than the less mobile subgroup. Statistical significance is confirmed for variables: costs of education and training  $\chi^2$  (2, n=420) = 6.862,  $p < .05$ , transportation costs  $\chi^2$  (2, n=520) = 12.956,  $p < .01$ , and general cost of living  $\chi^2$  (2, n=420) = 13.096,  $p < .01$ , with the more mobile subgroup perceiving those costs very expensive to expensive in larger percentages.

The most striking result is that not one respondent from the more mobile subgroup perceives housing cost as being cheap or very cheap, and that 94% of respondents who are somewhat likely to almost definitely to move away from their city considers them as being very expensive to expensive.

#### 4.15. Tolerance and likelihood of moving away

In distributed questionnaire there were 5 independent variables relating to issues of tolerance, with a scale of five choices: strongly agree, agree, neither, disagree, and strongly disagree. For our analysis, we aggregated scores of five choices into three: strongly disagree/disagree, neither, and agree/strongly agree.

Results in Table 8 (Appendix), show that 67,4% of respondents from the more mobile subgroup, and 61,4% from the less mobile subgroup, strongly disagree to disagree that their city accepts the gay population, and 55,4% from the more, and 54,7 from the less mobile subgroup of respondents strongly disagree to disagree that their city accepts the minority religious and ideological groups.

There is a significant difference in responses between members of the more and less mobile subgroups for three variables: agreeing that city is welcoming place to people from other countries, agreeing that their city accepts all ethnic groups, and agreeing that their city accepts the differences between rich and poor. Respondents who are somewhat likely to almost definitely to move away from their city significantly more strongly disagree to disagree to statements of tolerance regarding their city.

#### 4.16. Factor analysis

We divided issues of concern listed in Table 6 in the Appenix (Issues of concern and likelihood of moving away) into two groups of factors, cultural/societal factors, which represent social milieu of their city, and economic factors, which are more directly influenced by the amount of public funding. We use factor analysis and in order to determine which factors, economic or cultural/societal, most significantly impact respondent's decision to move away from their city in the next three years:

##### Cultural/Societal Factors:

Amount of crime in the city  
Safety  
Amount of graffiti  
Drug problems  
Homelessness  
Aggressive/anti-social behaviour  
Prostitution on streets  
Behaviour of traffic participants  
Air pollution  
Demonstrations in the streets  
Illegal construction  
Presence of smugglers, dealers  
Appearance of building facades and shop windows

##### Economic factors:

Availability of jobs  
Availability of recreation for teenagers  
Availability of affordable housing  
Availability of recreation for seniors  
Quality of university education  
Quality of secondary and elementary education  
Quality of kindergartens  
Availability of public transportation  
Availability of recreation for children  
Maintenance of trees and green areas  
Lack of bicycle lanes  
Lack of sidewalks  
Quality of medical services

Results in Table 9 show that Bartlett's Test for the null hypothesis (correlations between variables equal



to zero) is significant for given variables, therefore we proceed to extract factors which encompass independent variables. Table 9: Bartlett's Test

Bartlett's Test		
Bartlett's Test of Sphericity	Approx. Chi-Square	4058,725
	df	325
	Sig.	,000

Table 10 displays communalities matrix data, with the amount of variability explained by the specific factors of the original variables (column Extraction).

Table 10: Communalities

Communalities		
	Initial	Extraction
Amount of crime in the city	1,000	,807
Safety	1,000	,819
Availability of Recreation for teenagers	1,000	,703
Availability of Affordable Housing	1,000	,569
Availability of recreation for seniors	1,000	,704
Availability of jobs	1,000	,596
Quality of university education	1,000	,743
Quality of secondary and elementary education	1,000	,763
Quality of kindergartens	1,000	,598
Availability of public transportation	1,000	,446
Availability of recreation for children	1,000	,652
Amount of graffiti	1,000	,525
Drug problems	1,000	,574
Homelessness	1,000	,613
Aggressive/anti-social behavior	1,000	,565
Prostitution on streets	1,000	,690
Behavior of traffic participants	1,000	,565
Air pollution	1,000	,512
Maintenance of trees and green areas	1,000	,453
Demonstrations in the streets	1,000	,605
Illegal construction	1,000	,601
Lack of bicycle lanes	1,000	,675
Lack of sidewalks	1,000	,712
Quality of medical services	1,000	,487
Presence of smugglers, dealers	1,000	,579
Appearance of building facades and shop windows	1,000	,612
Extraction Method: Principal Component Analysis.		

Results in Table 11 show components 1 to 7 that can be considered for future analysis. The first three columns (Initial Eigenvalues) are data for all factors, and in the other three (Extraction Sums of Squared loadings) are data for those factors that meet the criteria to be retained.

Table 11: Total Variance Explained

Total Variance Explained									
Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings		
	Total	% of Var.	Cumul. %	Total	% of Var.	Cumul. %	Total	% of Var.	Cumul. %
1	7,277	27,988	27,988	7,277	27,988	27,988	2,719	10,458	10,458
2	2,345	9,017	37,005	2,345	9,017	37,005	2,688	10,339	20,797
3	1,561	6,005	43,010	1,561	6,005	43,010	2,503	9,626	30,423
4	1,419	5,456	48,466	1,419	5,456	48,466	2,483	9,551	39,974



5	1,353	5,205	53,671	1,353	5,205	53,671	2,211	8,505	48,479
6	1,151	4,429	58,100	1,151	4,429	58,100	2,059	7,920	56,399
7	1,061	4,080	62,181	1,061	4,080	62,181	1,503	5,782	62,181
8	,917	3,526	65,706						
9	,846	3,256	68,962						
10	,813	3,126	72,088						
11	,748	2,878	74,966						
12	,701	2,696	77,662						
13	,627	2,411	80,073						
14	,579	2,225	82,298						
15	,560	2,153	84,451						
16	,520	2,000	86,450						
17	,463	1,780	88,231						
18	,455	1,749	89,979						
19	,412	1,586	91,565						
20	,388	1,491	93,056						
21	,362	1,391	94,448						
22	,346	1,331	95,779						
23	,319	1,228	97,007						
24	,303	1,167	98,174						
25	,262	1,008	99,182						
26	,213	,818	100,000						

Extraction Method: Principal Component Analysis.

Seven factors shown in Table 12 correlate to specific independent variables. Therefore, we find that individual factors are mostly correlated with:

- Factor 1 (Fac1\_antisocial) with: drug problems, homelessness, prostitution on streets
- Factor 2 (Fac2\_recreation): availability of recreation for teenagers, availability of recreation for seniors
- Factor 3 (Fac3\_education): quality of university education, quality of secondary and elementary education
- Factor 4 (Fac4\_cycling&walking ): lack of bicycle lanes, lack of sidewalks
- Factor 5 (Fac5\_revolt): amount of graffiti, demonstrations in the streets
- Factor 6 (Fac6\_safety): amount of crime in the city, safety
- Factor 7 (Fac7\_architecture): illegal construction, appearance of building facades and shop windows

Table 12: Rotated Component Matrix

Rotated Component Matrix <sup>a</sup>							
	Component						
	Fac1	Fac2	Fac3	Fac4	Fac5	Fac6	Fac7
Amount of crime in the city	,183	,152	,046	,064	,045	,859	,066
Safety	,204	,136	,055	,077	,069	,862	,053
Availability of Recreation for teenagers	,011	,770	,216	,102	,102	,207	,003
Availability of Affordable Housing	,042	,666	,058	,105	-,051	,054	,323
Availability of recreation for seniors	,157	,789	,074	,112	,087	,085	,158
Availability of jobs	,345	,361	,187	,008	-,212	-,068	,511
Quality of university education	-,001	,133	,807	,116	,007	,035	,243
Quality of secondary and elementary education	,070	,185	,828	,035	,072	,094	,151
Quality of kindergartens	,105	,294	,646	,114	,215	-,009	-,156
Availability of public transportation	,040	,346	,287	,318	,348	,122	-,070

Availability of recreation for children	,095	,612	,366	,263	,198	,035	-,161
Amount of graffiti	,216	,029	,054	-,002	,687	-,009	,051
Drug problems	,691	,060	,083	,142	,199	,159	,035
Homelessness	,730	,139	-,031	,140	,177	,092	,000
Aggressive/anti-social behaviour	,501	,087	,082	,195	,105	,447	,225
Prostitution on streets	,729	,068	,100	,046	,342	,156	-,036
Behavior of traffic participants	,441	-,014	,154	,539	,050	,219	,072
Air pollution	,311	-,044	,278	,460	,196	,290	-,034
Maintenance of trees and green areas	,104	-,007	,321	,357	,439	,134	-,039
Demonstrations in the streets	,209	,090	,040	,123	,730	,050	,036
Illegal construction	-,032	,132	,116	,465	,232	,160	,523
Lack of bicycle lanes	,115	,232	,058	,752	,030	-,064	,184
Lack of sidewalks	,124	,256	,053	,782	,070	,066	,085
Quality of medical services	,359	-,043	,397	,270	-,142	,054	,321
Presence of smugglers, dealers	,346	,140	,007	,002	,527	,112	,386
Appearance of building facades and shop windows	-,085	,144	,164	,226	,366	,187	,580
Extraction Method: Principal Component Analysis. Rotation Method: Varimax with Kaiser Normalization.							
a. Rotation converged in 14 iterations.							

Values of  $\text{Exp}(B) = e^{b_i}$ , represent the ratio of the likelihood that someone leaves and stays in their city. Ratios greater than 1 represent the motivating factor for leaving their city, with given statistical significance. Therefore, our analysis returned three statistically significant variables (Table 13): Fac4\_cycling&walking, Fac6\_safety, and Fac7\_architecture in relation to likelihood that respondents leave or stay in their city.

Table 13: Variables

Variables									
		B	S.E.	Wald	df	Sig.	Exp(B)	95% C.I. for EXP(B)	
								Lower	Upper
Step 1 <sup>a</sup>	FAC1_1	-,073	,123	,351	1	,554	,930	,730	1,184
	FAC2_1	,137	,127	1,162	1	,281	1,147	,894	1,472
	FAC3_1	,152	,133	1,313	1	,252	1,164	,898	1,509
	FAC4_1	,405	,138	8,552	1	,003	1,499	1,143	1,966
	FAC5_1	,079	,122	,420	1	,517	1,083	,852	1,376
	FAC6_1	,262	,127	4,282	1	,039	1,300	1,014	1,667
	FAC7_1	,312	,131	5,641	1	,018	1,366	1,056	1,766
	Constant	-1,433	,131	119,360	1	,000	,239		
a. Variable(s) entered on step 1: FAC1_1, FAC2_1, FAC3_1, FAC4_1, FAC5_1, FAC6_1, FAC7_1.									

## 5. DISCUSSION

Our research journey started with recognition that growth of the knowledge and creative economy represents the main development strategy for developed, as well as for countries in transition. We found that literature on knowledge and creativity is wide and varied, but lacks depth in terms of human capital mobility as a factor of economic development. So far, reasons why human capital migrates from place to place are being researched from behind, based on historical data, what is an approach that lacks validity and purpose in the fast changing environment.

For cities in BiH, faced by prolonged and increasing emigration to developed countries, it is crucial to determine key factors that could discourage emigration, and eventually encourage immigration of high skilled people. Florida (2002) argues that key factors of human capital mobility are technology available in the city, community's tolerance to differences, and amenities and bohemian-like lifestyle opportunities, while the ACRE research (Musterd et al., 2010) found that human capital in the EU is more likely to stay in cities closer to their families and friends, regardless of other advantages. In the following discussion reflects upon the outcomes of the statistical hypothesis tests.

H1) We find that *the proximity to family and friends* significantly impacts the choice of place of residence of sampled knowledge and creative workers.

Our findings show that reasons: the proximity to family and friends, being born in the city, and studied in the city represent 64,65% of the total sum of responses, while 14,28% of responses are job-related. In line with that, it is notable that 86% of respondents have been living in their city 10 years or longer, and that 25,7% of respondents still live with their parents. Family and social networks are also the key factor on choosing the place of residence for human capital in Dublin (Murphy et al., 2008).

Findings, that that the most practiced social activities for more than half of all respondents in their cities is linked to the time they spend with their friends, confirm findings of Glaeser & Redlick (2008) that inopportune areas, such as cities in transitional countries, may not experience decline in social capital, while human capital gradually deteriorates. Also, it seems that knowledge and creative workers in Europe are generally more likely to settle in a city where they were born or where they studied, in near vicinity to their family and friends, even when faced with a lack of career opportunities. This diverges from findings of Florida (2002), that technology (concentration and size of the high tech industries), talent (concentration of highly educated people), and tolerance (tolerance to ethnic, racial, sexual, and other minorities) are three most important environmental factors for *creative class* to settle in a city.

H2) Results confirm that *the cost of living significantly influence the decision of change of residence*.

Respondents perceive costs of living in their city as either very expensive or expensive for all basic facilities and services. Respondents who are more likely to move away from their city perceive costs of housing, education and training, transportation and general cost of living higher than respondents who are less likely to move away. Housing costs are perceived to be very expensive by 94% of knowledge and creative workers, and by 97.3% of those who are more likely to move away from their city. This could be the prime reason why over 1/4 of respondents still live with their parents.

The most expensive properties are in the city centre, what is also the most popular residential area for creative and knowledge workers, since it is where the entire city buzz is and where most events take place. Findings that more than 3/4 of respondents choose to live in the central part of their city, less than 2km from the centre, are in line with arguments of Glaeser et al. (2004) that city centers are the most desirable living places for skilled workers.

H3) We reject the hypothesis that *the city features do not significantly impact human capital mobility*.

Our analysis shows that lack of bicycle lanes, lack of sidewalks, amount of crime in the city, safety, illegal construction, and appearance of building facades and shop windows are factors that significantly impact perception of knowledge and creative workers about their living environment. Our results confirm that urban amenities and street life culture attract knowledge and creative workers (Clark, 2003b; Florida, 2002; Glaeser et al., 2004). We find valid arguments of Glaeser et al. (2004) that four key city amenities for human capital are: range of available goods and services, aesthetic features of their city, quality and range of public services, and the quality and speed of transport in terms of accessibility of services and jobs.

### 5.1. Social activities

Our findings support argument of Florida (2002) that people are attracted to colourful places buzzing with life, local streets and squares bustling with street-level culture and small scale events, places where kids run around, where café goers enjoy the small talk, and people have an opportunity to meet and have a chat with no previously made arrangements.

Results show that knowledge and creative workers who speculate with the possibility of leaving the city spend less time with friends, what supports the argument of Glaeser & Redlick (2008) that people who are considering moving away tend to decrease their investments in social capital. More mobile people also are significantly more frequent visitors to museums and art galleries, night clubs, and festivals. They are, however, less likely to participate in religious activities and community work.

### 5.2. Leisure amenities

Our results show that city amenities significantly impact mobility of knowledge and creative workers in BiH. This supports arguments (Clark, 2003a; Florida, 2002; Glaeser et al., 2004) that people are attracted to vibrant places, with strong local culture, and abundance of amenities. The largest percentage of dissatisfaction is recorded for the city architecture and monuments, what confirms argument of Glaeser et al. (2004) that aesthetic features of the city are one of the key amenities. The key city amenities are significantly more disappointing to those who are more likely to leave their

city, especially the quality of public spaces, art galleries, museums, bars, cafés, cinemas, shopping areas, city architecture, monuments, and the quality and range of fitness centers.

### 5.3. Public services

Our results show that knowledge and creative workers in BiH are very concerned about the range and quality of public services in cities where they live. Knowledge and creative workers who are more likely to leave their city are significantly more dissatisfied with the quality of public transportation system, police services, number of bicycle lanes, quality of tourist attractions, social security, quality of health services, quality of the university education, and quality of the high school and elementary school education. This positively corresponds with arguments of Glaeser et al. (2004) that one of the key amenities for human capital is the quality and range of public services. We also find arguments of Clark (2003a; 2003) and Florida (2002), that creative cities have become tourist places for their citizens, to be germane to the knowledge and creative community in BiH.

Our results confirm the argument that the quality of university and schools available in the city impacts mobility of human capital (Glaeser et al., 2004). This contradicts the argument of Clark (2003) that vicinity of good schools is not relevant, but that facilities for recreation and consumption have the major impact on human capital mobility.

### 5.4. Tolerance

Our results show that over 60% respondents perceives that gay population is not well accepted in their city, and over 50% considers that that their city does not accept the minority religious and ideological groups.

Tolerance is not directly or widely discussed in literature regarding human capital mobility. Authors note that highly educated workers are attracted to environment which is supporting pluralism of thought (Amabile, 1998; Florida, 2002; Long & Fahey, 2000), but mostly presume that other people are tolerant to new knowledge and new ideas. Florida (2002) places tolerance among three most important city features that impact human capital mobility, since innovative ideas, new knowledge and different lifestyles are more likely to take root in environments which are tolerant to new ideas and unprejudiced towards developing trends, especially for changes in local culture and differences in individual lifestyles.

Our results show that respondents who are more likely to leave their city are significantly more critical towards issues of tolerance in their cities, especially towards the people from other countries, different ethnic groups, and differences between the rich and the poor.

## 6. CONCLUSIONS

Existing literature in large proportion relates to developed countries, with questionable applicability for transitional economies, especially for countries affected by recent wars and ethnic conflicts. Our main aim was to answer the main research question, relating to the impact of economic and societal factors of the living and working environment in terms of choice of residence of knowledge and creative workers in BiH.

An abundance of talented people, modern technologies and tolerant and opened society are factors that predispose future city growth. Characteristics of a city are important for attracting and maintaining human capital. Therefore, in the context of the cities in the SEE countries, attention has to be given to mobility of human capital, especially young and highly educated people.

The SEE countries have slim chances to compete on the EU and worldwide markets if they fail to develop its human capital base. Outbound migration of the best and brightest could considerably increase once the SEE countries join the EU, further deteriorating the present pool of knowledge.

We found that local culture and social networks play very important role in economic development, but there is a room for research in terms of quantifiable causalities.

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## Appendix I

Table 1: Four most important reasons for living in the city

Reason	N	Range	Min. value*	Max. value**	Sum of scores	Mean	Std. Error	Std. Deviation $\sigma$	Sum of scores / Total sum x 100
Family lives here	296	3	1	4	992	3,35	0,05	0,86	25,57%
Born here	181	3	1	4	574	3,17	0,08	1,10	14,80%
Proximity to friends	221	3	1	4	492	2,23	0,06	0,86	12,68%
Studied in the city	182	3	1	4	450	2,47	0,08	1,07	11,60%
Size of city	146	3	1	4	299	2,05	0,08	0,96	7,71%
Moved here because of my job	52	3	1	4	170	3,27	0,15	1,05	4,38%
Good employment opportunities	69	3	1	4	164	2,38	0,12	0,97	4,23%
Proximity to natural environment	66	3	1	4	120	1,82	0,10	0,82	3,09%
Higher wages	46	3	1	4	116	2,52	0,16	1,07	2,99%
Moved here because of my partner's job	37	3	1	4	104	2,81	0,18	1,10	2,68%
Safe for children	47	3	1	4	100	2,13	0,15	1,03	2,58%
Housing quality	54	3	1	4	95	1,76	0,12	0,87	2,45%
Weather/climate	53	3	1	4	89	1,68	0,12	0,85	2,29%
Openness to different types of people (in terms of race, ethnicity)	14	2	1	3	26	1,86	0,23	0,86	0,67%
Good transport links	14	2	1	3	25	1,79	0,24	0,89	0,64%
Housing affordability	12	2	1	3	24	2,00	0,25	0,85	0,62%
Open minded and tolerant	13	3	1	4	22	1,69	0,31	1,11	0,57%
Housing availability	6	1	1	2	9	1,50	0,22	0,55	0,23%
tolerant to gay/ LGBT	6	1	1	2	8	1,33	0,21	0,52	0,21%
Language (able to communicate with foreigners)	0								0,00%
Overall friendliness of city	0								0,00%
Diversity of leisure and entertainment facilities	0								0,00%
Cultural diversity	0								0,00%
Diversity of the built environment	0								0,00%
Presence of good universities	0								0,00%
Presence of good schools	0								0,00%
Total SUM					3.879				100,00%

\* 1 - the least important (minimal value on the scale 1 to 4),

\*\* 4 – the most important (maximal value on the scale 1 to 4),

N Number of respondents who choose a given variable on a scale 1 to 4

Table 2: Social activities and likelihood of moving away from their city

Likelihood of moving from the city in the next three years?	Almost never	At least once a year	At least once a month	At least once a week	Every day	$\chi^2$
Going out to the pub/bar						
Somewhat likely to almost definitely	3.3%	8.2%	34.2%	51.1%	3.3%	4.224
Not too likely to not likely at all	5.9%	11.4%	36.0%	44.5%	2.1%	
Visiting coffee shops, during the day						
Somewhat likely to almost definitely	2.7%	0.5%	16.3%	52.7%	27.7%	2.754
Not too likely to not likely at all	3.0%	2.1%	13.1%	51.7%	30.1%	
Eating out						
Somewhat likely to almost definitely	11.4%	25.5%	48.4%	14.7%	.0%	4.638
Not too likely to not likely at all	6.4%	24.2%	51.7%	17.4%	.4%	
Going to movie, theatre and/or concerts						
Somewhat likely to almost definitely	6.5%	19.0%	58.7%	15.8%	.0%	2.249
Not too likely to not likely at all	5.9%	24.6%	56.8%	12.7%	.0%	
Going to museum and/or art gallery						
Somewhat likely to almost definitely	23.9%	37.0%	32.6%	6.5%	.0%	13.813**
Not too likely to not likely at all	27.1%	50.0%	19.9%	3.0%	.0%	
Walking around city centre						
Somewhat likely to almost definitely	3.8%	6.0%	21.7%	45.1%	23.4%	8.946
Not too likely to not likely at all	2.1%	3.0%	14.4%	49.6%	30.9%	
Excursions in parks or peripheral green areas						
Somewhat likely to almost definitely	4.9%	16.8%	40.8%	35.9%	1.6%	3.461
Not too likely to not likely at all	2.5%	17.8%	37.3%	39.0%	3.4%	
Going to a night club						
Somewhat likely to almost definitely	16.8%	23.4%	45.7%	14.1%	.0%	8.707*
Not too likely to not likely at all	28.4%	23.7%	36.0%	11.9%	.0%	
Going to sport events						
Somewhat likely to almost definitely	41.8%	33.7%	17.9%	6.5%	.0%	7.423
Not too likely to not likely at all	29.2%	42.8%	20.3%	7.6%	.0%	
Going to city parks						
Somewhat likely to almost definitely	5.4%	12.5%	37.5%	37.5%	7.1%	2.473
Not too likely to not likely at all	6.4%	9.3%	33.5%	43.2%	7.6%	
Going to a festival (when happening in the city)						

Somewhat likely to almost definitely	13.0%	36.4%	18.5%	15.2%	16.8%	11.174*
Not too likely to not likely at all	11.0%	40.3%	20.8%	20.8%	7.2%	
Visiting friends						
Somewhat likely to almost definitely	.0%	3.8%	32.1%	55.4%	8.7%	3.742
Not too likely to not likely at all	1.3%	2.1%	29.7%	57.2%	9.7%	
Participating in Resident’s associations						
Somewhat likely to almost definitely	50.0%	20.7%	10.3%	9.8%	9.2%	3.265
Not too likely to not likely at all	55.1%	19.5%	12.3%	6.4%	6.8%	
Participating in Religious activities						
Somewhat likely to almost definitely	64.7%	24.5%	8.7%	2.2%		10.241* (df=3)
Not too likely to not likely at all	51.7%	27.5%	14.4%	6.4%		
Participating in community work						
Somewhat likely to almost definitely	67.4%	22.8%	5.4%	2.7%	1.6%	11.338*
Not too likely to not likely at all	55.1%	24.6%	14.4%	4.2%	1.7%	
Participating in political activities (trade union, political party, etc) political party, etc)						
Somewhat likely to almost definitely	87.5%	8.2%	2.7%	.0%	1.6%	6.700
Not too likely to not likely at all	87.7%	5.5%	2.1%	3.0%	1.7%	

(df=4, N = 420), \* p<0,05, \*\* p<0,01

Table 3: Satisfaction with leisure amenities and likelihood of moving away

Likelihood of moving from the city in the next three years?	Dissatisfied to very dissatisfied	Neither	Very Satisfied to satisfied	$\chi^2$
Quality of Public spaces (plazas, parkas, etc)				
Somewhat likely to almost definitely	33.7%	25.5%	40.8%	12.621**
Not too likely to not likely at all	18.6%	29.2%	52.1%	
Quality of sport facilities				
Somewhat likely to almost definitely	32.6%	48.4%	19.0%	3.705
Not too likely to not likely at all	24.2%	55.1%	20.8%	
The quality and range of festival events and cultural activities				
Somewhat likely to almost definitely	31.5%	41.8%	26.6%	2.441
Not too likely to not likely at all	26.3%	40.7%	33.1%	
The quality and range of art galleries / museums				
Somewhat likely to almost definitely	42.9%	39.1%	17.9%	9.096**
Not too likely to not likely at all	28.8%	49.6%	21.6%	
Quality and range of libraries				
Somewhat likely to almost definitely	29.3%	41.3%	29.3%	2.933
Not too likely to not likely at all	22.0%	45.8%	32.2%	
Quality and range of restaurants				
Somewhat likely to almost definitely	12.5%	35.3%	52.2%	2.697
Not too likely to not likely at all	10.6%	29.2%	60.2%	
Quality of bars and cafés				
Somewhat likely to almost definitely	20.1%	33.2%	46.7%	10.295**
Not too likely to not likely at all	13.1%	24.6%	62.3%	
Quality of cinemas				

Somewhat likely to almost definitely	14.1%	22.8%	63.0%	6.716*
Not too likely to not likely at all	8.1%	17.8%	74.2%	
Quality of shopping areas				
Somewhat likely to almost definitely	39.1%	32.6%	28.3%	10.108**
Not too likely to not likely at all	29.7%	27.1%	43.2%	
Architecture of city/relevant monuments				
Somewhat likely to almost definitely	60.3%	25.5%	14.1%	17.437**
Not too likely to not likely at all	39.8%	37.7%	22.5%	
Number of associations/ organizations for social activities				
Somewhat likely to almost definitely	42.4%	41.3%	16.3%	5.567
Not too likely to not likely at all	31.8%	51.7%	16.5%	
Quality and range of fitness centers				
Somewhat likely to almost definitely	15.8%	47.8%	36.4%	7.028*
Not too likely to not likely at all	8.1%	47.5%	44.5%	
Quality and range of saunas, spa and wellness centres				
Somewhat likely to almost definitely	28.3%	54.3%	17.4%	5.172
Not too likely to not likely at all	24.2%	49.2%	26.7%	
df = 2, N = 420, *p < 0.05, **p < 0.01				

Table 4: Satisfaction with public services and likelihood of moving away

Likelihood of moving from the city in the next three years?	Dissatisfied to very dissatisfied	Neither	Very Satisfied to satisfied	$\chi^2$
Quality of public transportation system				
Somewhat likely to almost definitely	34.2%	32.6%	33.2%	6.650*
Not too likely to not likely at all	22.9%	37.7%	39.4%	
Transport within the city – all types				
Somewhat likely to almost definitely	39.1%	32.6%	28.3%	4.118
Not too likely to not likely at all	30.9%	32.6%	36.4%	
Connectivity between city & periphery				
Somewhat likely to almost definitely	33.2%	39.1%	27.7%	3.907
Not too likely to not likely at all	24.6%	42.4%	33.1%	
Safety on the streets				
Somewhat likely to almost definitely	56.0%	19.0%	25.0%	4.998
Not too likely to not likely at all	50.4%	28.4%	21.2%	
Police services				
Somewhat likely to almost definitely	57.6%	31.5%	10.9%	8.969**
Not too likely to not likely at all	43.2%	39.8%	16.9%	
Municipal police services				
Somewhat likely to almost definitely	46.7%	35.3%	17.9%	2.454
Not too likely to not likely at all	39.4%	38.6%	22.0%	
Number of bicycle lanes				
Somewhat likely to almost definitely	85.9%	8.7%	5.4%	6.268*
Not too likely to not likely at all	80.1%	16.5%	3.4%	
Quality of tourist attractions				
Somewhat likely to almost definitely	82.6%	14.7%	2.7%	7.216*
Not too likely to not likely at all	72.5%	20.3%	7.2%	
Social security				



Somewhat likely to almost definitely	69.6%	23.9%	6.5%	11.500**
Not too likely to not likely at all	53.4%	35.2%	11.4%	
Quality of health services				
Somewhat likely to almost definitely	65.8%	27.2%	7.1%	9.969**
Not too likely to not likely at all	50.8%	36.4%	12.7%	
Quality of the university education				
Somewhat likely to almost definitely	60.9%	26.1%	13.0%	14.219**
Not too likely to not likely at all	45.3%	28.0%	26.7%	
Quality of the high school and elementary school education				
Somewhat likely to almost definitely	50.5%	33.2%	16.3%	14.020**
Not too likely to not likely at all	39.4%	28.4%	32.2%	
df= 2, N=420, * p<0,05, **p<0,01				

Table 5: Satisfaction with environmental aspects and likelihood of moving away

Likelihood of moving from the city in the next three years?	Dissatisfied to very dissatisfied	Neither	Very Satisfied to satisfied	$\chi^2$
Pavement condition of city streets and sidewalks				
Somewhat likely to almost definitely	47.8%	22.8%	29.3%	.575
Not too likely to not likely at all	44.9%	25.8%	29.2%	
Condition/cleanliness of city streets and sidewalks				
Somewhat likely to almost definitely	12.0%	15.8%	72.3%	.794
Not too likely to not likely at all	11.9%	19.1%	69.1%	
Recycling collection services				
Somewhat likely to almost definitely	65.8%	20.7%	13.6%	2.170
Not too likely to not likely at all	59.7%	26.7%	13.6%	
Quality of drinking water				
Somewhat likely to almost definitely	19.0%	26.1%	54.9%	5.317
Not too likely to not likely at all	13.1%	21.2%	65.7%	
Garbage/waste collection				
Somewhat likely to almost definitely	8.7%	16.8%	74.5%	1.019
Not too likely to not likely at all	7.2%	20.3%	72.5%	
Cleanliness of facilities in city parks				
Somewhat likely to almost definitely	6.0%	14.1%	79.9%	3.711
Not too likely to not likely at all	9.7%	18.2%	72.0%	
Care of trees and city parks				
Somewhat likely to almost definitely	25.5%	22.8%	51.6%	5.711
Not too likely to not likely at all	16.1%	25.8%	58.1%	
Traffic congestion				
Somewhat likely to almost definitely	64.1%	25.5%	10.3%	.112
Not too likely to not likely at all	65.7%	24.6%	9.7%	
Availability of parking space				
Somewhat likely to almost definitely	59.2%	23.4%	17.4%	.780
Not too likely to not likely at all	62.7%	19.9%	17.4%	
Levels of use of bicycles as a means of transport				
Somewhat likely to almost definitely	75.5%	16.3%	8.2%	3.569
Not too likely to not likely at all	75.4%	20.3%	4.2%	
Levels of noise in the city				
Somewhat likely to almost definitely	35.9%	42.4%	21.7%	.197
Not too likely to not likely at all	37.7%	41.9%	20.3%	
Air pollution				
Somewhat likely to almost definitely	47.3%	34.2%	18.5%	5.427
Not too likely to not likely at all	38.1%	45.3%	16.5%	
Quality of children playgrounds				

Somewhat likely to almost definitely	56.5%	33.7%	9.8%	.585
Not too likely to not likely at all	56.8%	31.4%	11.9%	
Tidiness and cleanliness of rivers and river banks				
Somewhat likely to almost definitely	64.7%	19.0%	16.3%	5.841*
Not too likely to not likely at all	67.4%	23.7%	8.9%	
df= 2, N=420, * p<0,05				

Table 6: Issues of concern and likelihood of moving away

Likelihood of moving from the city in the next three years?	Not worried at all to Not worried	Not particularly worried	Somewhat worried to very worried	$\chi^2$
Amount of crime in the city				
Somewhat likely to almost definitely	4.3%	17.4%	78.3%	.194
Not too likely to not likely at all	4.2%	19.1%	76.7%	
Safety				
Somewhat likely to almost definitely	7.1%	19.6%	73.4%	4.335
Not too likely to not likely at all	8.5%	27.5%	64.0%	
Availability of Recreation for teenagers				
Somewhat likely to almost definitely	9.8%	17.9%	72.3%	9.465**
Not too likely to not likely at all	10.6%	30.5%	58.9%	
Availability of Affordable Housing				
Somewhat likely to almost definitely	10.3%	14.7%	75.0%	15.655**
Not too likely to not likely at all	12.3%	30.1%	57.6%	
Availability of recreation for seniors				
Somewhat likely to almost definitely	8.7%	20.1%	71.2%	11.039**
Not too likely to not likely at all	11.9%	32.6%	55.5%	
Availability of jobs				
Somewhat likely to almost definitely	1.6%	3.8%	94.6%	.454
Not too likely to not likely at all	2.5%	3.4%	94.1%	
Quality of university education				
Somewhat likely to almost definitely	5.4%	9.8%	84.8%	3.718
Not too likely to not likely at all	6.8%	15.7%	77.5%	
Quality of secondary and elementary education				
Somewhat likely to almost definitely	7.1%	14.7%	78.3%	5.196
Not too likely to not likely at all	12.7%	18.2%	69.1%	
Quality of kindergartens				
Somewhat likely to almost definitely	13.0%	24.5%	62.5%	.435
Not too likely to not likely at all	11.9%	27.1%	61.0%	
Availability of public transportation				
Somewhat likely to almost definitely	17.9%	37.0%	45.1%	5.638
Not too likely to not likely at all	24.6%	41.1%	34.3%	
Availability of recreation for children				
Somewhat likely to almost definitely	9.8%	22.8%	67.4%	5.113
Not too likely to not likely at all	16.9%	24.2%	58.9%	
Amount of graffiti				
Somewhat likely to almost definitely	41.8%	32.1%	26.1%	7.227*
Not too likely to not likely at all	33.1%	44.9%	22.0%	
Drug problems				
Somewhat likely to almost definitely	8.2%	10.9%	81.0%	2.769
Not too likely to not likely at all	7.2%	16.5%	76.3%	
Homelessness				
Somewhat likely to almost definitely	10.3%	19.6%	70.1%	3.767
Not too likely to not likely at all	13.1%	25.8%	61.0%	
Aggressive/anti-social behaviour				
Somewhat likely to almost definitely	6.5%	13.0%	80.4%	1.486
Not too likely to not likely at all	6.4%	17.4%	76.3%	
Prostitution on streets				

Somewhat likely to almost definitely	23.4%	38.0%	38.6%	.491
Not too likely to not likely at all	26.3%	37.3%	36.4%	
Behavior of traffic participants				
Somewhat likely to almost definitely	5.4%	13.0%	81.5%	.987
Not too likely to not likely at all	5.1%	16.5%	78.4%	
Air pollution				
Somewhat likely to almost definitely	12.0%	27.7%	60.3%	1.601
Not too likely to not likely at all	9.7%	33.1%	57.2%	
Maintenance of trees and green areas				
Somewhat likely to almost definitely	23.4%	29.9%	46.7%	7.858*
Not too likely to not likely at all	27.1%	39.4%	33.5%	
Demonstrations in the streets				
Somewhat likely to almost definitely	40.8%	41.3%	17.9%	1.143
Not too likely to not likely at all	44.5%	41.1%	14.4%	
Illegal construction				
Somewhat likely to almost definitely	6.5%	15.8%	77.7%	21.920**Cramer's V =0.228
Not too likely to not likely at all	14.8%	29.2%	55.9%	
Lack of bicycle lanes				
Somewhat likely to almost definitely	6.5%	12.0%	81.5%	4.809
Not too likely to not likely at all	7.6%	19.5%	72.9%	
Lack of sidewalks				
Somewhat likely to almost definitely	4.3%	19.6%	76.1%	8.116*
Not too likely to not likely at all	12.3%	17.8%	69.9%	
Quality of medical services				
Somewhat likely to almost definitely	4.3%	9.8%	85.9%	6.069*
Not too likely to not likely at all	4.7%	18.2%	77.1%	
Presence of smugglers, dealers				
Somewhat likely to almost definitely	18.5%	31.5%	50.0%	4.964
Not too likely to not likely at all	16.9%	41.9%	41.1%	
Appearance of building facades and shop windows				
Somewhat likely to almost definitely	9.2%	25.5%	65.2%	9.087**
Not too likely to not likely at all	15.3%	33.9%	50.8%	
df= 2, N=420, *p<0.05, **p<0.01				

Table 7: Cost of living and likelihood of moving away

Likelihood of moving from their city in the next three years?	Cheap to very cheap	Average	Very expensive to expensive	$\chi^2$
Housing cost (mortgage, rent)				
Somewhat likely to almost definitely	0%	2.7%	97.3%	
Not too likely to not likely at all	.4%	7.2%	92.4%	
Cost of basic services related to the house (water, electricity)				
Somewhat likely to almost definitely	.5%	15.2%	84.2%	
Not too likely to not likely at all	3.0%	19.1%	78.0%	
Cost of leisure activities				
Somewhat likely to almost definitely	1.6%	35.3%	63.0%	4.954
Not too likely to not likely at all	4.2%	41.9%	53.8%	
Costs of education and training				
Somewhat likely to almost definitely	6.0%	34.2%	59.8%	6.862*
Not too likely to not likely at all	8.9%	44.1%	47.0%	
Transportation costs				
Somewhat likely to almost definitely	2.7%	42.9%	54.3%	12.956**
Not too likely to not likely at all	4.7%	58.5%	36.9%	
Cost of food and beverages (basic consumables)				
Somewhat likely to almost definitely	.5%	13.0%	86.4%	
Not too likely to not likely at all	.8%	24.2%	75.0%	
General Cost of Living				
Somewhat likely to almost definitely	0%	6.0%	94.0%	13.096**
Not too likely to not likely at all	0%	17.8%	82.2%	
df= 2, N=420, *p<0.05, **p<0.01				

Table 8: Tolerance and likelihood of moving away

Likelihood of moving from their city in the next three years?	Strongly Disagree/ Disagree	Neither	Agree/ Strongly Agree	$\chi^2$
Agreeing that city is welcoming place to people from other countries				
Somewhat likely to almost definitely	19.0%	20.7%	60.3%	11.658**
Not too likely to not likely at all	8.1%	20.3%	71.6%	
Agreeing that their city accepts all ethnic groups				
Somewhat likely to almost definitely	37.0%	29.3%	33.7%	8.981**
Not too likely to not likely at all	23.7%	33.1%	43.2%	
Agreeing that their city accepts the gay population				
Somewhat likely to almost definitely	67.4%	26.6%	6.0%	1.603
Not too likely to not likely at all	61.4%	31.8%	6.8%	
Agreeing that their city accepts the minority religious and ideological groups				
Somewhat likely to almost definitely	55.4%	32.6%	12.0%	1.986
Not too likely to not likely at all	54.7%	28.8%	16.5%	
Agreeing that their city accepts the differences between rich and poor				
Somewhat likely to almost definitely	51.1%	28.8%	20.1%	11.971**
Not too likely to not likely at all	34.3%	38.1%	27.5%	
df = 2, N= 420, *p< 0,05, **p< 0,01				

**INNOVATION IN THE PUBLIC SECTOR THE WAY FORWARD FOR AN EFFECTIVE REFORM OF PUBLIC SECTOR MANAGEMENT IN BOSNIA AND HERZEGOVINA****Ilija Stojanović**

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E-mail: [jovo.ateljevic@gmail.com](mailto:jovo.ateljevic@gmail.com)**Abstract**

Innovation has become important consideration for the public sector today, particularly in the policy development, programs design and delivery of public services. This paradigm is shifting from a highly rational approach towards a more efficient and flexible management, which has been triggered by fast socio-economic, political and other changes across the World. An increasing number of practitioners, including those from various international organizations, have questioned the efficiency and effectiveness of the public sector management in transitional countries, such as Bosnia and Herzegovina (BiH). In BiH itself, numerous administrative barriers are cited as the most common factors discouraging economic and business development, thus reducing the overall competitiveness of the country. Despite such claims, there is a great need for scholarly research into the problem identified in order to find the best solutions for tackling it. This paper is aimed to answer the following research question: *Does transition to an innovative model of strategic public sector management in Bosnia and Herzegovina affect its efficiency and effectiveness?*

The research took an explanatory approach, establishing causal links between the selected variables. Values of the independent variable are presented through the Global Innovation Index of pillar institutions. Values of the dependent variable for different elements of public sector efficiency and effectiveness are presented through data of the Index of Economic Freedom of the World (pillar: Bureaucracy Costs), Doing Business Report (World Bank), Global Competitiveness Index (World Economic Forum) and GPD per capita. The data was analysed through quantitative statistical techniques to test the hypotheses and observe significant correlations. More specifically, the methods of correlation and regression were employed to measure the impact of identified indicators. An on-line survey was conducted in July and August 2011 with different respondent groups: users of public sector services and public sector employees in BiH. The conclusions drawn from the preliminary results indicate a high degree of correlation and regression of independent and dependents variables, suggesting a potential theoretical contribution to the existing knowledge and valuable recommendations for practitioners and policy makers.

**Keywords:** Public sector management, Innovation, Efficiency, Effectiveness, Countries in transition, BiH.

**1. INTRODUCTION**

Today's world is becoming very open, and state boundaries are not so relevant for business activities. This affects the movement of capital, investments and business activities in countries that are more competitive. Those countries that are not ready for the competitive game are facing serious problems and crises. Furthermore, financial crisis and economic downturn have raised a host of new questions about the functioning of the public sector and have placed focus to their efficiency and effectiveness.

The most important source of country competitiveness lies in the public sector functioning efficiently with the existing dynamic environment. This requires reforming the public sector, and its transition from rigid bureaucracy to new management models. In a competitive environment, the public sector needs to innovate in order to survive (Potts, 2009).

Although many authors emphasize the importance of innovation in the public sector, and there are developed theoretical concepts that support management on the basis of innovation, there is insufficient research linking theory and practice. This is particularly the case for countries in transition. Due to the limitations of previous studies, effects of innovations on efficiency and effectiveness of public sector remain underdeveloped.

This paper is aimed to research the importance of innovation in terms of the efficiency and effectiveness of public sector. Broadly, we were analyzing the correlation between innovation within the public sector and their efficiency and effectiveness. The specific focus we put on the obstacles and possibilities of innovation in the public sector in Bosnia and Herzegovina, as a country in transition.



Citizens and businesses in transition counties, including Bosnia and Herzegovina, perceive the public sector as inefficient, too bureaucratic and very expensive. This situation leads to a reduction in the overall competitiveness of Bosnia and Herzegovina and lack of investor trust. This study raises the fundamental question: *Does transition to an innovative model of strategic management of public sector in Bosnia and Herzegovina may affect its efficiency and effectiveness?*

The contribution of this study is two-fold: (i) it provides insights into the relationship between innovations and specific elements of efficiency and effectiveness, and (ii) provides an overview at the public sector innovation in BiH, as a transition country. The results of study suggest a potential theoretical contribution to the existing knowledge and valuable recommendations for practitioners and policy makers.

## 2. LITERATURE REVIEW

According to Max Weber, bureaucracy management is the most rational form of management. He believed that bureaucracy is being “capable of attaining the highest degree of efficiency” (Weber, 1997:337). This theoretical assumption, based on hierarchical organizational structure and very strict procedures, has found practical application in the public sector organizations in many countries.

However, a lot of authors have the opposite opinion on bureaucratic efficiency and effectiveness. Since the 1930s, the bureaucratic paradigm has been criticized (Barzelay&Armajani, 1992:6). The opinion that “bureaucracy carries with it seeds of its own inefficiency” is a relevant insight (Singhi, 1974:184). Such opinion is linked with decreasing efficiency and effectiveness of the bureaucratic public sector. Some sources indicate the “the impact of red tape“, or so-called ‘bureaucratic burden’ (Global Competiveness report, 2008-2009:49), as a very important issue of competitiveness within public sector. In this regard, global economic competition and its competitive pressures associated with globalization is the most important motivator in reforming the public sector (Parker, 2004; Kamarck, 2003:11).

The lack of competitiveness in the global world leads to economic crisis. The 2008 economic and financial crisis changed entrenched views on efficiency and effectiveness of public sector (Kamarck, 2003, Mihaui, 2010; Klein et.al, 2010), thus requiring a fresh approach in activities regarding the public sector. According to Brümmerhoff, the “bilateral monopoly”, in which politicians are monopolists in securing funds in the budget, while bureaucrats become the only providers of public services (Brümmerhoff, 1996), is a closed system both to its environment and the users of public services.

According to Parker and Bradley (2004:198), embracing new management techniques is a necessary step towards overcoming problems such as inefficiency and inflexibility. The application of new management techniques begins its realization through the systematic reform of public management (Pollitt&Bouckaert, 2000). In recent decades, this type of reform has reached the top of the political agenda in many countries.

### 2.1. Entrepreneurial Management in the Public Sector

In the last decades the entrepreneurial paradigm has become the key driving force in public management reform. A special contribution to the analysis of entrepreneurial policies in the public sector gave Peter Drucker (1909-2005), renowned management consultant. In his work “*Innovation and entrepreneurship practice and principles*”, Drucker sets out the basic principles of entrepreneurship policy in the public sector. According to him, each organizational unit within the public sector should have a clearly defined role and its mission. It is the mission, rather than legal standards, that determines the course of action of the public sector (Drucker, 1991:223).

Entrepreneurial management has a clear interest for profit. On the other hand, the public sector does not have profit as its main interest but is more focused on satisfying public needs and public services. The problem arises in the impossibility of measuring achievement of strategic goals and operational tasks, but also in the absence of competition in the public sector. For application of the entrepreneurship concept into public management, it is important to identify differences between private and public entrepreneurial action (Klein et.al, 2010:2). The practices of the private and public sector should be brought into line and with market-based decision-making (Wanna&Forset, 1996:33).

The application of entrepreneurial management in the public sector prevents conformism as priority objective of bureaucrats and focuses primarily on encouraging innovation. In doing so, the emphasis is solely on results, and not on bureaucratic work procedures.

## 2.2. The New Public Management

The New Public Management is a new philosophy of management in the public sector. New Public Management (NPM) is sometimes confused with the 'New Public Administration' movement in the USA of the late 1960s and early 1970s as well with the public administration reform agenda of most OECD countries from the late 1970s. The genuine rise of "new public management" began in the 1980s (Smelser et.al, 2001:12553; Hood, 1991; Development Policy Management Division, 2003).

NPM occurs in the period of globalization, with the expanding global economy, which brings costs and benefits to countries. It requires the reinforcement of an effective state that can focus on compensating losses caused by globalization and technical change. NPM follows that a well-organized public administration gives a better opportunity to benefit from globalization (Development Policy Management Division, 2003). x

New public management is tied to the political program of Margaret Thatcher, former Prime Minister of Great Britain, which has significantly reformed the public sector during her mandate. Under the Thatcher's leadership (1979-1990) came the reform of the public sector management that led to a very competitive system compared to other states. This was a period when the UK had suffered heavily from recessive developments and tax revolts of their citizens; it was a period of crisis. This was an incentive for other commonwealth countries, mainly New Zealand and Australia, to join the reform. Later in almost all OECD countries, the NPM became priority on their political agendas (Gruening, 1998:2; Hood 1995:99).

The inefficiency and ineffectiveness of the public sector were the most important factors for the reforms and are therefore the core paradigm of the NPM (Development Policy Management Division, 2003). It has initiated a wide range of reforms that need to contribute to greater market orientation in order to increase cost efficiency, avoiding negative impacts on social goals and tasks of the public sector.

New Public Management (NPM) is a label used to describe a management culture that use management approaches and techniques borrowed from the private-for-profit sector (Development Policy Management Division, 2003). NPM is linked with the term "managerialism" (Hood, 1991; Gruening, 1998, Development Policy Management Division, 2003) meaning more "discretionary decision space in exchange for direct accountability for their actions" (Smelser et.al, 2001:12554). It implies a business type and market-based public service management based on enterprise culture with smaller, faster-moving service delivery organizations that would be kept lean by the pressures of competition (Development Policy Management Division, 2003).

According to Hood (1991), the major NPM doctrines of what must be done are that: cut costs in the public sector, increase flexibility, labor discipline, completion, decentralization, establishment of standards and performance. In addition, Hood (1995) believes that basic principle of NPM is removing differences between the public and the private sector.

## 2.3. Public Sector Innovation

According to Mulgan and Albury (2003), "Successful innovation is the creation and implementation of new processes, products, services and methods of delivery which result in significant improvements in outcomes efficiency, effectiveness or quality".

When governmental action is failing in a period of increasing problems, the public sector is expected to increase their capacity to innovate (Bland, et.al, 2010; Eggers et.al, 2009). In such circumstances, internal problems and crises are important factors leading to innovations (Borins, 2001). Innovations are very important for public sector performance with the aim to improve service delivery to users and citizens with focus on improving their quality of life and building a better and stronger community (Walker, et. al, 2011:367). This is a source of competitive advantage in the global economy (NESTA, 2006; INSEAD). In addition, innovative states are more competitive and richer, and they are above average in wealth and competitiveness (Grey, 1973:1182). However, the bureaucratic model of public management is an obstacle for innovations and entrepreneurship (Thompson, 1969; Borins, 2001), as in many transitional countries public sector suffers from an innovation deficit and entrepreneurial attitude amongst the political elite (Potts, 2009).

Innovation, per se is characteristic of the private sector as they encourage profitability as their value. Values and motivations in public sector are more complex and difficult to measure. (Mulgan and Albury 2003, IDaA, 2005). With the aim of exploring levels of innovation performance in the public sector, a number of indicators have been developed, such as the Worldwide Governance Indicators, Global Innovation Index, NESTA Innovation Index, European Innovation Scoreboard etc.

### 3. A STUDY OF IMPORTANCE OF INNOVATION IN PUBLIC SECTOR

In the last few decades, we have witnessed an ongoing debate among scholars and public policy practitioners on the importance of innovation in the public sector. Application of empirical assessments of the efficiency and usefulness (effectiveness) of public sector activities has impacted on the shifting of their role (Aristovnik, 2009:2).

It is true that a number of significant studies (as mentioned in the Literature Review) have recently been done in order to confirm the necessity of reforming the public sector, but the question of how such inferences would help towards building up innovative models of public management, especially in transition countries, still remains. While there has been some research on the general impact of innovation in the public sector, little has been written about the effects of on specific elements of the efficiency and effectiveness.

There have been a number of valuable studies and reports relating to the level of innovation in public sector across the World (Global Innovation Index Report, The World Competitiveness Report). However, these studies do not provide a picture of correlation between innovation indicators in the public sector and elements of their efficiency and effectiveness. Different measurement systems and the lack of reliable data (Kamarck, 2003:23; Klein et.al, 2010:5; Aristovnik 2009:4; Mandl et.al, 2008) are contributing to the lack of understanding of the importance of innovation in the public sector, especially when it comes to countries in transition.

Studying the impact of innovation is mainly carried out in the sphere of the private sector and less in the public sector. According to Mulgan and Albury (2003), whilst a substantial body of research has emerged in the past four decades on innovation in the private sector, a significant knowledge gap exists with regard to innovation within the public sector, where quality research on the subject is rather limited.

This paper will suggest key issues that need to be addressed when considering the effects of innovations in public sector. In addition, it will review the capacity to introduce an innovative management model in the public sector in Bosnia and Herzegovina, as an example of a country in transition.

#### 3.1. Key issues on effects of innovation within the public sector

In our research, we have looked at two aspects in order to find out whether and to what extent they are conditioned from the level of innovation in the public sector:

- Efficiency – describes the extent of using of time or effort for the implementation tasks or purpose;
- Effectiveness - describes the capability of producing effect.

To achieve research objectives and assess the impact of innovation in the public sector, this paper identifies these two dimensions of public sector performance. In accordance with our research question, we set the main hypothesis, as follows:

*(H0) Application of an innovative model of strategic management of public sector will significantly affect the increase in elements of its efficiency and effectiveness.*

According to Khan and Akif (2005), “efficient and effective institutional structure is the back bone of sustainable social and economic structure”. Mihaiu et.al. (2010), as stated as an opinion as stated as an opinion of Peter Drucker (2001), share an opinion that there is no efficiency without effectiveness; they are part of a whole. Both elements are part of the performance in the public sector.

However, in order to comprehend more deeply the effects of innovation in the public sector on the efficiency and effectiveness, we analyzed specific elements. The research will therefore test the following working hypothesis:

*(H1): Application of an innovative model of strategic management of public sector will lead to a reduction in the cost of bureaucracy.*

*(H2): Application of an innovative model of strategic management of public sector will contribute to reducing number procedures and their shorter duration.*

*(H3): Application of an innovative model of strategic management of public sector will result in increasing the overall competitiveness of country.*

*(H4): Application of an innovative model of strategic management of public sector will contribute to increasing the level of living standard.*

#### 4. METHODOLOGY

Measuring efficiency and effectiveness in the public sector is difficult because of the lack of suitable data (Mandl et.al, 2008). In order to avoid a general look at the problem, research was realized in two phases: (i) the analysis of the correlation and regression between innovation and specific elements of the efficiency and effectiveness, and (ii) the analysis of perceptions about the innovative capacity of the public sector in BiH, as an example of country in transition. This enabled consideration of the research problem at a general level as well as a specific level.

The first general phase of research was carried out with the analysis of correlation and regression between independent and dependent variables. The efficiency and effectiveness of the public sector were presented as dependent variables, while independent variables in our study were defined at the level of innovation in public sector. The research took an explanatory approach establishing causal links between the selected variables.

The values of the independent variable were presented through data of the Global Innovation Index - GII, for pillar Institutions (INSEAD, The Global Innovation Index). The values of the GII move in interval from 1 (lowest) to 7 (best). The GII Institution pillar is described as: “nurturing an institutional framework that attracts business and fosters growth by providing good governance and the correct levels of protection and incentives” (INSEAD, The Global Innovation Index).

With the aim of systematic review, dependent variables were presented in the following table.

Table 1: Metrics for dependent variables

Hypothesis	Dependent variable	Source of data	Interval values	Description	Number of observations
H1	cost of bureaucracy	The Economic freedom of the World Report	1 (lowest) to 7 (highest)	Bureaucracy Costs as a component of the EFW Index, section: Business Regulation	119
H2	procedures (number and duration)	Doing Business Report	lower values are better	The number of procedures and duration (days) of the day in section “Starting a Business”	240/2321
H3	overall competitiveness of country	The Global Competitiveness Report	1 (lowest) to 7 (best)	A set of institutions, policies, and factors that determine the level of productivity	200
H4	level of living standard	UNSTAT: National Accounts and Main Aggregates Database: GDP p/c US Dollars	GDP per capita in US Dollars	used as an indicator of living standards	250

The data was analysed through quantitative statistical techniques to test the hypotheses and observe significant correlations. More specifically, the methods of correlation and regression were employed to measure the impact of identified indicators.

The second specific phase of research was carried out with descriptive analysis of the data which the respondents expressed an opinion on important issues of innovation in the public sector in Bosnia and Herzegovina. The questionnaire was constructed around the key research objectives with the aim of analyzing several topics relevant for Bosnia and Herzegovina, as a county in transition: efficiency, effectiveness, status of public sector reform, innovative management principles, sources of innovation, and obstacles and opportunities for the application of innovation. The questionnaire was made up of categorical options for the respondents to choose from. For the questions geared at obtaining the respondent’s opinion, a list of statements was presented using the Likert-style rating.

With the aim of analyzing the specific situation of the public sector in BiH and the possibility of introducing an innovative management model, an online survey was conducted during July and August of 2011. The survey was conducted with two different groups: users of public sector services, and public sector employees in BiH. This division enabled descriptive cross-tab analysis of the specific questions in order to comprehend the situation from two angles: from inside and outside the public sector.

We obtained responses from 121 respondents, of which were 56 (46.28%) were users of public sector services and 65 (53.72%) public sector employees. There were 53 (43.80%) female and 68 (56.20%)



male respondents. The respondents divided into the following age groups: 18-25 (1/0.83%), 26-35 (50/41.32%), 36-45 (34/28.10%), 46-55 (22/18.18%), above 55 (14/11.570%). Respondents were from different areas in Bosnia and Herzegovina: Republic of Srpska (34/28.10%), Federation of BiH (61/50.41%), Brcko District (26/21.49%).

Given the large number of questions in the questionnaire, we presented the answers on the most important questions. Basic descriptive analysis of the data collected was carried out to see where the majority of the responses tended to be positioned. As many of the variables used were ordinal (categorical variable with some form of intrinsic ranking) non-parametric measures were employed. The correlation coefficient was used to assess the strength of the linear association between pairs of ordinal variables, which included questions where respondents were asked to indicate strongly agree (5), agree (4), neutral (3), disagree (2) or strongly disagree (1).

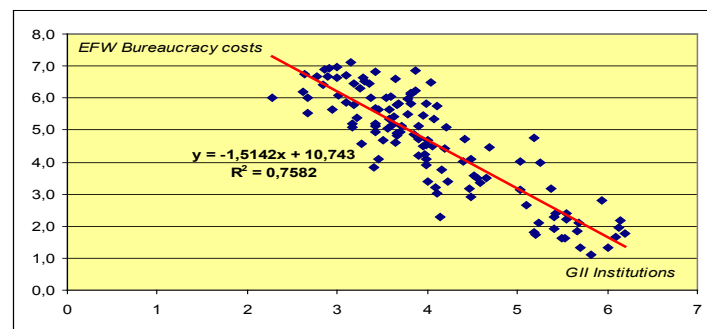
## 5. RESULTS AND INTERPRETATION

The results for each section, geared at testing each hypothesis, are now presented and interpreted. Although not every result can be covered in this section, the results most relevant to answering the research questions have been presented.

*(H1): Application of an innovative model of strategic management of public sector will lead to a reduction in the cost of bureaucracy.*

The correlation analysis of GII Institutions (IV) and EFW Bureaucracy Cost (DV) indicated strong high negative correlation between their values (-0,871). The equation shows a negative trend, which confirms that increasing level of innovation in the institutions leads to the reduction of bureaucratic costs.

Graph 1- GII vs. Bureaucracy Costs



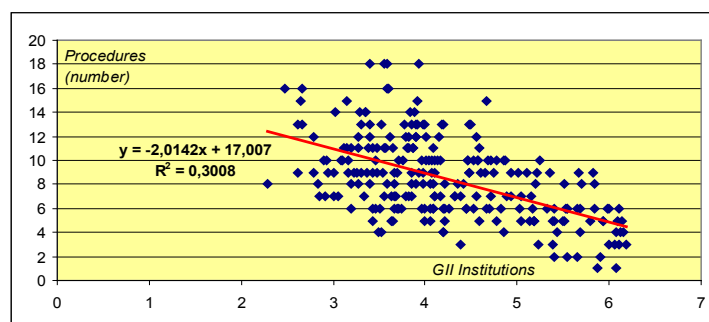
The results from the second phase show that most respondents either disagree (52,893%), or strongly disagree (27,273%) on the statement that “the costs of the public sector in BiH in carrying out its responsibilities and duties is justified”. The central tendency of mean at 1,967 (1 to 5 interval) suggests that the majority of respondents disagree with the above mentioned assumption. The observed correlation between opinion on the orientation of public sector in BiH on innovation and cost justification is statistically significant (0,353).

*(H2): Application of an innovative model of strategic management of public sector will contribute to reducing a number procedures and their shorter duration.*

The correlation analysis of GII Institutions (IV) and the number of procedures (DV) indicated reasonable negative correlation between their values (-0,548). The equation shows a negative trend, which confirms that increasing level of innovation in the institutions would lead to reducing the number of procedures.



Graph 2: GII vs. Procedures (number)



In the context of BiH we found that most respondents are “disagree” (42,975%), and “strongly disagree” (29,752%) on the thesis that “the number of rules and procedures governing the resolution of certain rights / services in the public sector in BiH is not large”. The central tendency of mean amounts 2,066, closer to score “disagree”. The observed correlation between opinion on orientation of public sector in BiH on innovation and extensiveness of the procedures is statistically significant (0,234).

Going further into the analysis, the correlation analysis of GII Institutions (IV) and the duration of procedures in days (DV) indicated reasonable negative correlation between their values (-0,502). The equation shows a negative trend, which confirms that increasing levels of innovation in the institutions leads to reducing the duration of procedures.

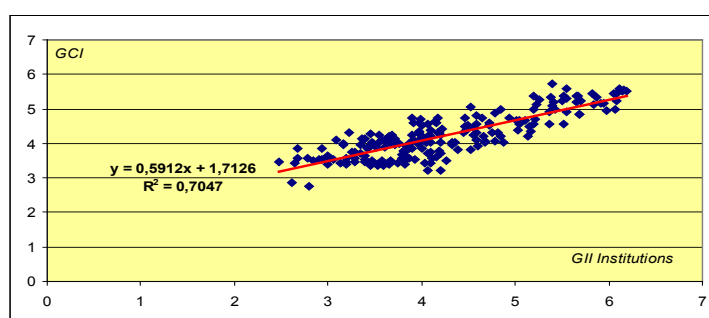
Graph 3: GII vs. Time

In the analysis of the second phase we found that most respondents disagree (42,149%), while 22,314% strongly disagree, and 21,488% are neutral on the thesis that “the public sector in BiH is carried out their duties in acceptable time limits”. The central tendency of mean amounts to 2,273, again closer to score disagrees. The observed correlation between opinion on orientation of public sector in BiH on innovation and duration deadlines is statistically significant (0,469).

*(H3): Application of an innovative model of strategic management of public sector will result in increasing the overall competitiveness of the country.*

The correlation analysis of GII Institutions (IV) and the global competitiveness index (DV) indicated strong high positive correlation between their values (0,839). The equation shows a positive trend, which confirms that increasing level of innovation in the institutions would lead to greater overall competitiveness.

Graph 4: GII vs. GCI



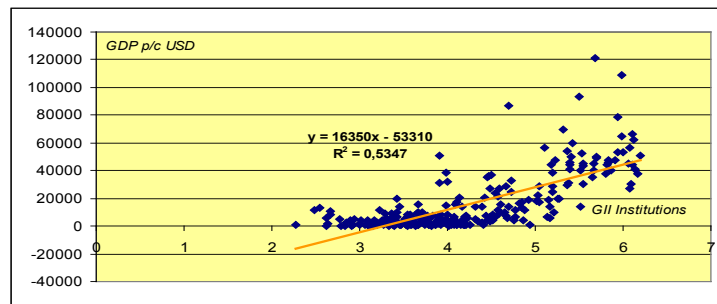
Most respondents disagree (42,149%) or strongly disagree (31,405%), while 20,661% are neutral about the thesis that “the public sector in BiH contributes to the overall competitiveness at the regional / global level”. As the amount of mean amounts to 2,008, the central tendency is closer to score disagree. The observed correlation between opinion on orientation of public sector in BiH on innovation and contribution to competitiveness is statistically significant (0,489).

*(H4): Application of an innovative model of strategic management of public sector will contribute to increasing the level of living standard.*

The correlation analysis of GII Institutions (IV) and GDP p/c (DV) indicated strong high positive correlation between their values (0,731). The equation shows a positive trend, which confirms that increasing levels of innovation in the institutions leading to increasing of standard of living represented

by GDP p/c.

Graph 5: GII vs. GDP p/c



Going further, the analysis found that most respondents disagree (41,322%), while 26,446% strongly disagree and 24,793% are neutral on the thesis that “the public sector in BiH contributes to the living standard”. The central tendency of mean amounts 2,132, closer to score disagrees. The observed correlation between the opinion on the orientation of the public sector in BiH on innovation and contribution to living standard is statistically significant (0,469).

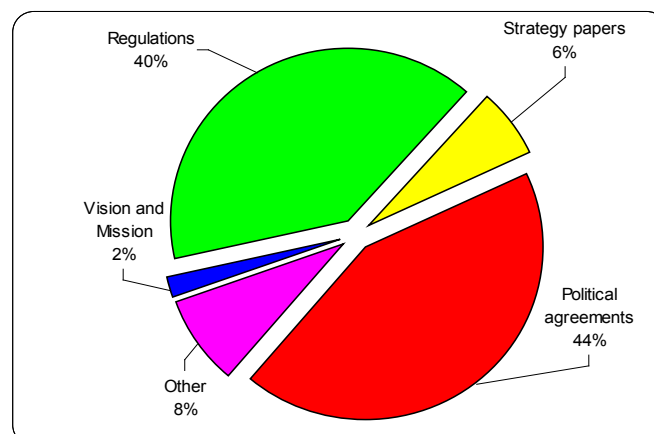
### 5.1. Main Findings in the Context of Bosnia and Herzegovina

The majority of the respondents (44,628%) in regard to their opinion on the efficiency of the public sector in BiH gave a score disagree, while the central tendency of mean amounts to 2,190. On the other hand, great percentages (38,017%) of those surveyed strongly disagree on the thesis that the public sector in BiH is strategically oriented to the application of innovation in their work. Based on the distribution of responses of other respondents, the central tendency of mean is 2,025. The observed correlation between these two variables (application of innovation in public sector-IV, level of efficiency-DV) is statistically significant (0,394). Regarding opinions on the effectiveness of the public sector in BiH, the majority of the respondents (46,281%) disagree on the positive statement on this topic; the mean is 2,116.

The observed correlation between effectiveness and application of innovation in the public sector is statistically significant (0,530). A specific question on the impact of innovation in the public sector u BiH in increasing its efficiency and effectiveness, focused the majority of respondents to answer agree (50,413%) and strongly agree (42,975%); the mean amounts to 4,355.

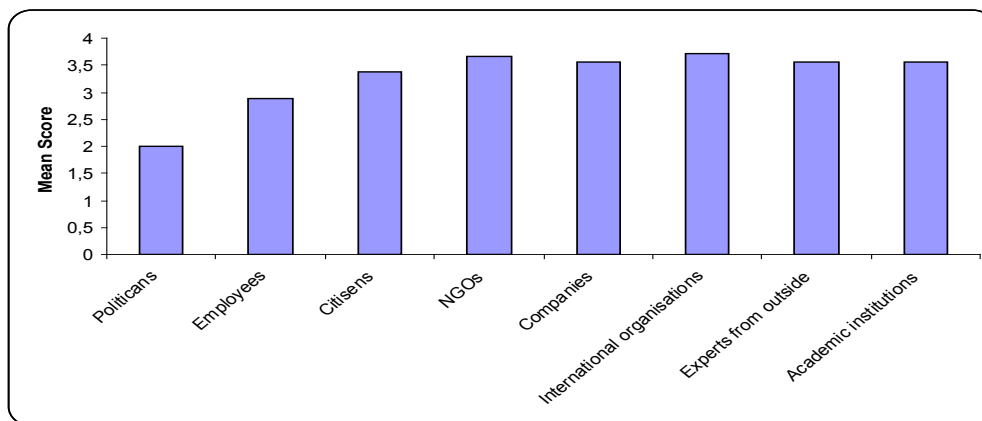
The analysis of the current situation in the public sector in BiH showed that most respondents disagree (37,190%), or strongly disagree (28,926%), while 26,446% are neutral so the current bureaucratic model of organization and management in the public sector in BiH enables room for innovation in their work. The majority of respondents gave the score strongly disagree (38,843%) and disagree (34,711%) on the claim that there are adequate methods of measuring efficiency and effectiveness of public sector in BiH. The chart below showed the results of respondents' opinions on current base for conducting operations of the public sector in BiH. The survey showed that the public sector in BiH is firmly based on bureaucratic principles because its basics are legislation and political platforms, rather than vision, mission and strategic documents.

Graph 6: Current base for conducting operations of the public sector in BiH

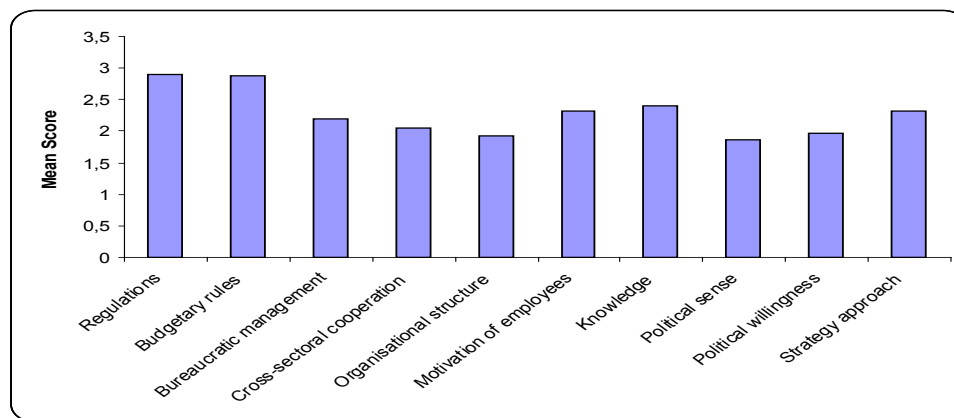


Exploring incentives that contribute to the change management model, we found that most respondents agree (40,496%) that global/regional competition in principle contributes to the innovative behavior of public sector in the world. At the same time the majority of respondents disagreed (39,669%) or are neutral (28,099%), while 23,967% strongly disagreed with the claim that the innovations are due to the global/regional competition actively applied in the public sector in BiH. The central tendency of mode amounts to 2,207, clustering opinions about score disagree on the claim. Pearson Correlation (0,041) of contribution global/regional competition to innovation and application of innovation in BiH due to competition showed that the observed correlation is not statistically significant. This means that global competition does not affect incentive to apply innovation in the public sector in BiH. In order to comprehend the reasons for this situation, we examined respondents' opinions about the most important obstacles for the implementation of innovation. Furthermore, we examined potential sources for innovation that have ideas for increasing the level of innovation in the public sector in BiH. Analysis of respondent opinion is presented in graphs 6 and 7 (mean score mode).

Graph 7: Obstacles for Innovation<sub>1</sub>



Graph 8: Sources for Innovation<sub>2</sub>



## 6. DISCUSSION

The inefficiency and ineffectiveness of the public sector were the most important factors for the reforms in public sector based on the New Public Management Paradigm (Development Policy Management Division, 2003). Our survey results showed a strong link between the level of innovation in the public sector and their efficiency and effectiveness. Taking into account the complexity of measuring efficiency and effectiveness (Aristovnik, 2009), establishing relationships between innovation with some elements of efficiency and effectiveness in this research was very important for elaborating hypothesis.

As Mulgan and Albury (2003) point out, the cost of public services tends to rise faster than the rest of the economy because of the lack of competition. According to research performed by NESTA (Hughes, et.al, 2011), the impacts of innovation in service delivery lead to cost savings. Innovation is the basis for entrepreneurial activities and allows more competition within the public sector. Considering the rising costs in the public sector compared to the rest of economy, the management of this issue is of

1 Research question: What are the most important preconditions (obstacles) for the implementation of an innovative model of strategic management in the public sector in BiH?

2 Research question: (-----) have ideas that can increase the level of innovation in the public sector in BiH

great importance. In this regard, innovation occurs when resources are deployed in new ways (Klein et.al, 2010).

Our research has clearly shown that lower levels of innovation in the public sector are correlated to higher bureaucratic costs, and vice versa. For further analysis of the impact of innovations on public sector cost, it would be interesting to perform a comparison of cost movement between countries that are applying innovation (e.g. OECD countries) and others that are not innovatively oriented. For this purpose indicator "Expense (%GDP)" in the public sector could be interesting to compare (The World Bank: World dataBank).

Besides the costs, as a tool of efficiency in this study, we measured the number and duration of the procedures. Procedures, according to Doing Business Report (The World Bank: Doing Business Report), are one of 'the bureaucratic and legal hurdles which an entrepreneur must overcome to incorporate and register a new firm'. Process innovation refers to the way new internal procedures, policies and organisational forms may be required for supporting innovation (IdeA, 2005). In the research, we supported a claim that higher innovation performance in public sector leads to reducing the number of procedures and their shorter duration.

Many authors (Parker, 2004; Kamarck, 2003) support ideas that global economic competition and the competitive pressures associated with globalization are the most important motivators of public sector reform. According to Borins (2001), internal problems and crises are important factors leading to innovations. In response to the crisis, many countries, especially OECDs of in late 1980s, have begun reforming the public sector in order to enable innovation (Gruening, 1998; Hood 1995). Innovation is a source of competitive advantage in global economy (NESTA, 2006; INSEAD). Furthermore, innovative states are more competitive and richer, and they are above average in wealth and competitiveness (Grey, 1973:1182). For this reason, we analyzed the impact of innovation in the public sector to the country's competitiveness. The correlation between these two variables suggests the need of deeper analysis of the sources of competitiveness during public administration reform.

According to Potts (2009), in a competitive environment, the public sector needs to innovate in order to survive. However, it has been shown that these principles do not apply in the context of public administration reform in Bosnia and Herzegovina. Our research has shown that despite the fact that global competition affects the application of innovation in the public sector, innovation through global influences has not been successful in BiH. It seems that Brümmerhoff's (1996) concept of "bilateral monopoly" has found fertile ground in Bosnia and Herzegovina.

A clearly defined role and mission, according to Drucker (1991), should be over legal standards, as a base of determination of action within the public sector. Our research has shown that the vision and mission, as well as strategic management, are routinely negligible when conducting operations of the public sector in BiH. Instead, importance is placed on political agreements and regulations indicating the existence of strong bureaucratic structures, despite the current reform processes within the public sector in BiH.

Our research suggests that the public sector in BiH is not strategically oriented to the application of innovation in their work. Such confirmation is in accordance with claim of Thompson (1969) and Borins (2001) that the bureaucracy model of public management is an obstacle for innovation.

Conclusively, we can confirm the existence of an innovation deficit in the bureaucratic public sector that is emphasized by Potts (2009). He believes that political leaders should act as entrepreneurs. Our research has shown that insiders (politicians and employees) are not "blessed" with ideas that encourage innovative ideas and do not represent a significant source of innovation in the public sector in BiH.

The importance of innovation lies in the aim to improve service delivery to users and citizens with a focus on improving quality of life, and building better and stronger communities (Walker, et. al, 2011). Our research is relevant in examining the influence of innovation in the public sector in relation to living standards. Through the study of the correlation between innovation and GDP p/c we have confirmed the working hypothesis, and supported the claims imposed by this author.

We will summarize by discussing the importance of measurement methods in the public sector. According to Aristovnik (2009), application of empirical assessments of the efficiency and usefulness (effectiveness) of public sector activities has impacted on shifting their role. Mulgan and Albury (2003) believe that research innovation is mainly carried out in the private sector sphere and less in the public sector. In the context of the research situation in BiH, we have confirmed a claim of the lack of methods for measuring innovation, efficiency and effectiveness within the public sector. This may

be the reason behind the consequent lack of desire for significant changes in the public sector in BiH.

## 7. CONCLUSIONS AND IMPLICATIONS

To surmise, both Entrepreneurial Management in the Public Sector, and New Public Management theories have created solid basis for the improvement of public management. Their principle of the importance of innovations found their application in the public sector around the world. However, transition from bureaucratic models to innovative models represents a major change. It is a transition from the 'status quo' to the status of 'permanent changes'. It should be based on changing management models that systematically support innovation, rather than adapting bureaucratic organization to public sector. For those who lead this process, it can be very tedious. Especially as these changes introduce principles of work from the private sector, and that means the risk of job loss, struggle to achieve results, permanent work and training. This requires that public administration should consider innovation rather than being orientated towards conformism.

This paper highlighted global competition as a motivator for the states to reform the public sector. Analysis that we did in this paper confirms the hypothesis that the application of innovation in the public sector contributes to their efficiency and effectiveness. States whose public sector is more innovative are also more competitive.

The findings of this study suggest a potential theoretical contribution to the existing knowledge and valuable recommendations for practitioners and policymakers. They point out the need to question the application of innovation above the dominating political agenda. Today, this is not only an unfashionable practice in public administration reform but also a necessity to survive in the game. This should be a special message to decision and policy makers in Bosnia and Herzegovina, as a country in transition. Research has shown that the main obstacles to success are sources of innovation in public sector. Future research should examine forms of overcoming obstacles and ways to better utilize resources for innovation.

Ways of measuring innovation within the public sector remains an important issue to discuss. Apart from the improvement in developing indicators to measure innovation, it is necessary to develop a system of measuring the impact of innovation on the efficiency and effectiveness of the public sector. Only on the basis of such systematic analysis can one make decisions relating to public sector reform.

## 8. LIMITATIONS AND SUGGESTIONS FOR FURTHER RESEARCH

Limited time and resources have put limitations on the research. The sample size, 121 respondents, is not an ideal amount. This is especially the case as the sample covered a wide range of demographic groups, meaning many of the groups were too small to carry out any statistical tests upon. All that can be said for the sample is that it includes respondents from a wide range of different groups and demographic backgrounds, but there are not enough respondents within each group to make any decent generalizations regarding the differences between the groups. Further research could involve a larger more representative sample allowing statistical tests to be carried out and assess the significance of demographic groups to the responses given.

The results are also limited in that they reflect the opinions of Internet users only. The results cannot be applied to other groups that are not using Internet. Further research could use mixed model for collection of survey data.

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## **ENTREPRENEURSHIP IN THE CREATIVE INDUSTRY**

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### **Abstract**

Economies of developed countries heavily rely on small and medium enterprises, in which entrepreneurship is highly expressed. For that reason, the government's economic planners focused attention on creating the economic environment within all industries in which SMEs will be able to develop easily and freely. However, entrepreneurship in Serbia and in most Western Balkan countries mainly refers to the production and service activities of the real sector and much less on the creative industries. It deals with insufficient knowledge of the potential of this industry which in developed western countries recorded the continual highest growth rates both in revenue and in number of employees and we're always looking for additional qualified staff. In addition, products and services of creative industries in these countries are become the very important export items. The importance of the creative industry expresses not only the results that it achieves, but also the attention that it deserves from the most important global institutions such as UNDP, UNCTAD, World Bank. Statistical indicators from the United States, which are used in this paper very clear show the kind of results which can be achieved by the creative industry if government intends to help its development. Entrepreneurship has particularly important place in the creative industry, given that a large part based on the creativity and initiative of individuals. Beside film and music industries, which by their very nature and number of consumers realize huge incomes, creative industries includes specific vertical segments that will reach its peak in coming years, this are primarily related to the development of computer animation and interactive television. For this reason, the economic planners of the Western Balkan countries should devote significantly greater attention towards creative industry that would also have to be taken into account in long-term plans of educational systems. A creative industry requires much less investment for the new job creation, which usually represents the biggest obstacle to faster economic development in these countries. This industry are partially relying both on the cultural heritage and cultural tourism, which by their nature entail a development of numerous other industries, such as transport, construction, food processing, textile industry and others. In order to encourage the development of creative industries should be used best practices from the European Union in particular from Great Britain, where creative industry accounts for a significant percentage of the GDP, and also in the foreign trade balance.

**Key words:** Creative industry; Entrepreneurship; Economic development;

### **1. INTRODUCTION**

Broadly speaking, creative activities has occurred at the dawn of civilization when, beside to the permanent struggle for survival, people find time to be creative and express themselves. Many artefacts show that the ancient civilization developed and encourage creativity in fulfilling everyday necessity as well as in the construction of monuments, some of these are classified as an invaluable human inheritance. Looking from this angle, could be said that the creative industries have always existed, but the term industry implies that these refers to the organization of mass production, thus their origin particularly related to the modern era.

The first mention of the phrase creative industries is in the document Australian Government's „Creative Nation” in which it addresses the potential of cultural industries. Later on, that phrase is widely accepted by members of these industries and also by the general public. Also, the creative industries have become well-deserved recognised economic sector in the plans of the government that can achieve significant revenues for the Gross national product with a modest investment.

The aim of this paper is to highlight the importance of entrepreneurship in the creative and artistic activities and to show to creators of economic development how important may be the development

of creative industries, which generally do not require large investments, excluding some high-tech industries.

For the purposes of this study, have been research the effects of creative industries in a few developed countries where these industries are particularly encouraged by various measures of governments as holders of highest revenue and employment growth in comparison to other industries. Also were collected all available data on the state of creative industries in Serbia and the Balkans.

Special attention is given to the self-employment opportunities of young artists of all artistic genres, by fostering entrepreneurship and creating an environment for the promotion of such way of financing and organizing creative activities. The results have been achieved in some countries, fully justify this approach.

Creative industries are based on the artist as producer, who, beside real artistic creativity, can create huge profits in the production of mass culture, such as film, music or publishing. The concept of creative industries makes it necessary that artists have to actively participate not only in arts activities but also in economic approaches, and not to wait that money comes from state budgets and sponsorship. For this reason, governments should create the environment to consolidate the status of national culture and encouraging creative people. Cultural policy must provide the artistic professionals a chance to survive in the market, and avoids any economic restrictions for artistic projects by the government.

## 2. METHODOLOGY

**The subject** of this paper is to define the determinants of success in entrepreneurial process on example of the creative industries as the industries of future either in Serbia, EU Member States and the countries of the Western Balkan. **The research problem**, identification of major determinates and key success factors in this business area. **The aim** of this work is to analyze the possibility of applying a modern concept of entrepreneurship. The key point in such endeavours is accepting risks and changes based on the innovative activities in order to create conditions for businesses development within the creative industries and strive to achieve EU business excellence model. The final intention is to create of the same business environment in Serbia in order to reducing the poverty and unemployment, through increasing the profitability and vitalization of the economy as a whole. Having in mind the specificities of this research subject, it has been used the different research methods to fulfil the basic methodological requirements: objectivity, reliability, generality and systematicity.

For the purpose of this work, we undertook various research and study on the theoretical scientific knowledge, relevant literature and contemporary business practices by using methods: **induction, analysis, synthesis, generalization, complex observation, comparison and content analysis**

## 3. RESEARCH RESULTS AND DISCUSSION

### 3.1. What are the Creative Industries

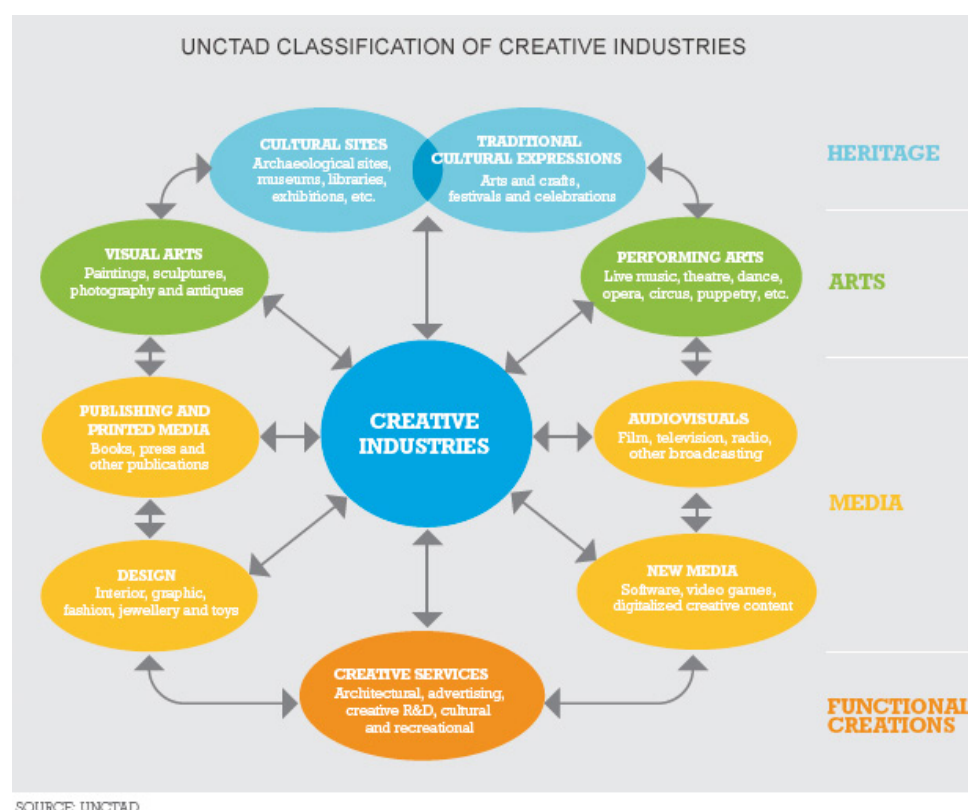
The creative industries encompass a broader range of activities which include the cultural industries plus all cultural or artistic production, whether live or produced as an individual unit. The term "Creative Industries" was a concept of the Department of Culture, Media and Sports of United Kingdom (UK DCMS), which has listed out 13 types of industries: Advertising, Architecture, Art & Antiques Market, Crafts, Design, Designer Fashion, Film & Video, Interactive Leisure Software, Music, Performing Arts, Publishing, Software & Computer Services, and Television & Radio. The broad definition of the creative industry also includes a number of creative sectors which specialize in production, distribution and retail, for example museums, booksellers and cinemas. These categories were classified conforming to the actual situation and business development in UK, and hence not necessarily applicable to other countries. For comparison in the table below, provides another classification of creative industries.

Table 1. Concept and context of the creative economy

UK DCMS model	Symbolic texts model Core cultural industries	Concentric circles model Core creative arts	WIPO2 copyright model Core copyright industries
Advertising Architecture Art and antiques market Crafts Design Fashion Film and video Music Performing arts Publishing Software Television and radio Video and computer games	<b>Core cultural industries</b> Advertising Film Internet Music Publishing Television and radio Video and computer games <b>Peripheral cultural industries</b> Creative arts <b>Borderline cultural industries</b> Consumer electronics Fashion Software Sport	Literature Music Performing arts Visual arts <b>Other core cultural industries</b> Film Museums and libraries <b>Wider cultural industries</b> Heritage services Publishing Sound recording Television and radio Video and computer games <b>Related industries</b> Advertising Architecture Design Fashion	Advertising Collecting societies Film and video Music Performing arts Publishing Software Television and radio Visual and graphic art <b>Interdependent copyright industries</b> Blank recording material Consumer electronics Musical instruments Paper Photocopiers, photographic equipment <b>Partial copyright industries</b> Architecture Clothing, footwear

Source: <http://www.ifap.ru/>

Figure 1. UNCTAD classification of creative industries



SOURCE: UNCTAD

The creative industries are those in which the product or service contains a substantial element of artistic or creative endeavour and include activities such as architecture and advertising, in accordance to that, UK DCMS offered a definition of Creative industries "...those industries which have their origin in individual creativity, skill and talent which have a potential for job and wealth creation through the generation and exploitation of intellectual property"<sup>1</sup>

Although these industries connected creativity, their structure is very different, not only by meter of work, but much more in terms of organization and technologies for their product realization. Such kind of diversity in some way implies the kind of entrepreneurship and ability to quickly adapt to

<sup>1</sup> 'Creative Industries Mapping Document', DCMS, 2001

market demands. In order to illustrate this assumption should be given a brief description of each of the aforementioned industries.

- Advertising

Beside numerous of definitions, the following definition very clear describe the core of advertising. „The activity or profession of producing information for promoting the sale of commercial products or services.”<sup>2</sup> Without any doubt, advertising is the most dynamic creative activity where only constant is change. Innovative formats, new technologies and shifts in priorities mean there’s always something new and always something next in ongoing quest to communicate with consumers.

- Architecture

Architecture is the activity of designing and constructing buildings and other physical structures that integrate with their surrounding landscape as town planning, urban design, and landscape architecture. On the micro level, architecture means design of architectural or construction details and, sometimes, furniture.

- Art & Antiques Market

“Art and Antiques includes paintings sculpture, works on paper, other fine art, furniture, other discrete disciplines and collectibles. The main outlets for these products are: auctions, galleries, specialist fairs, shops, warehouses, department stores and, more recently, the Internet.”<sup>3</sup>

- Crafts

Craft production refers to work carried out by a skilled worker. Its aim is to produce not just a commodity but to do something for its own pleasure. In craft production, the work expresses the individual’s talent and creativity. Therefore it is less standardised form of production than the machine based mass industrial production.

- Design

Design itself is highly artistic discipline with different way of expression as graphic design, industrial design, system design etc. However design is primarily creative work, as said in following definition: “Design is the human power to conceive, plan, and realize products that serve human beings in the accomplishment of any individual or collective purpose.”<sup>4</sup>

- Fashion Design

The definition of fashion designing is very wide and covers host of activities relating to conceptualizing, creating the designs and preparing patterns for costumes, clothes, garments, clothing accessories, jewellers or any other articles intended to be worn by humans. Most of high-fashion designers, who established fashion trends, are self-employed and design for some fashion companies. These designers create original garments, as well as clothing that follow other fashion designers who are working for apparel manufacturers, creating designs of men’s, women’s, and children’s fashions for the mass market.

- Film & Video

Film and video produces, beside feature films, mass adverts spots promotion and other videos for cinema, video, DVD and television. The integral and very strong part of this industry is distribution, broadcasting and cinema showing. Through wide distribution channels film and video industry provides film and tape delivery and storage, as well as buying and selling of film and video distribution rights.

- Interactive Leisure Software

Interactive Leisure Software products are generally known as video games. The same as traditional games, they are created with the purpose of entertainment and support learning in schools. Teachers play a crucial role in the successful use of these games for learning and motivating children to learn competencies such as communication and team work.

- Music

<sup>2</sup> <http://www.businessdictionary.com/definition/advertising.html>

<sup>3</sup> UK Department for Culture, Media and Sport <http://www.culture.gov.uk/images/publications/Arts2001.pdf> (accessed Jun, 28, 2011)

<sup>4</sup> Richard Buchanan is professor of Design, Management and Information Systems at the Weatherhead School of Management at Case Western Reserve University



Music industry, well known from the second half of twenty century as recording industry, include music performance, composition, distribution, promotion, production, training and education, as well as record labels, recording studios, live music venues, manufacturing and sales music equipments.

- Performing Arts

The performing arts covers all sorts of stage art, performed live by artists for an audience, it can take the form of theatre, opera, poetry, dance, ballet, concerts, the circus, puppetry, etc., Performing arts are a special case since their products are expressed only as an intangible service, unlike other sectors of creative industries that produce tangible creative goods.

- Publishing

Publishing and printed media are the literary production in the form of various types of books as novels, poetry, education, entertainment as well as all types of printed media, newspapers and magazines. Publishing and print media are very important sector of creative industries from the cultural and economic point of view. In the last twenty years, publishing and print media are facing a growing trend of electronic publishing, which forces them to think of alternative ways of preservation the market positions.

- Software & Computer Services

Software & Computer Services generally include the development of computer software and providing related services. This industry, beside it's creatively sector, includes production of equipment, consultancy, training etc. The importance of this industry is primarily reflected in the software development business that can directly contribute to new jobs creation as a labour-intensive activity, and to bring significant revenues to the country's GDP. In addition, this industry significantly influence to growth of other industries' production and services, due the fact that ICT systems are essential for all other businesses.

- Television & Radio

Radio TV industry includes broadcasting station and a network of companies that produce programs or sell the rights to broadcasting the recorded TV and radio programs. Programs are usually consisting of national and local news, some specific thematic contents, musical shows, movies, various entertainment shows, commercials and other. Some of the larger and better equipped stations produce own programs, but most of the programs are produced outside the broadcasting radio television stations by specialized companies that are usually classified into film and video industry.

Since the activities of the creative industries are overlapping with some other industries there are lot of classifications of these industries, but classification done by UNCTAD is very illustrative due its horizontally layers according the types of activities.

### 3.2. Development of the creative industries

History of the creative industries dated long before the first formal use of that phrase, however organized development of the industry begins only when some economists from the developed countries began to understand its potential as a generator of new job places and as a significant export opportunity. The beginning of the modern creative industry can be related to initiatives of creative and enterprising artists who have invested their own funds in various forms of creative production, with uncertain possibilities to return of investment. Over time, in creative industries have come professional managers specialized in this type of activity bringing the spirit of entrepreneurship. And just this symbiosis of arts and entrepreneurship has delivered the modern creative industries. Today there is no doubt, should be creative industries develop or not, but planners are trying to find as much as possible effective way for its development. Also, they gladly include all stakeholders as artists, arts managers, NGOs, cultural institutions, founders and the education sector, in definition of long-term economic development plans counting that all investment will be multiply returned.

## 4. THE CURRENT POSITION OF THE CREATIVE INDUSTRIES

Despite all the attention directed to the creative industries their position in most of countries aren't adequate in comparison with their economic potential. However in some developed countries as UK, USA, Canada and Australia, the creative industries are concerned as economic sector with high priority in government's plans. Very deep economic crisis, that has shocked the leading developed countries, has redirected attention to the creative industries as key factor in structural transformation of world economy. Thanks to their flexibility and adaptability creative industries can initiate the



process of economic recovery, without significant investment. For example, the UK film industry in “compares with a current cost of the film tax relief of around 110 million pounds a year, meaning that an extra 13 pounds in GDP is generated for every one pound invested. Overall, the report estimated that the movie business contributed 4.6 billion pounds to the economy last year, compared with around 4.3 billion in 2007.”<sup>5</sup>

Also, EU Commission has show a particular attention to the creative industries in their study “The Economy of Culture in Europe” issued in 2006. which “has been the starting point of a quick political revaluation of the Creative Industries in Europe and its member states.”<sup>6</sup> This study underlines the sustainability development of whole culture and force member states to adopt the development plans of these industries. “More importantly, some EU member States have been looking into ways of analysing the commercial value of creative industries without necessarily attempting to capture their cultural and social values. Those countries are developing programmes to turn creativity into industrial successes. These attempts are relayed in cities and regions.” (p. 32)

#### **4.1. The creative industries in Serbia**

The creative potential of Serbia, its creative capital, and especially the different domain of entrepreneurship in the culture, therefore, the contribution of the private sector, never gained enough attention in the development process neither at national nor at the regional level. (Kreativne industrije i ekonomija znanja p.11). Unfortunately this statement is still valid, and there is no indication that Serbian Government has intention to change anything. Only active voice has come from some NGO as well as from some art associations as is Academica from Belgrade. These initiatives result in 2006. in new way of thinking about creative industries in Serbia. The first tangible result was the study „Creative industries: recommendations for the development of creative industries in Serbia” which was the result of one-year project initiated by the British Council in Belgrade, the field of creative work is beginning to be considered in a different socio-economic perspective. (Mikic, 2008. p 40,41) Thanks to this study and enormous effort of different organizations now we do have vide initiatives to create creative clusters in Serbia. The first one is Creative cluster of Vojvodina with numerous of artist and creative entrepreneurs associated in very powerful organization. The similar cluster is organizing in Southeast region of Serbia.

#### **4.2. The creative industries in the South East Europe**

In order to properly perceive the change mode in the context of the creative economy of South East Europe, it is important to analyze several key preconditions for the development of creative economy in Southeast Europe. The first and most important of these key dimensions related to the issue of (de) centralization - with one hand as regards the areas of financing, on the other hand, considering the spatial dimension (de) centralization. In South Eastern Europe there are two levels of centralization that can be spoken when exploring the area of creative industries. The first level and centralization stems from the fact that until recently, financial support for these activities was centralized at the state level. It is still the tendency is present, whether we are talking about financial aid that is allocated to central level or that level of local administration and government. Investment in creative industries was also minimal, as businesses venture and private initiatives in this field. (Primorac, 2010, p 104). The way out from this *circulus vitiosus* is introduce the entrepreneur behaviour in creative industries and leave the habit to wait the support from government’s budget as unique sources of financing.

### **5. THE CREATIVE ECONOMY**

The best illustration how important is creative economy gives the following citation “Britain makes more money from music than from its car industry. In the United States, the core copyright industries achieved foreign sales and exports of \$60.18 billion-a figure that surpasses, for the first time, every other export sector, including automobiles, agriculture, and aircraft.”<sup>7</sup> Knowing this facts it seems very logical why UN gain such attention to the Creative economy. They suggest that that “Fundamental to an understanding of the creative economy – what it comprises and how it functions in the economies of both developed and developing countries – are the evolving concepts of “cultural industries” and “creative industries”.( Creative Economy, Report 2010,p3) This publication, also contains a number of successful examples from undeveloped countries: film industry in India

<sup>5</sup> The UK Film Council report for year 2010. - <http://www.reuters.com/> (accessed July 3. 2011.)

<sup>6</sup> <http://www.european-creative-industries.eu/> (accessed July 3.2011)

<sup>7</sup> John Howkins - The Creative Economy: How People Make Money From Ideas, 2008. Product description [http://www.amazon.com/gp/product/0140287949/sr=8-1/qid=1154956721/ref=pd\\_bbs\\_1/104-7929277-7071141?ie=UTF8](http://www.amazon.com/gp/product/0140287949/sr=8-1/qid=1154956721/ref=pd_bbs_1/104-7929277-7071141?ie=UTF8) (accessed July 10.2011)

and Nigeria, fashion industry in Africa and Asia, soap operas in Mexico and Brazil, tourist attractions in Brazil and Caribbean. Such industries in developing countries have been promoting trade, while often providing training and employment to the poor. The best example is Nigeria's film industry with revenue of almost 3 billion USD. It is the third largest film industry in the world, following the US and India. Their "Nollywood" produces more than 1,000 films annually, creating thousands of jobs and is the country's second most important industry after oil.

It is obvious that the shortest way to improve a country's economy is to encourage creativity and entrepreneurship in the cultural and creative industries. Developing countries in particular have a good reason to run their economies in such a way taking into account the untapped potential of tourism, national heritage and culture that can be a locomotive in the economic recovery. The current approach, of most third world economies, to establish a production and export of raw materials has proved to be fatal due to the price fluctuations and limited natural resources as well.

### 5.1. The creative industries - Fact and figures

Due to the limited scope of this work have been presented data only from two sources, but they are sufficiently illustrative to confirm the assumption that the creative industries have the highest growth rate compared with any other industries, especially in comparison with conventional manufacturing industries. The importance of the creative economy has been emphasise in a recent survey on employment in the cultural sector conducted by the EU, which showed that the rate of employment growth in cultural sector were four times higher than the EU average. The similar situation is in UK, shown in Table 3.

Table 2: Gross Value Added (GVA) of the Creative Industries, UK - 2008 Data

Sector	GVA at basic prices (£million)	Proportion of total UK GVA (%)
1. Advertising	7,800	0.7%
2. Architecture	3,600	0.3%
3. Art & Antiques	300	0.03%
5. Design	1,600	0.2%
6. Designer Fashion	100	0.01%
7. Film, Video & Photography	2,700	0.3%
9 & 10. Music & Visual and Performing Arts	3,200	0.3%
11. Publishing	10,100	1.0%
8 & 12. Software & Electronic Publishing	26,400	2.5%
8 & 12. Digital & Entertainment Media	200	0.02%
13. TV & Radio	3,200	0.3%
Total GVA for Creative Industries	59,100	5.6%
Total GVA for all Industries	1,053,9002	

Source: Annual Business Survey (ABS), Office for National Statistics (from Creative Industries Economic Estimates, 2010)

Table 3: Creative Employment, Great Britain - 2010 Data (July - September)

Sector	Employees in Creative Industries	Self-employed in Creative Industries	Employees doing creative jobs in other industries	Self-employed people doing creative jobs in other industries	Total Employment
1. Advertising	89,100	25,400	163,800	21,000	299,200
2. Architecture	63,300	35,300	26,300	3,500	128,400
3. Art & Antiques	6,600	3,200			9,800
4. Crafts			66,300	45,100	111,400
5. Design	35,000	56,600	113,500	20,400	225,400
6. Designer Fashion	2,500	3,700	3,200	400	9,700
7. Film, Video & Photography	26,000	13,300	10,700	10,500	60,500
9 & 10. Music & Visual and Performing Arts	67,200	136,300	33,300	69,000	305,800
11. Publishing	151,100	20,500	55,700	9,300	236,600

8 & 12. Software & Electronic Publishing	347,000	81,000	290,600	34,500	753,000
8 & 12. Digital & Entertainment Media	5,600	700			6,200
13. TV & Radio	77,300	37,300	10,500	7,200	132,300
Total	870,600	413,200	774,000	220,700	2,278,500
Employment within Creative Industries				1,283,800	
Employment in businesses outside Creative Industries				994,700	
Total Creative Employment				2,278,500	
All Employment <sup>1</sup>				29,189,000	
Total creative employment as a proportion of all employment (%)				7.8%	

Source: Labour Force Survey (LFS), Office for National Statistics (from Creative Industries Economic Estimates, 2010)

Table 4: Number of business in the Creative Industries, UK - 2010 Data

Sector	Number of enterprises	As a proportion of Creative Industry Enterprises (%)	As a proportion of all enterprises (%)
1. Advertising	14,800	8.1%	0.7%
2. Architecture	11,500	6.3%	0.5%
3. Art & Antiques	2,700	1.5%	0.1%
5. Design	14,200	7.8%	0.7%
6. Designer Fashion	900	0.5%	0.04%
7. Film, Video & Photography	9,900	5.4%	0.5%
9 & 10. Music & Visual and Performing Arts	30,800	16.9%	1.5%
11. Publishing	7,700	4.2%	0.4%
8 & 12. Software & Electronic Publishing	81,700	44.9%	3.9%
8 & 12. Digital & Entertainment Media	200	0.1%	0.01%
13. TV & Radio	7,700	4.2%	0.4%
Total	182,100	100.0%	8.7%
All enterprises	2,100,400		

Source: Inter-Departmental Business Register (IDBR), Office for National Statistics (from Creative Industries Economic Estimates, 2010)

Notes The data available did not allow us to measure the number of enterprises in the Crafts Industry.

Table 5. Creative goods: Exports, by economic group, 2002 and 2008 (in millions of \$)

	World		Developed economies		Developing economies		Transition economies	
	2002	2008	2002	2008	2002	2008	2002	2008
All Creative	204,948	406,992	127,903	227,103	75,835	176,211	1,210	3,678
Art Crafts	17,503	32,323	8,256	11,443	9,202	20,715	45	164
Audiovisuals	462	811	425	726	35	75	3	10
Design	114,692	241,972	60,967	117,816	53,362	122,439	362	1,716
New Media	17,365	27,754	11,422	13,248	5,908	14,423	36	82
Performing Arts	9,689	26,136	8,947	22,539	698	3,323	43	274
Publishing	29,817	48,266	25,970	38,753	3,157	8,138	690	1,376
Visual Arts	15,421	29,730	11,916	22,578	3,474	7,097	31	56

Source: UNCTAD, based on official data in UN COMTRADE database (from Creative Economy report 2010)

Table 6. Creative goods: Top 20 exporters worldwide, 2002 and 2008

Rank	Exporter	Value (in millions of \$)		Rank	Market share %	Growth rate %
2008		2008	2002	2002		
1	China	84,807	32,348	1	20.8	16.9
2	United States	35,000	18,557	3	8.6	13.3
3	Germany	34,408	15,213	6	8.5	14.7
4	China, Hong Kong SAR	33,254	23,667	2	8.2	6.3

5	Italy	27,792	16,517	4	6.8	9.7
6	United Kingdom	19,898	13,657	7	4.9	6.5
7	France	17,271	8,999	9	4.2	10.2
8	Netherlands	10,527	3,686	15	2.6	11.6
9	Switzerland	9,916	5,141	11	2.4	13.5
10	India	9,450	-	-	2.3	15.7
11	Belgium	9,220	5,387	10	2.3	6.7
12	Canada	9,215	9,327	8	2.3	-0.9
13	Japan	6,988	3,976	13	1.7	14.7
14	Austria	6,313	3,603	16	1.6	8.5
15	Spain	6,287	4,507	12	1.5	4.9
16	Turkey	5,369	2,154	23	1.3	15.0
17	Poland	5,250	1,983	24	1.3	14.9
18	Mexico	5,167	3,797	14	1.3	9.1
19	Thailand	5,077	2,899	18	1.2	10.3
20	Singapore	5,047	2,619	21	1.2	6.0

Source: UNCTAD, based on official data in UN COMTRADE database (from Creative Economy report 2010)

Table 7 World exports of all creative industry (goods and services), by subgroup, 2002 and 2008

Subgroup	Value (in millions of \$)	As % of all creative industries	As % of total world export	Value (in millions of \$)	As % of all creative industries	As % of total world export	Growth rate (%)
	2002			2008			2003-2008
All creative industries	267,175	100.00	-	592,079	100.00	-	14.4
All creative goods	204,948	76.71	3.52	406,992	68.74	2.73	11.5
All creative services	62,227	23.29	3.79	185,087	31.26	4.80	17.1
Heritage	25,007	9.36	-	43,629	7.37	-	-
Art crafts goods	17,503	6.55	0.30	32,323	5.46	0.22	8.7
Other personal, cultural and recreational services	7,504	2.81	0.46	11,306	1.91	0.29	7.3
Arts	25,109	9.40	-	55,867	9.44	-	-
Visual arts goods	15,421	5.77	0.27	29,730	5.02	0.20	12.8
Performing arts goods	9,689	3.63	0.17	26,136	4.41	0.18	17.8
Media	43,960	16.45	-	75,503	12.75	-	-
Publishing goods	29,817	11.16	0.51	48,266	8.15	0.32	7.3
Audiovisual goods	462	0.17	0.01	811	0.14	0.01	7.2
Audiovisual and related services	13,681	5.12	0.83	26,426	4.46	0.69	11.0
Functional creations	194,283	72.72	-	454,813	76.82	-	-
Design goods	114,692	42.93	1.97	241,972	40.87	1.62	12.5
New media goods	17,365	6.50	0.30	27,754	4.69	0.19	8.9
Advertising and related services	8,914	3.34	0.54	27,999	4.73	0.73	18.4
Architecture and related services	18,746	7.02	1.14	85,157	14.38	2.21	20.9
Research and development services	12,639	4.73	0.77	31,111	5.25	0.81	14.8
Personal, cultural and recreational services	21,927	8.21	1.34	40,821	6.89	1.06	10.4

Source: UNCTAD Secretariat calculation based on official data in UN COMTRADE database (from Creative Economy report 2010)

## 5.2. Entrepreneurship in the Creative industries

On the very beginning we should be aware that there are the crucial question how to delineating the natures of entrepreneurship in the creative industries, even if these have received significant attention from economists. The identification of entrepreneur role becomes all the more difficult when we consider that some segments of the creative industries are organized in a complex way as project-based activities. However on another hand, the OECD's position on this question is very clear, they consider that "Encouraging entrepreneurship is high on the agenda of governments in OECD member countries and in transition, emerging, and developing economies, as entrepreneurs are the catalysts of growth, combining capital, innovation and skills. The importance of entrepreneurship stands out in this time of innovative change, and fostering a climate to help the dynamism in firm creation is considered fundamental worldwide."<sup>1</sup>

Since the creative business highly depends on the personal talent, skill and ability it is very obvious that entrepreneurship is the crucial factor for creative industries development. According to this matter of fact in 1999 the British Council has start the Creative and Cultural Economy programme<sup>2</sup>, within his Arts department having in mind an idea to work with the UK's creative sectors and to develop a programme of work that would share the UK's experience of developing the creative economy and the wider impact of this process in terms of education, economic regeneration, social inclusion and international engagement. This programme give particular attention to stimulate young people to start the own business in creative sector. Therefore they announce the call for Young Creative Entrepreneur (YCE) Award Programme, giving participant definitions:

- Somebody working in the creative sector who is able to demonstrate business success in the classic terms of business growth (profit, market share, employees) and/or in terms of his or her reputation (creativity, quality and aesthetic) amongst their peers.
- Somebody working in the creative sector who has developed a successful (in terms of impact and reach) social or not-for-profit enterprise in this sector.
- Somebody working in the creative sector who has shown leadership in the industry by championing its development in their country.
- Somebody working in the creative sector who has developed initiatives (exhibitions, trade fairs, festivals etc) that develop and grow the market for this sector in their country.

This call covers all sectors of the creative industries, but creative entrepreneurs should possess the following qualities:

### Entrepreneurial ability

- Risk taking: Can assess, enjoy and face risks, with the skills/initiative to successfully drive ideas forward
- Passion for their creative sector: Creative entrepreneurs are the mediators that bring creative products to the market and require an ability to talent spot, respect, understand and manage creativity
- Corporate skills: Business acumen, commercial awareness, managerial ability, vision and strategy
- Interpersonal skills: Ability to sell an idea, negotiate and network

### Innovation/ development of new business models

- Finds new, innovative ways to take creative work to audiences and communities – new models of production, distribution, value – highlighting the wider social, economic and cultural benefits in doing so
- Original ideas and the flexibility and self-confidence to take these to market

### Leadership ability/potential to change their sector

- Leadership ability: Have the vision to combine their creative and entrepreneurial skills to be a leader in their national creative community. Ability to share the lessons of their IYCE experience with others.

<sup>1</sup> <http://www.oecd.org/> (accessed July 7, 2011)

<sup>2</sup> <http://creativeeconomy.britishcouncil.org/creative-entrepreneurship/young-creative-entrepreneur-programme/> (accessed July 11, 2011)



- Agent of change: ability to make a difference – as not merely successful in business terms but also intervenes in the domestic market to impact positively on its infrastructure.

#### **Market awareness and understanding**

- Market awareness: Knowledge of the local market situation and their role in it
- Ability to spot gaps within the market and exploit these opportunities into real solutions

#### **International outlook and ability to network with the UK/globally**

- International outlook: Wants to develop a mutually beneficial culture of personal/professional engagement and collaboration with the UK, and to benefit from dialogue with other international participants and is keen to develop future international projects
- Such qualities are valid around the world and can be the very good example for other countries how stimulate and support the creative entrepreneurship especially for young skilled people.

### **6. CONCLUSION**

Creative industries are the industries of the future and will absorb the huge number of surplus labour force which is due to the fact that traditional industries are increasingly implementing automation and robotics, which resulting with significantly reducing actual number of employees. Because of that labour-intensive sector of creative industries can be real way out from the huge problems of unemployment and poverty especially in the developing countries and transition economies. In addition, low-investment in opening new jobs allows these countries to finance new jobs without expensive credit lines from international financial market. The best example of this approach is China, which is only in 20 years from extremely underdeveloped and poor countries has become the second economy in the world with a tendency that in the next few years takes the leading position. It should be taken in consideration that China from the very beginning has not been in high technologies, but just in crafts and textile industry, whose revenues are then financed the high-tech industry.

This example should be followed by the Western Balkan countries, which are still looking for their place in a complex structure of the European economy, as their logical and largest partner. This is particularly important, due the fact that EU member states are working very intensively on promoting and encouraging the development of own creative industries. Therefore governments in the Western Balkans have to make plans for the development of these industries, very quickly otherwise they will lose this race long before the start.

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## DECREASE POVERTY THROUGH ENTREPRENEURSHIP PROMOTION AND COMMENCEMENT OF FAMILY BUSINESS

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### Abstract

Small or family managed businesses are the driving force behind poverty reduction and stimulation of economic growth in transitional economies. Enforcing the entrepreneurship spirit could significantly support the objective for the decline of unemployment rate and augmentation of the living standard of the population. For these reasons, constraints limiting the development of entrepreneurs should be decreased with the tendency for the same to be eliminated. Some of the major constraints are the inappropriate educational background, lack of experience, as well as restricted access to available funds.

In Macedonia, many of the family owned businesses are started with the objective of earning a monthly income for covering business cost and covering the cost of living for the entrepreneur and his/her family. Considering the high unemployment rate in Macedonia, from the former it could be concluded that although entrepreneurs are striving for high profits, the primary objective is to earn a salary and escape the potential poverty problems eminent in the Macedonian economy.

In order for the entrepreneurs' businesses to be supported, step by step strategy should be put in place, a strategy that will capture and eliminate the primary restrictions obstructing the entrepreneur's development. This strategy should be consisted of program that will improve the entrepreneur's education and skills, change the way of thinking i.e. remodel the mentality "I know everything, I can do everything by myself" - of many entrepreneurs, and improve the availability of funds, more precisely, availability of low cost funds needed for business startup, and later on for business expansion.

Concluding remarks will present that initially foreign aid, and aid in general directed toward entrepreneurship development should be primarily focused on improvement of their skills and educating the same regarding the accurate analysis of financing options. With other words, giving financial aid to entrepreneur who doesn't have the needed skill to manage the funds adequately is the same as burning the money. - "Give a man a fish and feed him for a day, teach a man to fish and feed him for a life" - would be adequate description of what should be done. A program, which will provide in depth clarification of the potential financial and non-financial problems that might arise and adequate solutions of the same, should be established. In addition, maybe the most important point is that, entrepreneurs should fully understand the role and the potential of family owned business in the objective of poverty reduction and improved standard of living.

**Keywords:** Entrepreneurship promotion, Poverty, Programs, Education, Financial resources

### 1. INTRODUCTION

The dissolution of Yugoslavia has initiated the privatization process of social companies, which in turn offered the possibility for development of entrepreneurs. The problems were that many of the newly privatized companies' layoff large number of employees, thus sharply increasing the unemployment rate and decrease the living standard in Macedonia. Moreover, the new entrepreneurs lacked crucial skills and experience needed for running a company in a capital manner. The dissolution have opened the gates for entrepreneurs' development, and the transition itself has imposed a lot of constraints, and at the same time influenced the economic growth.

For these reasons, policy makers, should develop a strategy for elimination of the most basic constraints obstructing the development of self employed entrepreneurs. Constraints consisted of lack of experience, inadequate education and limitation of financial resources availability should be primary focus of the entrepreneurship development strategy.

Moreover, policy makers should not be focused solely on development of large companies in order to achieve an economic growth. The focal point should be the decrease in poverty and improvement of living standards, through the decrease of jobless population. As result of the former, the government should develop a strategy for promotion of self employment entrepreneurs.

## 2. IMPORTANCE OF ENTREPRENEURS FOR TRANSITIONAL COUNTRIES

It is a well known fact that small firms are responsible for the biggest part of an economic activities. Although the corporations are the one employing thousands of individuals, their activities have little contribution toward the economic growth. While corporations do impact the economic growth, it should be noted that the economic growth should not be seen only from the point of view that large corporations are contributing significantly for the GDP. Instead, the economic growth should be also viewed from different perspective i.e. the perspective of technological innovation, increase competitiveness, increase in production efficiency, and increase in investment activities all of these leading toward primarily, decrease in the unemployment rate, and later on increase in wealth. The former is of crucial importance when considering the transitional economies, especially economies with socialist background. In some of these economies, as a result of the system itself, the idea behind entrepreneur's spirit and the functioning of small firms has been abandoned until the transformation into capitalist society. Facing the capitals functioning, many of the state owned companies have been privatized and large number of the population has been faced with unemployment. During the period of privatization, the newly privatized companies provided little or no new employments, whereas they were responsible for job destruction and increased in unemployed individuals (Mete Karayel and Münire Ciftci, 2007, pp.180 - 182 ). The increased in unemployment rate had significant negative impact initially for the living standard of the individuals and later on for the decrease in economic development.

After privatization, the big companies continued to contribute toward economic growth, but the problem was, and is some transitional countries such as Macedonia this problem is still evident after 20 years of transition, the sudden high unemployment rate and decrease in the living standard of the individuals which in turn, gradually lead toward increased poverty. Many of the jobless individuals unaware of the entrepreneurship concept were forced to become entrepreneurs themselves in order to survive the difficult economic situation they were faced with. Progressively, many of these entrepreneurs have established firms that grew into large companies, significantly affecting the economic growth from all aspects. As the concept of entrepreneurship become part of individual's everyday life, many of them have seen a possibility to improve their standard by engaging into some economic activity.

The success of small firms growing into large companies (corporations) is important for the economy because they reduced unemployment, economically influence the development of the surrounding region, and have undertaken investment activities. But what is more important for economic development, are the small firms themselves. They are important because they are the mechanism for direct decrease of unemployment and thus decrease in the burden for the state, originating from the unemployed population (Mete Karayel and Münire Ciftci, 2007, pp.180 - 182). These firms are the primary source for the economic development, in a way that primarily they remove the cost of the government for taking care of the unemployed population. Secondly, they are contributing toward the government revenues since they are paying taxes. Thirdly, the newly established firms have created a competitive discipline for the companies founded under the socialist system (Mete Karayel and Münire Ciftci, 2007, pp.180 - 182). The most important point is that through entrepreneurship activities, the entrepreneurs are improving the standard of living for themselves and their family. Stated differently, the lack of competition have made the existing companies lazy in terms of innovativeness and improvements in efficiency, thus the new entrepreneurs firms brought fresh thinking which forced these companies to restructure their activities and the organization as a whole. The former have lead toward increased efficiency of both the newly created and socialist companies.

In addition entrepreneurial firms could be considered as a dynamic firms, because of their learning curve resulting in numerous research regarding the process for conducting a business (Mete Karayel and Münire Ciftci, 2007, pp.180 - 182). In some instances, entrepreneurship is considered to be the fourth factor of production i.e. a factor responsible for the formation of wealth by joining together the current production factors in new ways (Erik Stam and André van Stel, 2009, pp. 5 -7). This is in a sense that entrepreneurs are using new and innovative approaches of doing business in order to first and foremost improve their standard of living through profit maximization.

(Landes, 1998, pp. 44) is stating that the entrepreneurship has been perceived as fundamental mechanism for economic development. Some analyses draw the conclusion that although economic growth might not be experienced in low income countries as a result of the entrepreneurship activates, it is achieved in the transitional countries, where entrepreneurship focused on growth significantly contributes for

3 The unemployed population has the right on health insurance paid by the government, social help, and other benefits that significantly impact the level of government expenditure.

the macroeconomic growth (Vilasinee Bunyasrie, 2010, p.151- 152). Additionally, viewing economic growth in terms of GDP in transitional countries, is more evident if growth oriented entrepreneurs exist in comparison with the general entrepreneurship (Vilasinee Bunyasrie, 2010, p.151- 152). More over it could be said that the small firms are the main pillar of a transitional economy and they represent the key source for economic growth because these businesses are bringing value for the economy in terms of innovative products or techniques (Vilasinee Bunyasrie, 2010, p.151- 152). Noteworthy is to say that the former is indirectly pointing out the role of the small entrepreneurship firms as a key mechanism for job creation i.e. self-employment.

As a result of the low level of incentives for innovation under the socialist system, the transition into capitalist system opened new prospects for entrepreneurs to use the resources for high productivity activities. In addition, in order for the transition economies to experience a growth and economic development, there was the need for employment of new technologies, and these technologies were brought by the capitalist entrepreneurs (Saul Estrin, Klaus E. Meyer, and Maria Bytchkova, 2005, pp. 2 -25).

Talking about the economic growth, two differences should be made. Namely, the difference between self – employed entrepreneurs, and entrepreneurs whose business grew and increase the employment in the region (Saul Estrin, Klaus E. Meyer, and Maria Bytchkova, 2005, pp. 2 -25). From the former it could be concluded that the entrepreneurs can directly and indirectly influence the economic growth and development. The self – employed entrepreneurs are contributing toward the decrease of unemployment rate and thus indirectly supporting the economic growth. On the other hand, the entrepreneurs starting a small firm and latter on expanding its activates directly influences the GDP growth. Stated differently, entrepreneurship can significantly help in the objective of poverty reduction and at the same time support the economic growth and development.

Worth mentioning is the fact that many of the jobless citizens are still maintaining some level of living standard although, formally, they do not have any income. This is because of the fact that they are working in the informal economy and thus earning some income, which is not registered and no taxes are paid for. These activities are with the objective of self-employment, an example would be the new car import legislation, when some entrepreneurs have imported second hand cars and sold them on the Macedonian market. The problem was that, for many, this was a short term business, but it did increase the economic activity.

### **3. MAJOR CONSTRAINS SUFFOCATING THE ENTREPRENEURS SPIRIT**

#### **3.1. Insufficient educational background**

“Claiming to go entrepreneurial does not involve only creation of new businesses and firms but also incentives and provision of relevant education and training. Young business leaders need to be educated and trained, particularly when it comes to exploitation of technologies and innovations” (Mohand-Said Oukil, 2009, p. 10 – 13)

One of the main constrain for the entrepreneurs is their educational background in terms of the knowledge they possess for developing and managing a business. This is in a way that, although many entrepreneurs might be the best in their field of expertise and accordingly to have the desire to establish a family owned business, they might lack the necessary skill to manage the business. More precisely, they will know how to set up the firm, they might conduct an analysis of what the market needs and offer the best product, but they don't know how to manage the business itself. Suddenly they are making mistakes in the area of financing, marketing and organizing and managing employees.

Although it is generally know fact that an entrepreneurs will not know everything he/she needs for proper functioning of the firm, the problem here is the mentality of the entrepreneurs themselves the mentality of “I know everything, I can do everything by myself”. This way of thinking is as a result of the insufficient education and lack of experience in term of managing an organization whether small or a large one. There are many consulting companies existing in the market, and the entrepreneurs should seek their consultation services during the early stages of the firm's development. For instance, consulting companies might provide to be helpful for a non-finance entrepreneur in managing his/her financing sources. One of the most frequent mistakes that entrepreneurs are doing is the mismatching of the maturity of financial sources with the investment activity to be financed. For instance, entrepreneurs with no financial background usually are acquiring short term loans to finance long term investment. The problem is that the loan will mature before the investment starts to generate any revenue thus creating liquidity problems. These liquidity problems might result in lost business



due to bank collateral. The consequences from such a simple mistake might be devastating for the entrepreneurs because of the lack of desire to ask for an advise from investment advisors. The former is an example regarding portion of the issues that might go wrong as a result of inadequate education. Other things considered the entrepreneurs could face problems in the process of management of their employees, their customers, suppliers, etc.

### 3.2. Lack of experience

This constrain of the entrepreneurs is closely related with the inadequate educational background in terms of management of specific business activities. Namely, although entrepreneurs might have specific experience<sup>4</sup> in some areas such as - product innovation, employee management, financial management, marketing, and lack the needed experience for most of the other relevant activities. One of the main problems is not the lack of experience; instead the problem is the absence of the aspiration to acquire the needed knowledge and accordingly, the experience for improvement of personal skills.

Because of the lack of market experience and the bureaucratic planned economy, many of the socialist directors lack the managerial skills needed for proper management of a firm (Saul Estrin, Klaus E. Meyer, and Maria Bychkova, 2005, pp. 2 -25).

### 3.3. Limited access to financial resources

Another major constrain for the entrepreneurs in transitional economies are the availability of funds for starting a business or for expansion of the business activities. There are two perspectives that should be taken into consideration when discussing the financial availability. Firstly, the general access to financial resources and secondly the availability of low cost capital.

The choices that an entrepreneur might have for financing its entrepreneurial activities in transitional economies are the family owned money, loans from commercial banks, venture capitalist or angel investors, the capital market, and different governmental programs for supporting entrepreneurs. Although there are various financing options present in the markets, we should see the real availability of these options. Namely, in most transitional countries, especially in Republic of Macedonia, the amount of family money is highly limited for the entrepreneurs, since in most cases they have low living standard and thus low savings. It is suggested that because of the insufficient family wealth, a well developed financial system should be established if an economy wants to support the development of entrepreneur activities (Mete Karayel and Münire Ciftci, 2007, pp.180 - 182 ).

Considering the capital market, it has limited capacity because very few entrepreneurs are able (or willing for that matter) to sell part of their ownership, or sell a debt to other investors usually seeking low risk investments. One of the widely available options is the venture capitalist and angel investor financing. The drawbacks of this form of financing are the lost control over the firm and the high returns that the investors are demanding. Most often entrepreneurs in Macedonia are financing their activates using the commercial banks as a primary source of funds and from couple of years back, the different governmental programs.

Using bank loans might be a good option for financing an expansion of a firm, but the new entrepreneurs have the need of funds for financing their startup firms and this is the stage where they face the major constrain. The problem is that with most of the banks, entrepreneurs should practically show that they don't need the money so that banks are willing to approve the loan. The former is a direct result of the banks unwillingness to finance "risky" borrower, and the lack of the aspiration to support new entrepreneurs. Stated differently, banks are unenthusiastic when it comes to lending to newly created firms or small firms because of the possible high risk and high administrative cost for the specific loans (Donald J. Johnston and Carlos Magariños, 2004, pp. 37).

One of the main reasons responsible for the financing problems faced by entrepreneurs is the inadequate assortment of financial products and services and lack of information for the banks as well as the small firms (OECD, 2006, p. 3 – 4). Very often banks may be unwilling to offer their products to young firms or start up business due to the deficiency in the level of collateral required, since these firms have the opportunity to enjoy above average profits that are followed with the same level of risk (OECD, 2006, p. 3-4).

4 This is from a perspective of their past employment i.e. employment and position they have held within the socialist companies.

5 This process is a bit debatable because there wasn't a lot of marketing programs used in the planned economy, so most probably this would be one of the weakest points for the entrepreneurs in terms of experience.

Presenting the numerous options for financing, one might say that raising funds should not be considered a problem faced by the entrepreneurs. But these financing options have another perspective that should be taken into account i.e. the cost of these funds. As a result of the way in which the thinking is shaped in transitional economies, there are two aspects related to the cost depending on the financing option. The psychological cost is usually present when the entrepreneur needs to give up a part of the ownership in his firm to third party investors such as the angel investors or venture capitalist. The financial cost of capital is another issue that is highly relevant for the entrepreneurs and is crucial for the business activities.

Although the psychological cost could be “easily” overcome, the financial cost is much difficult to solve and this is where most of the entrepreneurs give up and does not implement their activities. As it was previously mentioned, in transitional economies the main source for financing is the banking sector. This sector has high interest rates and in order to protect itself against the increased risk of the entrepreneurs segment, they set up a financial products and services with above market interest rates. In turn, these high interest rates demand that the entrepreneur earn much higher profits in order to cover the interest expense as well the business operating costs.

The government support has significant role in the financing stage of the entrepreneur’s activities, in a way that some government programs offer “cheap” loans for newly established or small firms, and these loans drastically decrease the interest burden for the entrepreneurs.<sup>6</sup> Another government programs that might eliminate portion of the financing costs, are the different grants available for financing investment activities of entrepreneurs.

### **3.4. Suggestions for improvement of entrepreneurs efficiency resulting in decreased poverty and economic growth**

“In contexts where business culture is not highly developed, boosting an entrepreneurship mindset requires an active role of governments and education institutions to make citizens exposed to entrepreneurship and aware of all possibilities and opportunities” (Mohan Said Oukli, 2009, p.13).

Economic development and growth objectives in transitional economies should be accompanied by activities directed toward strengthening of the financial institutions, creation of adequate financial instruments, and supporting the relationships between the lending institution and entrepreneurs (Donald J. Johnston and Carlos Magariños, 2004, pp.37).

Suggestions regarding the steps that should be included in the strategy for the entrepreneurial development could be presented from the following perspectives:

- The primary focus of foreign and government aid
- Developing a reliable financing mechanism
- Presentation of the entrepreneurial benefits
- In – depth education about the concept of self employment
- In-depth education about the benefits of paying taxes

Firstly, the foreign aid as well as the aid provided by the transitional government should be directed toward education of the existing and potential entrepreneurs. This is in a sense that instead of just offering a financial aid, they should first offer a preparation of the entrepreneurs in terms of managing financial resources and resources in general, for that matter. This pre –entrepreneurial activity preparation should be formulated in a way that will be adequate for entrepreneurs with different background. It might also include testing of their skills and abilities in a virtual company, as a prerequisite for granting the financial and any other support offered by the government or other institutions.<sup>7</sup>

Secondly, the state should establish a reliable financing mechanism through the development of advanced financial system consisted of capital markets and banking sector, instead of the focus being on strengthening the banking sector, as it might be obvious in some transitional economies.<sup>8</sup> Moreover, in order for the bank’s financing obstacles to be overcome, resulting from the inadequate and insufficient information, a close collaboration and information sharing between the entrepreneurs,

6 An example would be the financial services offered by the Macedonia Bank for Development Promotion. For more info please visit [www.mbdp.com.mk](http://www.mbdp.com.mk)

7 Other institutions providing support are the different NGO, the support provided by the European Union, etc.

8 Although debatable, but the restriction of Macedonian citizens to directly trade on foreign capital markets is serious drawback when it comes to raising the necessary funds.

financing and government institutions should be formed. If we want to develop successful businesses, an in-depth understanding of the business finance should be present, as well as access to capital, and relationships with lenders (Gwen Richtermeier, 2003, p. 1).

Thirdly, the government and the NGO's supporting the entrepreneurial development should initially present the concept of entrepreneurship to the population. Namely, although many business owners are engaged in this process, they are not aware about the concept itself. For this reason, getting the process closer to the market participants is of crucial importance, because all positive and negative aspects, as well as potential problems, could be directly communicated. Presenting the entrepreneurship concept to the population, especially the unemployed, could increase the self employment awareness.

For this reason the government should initiate a more aggressive campaign for self-employment. The self employment is not only important in terms of decrease in unemployment rate, but it is also important because the increase in employments will reduce the government burden to finance the social benefits and other benefits of jobless population.

As it was mentioned earlier, portion of the unemployed population is earning an income through informal channels, which means that they are not presenting their income and thus avoid tax obligations. The governmental programs, aside of the financial and educational focus, they should also have the objective of educate the entrepreneurs about the benefits of paying taxes. This is because many of the informal entrepreneurs are unwilling to pay taxes, but in many instances they are criticizing the government of not providing enough support to the small businesses.

Value should be given to the actions undertaken by the government to support the private sector and the development of startup companies with the initiation of the business startup centers, the Macedonia Bank for Development promotion, the government program for supporting of young and jobless citizens, etc. Although all actions and steps undertaken by the government are adding value for the Macedonian entrepreneurs and they are offering the means for entrepreneurial activity, they do not provide the knowledge as well as the experience. Even though one might argue that the experience is not something you read in the books, but still it is something you could share with others and help them avoid some basic mistakes.

#### **4. CONCLUSION**

As result of the transitional period in the socialist countries, a major opportunity has aroused for the development of an entrepreneurship, especially because of the large number of jobless population. When using entrepreneurship as one of the means for economic development and growth, the government should direct its resources toward the self-employment entrepreneurs. These entrepreneurs are decreasing the level of unemployment rate, and also they are decreasing the individual poverty, and thus improving the living standards.

The focal point for promotion and support of entrepreneurs should be their education and experience sharing, as well as foundation of a firm financial system. In addition, the government should develop a strategy for the registration of entrepreneurs conducting its activities in the informal economy. This strategy could provide accurate insight into the real poverty and unemployment problems, and the cost of these problems for the country i.e. the government. This type of strategy could free up additional governmental financial resources, a resources which could be directed toward the entrepreneurship promotion, instead of being directed toward "unemployed population".

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## CHARACTERISTICS OF ENTREPRENEURIAL ACTIVITIES IN TRANSITIONAL COUNTRIES AND THEIR INFLUENCE ON DEVELOPMENT

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### Abstract

The GEM approach in measuring the volume of entrepreneurial activities and their interrelations with the general social, economic and entrepreneurial conditions, on the one side, and the results of economic activities at the level of national economy on the other side, gives the whole, systematically and methodologically well established understanding of entrepreneurship as the significant factor of the cited environment.

The level of entrepreneurial activities exert influence on GDP growth depending on the level of country development, i.e. there is far bigger GDP growth in highly developed countries, while the results in less developed countries is far less regarding to the exploitation of entrepreneurial sectors in the function of economic growth.

Not all this means that the entrepreneurship in less developed countries, in this case, in transitional countries, should be discouraged for their contribution to economic development; on the contrary, small businesses and entrepreneurial projects represent the driving force to go through crises and the factor of economic stabilization in transitional countries.

**Keywords:** Entrepreneurial activity, Transition, Economic growth, Economic development

### 1. INTRODUCTION

The traditional analysis of the economic growth did not provide an observed place, role to entrepreneurs, entrepreneurship, entrepreneurial processes, and its creation (Bosma and Levie, 2009). Many factors generally explained the economic growth and development, both economic and noneconomic ones (Bleaney and Nishiyama, 2002). Seen through history, the biggest contribution in developing the theory of entrepreneurship and its role is ascribed to the Austrian economist L. Schumpeter (1934) to whom entrepreneurship is the driving force of all the changes disturbing the current state and cause to the creative destruction. It is indisputable that many economists attach much importance to entrepreneurship for the economic development, especially in critical situations, both in developed and developing countries, as a tool for solving the developmental problems in transitional countries (see Giamartino, 1991), but no more than that.

The previously said enables us, before all, to outline this work and analyze the scope and structure of entrepreneurial activities, as well as their role and connectivity with the economic growth of transitional countries (mostly in Central and East Europe, without China) in relation to other groups of countries of less or more development degree. In this work, we want to show how transition environment is suitable for developing the volume and structure of entrepreneurial activities in relation to other groups of countries, more or less developed.

Many previous works in this field emphasize entrepreneurship and the sector of centrally planned economies to market economies (Smallbone & Welter, 2001), but highly developed countries do not renounce this development lever, determining formally even in strategic documents.

As it can be seen from the previous attitudes, entrepreneurship, as sort of activity plays the same role in all the economies disregarding the degree of development. However, the volume and quality of entrepreneurial activities in the form of contribution to the economic growth and development is different depending on the level of development of the country where the environment quality is one of the main criteria of division. At the same time, it is a direct factor of entrepreneurship. Special attention will be paid to in the second part of the work.



The rest of work is outlined in four parts. The second part points to the relationship of transition and entrepreneurship. The third part illustrates the methodology and sources of data processed by statistical procedures. In addition, in this part, selected indicators as research variables are specially represented. The fourth part comments the results carried out by statistical analysis, while the fifth part is reserved for conclusions.

## 2. TRANSITION, ENTREPRENEURSHIP AND DEVELOPMENT

The stage of social and economic development, called transition, concerning to new history that has happened in all the former socialist countries, among which our country is, relates to transition in market business frameworks with dominant private property so it is considered the basic prerequisite for entrepreneurship development in the former socialist countries (Smallbone & Welter, 2001).

Transition processes create economic and system conditions for entrepreneurship development and small businesses that will be the carrier of transformation processes, but most important are:

- Private property;
- Market as a regulator economic processes;
- Managers as a office holder management - separation of property from management (Lekovic, 2006).

Money value plays important role in these processes, which, if stable, does not cause damage to investors with the long-term loan contracts and fixed compensation. "In the period of changes, when prices are on the rise, entrepreneurs have favorable possibilities to profit increase because purchase is done to favorable prices. The fall of money value causes to encouragement to invest and the fall of entrepreneurial activities. They hesitate to start the long-term production process that requires investment much earlier than the possibility to return it. Urgent problems are not any more only "profiteers", but employment" (Keynes, 1937). The previously cited Keynes' attitudes speak about another essential problem for entrepreneurship development, and it is the stability of money values, which, if not present, affects negatively on entrepreneurial activities.

Transition as an economic ambient for entrepreneurship development in the former socialist countries carries two big limiting factors:

Firstly, the heavy historical heritage, and economic and system conditions, which proceeded the transitional period, within the framework of which every entrepreneurial form of behavior was doomed to failure in advanced. After the Second World War in Yugoslavia, as in other socialist countries, except the U.S.S.R., where socialism came with the October Revolution and V. I. Lenin, the period of centrally planned management and the social property, administrative pricing and the interventionism of the state organs came. With the new social system, market, economic business criteria and competition were pushed into the background choking initiation, creativity and entrepreneurship. "Small number of large enterprises is all, a million of small is nothing", then "Small commodity producers should be destroyed by a long, slow organizational work because small commodity producers spoil proletariat and they are a constant reservoir for capitalism restoration". "To destroy classes does not only mean to expel capitalists; it means to destroy small commodity producers, they cannot be expelled, they cannot be destroyed, it is necessary to live with them, but they can be changed and re-educated" (Jojic, R., 1973). Fear can be seen from these Lenin's words, importance and power which he attached to small commodity producers as an indestructible root of capitalism, which, adapt, in unfavorable economic and social ambient, to survive and further expansion when a favorable moment comes, and to which it must be approached in the way described in the citation.

That what was Yugoslavia in the period of socialism in relation to other socialist countries it is China in the period of transition. Just these characteristics, we are talking about, and which used to differentiate Yugoslavia from other socialist countries enabled private property, entrepreneurship and small commodity producers to provide continuity. This continuity, which we mention, provided a more favorable economic ambient than in other socialist countries, necessary to survive the so-called socialist black hole and welcome the favorable moment for revival and prosperity of the oppressed economic sector, and which understands deep changes.

The basic differences in relation to other socialist countries were, at the same time, the main characteristics of the self-management socialism. The state, from the position of the "central planner" took over the role of the coordinator of economic activities. It caused management decentralization, workers, which represented the central organ of management and made all decisions in the so-called

“assemblies of working people”, did enterprise management. Enterprises were social ownerships. Neither the state nor workers as owners had the right to sell them. Workers had the right to distribute the rest of income as their personal income.

“Socialism in the East collapsed because three the most important rights of people were not respected: religion, freedom and property” (Zlatkovic, 1994). People did not work, did not produce and did not buy on behalf of other people, or to advance the society, but for their own interest. In this way, at the same time, not knowing, not intending, they advance interests of the society and increase the social welfare”. Only complete freedom of the individual to work as he thinks it is the best for him and his competition with others, the same with individuals to follow their own interest in the struggle for poor goods, brings to the natural order of freedom, which necessarily leads to progress and welfare of humankind. These are the words of Adam Smith. Smith steadily believed that, in the way to progress, it was needed to eliminate all obstacles and troubles by which the state and its regulations limited the natural order that was the best for all people. “As a specification of the nature and product of the society, the human accepts this society only if it does not prevent him to use efficiently his work and his knowledge and skills, to be enterprising. Every prevention to be rich based on his work and capabilities represents the violation of the natural right of the human and restriction of his existence” (Jojic, 1973).

Secondly, transition in most of the former socialist countries, especially in our country, is not a determination but the running way from the past and looking for the solution for the deep social-political and economic-social crisis. Such an approach to the reform of the social-economic system contributed to the appearance of “transition recession”, which reflected in the fall of the living standard, inflationary growth, instability of the rate of exchange, increase of the foreign-trade deficit, unemployment growth and other macroeconomic indicators, which had definitely negative trends. An urgent problem in transitional countries was an increasing unemployment caused by the fall of large enterprises, which were the state and social property (Drnovsek, 2002).

The essential reason for the economic collapse, at the beginning of the transitional period, in all the countries of Central and East Europe and the former Soviet republics, as well as in our country, was the huge pressure of simultaneous blows, i.e. the following factors (Avramovic, 1994):

- Inflation, which was characteristic for almost all the countries because of strict stabilization programs, for the purpose to end inflation as soon as possible, budget balance, closing gaps in balance of payments, price liberalization to eliminate disparity with the deflation policy, caused the fall of production
- Abandoning the centrally planned system of management without establishing market mechanisms caused an undefined state of the economies in these countries. This is something quite contrary to the Chinese transition.
- Import liberalization brought about the collapse of domestic production
- Privatization of the state and social property – with much uncertainty represents one the long-lasting process, which stopped investments and slowed down the current production
- Socialist countries remained without the huge market by the collapse of the socialism system

Of course, these five blows did not meet every country at once. Dependent on the intensity of numerous factors, which met one country, the depth of crises was dependent. We can cite the case of Czechoslovakia, which did not suffer from inflation so much and did not have the big foreign-trade deficit, while Hungary introduced important market elements before the process of transition so these two countries easily adapted to the new (the old one before 1948) market business system. Because of all this, there was the appearance of one economic vacuum system, which was the fertile soil for all illegal flows and stimulating the “grey economy”. One of the successful models of economic transformation is the Chinese model, which understood the existence of two parallel models of economic systems and well-planned and justified set of actions of the economic reform. Regarding the fact that it is about a mega economy, China could not allow the appearance of transition recession, as it was the case in most socialist countries. In China, the fall of so big economy required huge efforts and the long period of recovery and it could be disastrous relating to power redistribution and its future position in the world economy. All other transitional economies were characterized by deep recession, which generated many barriers of one non-defined social-economic environment for entrepreneurship development, the main task in the process of transition. Most barriers for growth and development of SMEs represent product of the environment (Doern, 2009). It relates to the crisis of institutions, non-defined political, legal and financial framework where the cited sector dominates.

As this sector plays a vital role in the process of transition, it provides the exit from recession (Wells at al., 2003). As the driving force, it generally strengthens the economy by creating new jobs and innovations. Every obstacle in the road in the form of cited barriers leaves irreparable consequences. The state is responsible for creating a favorable economic environment at all the levels (Smallbone, 2010) and it should provide an appropriate institutional, legal and cultural framework, as the external environment is one of the essential conditions for entrepreneurship development both in transitional countries and in the countries of developed market economies (Smallbone and Welter, 2001). Well-developed SME sector provides all benefits to one economy, as well as in highly developed economies (Aidis, 2005). It means that there is no difference between the role of entrepreneurship and SME characteristics, relating to the level of economic development (Smallbone and Welter, 2001). The connection between entrepreneurship and economic development was supported in developed countries, as the U.S.A. still in the second part of the 20<sup>th</sup> century (Birch, 1987). It is indisputable that large companies played the leading role in developing these countries. However, in the crises in the 1990s (crises in 1973/74 and 1978/1979) they showed their weakness and impossibility to adapt to the new situations. Developed countries found their chance just in small business firms, which, in such situations, successfully amortized crisis blows. Thanks to big flexibility and innovations, small businesses adapted faster and better to newly created situations. The relationships between the environment and entrepreneurial strategies suggest that the entrepreneurial environment is characterized by dynamism and heterogeneity. Hostility can also exert influence on entrepreneurial perception, which, in return can make small businesses to adapt some strategic orientations as innovation, proaction and risk taking (Tan, 1996). The trend of strengthening small businesses is present in almost all developed countries and represents the main determination of economic policy, relating to chances and possibilities it gives. Therefore, EU, setting itself the goal called the most competitive economy until 2010, determined the SMEs sector as one of the strategies. All these directives for development, EU defined by the European Charter For Small Enterprises<sup>2</sup>, initiated by the European Commission and the Declaration<sup>3</sup> about policy which oblige all the EU candidate countries to help in realizing the goals of EU (UNECE, 2000-2001).

The analysis in this work is oriented towards transitional economies, mostly in Central and East Europe, relating to other countries classified in line with WEF. This classification indirectly means institutional, demographic and cultural differences as the result of the degree of economic development. Based on the previous analyses and exposed attitudes, it can be seen that the role and characteristics of entrepreneurial activities in all the stages of economic development are identical, but different types and phases of entrepreneurship may affect economic growth differently in different parts of the world (Sternberg and Wennekers, 2005). According to Bosma and Levies, countries of the lower degree of development like *factor-driven economies* are characterized by dominant agricultural sector, which provide the existence of the population, the starting phase of industrialization and natural resources exploitation. Big unemployment and the low standard of life exert influence on the people to provide their survival through entrepreneurial activities and self-employment. The countries being qualified as *efficiency-driven economies* are characterized by powerful industrial sector and productivity increase through the economies of scale. By means of significant industrial support, the SME sector is formed, dominantly productive. In highly market economies, classified as *innovation-driven economies*, the service sector broadens. Research, development and knowledge-based activities dominate as the stage in development. It contributes that entrepreneurs use the advantages of productivity based on innovations.

### 3. DATA AND METHODOLOGY

We shall analyze the sample of 48 countries classified in four subsamples in relation to the degree of development according to the methodology of the World Economic Forum: Group 1 – Factor-driven economics (n- 8), Group 2 – Efficiency-driven transitional economies (n – 7)<sup>7</sup>, Group 3 – efficiency-driven other countries (n 14) and Group 4 – Innovation-driven economies (n – 19). The subgroup within the framework of *efficiency-driven economies* was formed, to authors' determination, under the name of efficiency-driven transitional economies, which consists of seven transitional countries, mostly from Central and East Europe plus China. It was done to carry out an analysis to selected features in relation to other groups. As the source for GDP characteristics per capita in US\$, we used the data from the International Monetary Fund, World Economic Outlook Database, October 2010. Criteria to select countries for the sample were data availability for every country according to chosen variables. To the same criteria, the year to be observed was chosen; in this case, it is 2009 because in this year, the number of 48 countries was provided in the sample, as well as satisfying structure in subsamples.

Observed variables, development degree represented as GDP per capita in US\$, total entrepreneurial activity reported as Overall Entrepreneurial Activity (OEA anybus), Total Early Stage Entrepreneurial Activity (TEA) including nascent and up to 3.5 years entrepreneurs, entrepreneurs more than 3.5 years (estbu) and the rate of economic growth ( $\Delta$ GDP percent change) are the features or variables. They make together the research space in this work. The feature – development degree, represented as GDP per capita in US\$ in relation to those for sample division are the criterion feature.

Indicator, of the volume and structure of entrepreneurship, three variables/features were chosen: indicator of Overall Entrepreneurial Activity (OEA anybus), indicators of Total Early Stage Entrepreneurial Activity (TEA) that includes nascent up to 3.5 years entrepreneurs and indicator of entrepreneurs more than 3.5 years (estbbu). These chosen indicators of entrepreneurial activities reflect different phases of the entrepreneurial process. Every phase reflects different barriers in entrepreneurial development and different motives of entrepreneurial behavior (Reynolds, et al., 2005). These indicators are the result of methodology and research of the GEM project, which was successfully implemented in Serbia in 2007, 2008, and 2009 by the GEM National Team. In 2009, the GEM project included 55 countries, of which 48 were included as the sample in this work, according to the established criteria. The database for chosen indicators, besides many others, which also were the result of this project, is GEM 2009 Adult Population Survey Country, version 3b. All these indicators are defined as percentage of adult population (18 – 64 years old) involved in some phase of the entrepreneurial process or activity being researched.

As the indicator of growth in this work, and also for this analysis, we use the variable of GDP growth rate (as percent change –  $\Delta$ GDP), where the source of data for selected countries is International Monetary Fund, World Economic Outlook Database, October 2010.

Hypothesis definition for applied procedures is carried out in the following way:

By the procedure of MANOVA, the hypothesis  $H_1$  is tested, which is worded like:

$H_1$  There is no significant difference between the subsamples for the observed thematic entirety

$A_1$  There are significant differences between some subsamples for the observed thematic entirety

By the procedure of discrimination analysis, the hypothesis  $H_2$  is tested:

$H_2$  There is not clearly defined limit between subsamples for the observed thematic entirety

$A_2$  There is clearly defined limit between some subsamples for the observed thematic entirety

By the procedure of ANOVA the hypothesis  $H_3$  is tested:

$H_3$  There is no significant difference between subsamples to some features

$A_3$  There is significant difference between some subsamples to some features

### 3. RESULTS AND DISCUSSION

In the first part, central and dispersion parameters, measures of asymmetry and skewness in relation to the followed parameters will be reviewed. In the second part, the difference between the groups of countries will be analyzed, i.e. hypotheses will be proved or rejected.

**Table 1.** Central dispersion parameters, measures of skewness and analyzed characteristics per groups of countries

		Medium value	Standard deviation	min	max	Coef- ficient of variation	Interval of trust		Skewness	Kurto- sis	p
Factor driven economies	GDP per capita in US\$	6226.24	4937.27	481.9	14744.6	79.30	2097.46	10355.02	.62	-.96	.586
	TEA – nascent and up to 3.5 years	19.03	8.49	4.7	33.7	44.60	11.93	26.12	.08	-.15	.995
	es- tabbu – more than 3.5 years	11.11	7.03	4.1	22.0	63.26	5.24	17.00	.24	-1.51	.729
	OEA – anybus	29.32	13.02	8.4	53.5	44.41	18.43	40.20	.35	.10	.846
	ΔGDP – percent change	2.29	4.50	-3.3	9.0	196.85	-1.48	6.05	.17	-1.23	.996
Efficiency driven transitional economies	GDP per capita in US\$	8331.84	4345.02	3734.6	15283.7	52.15	4312.32	12351.36	.56	-1.09	.974
	TEA – nascent and up to 3.5 years	7.49	5.28	3.9	18.8	70.46	2.61	12.38	1.66	1.23	.297
	es- tabbu – more than 3.5 years	6.15	5.05	2.3	17.2	81.99	1.49	10.82	1.73	1.50	.317
	OEA – anybus	13.48	10.25	6.0	35.7	76.04	4.00	22.96	1.70	1.35	.324
	ΔGDP – percent change	-3.45	5.85	-7.9	9.1	169.46	-8.86	1.96	1.62	1.24	.434



Efficiency driven other economies	GDP per capita in US\$	6671.79	2349.95	4170.9	11465.6	35.22	5314.63	8028.96	.58	-.81	.827
	TEA – nascent and up to 3.5 years	12.86	5.16	4.4	22.4	40.14	9.88	15.84	.28	-.58	.975
	es-tabbu – more than 3.5 years	7.88	3.62	1.4	13.5	45.93	5.79	9.97	.02	-1.03	.953
	OEA – anybus	20.29	7.82	7.2	33.8	38.55	15.77	24.80	-.05	-.85	.951
	$\Delta$ GDP – percent change	-.34	5.38	-18.0	3.5	1560.61	-3.45	2.76	-2.70	6.55	.297
Innovation driven economies	GDP per capita in US\$	42117.53	13152.85	24111.4	78178.3	31.23	35776.51	48458.55	1.13	1.24	.377
	TEA – nascent and up to 3.5 years	6.24	2.81	3.3	13.3	45.01	4.89	7.59	1.05	.34	.577
	es-tabbu – more than 3.5 years	6.49	2.86	2.5	15.1	44.01	5.11	7.87	1.27	2.44	.632
	OEA – anybus	12.48	4.72	6.0	23.6	37.86	10.20	14.75	.69	-.18	.713
	$\Delta$ GDP – percent change	-3.81	2.24	-8.0	.8	58.72	-4.89	-2.73	-.20	-.25	.989

**Notes:** Value of asymmetry and skewness at intervals from  $-.04$  to  $.04$  are not discussed

The central and dispersion parameter, measures of asymmetry and skewness of followed characteristics represent the groups of countries and orient towards the possibility of applying parameter procedures in the next analysis in view of the fact that distribution of values of all the observed characteristics ranges within the framework of normality according to schedule (p).

Values of skewness (sk) and kurtosis (ku) point to the appearance of normal distribution curve (value distribution within the framework of normal distribution) relating to kurtosis (higher value ku), i.e. skewness (less value ku), symmetry (sk = 0), i. e. negative asymmetry (higher value sk). When the curve of value distribution of the observed characteristic inclines to higher values, i.e. there are more higher values in relation to the normal distribution as it is the case with all the groups of countries according to all the observed characteristics.

The higher value of coefficient variance (k. var.) evident with all the groups of countries points to heterogeneity to all observed characteristics. The highest value is especially met in efficiency-driven traditional economies in all the observed characteristics: GDP per capita in US\$ (52.15), TEA-nascent and up to 3.5 years (70.46), estabbu-more than 3.5 years (81.99), OEA-anybus (76.04) and  $\Delta$ GDP-percent change (169.46).

Minimal (min) and maximal (max) values of observed characteristics per the groups of countries point

that values are in the expected range. The analysis of min, max and medium values confirms the standard traits of observed characteristics per the groups of countries. Therefore, within the framework of the groups of countries of factor-driven economies, the lowest development degree of measured GDP per capita in US\$ (medium value 6226.24 US\$), we meet the highest medium values TEA –nascent and up to 3.5 years (19.03), estabbu-more than 3.5 years (11.11), OEA-anybus (29.32) and  $\Delta$ GDP-percent change (2.29). Holders of the biggest individual values are in the same group of countries, that is for TEA-nascent and up to 3.5 years (33.67) Uganda, estabbu-more than 3.5 years (21.95) Uganda, OEA-anybus (53.54) Uganda, while  $\Delta$ GDP-percent change (9.01) China. It makes this country an already known phenomenon of economic growth and development. Based on the previous assertions, minimal medium values of characteristics are present in innovation-driven economies (medium value GDP per capita 42117.53 in US\$) and TEA-nascent and up to 3.5 years (6.24), estabbu-more than 3.5 years (11.11), OEA-anybus (12.48) and  $\Delta$ GDP-percent change (-3.81), while the minimal medium value estabbu-more than 3.5 years (6.15) is in efficiency-driven traditional economies. Holders of the smallest individual values come from the same groups of countries. Therefore, Japan has the smallest TEA –nascent and up to 3.5 years (3.3). Belgium has OEA-anybus (5.96), Finland has  $\Delta$ GDP-percent change (-8.02), and Russia has the smallest estabby-more than 3.5 years (2.30). For the efficiency-driven traditional economies from the aspect of analyses of medium values of observed characteristics, the level of economic development, the scope and structure of entrepreneurial activities and the level of economic growth, the previously mentioned and noted correlation is valid. Factor-driven economies (6671.79) have some closeness and efficiency-driven other economies (6671.79) according to the degree of development. According to the level and structure of entrepreneurial activities and economic growth, efficiency-driven transitional economies (OEA- anybus 13.48;  $\Delta$ GDP – percent change -3.45) are the closest to innovation-driven economies (OEA – anybus 12.48;  $\Delta$ GDP – percent change -3.81). As the groups of countries reflect the different level of economic development, as one of the observed characteristics, that is the criterion one (based on which sample division is done to subsamples, and countries in subgroups), opposite proportion to characteristics of entrepreneurial activities and economic growth is obvious and drastically expressed. It induces us to the following analysis for the purpose of searching answer to the previous observation. This negative correlation is visible in the illustrated correlation matrix (Table 2) that is the result of analyzing the structure of two separated factors (by the method of main components) of observed characteristics at the whole sample of 48 countries.

**Table 2.** Correlation matrix for all the countries to observed characteristics

	$\Delta$ GDP as a percent change	estabbu more than 3.5 years	OEA anybus	TEA nascent nd up to 3.5 years	GDP per capita in US\$
$\Delta$ GDP – as a percent change	1000				
estabbu – more than 3.5 years	449	1000			
OEA – anybus	539	876	1000		
TEA – nascent and up to 3.5 years	524	670	945	1000	
GDP per capita in US\$	-359	-215	-417	-490	1000

The visible in the matrix that should be emphasized is the negative correlation of the level of economic development measured as GDP per capita in US\$ and all observed characteristics of the scope and structure of entrepreneurial activities, as well as growth level. Countries at the higher level of the social-economic development have developed institutional system infrastructures, national welfare growth, economic development guided by industrialization and economies of scale, stability, social security and wide possibilities for employment. Significant participation of large companies, where most population has stable jobs, exerts influence on reducing the pressure on the early phase of entrepreneurial activities. On the other side, in countries with the lower degree of development because of large unemployment, entrepreneurship is the only possibility. Therefore, in countries of the lower degree of development (as in efficiency-driven economies), the fall of the level of entrepreneurial activities can be a good signal of economic stability and development.

The biggest positive correlation (945) in the matrix is observed between the total entrepreneurial

activities of the country OEA-anybus and the early stage of entrepreneurial activity TEA. It points to the fact that TEA has significant contribution in the total entrepreneurial activity of the country, but at the lower level of economic development (factor-driven economies TEA 19.03; estbbu 11.11). Here this participation reduces significantly in highly developed countries (innovation-driven economies – TEA 6.24; estbbu 6.49), where there is no risk because of stable economic circumstances at the early phases of entrepreneurial activities.

As open questions should be the subject of the next analysis, it is necessary to test hypotheses and establish the existence of differences, their significance and limits as illustrated in Table 3 and Table 4.

Table 3. MANOVA and discriminative analysis between groups of countries relating to observed characteristics

Analysis	n	F	p
MANOVA	5	8.461	.000
discriminative	5	13.017	.000

Table 4. ANOVA analysis for observed characteristics/variables

Characteristics/variables	F	p	Coefficient of discrimination
<b>GDP</b> per capita in US\$	60.092	.000	.000
<b>TEA</b> – nascent and up to 3.5 years	13.504	.000	.035
<b>estabbu</b> – more than 3.5 years	2.477	.074	.049
OEA - anybus	8.841	.000	.040
<b>ΔGDP</b> – as a percent change	4.668	.006	.080

By the next analysis, we try to make differences between the groups of countries to all observed characteristics. As  $p < 1$ , alternative hypothesis A3 is accepted. It means that there is a significant difference between the groups of countries to all observed characteristics with: GDP per capita in US\$ (.000), TEA-nascent and up to 3.5 years (.000), estabbu-more than 3.5 years (.074), OEA-anybus (.000) and ΔGDP-percent change (.000).

The coefficient of discrimination points to that the biggest contribution to discrimination between the groups of countries in relation to observed characteristics/variables, i.e. difference is the biggest with: ΔGDP-percent change (.080), estabbu-more than 3.5 years (.049), OEA-anybus (.040), TEA-nascent and up to 3.5 years (.035), GDP per capita in US\$ (.000).

Based on the former consideration and the sample analysis of 48 countries, divided in four groups to the degree of development, in line with the applied methodology, the logic flow of researching is the determination of characteristics and homogeneity of every group of country and distance between them. The fact that  $p = .000$  of discriminative analysis means that there is a clear defined limit between the group of countries, i.e. it is possible to determine characteristics of every group of countries in relation to observed characteristics.

Table. 5 Characteristics and homogeneity of groups in relation to the observed characteristics/variables

	Factor driven economies	Efficiency driven transitional economies	Efficiency driven other economies	Innovation driven economies	dpr %
<b>ΔGDP</b> – as a percent change	biggest* <sup>2</sup>	smaller	bigger* <sup>1</sup>	smallest	39.216
<b>estabbu</b> – more than 3.5 years	biggest* <sup>1</sup>	smallest	veće	smaller	24.020
OEA - anybus	biggest* <sup>3</sup>	smaller	bigger* <sup>1</sup>	smallest	19.608
<b>TEA</b> – nascent and up to 3.5 years	biggest* <sup>3</sup>	smaller	bigger* <sup>2</sup>	smallest	17.157
<b>GDP</b> per capita in US\$	smallest	bigger	smaller	biggest* <sup>3</sup>	.000
n/m	7/8	6/7	13/14	19/19	
hmg %	87.50	85.71	92.86	100.00	
hmg - homogeneity					
dpr – contribution of characteristics of features					
*1 – related before, *2 – related before two, *3 – related before three					

In Table 5, it is obvious that the characteristics of every subsample of the group of countries is defined by  $\Delta$ GDP-present change because the contribution of characteristics of features 39.22. Then, it follows: establu-more than 3.5 years (24.02%), OEA-anybus (19.61%), TEA-nascent and up to 3.5 years (17.16) and GDP per capita in US\$ (.00%). Homogeneity, factor-driven economies is 87.50%, efficiency-driven transitional economies is 85.71%, efficiency-driven other economies is 92.86% and innovation-driven economies is 100.00%.

Based on the exposed, we can say that seven of eight countries have characteristics of factor-driven economies, homogeneity is 87.50% (bigger). It means that one country has other characteristics, not the characteristics of its own group. Six of seven countries have characteristics of efficiency-driven economies; homogeneity is 85.70% (bigger) because one country has other characteristics. Characteristics of innovation-driven economies have 19 of 19 cccl, homogeneity is 100.00% (bigger).

Based on the previous analysis of characteristics and homogeneity of the groups of countries to observed characteristics, it can be clearly seen that there are precise limitation between every group of countries to observed characteristics, therefore, every group has expressed specificities in relation to other groups of countries. A large percent of homogeneity points to that fact.

In the final part of the analysis, all these differences between the groups of countries will be also illustrated by calculating the Mahalanobis distance, by which another indicator of similarities and differences is obtained, for the purpose of graphical illustration.

Table 6. Distance (Mahalanobis) between the groups of countries in relation to observed variables

	Factor driven economies (1)	Efficiency driven transitional (2) economies	Efficiency driven other (3) economies	Innovation driven economies (4)
<b>Factor</b> driven economies	.000	2.42	1.25	4.69
<b>Efficiency</b> driven <b>transitional</b> economies	2.42	.00	1.21	3.85
<b>Efficiency</b> driven <b>other</b> economies	1.25	1.21	.00	4.20
<b>Innovation</b> driven economies	4.69	3.85	4.20	.00

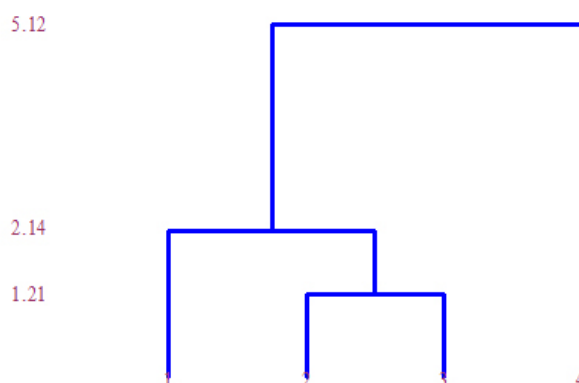
The distances of different spaces can be compared, and in this way, we can see the distance between the groups of countries. The distances in this Table point to the fact that the least distance is between efficiency-driven other economies and efficiency-driven transitional economies (1.21). Innovation-driven economies and factor-driven economies are the farthest groups of economies (4.69).

Table 7. Classifying countries according to observed characteristics/variables

Level	nearness
Group 2 – Group 3	1.21
Group 1 – Group 2	2.14
Group 1 – Group 4	5.12

Based of the illustrated dendrogram, we can notice the mutual position relating to the distance between the groups of countries to all observed characteristics

Figure 2. Dendrogram of closeness of the groups of countries in relation to observed characteristics



**Legend:** factor-driven economies (1) efficiency-driven transitional economies (2) efficiency-driven other economies (3) innovation-driven economies (4)

#### 4.CONCLUSION

Entrepreneurial behavior and activities, in contemporary economic circumstances at the global level, is identified as a significant potential and valuable resource in creating economic growth, development and the total social prosperity. Only recognizing the phenomenon, entrepreneurship and its glorification will not leave a deep trail and significant effects for economy and society. On the contrary, it will have the same destiny, uncertain result, as any other innovation that is the result of natural activities of an individual or the group. Of course, for the Republic of Serbia and other transitional countries, according to the phase of economic development, entrepreneurship represents something new, which the expert public characterized as positive and significant. It is necessary to fulfill some essential prerequisites for target orientation of entrepreneurial processes as a significant factor in building economic structures if we want to know the desired result with significant results and benefits for economy and society. These necessary prerequisites, in considering and understanding entrepreneurship is provided by the GEM project with its research results, making a basis for creating appropriate instruments and measures of the economic policy, using, in this way, rationally and efficiently this very significant resource. On the one side, we should know that economic entrepreneurial effects on economic growth are limited by the level of economic development, while, on the other side, the negatively characterized transitional environment is not a limiting factor.

With all the analyzed groups of countries, as well as with separated group of transitional countries within the framework of efficiency-driven economies, some specificities to all observed characteristics are identified. All the applied statistical procedures point to the previous assertion, by means of which we obtained the presented results with significant differences, precise limits of separation, characteristics and homogeneity of the groups of countries, as well as their mutual distances. It contributed to all observed characteristics at the level of economic development (as criterion), the scope and structure of entrepreneurial activities and economic growth. The traditional business environment of the former socialist countries and, besides many limitations and shortages represented in the first part of the work, is not a limiting factor of entrepreneurial activities and economic growth as observed derivations are completely appropriate to the reached level of economic development, disregarding to the social-economic characteristics of the environment. The separate group of transitional countries significantly differentiate. It has its characteristics and the significant level of homogeneity for the volume and structure of entrepreneurial activities and economic growth in accordance to the reached level of economic development. In this way reached level of economic development measured by GDP per capita represents a very complex, strong and reliable indicator of the social-economic potential of a country, regarding to the capabilities for creating growth and development, as defined by the World Economic Forum methodology and the Global Competition Index. As entrepreneurship is also a social and economic phenomenon, it becomes the direct consequence of the previous strategy.



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## DEVELOPING MACEDONIA'S ENTREPRENEURIAL CAPACITY: THE MISSING LINKS

Bisera Gjosevska<sup>1</sup>**Abstract**

Although considered a major driving force of all developed economies, entrepreneurship has only recently started gaining momentum among Macedonian authorities designing policies aimed at accelerating the completion of the transitional cycle. Thus, the purpose of this article is to evaluate the status of Macedonia's entrepreneurial potential in relation to its regional, sectoral and global peers for the year 2008. Using a cross-sectional study of the data available through GEM's Adult Population Survey, the determining factors of total entrepreneurial activity are identified. In addition, a number of issues intrinsic to the Macedonian economy, such as historical legacies, the role of female entrepreneurs and financing difficulties are also discussed, revealing the peculiar nature of the developmental path of Macedonian entrepreneurship.

**Keywords:** entrepreneurship, cross-sectional study, transitional economies

**1. INTRODUCTION**

The role of the entrepreneur has always been an intriguing one. Traditionally, apart from being seen as "responsible for all exchange and circulation in the economy" (Cantillon, 1959), the entrepreneur has also been regarded as having "good judgment as principle quality" (Say, 1821), and who, at the same time, fulfills two of the most vital functions in the economy, by being both an *innovator* (Schumpeter, 1949) and a *risk-taker* (Knight, 1921). Modern times, however, have seen the definition of entrepreneur evolve into a blend of "lucrative opportunities and enterprising individuals" (Shane & Venkatamaran, 2000), thus reflecting the changing and all-encompassing nature of the concept. Yet, a universal definition has proven to be a rather elusive goal as experts in the field have failed to settle on the distinctive traits of the entrepreneur. For the purposes of this paper however, entrepreneurs shall be defined as "business owners who seek to generate value, through the creation or expansion of economic activity, by identifying and exploiting new products, processes or markets" (OECD, 2011).

This paper provides an overview of the recent theoretical and empirical research on entrepreneurship in all its forms. Specifically, it examines all the different categories of entrepreneurial activity, as well as its evolution and development in the Republic of Macedonia. Moreover, it employs the terms developed by the Global Entrepreneurship Monitor in order to classify the economies in one of three categories: factor-, efficiency-, and innovation-driven. Due to the lack of regularly collected data, this paper focuses on cross-sectional studies conducted at one specific time points, such as 2008 and 2010, when Macedonia participated in the surveys. These years are especially interesting as they provide an insight as to how Macedonian entrepreneurship has evolved after the eruption of the Global Financial Crisis as they pinpoint the missing links that would allow an improved development of the local entrepreneurial capacity. The data suggests that the missing links are both of a psychological and of structural nature, but given the scant data, a cautious interpretation of the relationships is advised as any results would prove inconclusive within such a short time horizon.

Meanwhile, it is important to distinguish between entrepreneurial opportunities and entrepreneurial capacity; as Bygrave & Zacharakis caution, "what drives entrepreneurial activity is that people perceive opportunities and have the skills and motivation to exploit them" (2008).

The paper is structured as follows. In order to motivate the analysis, Section 2 presents a background on the development of entrepreneurship in Macedonia with its peculiarities a result of different sociopolitical systems. Section 3 presents the results of the GEM Adult Population Survey conducted in 2008, comparing the state of entrepreneurship in Macedonia with the region and the world. Section 4 presents the results of the same survey conducted two years later, again comparing the state of entrepreneurship in Macedonia regionally and internationally. Section 5 examines the impact of the Global Financial Crisis on entrepreneurship in the Republic of Macedonia. Section 6 concludes the paper, by identifying the missing links to developing the Macedonian entrepreneurial capacity.

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## 2. EVOLUTION OF ENTREPRENEURSHIP IN THE REPUBLIC OF MACEDONIA

The rather profound, if irregular, development of entrepreneurship on the territory of the Republic of Macedonia makes it a fascinating subject for researchers alike. Having spent approximately five centuries in economic hibernation under Ottoman rule, Macedonians were plunged into nascent capitalism under Serbian, Bulgarian, and later Yugoslav rule during the first half of the 20<sup>th</sup> century. The abrupt change of the economic system that followed after WWII fast-forwarded the local populace – some of which was still attached to the feudal mindset – directly into centrally planned government. The sociopolitical construct of self-management, specific to enterprises in the Former Yugoslavia, ensured that each employee carried one vote in his or her firm, thus becoming a direct participant in the decision-making process. Taking part during the second half of the 20<sup>th</sup> century, self-management disintegrated with the breakup of Yugoslavia. During this time, the Yugoslav economy was populated by large, sprawling socially-owned enterprises employing thousands of workers, as well as by numerous small private proprietorships. The middle way, however, was non-existent, as small and medium enterprises employing 20 to 80 people were virtually absent in Macedonia, leading Fiti et al. to declare this a phenomenon of a “socialist black gap” (1999). The Law on Transformation of Enterprises with Social Capital from 1993 brought the country one step closer to a free market system, but left a number of lingering issues in the fragile economy of the newly-formed Republic of Macedonia. The development of entrepreneurship became a priority of the successive democratically elected governments, but it wasn’t until the comprehensive Global Entrepreneurship Monitor (GEM) sponsored study of 2009 that the public received an impartial assessment of the state of entrepreneurship in the Republic of Macedonia.

According to the Global Competitiveness Report (Global Entrepreneurship Monitor, 2008), the Republic of Macedonia is ranked among efficiency-driven economies. These are countries whose GDPs vary from USD 3,000 to USD 9,000 per capita, with the Republic of Macedonia ranking in the lower end of the group with USD 4,656 per capita for 2008. These countries’ competitiveness stems not only from low prices, but improved quality of products, strengthened institutional framework and increased productivity as well. Specifically, the Republic of Macedonia has benefited from expansionary credit and monetary policy since 2003 and has boasted a combined BDP growth rate of 4.65% during the 2003-2008 period. The other two classes of economies are factor- and innovation-driven. Factor-driven economies have less than USD 2,000 per capita, basing their comparative advantage on low prices, usually coming from abundant natural resources or cheap labor. Innovation-driven economies have per capital income upwards of USA 17,000, with a vibrant manufacturing sector developing new, value-added, innovative products and services. The following table gives the GEM ranking of countries in Macedonia’s surrounding for which data are available.

Table 1. Country Classification

Country	Macedonia	Serbia	B&H	Croatia	Greece	Slovenia	Turkey
GEM 2008 Ranking	efficiency	efficiency	factor	efficiency	innovation	innovation	efficiency

It is important to note that data for Bulgaria, Albania and Montenegro are not provided by GEM for 2008. Therefore these countries have been excluded from the list.

### 2.1. MACEDONIAN ENTREPRENEURS AND THEIR PEERS DURING 2008

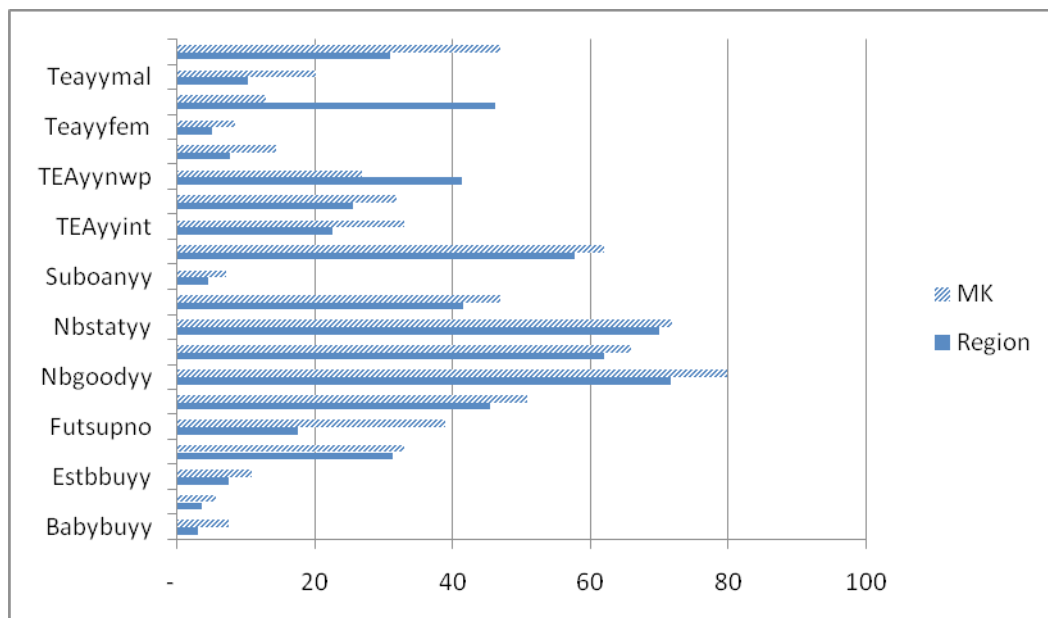
Given the lack of available data that would allow a precise time series analysis of the evolution of the entrepreneurial spirit in Macedonia, the only telling assessment which remains is that of comparative analysis with regional and international peers. Table 1 shows the average scores of surveyed variables in the above mentioned countries during 2008 have been contrasted with the scores attained for the Republic of Macedonia in the same year. As illustrated in Figure 1, Macedonia leads the region in most parameters, but falls significantly short in the bracket *teayido*, which GEM defines as “percentage of those involved in TEA who (i) claim to be driven by opportunity as opposed to finding no other option for work; and (ii) who indicate the main driver for being involved in this opportunity is being independent or increasing their income, rather than just maintaining their income”, where the regional average is 46%, as opposed to Macedonia’s 13%. In addition, the variable *teaynw* is also one for concern, as Macedonia falls short in original products and services as well, with 27% of local entrepreneurs indicating that their product or service is new to at least some customers, as opposed to 42% of the entrepreneurs in the region. This does not necessarily signal a lack of creativity or originality; it may also point to apprehension about introducing new products to the market and its reaction to the novelty.

Table 2. The state of entrepreneurship 2008 - Macedonia, its region, and the world (GEM)

Indicators	MK%	Region%	World%	Indicators	MK%	Region%	World%
Babybuyy	7.7	3	4.5	Suboanyy	7.2	5	6.1
Busangyy	5.7	4	4.7	Suskilyy	62	58	49.6
Estbbuyy	11	8	7.6	TEAyyint	33	23	18.9
Frfailop	33	31	34.7	TEAyyjg5	32	26	26.2
Futsupno	39	18	17,3	TEAyynw	27	42	43.2
Knoentyy	51	46	42.5	TEAyy	14.5	8	10.4
Nbgoodyy	80	72	66.5	TEAyyfem	8.6	5	8
Nbmediyy	66	62	76.9	TEAyyido	13	46	49
Nbstatyy	72	70	70.9	TEAyyimal	20.3	10	12.8
Oportyy	47	42	38.1	TEAyynec_p	47	31	24.2

When compared to the rest of the world, the situation differs slightly. As in the previous example, the average scores of the surveyed variables for the participating countries in the world during 2008 have been contrasted with the scores attained for the Republic of Macedonia in the same year.

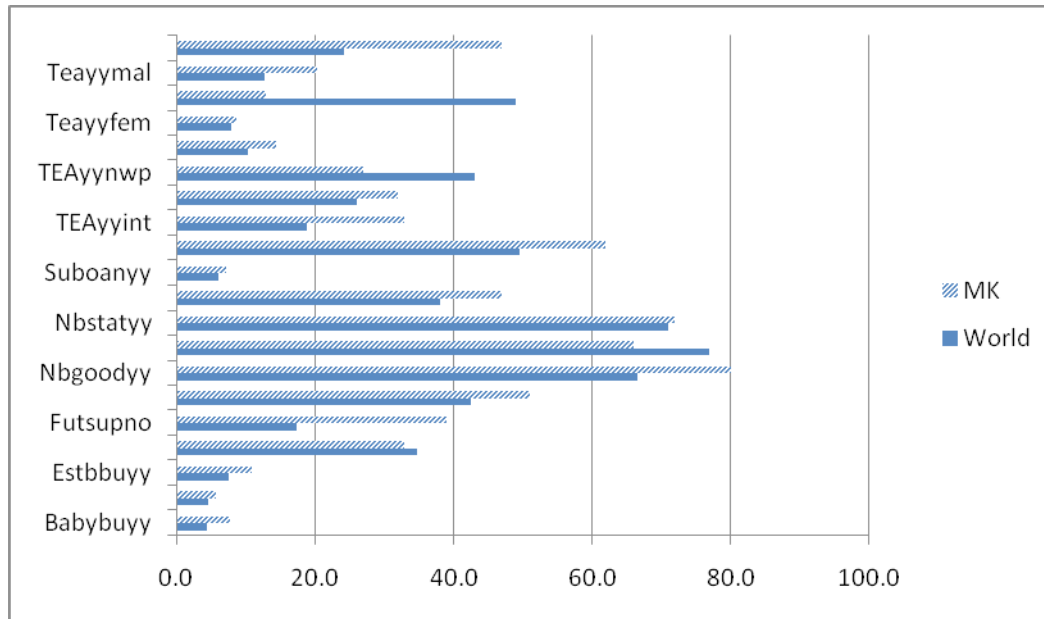
Figure 1. The state of entrepreneurship in Macedonia and its surrounding region, 2008 (GEM)



As illustrated in Figure 2, the percentage of Macedonian entrepreneurs that experiences fear of failure that would prevent them from setting up a business, *frfailop*, is 33%, somewhat less than the world average of 34.7%. Another category where a significant difference appears is the percentage of 18-64 population who agree with the statement that successful entrepreneurs receive favorable media coverage, *nbmediyy*, with only 66% of the respondents agreeing, as opposed to 76.9% in the world. Again, the variable *teayynw* stands out as only 27% of Macedonian entrepreneurs indicate that their product or service is new to at least some customers, unlike 43.2% internationally.



Figure 2. The state of entrepreneurship in Macedonia and the world, 2008 (GEM)



## 2.2. Macedonian Entrepreneurs And Their Peers during 2010

With the advent of the Global Financial Crisis, the entrepreneurial sector was one of the first to suffer both locally and globally. When comparing entrepreneurial indicators within the region, one must not forget to mention that no GEM surveys were conducted in Serbia during 2010, but that one was nonetheless conducted in Montenegro. For the purposes of this paper, Macedonia's region for 2010 will therefore include Montenegro, but will still be missing Serbia, Albania and Bulgaria.

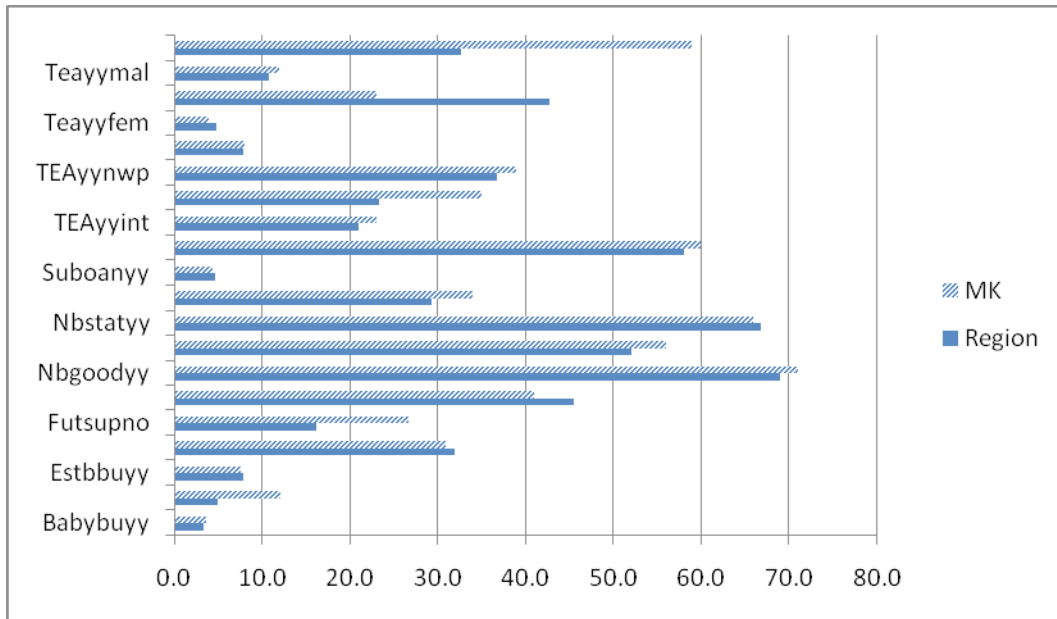
Table 3. The state of entrepreneurship 2010 - Macedonia, its region, and the world (GEM)

Indicators	MK%	Region%	World%	Indicators	MK%	Region%	World%
Babybuuy	3.6	3.4	5.9	Suboanyy	4.4	4.6	6.5
Busangyy	12.1	5	6.6	Suskilyy	60	58.2	54.9
Estbbuuy	7.6	8	8.5	TEAyyint	23	21	14
Frfailop	31	32	31.7	TEAyyjg5	35	23.4	22.9
Futsupno	26.7	16.2	21.8	TEAyyynw	39	36.8	39.5
Knoentyy	41	45.6	44	TEAyy	8	7.8	11.9
Nbgoodyy	71	69	68.3	TEAyyfem	3.9	4.9	9.9
Nbmediyy	56	52.2	60.6	TEAyyido	23	42.8	46.1
Nbstatyy	66	66.8	72.6	TEAyyymal	11.9	10.8	13.9
Oportyy	34	29.3	43.7	TEAyyynec_p	59	32.7	27

As shown in Table 3 and as illustrated in Figure 3, the consequences arising from a two-year economic slowdown offer a number of surprises, depending on the category. There appears to be a significant increase in *busangyy*, the portion of the population who have personally provided funds for a new business, started by someone else, in the past three years, with Macedonian business angels making up 12.1% of the population, as opposed to 5% in the region. There is also an increase in *futsupno*, the percentage of 18-64 population who intend to start a business within three years, with 26.7% future entrepreneurs in Macedonia, compared to 16.2% regionally. Another significant positive gap appears in the category *teayynec\_p*, that is, the fraction of population involved in entrepreneurship due to a lack of other options for work, with 59% in Macedonia and only 32.7% in the region. As expected, there emerges a large fall in *teayyido*, the percentage of entrepreneurs who claim to be driven by opportunity as opposed to finding no other option for work; and who indicate the main driver for being involved in this opportunity is being independent or increasing their income, rather than just maintaining their income. In the region, 42.8% fall within this category, as opposed to only 23% in Macedonia.

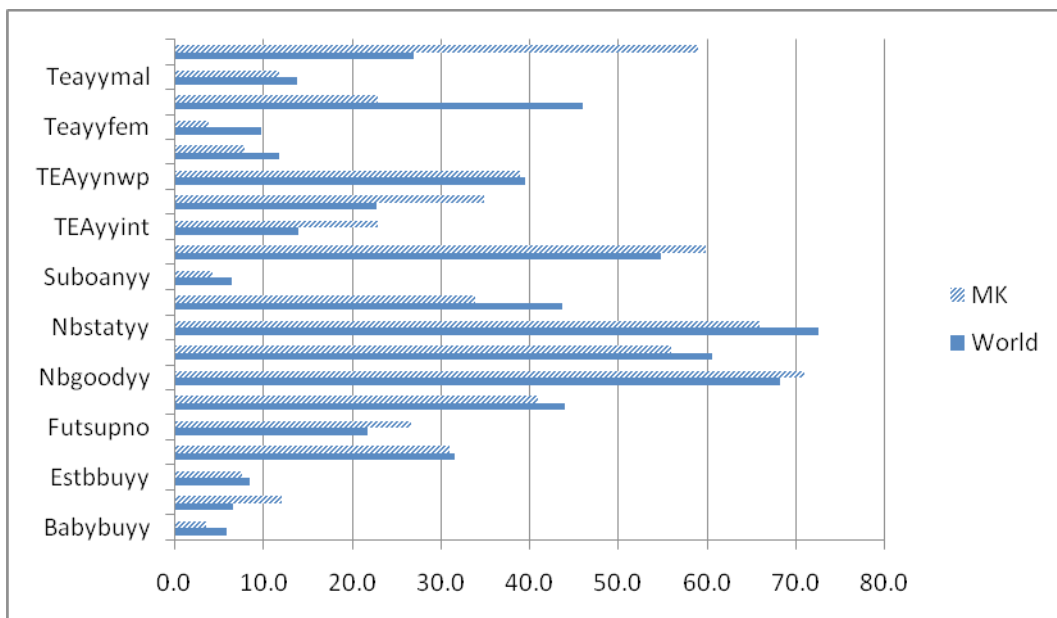
When compared to the rest of the world, as in Figure 4, the state of entrepreneurship in the Republic of Macedonia in 2010 should sound alarm bells. Only 34% of the local population sees good opportunities to start a firm in the area where they live, *oportyy*, in contrast with 43.7% in the world. The overall percentage of the 18-64 population who are either a nascent entrepreneur or owner-manager of new business, *teayy*, is only 8%, unlike 11.9% in the world.

Figure 3. The state of entrepreneurship in Macedonia and its surrounding region, 2010 (GEM)



The female population is especially vulnerable, as only 3.9% of the female 18-64 population is either a nascent entrepreneur or owner-manager of new business, as opposed to 9.9% in the world. Finally, there is a chasm between those entrepreneurs internationally who claim that they are driven by opportunity as opposed to not having any other option to work, *teayyido*, who stand at a staggering 46.1%, and a meager 23% of the population in Macedonia.

Figure 4. The state of entrepreneurship in Macedonia and the world, 2010 (GEM)



### 3. THE IMPACT OF THE GLOBAL FINANCIAL CRISIS ON ENTREPRENEURSHIP IN MACEDONIA

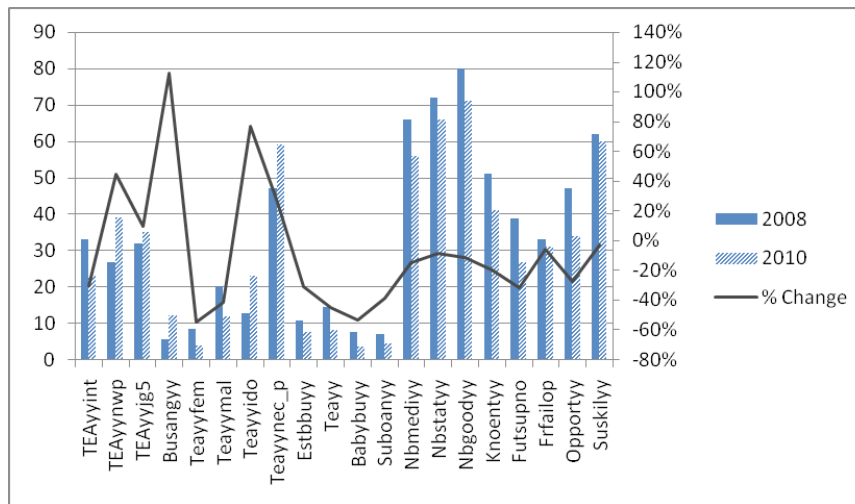
As with most other financial and economic parameters, the development of entrepreneurship in the Republic of Macedonia had taken a severe hit with the outbreak of the Global Financial Crisis. Its impact became most acutely felt in 2009 when GDP fell sharply to -0.9%, dragging down with it all other indicators of economic activity as well. Unfortunately, given that no data were collected by GEM prior to 2008 in Macedonia, the only way to measure the impact of the crisis, however inaccurately, is to perform comparative analysis with the data collected for 2010.

The results are worrisome – as can be seen in Table 4 and Figure 5, a staggering 15 out of 20 indicators have dipped into negative territory. *Teayyfem*, the percentage of female 18-64 population who are either a nascent entrepreneur or owner-manager of a new business has fallen by -54.64%, closely followed by *teayymal*, their male counterparts with -41.38%. The variable *futsupno*, showing the percentage of 18-64 population who intend to start a business within three years, has plummeted to -31.54%. The percentage of entrepreneurs who indicate that at least a quarter of their customers are international, *teayyint*, has experienced a -30.30% change. Overall, *teayy*, the percentage of 18-64 population who are either a nascent entrepreneur or owner-manager of a new business has decreased by -44.83%. The only bright spots can be seen in the variably *busangyy*, meaning that the percentage of 18-64 population who have personally provided funds for a new business, started by someone else, in the past three years, has skyrocketed by 112.28%. In addition, *teayynw*, the percentage of entrepreneurs who indicate that their product or service is new to at least some customers has increased to 44.44%. There has also been an increase of 76.92% in *teayyido*, the percentage of entrepreneurs who claim to be driven by opportunity, as well as a jump of 25.53% in *teayynec\_p*, the percentage of those involved in entrepreneurship because they had no other option for work.

Table 4. The impact of the Global Financial Crisis (2008-10) on entrepreneurship in Macedonia (GEM)

Indicators	2008	2010	%Change	Indicators	2008	2010	%Change
Babybuyy	7.7	3.6	-53.25	Suboanyy	7.2	4.4	-38.89
Busangyy	5.7	12.1	112.28	Suskilyy	62	60	-3.23
Estbbuyy	11	7.6	-30.91	TEAyyint	33	23	-30.30
Frfailop	33	31	-6.06	TEAyyjg5	32	35	9.38
Futsupno	39	26.7	-31.54	TEAyynw	27	39	44.44
Knoentyy	51	41	-19.61	TEAyy	14.5	8	-44.83
Nbgoodyy	80	71	-11.25	TEAyyfem	8.6	3.9	-54.65
Nbmediyy	66	56	-15.15	TEAyyido	13	23	76.92
Nbstatyy	72	66	-8.33	TEAyyymal	20.3	11.9	-41.38
Oportyy	47	34	-27.66	TEAyynec_p	47	59	25.53

Figure 5. The impact of the Global Financial Crisis on entrepreneurship in Macedonia



A caveat is in place, however. Considering the fact that GEM has conducted its survey only twice, both times during this particular crisis period, the results may be inconclusive or may provide evidence of spurious relationships which may, or may not exist, during normal times.

In order to clarify the use of the assorted shortened forms of the variables used throughout the analysis, a GEM-sponsored legend will be included in the Appendix to this paper.

#### 4. CONCLUSION: THE MISSING LINKS

The reasons behind the lagging numbers in the development of the entrepreneurial sector in the Republic of Macedonia, when compared to the region and to the world are twofold. One could distinguish between fundamental (or structural) and psychological (or behavioral) reasons that hinder the advancement of entrepreneurial activity. Taken broadly, even the GEM survey is divided along the fundamental/psychological line. On the one side there are the activity-based indicators which delineate the underlying fundamental intricacies of entrepreneurship. On the other side there are the aspirations-, attitudes-, and perceptions-based indicators which depict the psychological forces at play in the entrepreneurial mindset.

Financing, for one, appears to be among the major fundamental missing links in the development of entrepreneurial capacity in the Republic of Macedonia. Although 12.1% of the population constitutes the informal investors rate, the local economy remains predominantly bank-fueled. It is necessary to further raise the awareness about the benefits of venture capital, both in the form of equity and know-how. Structurally, it is of paramount importance for the government to facilitate access to venture capital funds and to provide a supportive fiscal policy, while private initiative could be used to form business angel networks, in line with Ramadan's recommendation (2011).

An increase of 25.53% in necessity-driven entrepreneurship is not automatically a favorable development, as this may come to be seen as forceful push toward entrepreneurship for those unable to find employment or enjoy the social welfare nets any longer. Fortunately, opportunity-driven entrepreneurship is also on the rise by 76.92% indicating that entrepreneurs are driven by opportunity rather than pushed by necessity.

Female entrepreneurs, traditionally less numerous than their male counterparts, have suffered severely during the most recent downturn, slashing their participation levels by 54.65%. This is another missing link, as it is imperative for the government to bring the numbers of female entrepreneurs up to par with their male rivals. A set of policies, ranging from maternity leave incentives to improved funding opportunities for females should be devised by the government in order to create a level playing field for both genders.

Having dramatically fallen during the recent crisis, established and new business ownership rates also present the danger of weakened, if not missing links. Given that national economic growth is a function of two sets of interrelated activities – established and new businesses – a prolonged slump in both sectors may kill the growth engine altogether.

The psychological reasons, given by two different sets of questions on aspirations as well as attitudes and perceptions also show interesting results. Entrepreneurial intention has experienced a serious

dip of 31.54%, suggesting disillusionment with business tendencies. Even perceived capabilities and opportunities have entered negative territory with -3.23 and -27.66%, respectively, reflecting an overall wave of pessimism. The same holds true for people who know startup entrepreneurs, whose numbers have fallen by -19.61%. Even the status of a successful entrepreneur has become marred, experiencing a -8.33 drop. The social norms of a system which has experienced a rollercoaster ride from feudalism to capitalism to socialism then back to capitalism are also a missing link, as there have been no time horizons long enough to warrant the steady emergence of successful entrepreneurs unscathed by dubious business dealings. They need to be strengthened and able to incorporate the perceptions and dispositions towards successful people who have thrived having relied on their entrepreneurial acumen only.

What all these numbers suggest is that a lot remains to be done in the behavioral realm. Psychological influences are firmly engraved in the entrepreneurial mindset and they may prove to be the engine able to kick-start the distressed economy. For until the biggest missing link – the belief in creating a successful business venture – is restored, it will be difficult to bolster the innovative, entrepreneurial part of the Macedonian economy.

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## Appendix: Gem Indicators

Described below are some of the most important variables that GEM (2008) derives from data collected as part of the Adult Population Survey (APS). This is not an exhaustive list.

### ACTIVITY

Estbbuyy - Established Business Ownership Rate - Percentage of 18-64 population who are currently owner-manager of an established business, i.e., owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than 42 months.

Teayyido - Improvement-Driven Opportunity Entrepreneurial Activity: Relative Prevalence - Percentage of those involved in TEA who (i) claim to be driven by opportunity as opposed to finding no other option for work; and (ii) who indicate the main driver for being involved in this opportunity is being independent or increasing their income, rather than just maintaining their income.

Busangyy - Informal Investors Rate - Percentage of 18-64 population who have personally provided funds for a new business, started by someone else, in the past three years.

Suboanyy - Nascent Entrepreneurship Rate - Percentage of 18-64 population who are currently a nascent



entrepreneur, i.e., actively involved in setting up a business they will own or co-own; this business has not paid salaries, wages, or any other payments to the owners for more than three months.

Teanec\_p - Necessity-Driven Entrepreneurial Activity: Relative Prevalence - Percentage of those involved in TEA who are involved in entrepreneurship because they had no other option for work.

Babybuyy - New Business Ownership Rate - Percentage of 18-64 population who are currently a owner-manager of a new business, i.e., owning and managing a running business that has paid salaries, wages, or any other payments to the owners for more than three months, but not more than 42 months.

Teayy - Total early-stage Entrepreneurial Activity (TEA) - Percentage of 18-64 population who are either a nascent entrepreneur or owner-manager of a new business (as defined above).

Teayymal - Total early-stage Entrepreneurial Activity for Male Working Age Population - Percentage of male 18-64 population who are either a nascent entrepreneur or owner-manager of a new business (as defined above).

Teayyfem - Total early-stage Entrepreneurial Activity for Female Working Age Population - Percentage of female 18-64 population who are either a nascent entrepreneur or owner-manager of a new business (as defined above).

## ASPIRATIONS

TEAyyjg5 - Growth Expectation early-stage Entrepreneurial Activity: Relative Prevalence - Percentage of TEA who expect to employ at least five employees five years from now.

TEAyynewp - New Product early-stage Entrepreneurial Activity - Percentage of TEA who indicate that their product or service is new to at least some customers.

TEAyyint - International Orientation early-stage Entrepreneurial Activity - Percentage of TEA who indicate that at least 25% of the customers come from other countries.

## ATTITUDES AND PERCEPTIONS

Futsupno - Entrepreneurial Intention - Percentage of 18-64 population (individuals involved in any stage of entrepreneurial activity excluded) who intend to start a business within three years.

Nbgoodyy - Entrepreneurship as Desirable Career Choice - Percentage of 18-64 population who agree with the statement that in their country, most people consider starting a business as a desirable career choice.

Frfailop - Fear of Failure Rate - Percentage of 18-64 population with positive perceived opportunities who indicate that fear of failure would prevent them from setting up a business.

Nbstatyy - High Status Successful Entrepreneurship - Percentage of 18-64 population who agree with the statement that in their country, successful entrepreneurs receive high status.

Knoentyy - Know Startup Entrepreneur Rate - Percentage of 18-64 population who personally know someone who started a business in the past two years.

Nbmediyy - Media Attention for Entrepreneurship - Percentage of 18-64 population who agree with the statement that in their country, you will often see stories in the public media about successful new businesses.

Suskilyy - Perceived Capabilities - Percentage of 18-64 population who believe to have the required skills and knowledge to start a business.

Opportyy - Perceived Opportunities - Percentage of 18-64 who see good opportunities to start a firm in the area where they live.

## DEVELOPMENT OF ENTREPRENEURSHIP AND GOING OUT FROM A VICIOUS CIRCLE OF POVERTY

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### Abstract

The way of going out from a vicious circle of poverty in Bosnia and Herzegovina, should be introducing innovation and development of entrepreneurship in all fields of economy and society. The emphasis should be put on stimulation and development of small enterprises as promoters of new entrepreneurial ideas. They should be given the opportunity to grow and reach a higher level and expand through convenient working conditions. They should also become cooperation carriers for some new small enterprises.

New and more complexes forms of organizing, doing business and synergetic development of small and medium enterprises is the best answer to the powerful foreign competitors in Bosnia and Herzegovina.

The correctness of this kind of approach towards making the role of small and medium enterprises stronger, is confirmed by the success of developed countries and regions. They achieved fast economic growth during the process of globalization, computerization and technologization of the world's economy.

These countries, also, showed that they are the most competent in finding the solution for newly appeared developmental issues, imposed by the latest global economic crisis. These solutions (which are very important) are not the old, restrictive clichés but, new, innovative-developing approaches.

**Keywords:** Innovation, Entrepreneurship, SME, Poverty, Development

### 1. INTRODUCTION

The economy of Bosnia and Herzegovina in the postwar period is constantly falling behind the economies of most countries in its surrounding. This can be especially seen through high unemployment, foreign trade deficit, export of cheap raw materials and import of expensive industrial products, technical/technological inferiority, low national GDP, worrying "brain drain" and other negative indicators.

Even though, this country possesses significant natural resources and very well educated labour force, the economy of Bosnia and Herzegovina is still stagnating and with the appearance of the world economic crisis, lately, it even declines. The situation in Republic of Srpska is better than in Federation of Bosnia and Herzegovina, but this fact does not change significantly the general image of the state of poverty and undevelopment.

Most of home and foreign economic analysts explain this state with the problem of inadequate business terms that block the efficient usage of available resources and decreases the influx of direct foreign investments and slows the involvement of knowledge in resolving problems of development.

The aim of this science project is not a detailed analysis of the problem of captivated resources, such as human, natural, economic, cultural and other, but to try to show the right way of going out from crisis and poverty, while relying on scientific knowledge and patterns of development given by world-famous economists (especially Nobel prize winner P. Samuelson). Those patterns were implemented by many countries which, lately, managed to achieve fast growth and development of the national economy. Therefore, we will make a short review on the essence of the problem called "vicious circle of poverty" that most of the undeveloped countries, such as Bosnia and Herzegovina, are facing. We will make this review especially from the aspect of opportunities and needs for founding new small enterprises. Bosnia and Herzegovina, falls behind on this aspect too, especially if we compare it with other countries that ended the process of transition successfully (Czech Republic, Slovakia, Poland, Slovenia,...) and became members of the EU. Falling behind these countries, when it comes to the number of small and medium enterprises, is 10 times per 1000 citizens.

## 2. VICIOUS CIRCLE OF POVERTY

Poor countries, such as Bosnia and Herzegovina, are facing big obstacles and problems in the combination of four key factors of progress: work, capital, natural resources and entrepreneurship. Beside that, these countries note that these difficulties, in fact, are reinforcing each other in the "vicious circle of poverty". Attached graphical display shows how one obstacle activates the other, according to Nobel prize winner P.Samuelson[6]. Low income, leads to low savings, low savings slow the growth of capital, inadequate capital prevents introducing new technical/technological solutions and faster growth of productivity, low productivity leads to low income for laborers. Poverty is followed by low levels of literacy and education, and these factors are preventing the implementation of new and improved technologies.

Simplified graphical display of "vicious circle of poverty" according to Samuelson looks like this:

Going out from "vicious circle of poverty" in the largest number of cases requires harmonized effort in many fields and economists who are dealing with the problem of development are recommending "the big step forward" to break the vicious circle. When it comes to developed countries it is not such a big problem. Those countries, thanks to bigger investments, better education of their population, "brain import" and other labor forces of high quality, can relatively easy break the "vicious circle of poverty" and encourage the "good circle" of economic development.

Scientists who are studying social disciplines, are dealing with differences in the velocity of economic growth between different countries. Some early theories were putting the emphasis on the climate as the cause of progress, highlighting the fact that the position of all developed countries is in the area of moderate climate. Others were putting emphasis on the importance of culture, religion and customs as the key factors. Max Weber was highlighting the "protestant ethics" as the leading force that initiates capitalism[1]. On the other hand, others distinguish the fact that the country starts to regress once when it's structure of bringing decisions becomes fragile and when interest groups or oligarchies start to prevent social and economic changes.

Every theory mentioned above has its value for certain time and place, but they are not the universal solutions for the economic development for different countries which are placed on different level of development, have different industrial tradition, business culture and other.

## 3. NEW AND/OR RENEWED APPROACHES TO DEVELOPMENT

During the long period of time, scientists and researchers of economic development were intensively working on new models of economic development for developed and for undeveloped countries. In addition, we will try to give the review of the most important models based on groups of similar approaches and experiences in economic development. Every single approach mentioned will try to describe how different countries break the "vicious circle of poverty" and try to mobilize the key factors of development.

**The take-off**-History of economic development of today's developed countries is full of standstills, declines and take-offs. Often, big inequalities in incomes enabled the minority to direct the savings to form capital and investments in big entrepreneurial ventures which led to unexpectedly fast economic development. For example, inequality between former periods and industrial revolution was so dramatic that scientists, such as W.W. Rostow, developed the theory that divides and puts the emphasis on the periods of economic growth[6]. One of Rostow's periods is called The take-off, and the analogy is made with the plane which is capable to fly only after achieving the critical speed.

Different countries had their take-offs during different periods. For example, England had its ascent at the beginning of the eighteenth century, USA around 1850., Japan in 1910., and in the last 15 years four big countries (China, India, Brazil and Russia) and a big number of smaller countries (South Korea, Finland, Ireland, Taiwan, Czech Republic, Slovakia and others).

The take-off is encouraged by the leading sectors from fast growing export markets or some industry that has large economy. Once when those sectors experience the expansion, the process of self-sustaining growth happens. Growth leads to profit, profit can be invested again, capital, productivity and GDP are advancing. The "good circle" of economic development replaces the "vicious circle of poverty".

**Hypothesis about relative backwardness**-The other point of view emphasizes the international context of development of the undeveloped countries which provides the overcoming of their backwardness in much shorter period. Nowadays, countries in transition can progress on the basis

of capital, skills, and technology of developed countries, which, before, was not an option for developed countries of today. This hypothesis, made by A. Gerschenkron from Harvard, states that relative backwardness itself can even have its contribution in the process of development. Countries in transition can purchase modern textile machines, efficient pumps, surprisingly well seeds, new chemicals and medical remedies and other goods produced with the help of high tech. Considering the fact that these countries can rely on technologies of developed countries, today they can develop and grow much faster than developed countries could in the past.

**Balanced growth-** Hypothesis about the take-off and relative backwardness have attracted the attention of scientists and experts. But, some authors point out that the growth is a balanced process in which developed countries are constantly moving forward. According to them, economic growth is similar to the tailor that progresses constantly and not to a rabbit that runs intermittently and rests when it is tired. In one exceptional study, Simon Kuznets examined the history of thirteen developed countries, going even 1800 years back in history. He came to the conclusion that the model of the balanced growth is the most consistent, at least when it comes to the countries that he studied.

In the end, the logical question is asked: Which of the three models of rapid leaving the “vicious circle of poverty” is the most suitable for Bosnia and Herzegovina, if we consider the country’s needs and possibilities?

Of course, reliable answer to this complex question would require an extensive study that goes beyond this article. But, the experiences of developed countries showed that the periods of crisis are the ideal time for big reforms and “destruction” of old economic structures and building absolutely new structures, based on new technologies[4].

#### 4. THE AMBIENT NECESSARY FOR THE RAPID DEVELOPMENT

Modern development implies, at first place, introducing innovations and entrepreneurship in all segments of economy and society[5]. This kind of development requires changes in basic political and economic values such as: democracy, competition, ownership, legal security, market freedom, education and others. These factors represent the frame of developing new entrepreneurial and economic values, opening new working places, the increase of export, better standards for the society, etc.

The latest world experiences indicate that the behavior of the country and its specific regulations in the area of economy is very important for the development of entrepreneurship. Of course, this does not mean that its action should be the substitution for objective economic legitimacy, but just correction and supplement for trade actions.

Exaggerated state regulation of economic processes can be very harmful and it can create such business ambient that prevents and slows down the initiatives and the entrepreneurial spirit, increases uncertainty and risk, limits the ability of making business predictions and the success rate of initiation and realization of entrepreneurial undertakings.

Creating favorable business ambient has a special significance for stimulating small and medium entrepreneurship through reasonable tax rates, appropriate monetary and credit politics, supporting science and research and education, etc.

Therefore, the state should create an ambient which will help in forming a bigger number of entrepreneurial companies as possible, which will create a competition and contribute to development of economic structure and strengthening the economic power of the state.

The state should contribute to removing the old ideological prejudices about marginal significance of small enterprises in comparison with big enterprises which were the carriers of the economic development through history. The old ideological prejudices about entrepreneurship should give place to the economic reason about rational organization of economical structure in which different forms of owning, organization and size of the business have their place.



## 5. INNOVATION AND ENTREPRENEURSHIP-SUCCESSFUL EXAMPLES IN OUR PRACTICE

Innovations are the generator for the development of the modern entrepreneurship and (self) employment. Along with innovations in technology, non-technological innovations, that refer to introducing the new way of doing business, became very important: organization, financing, selling, managing human resources, etc. Both forms are especially important in the period of economic crisis because they can help the most in fighting against it. Therefore, genuine entrepreneurs see the chance for new ideas and new business right in crisis. People who have ideas, innovations and entrepreneurial spirit do not pay attention on crisis because they have their own vision how to use the resources that are blocked by the crisis and how to turn the trouble into a chance for business[1].

The example of one economist who did not wait at the employment bureau to be offered a job, is very instructive. He decided to become an entrepreneur and with the help of innovation he managed to turn a relatively small business, in the field of special dishes, into a multinational company. The rise and expansion of his company, founded in Vienna, were happening very fast through producing new, patented sort of dishes, medical devices, new sorts of cosmetics and other products and services that were innovative in some way. Today, his group of companies is present in 40 countries and with 150 000 employees, experts and researchers. Business philosophy of his company is: innovation, quality, style and endurance[8].

Another entrepreneur started small home business in producing underwear, while working in a public company. But, when his business started bringing him more money than his salary, he left the old job and dedicated his time to the new business and constant improvement of the quality and design. Today, his company, only in the section based in Teslic, has several hundred employees. The company exports more than 90% of their products to the demanding and choosy European market, thanks to the innovations in producing program and cutting the costs.

Two big companies in Loznica had unused halls and equipment which helped the third entrepreneur (young technologist) to switch the production of metal equipment with the producing of-pellet. It is a cheap ecological fuel for heating, made from waste wood. He came to this idea when he noticed that the market of pallet was very disturbed. Because of the problems with the raw material, Austrian manufacturer reduced the production to one fifth and made a large shortage in the market. That increased the prize of the product for 60%.

Young veterinarian who, temporarily worked at the big pharmaceutical company "Krka" in Slovenia, came to the idea of breeding horses, but not for recreation. He realized that, with a special procedure, their blood can be turned into a serum for snake venom. This innovation increases the income from breeding horses 10 times.

Two graduated engineers of agriculture are preparing the production of fruit seedlings on spacious, neglected garden of his parents on the periphery of Banja Luka. Their business plan shows that the annual average profit will be 37.000 KM. That will only be the first phase of their project which they intend to expand quickly.

In one street in Banja Luka, on the same side of the street, there are five cafes. Four of them are periodically closed and not well visited. The fifth one, located in the end of the street is always offering new drinks and new services and constantly innovates the ambient and the way of serving the customers.

It is a pity that there are still not any sponsors or investors interested in the innovations of a very young group of innovators from the elementary school Stanko Rakita in Banja Luka. Three students from this school invented a new stick for blind people and new foil for the helmets of Formula 1 drivers and achieved a success on a global level. At the fair of innovations in Zagreb and Skoplje they won third place and a bronze medal and silver medal in Warsaw. Their biggest success was when their innovation was proclaimed the best in the competition of 220 innovations from seven countries by the First institute of innovators and researchers of Iran at the Eight exhibition of innovations in Zagreb "Arka 2010". This is a great chance of turning innovations into business which would make great profit and which would be a big stimulus for other young, talented people to, just like their peers in Finland, during their lifetime wish to register at least one patent. That would be a big economical benefit and it would help Republic of Srpska and Bosnia and Herzegovina to leave, as soon as possible, the circle of the undeveloped countries (that survive thanks to exploitation of the natural resources) and become the members of the group of countries that base their development on innovations and knowledge.

Global Entrepreneurship Monitor-GEM, divided the countries in three groups on the basis of their level of development and the competition ability of their economies in 2009. The first group of



countries are those that base their economic development on the natural resources (those are the least developed countries, one of them is Bosnia and Herzegovina). The second group of countries base their economic development on the efficiency of the industrial production (from ex Yugoslavia: Serbia and Croatia). The third group are the countries whose economic development is based on innovations (from ex Yugoslavia only Slovenia).

Innovations are not the monopoly of big and rich countries that invest significant amounts of money in research and science. Among 15 countries that, according to the research of the magazine "The Economist" in 2008., realized the most innovations per capita are also small developed countries: Switzerland, Israel, Finland, Austria and Slovenia. The example of Finland, that created great logistic support and social climate for innovations in numerous innovation centers, called "technopolis", is especially interesting. The life ambition for young people there is to register at least one patent during their lifetime. A similar program is initiated in Bosnia and Herzegovina through innovation centers in Tuzla and Banja Luka. This fact is encouraging but too modest because of the fact that innovations and their turning into business ideas, development and (self)employing are the best option for young people who have entrepreneurial preferences and skills.

## 6. SMALL COMPANIES MUST GROW INTO BIG ONES

Creating new entrepreneurial ambient, at all levels (from the state level to the local communities), in Bosnia and Herzegovina must be systematic and with clear aim of unblocking existing resources and creating new ones. Economic and law system must stimulate irrational usage of resources and bad entrepreneurial ideas. That means that the most important task of the economic and law system is to provide such business ambient in which the irrational usage of resources will be replaced with the new, more rational, and the unsatisfactory entrepreneurial ideas will be replaced with new, more progressive and more creative ones.

Removing the obstacles for realization of new entrepreneurial ideas, a new entrepreneurial social class that efficiently uses the existing resources and thinks about the opportunities of creating new resources, will be constituted. G. Gilder (former adviser of the president of the USA R. Reagan) said it wisely that the true entrepreneur is the one who, not only optimally combines the available resources, but also creates them. According to G. Gilder the entrepreneur is the "creator of the market and business opportunities, the one who encourages the resources and creates new technology". Such individuals do not pay attention to crisis but create and realize the vision of development of their business 30 of 50 years in advance. Their entrepreneurial projects are based on the principle of "turning the trouble into advantage" and they are recognized by the exponential growth of their business. Such entrepreneurial projects are at the same time crucial "drivers" in leaving the crisis and "vicious circle of poverty".

This approach in Bosnia and Herzegovina should also remove the obsolete point of view when it comes to small enterprises, which are the strategic component of economic development, increasing the employment, export and the social standard. It should not be forgotten that small enterprises have their spot in the market, but their prerogative task is to grow rapidly and develop into small and big enterprises. Small enterprise is the beginning of the big business (big enterprise), not the final goal and the final form of business. Small enterprises can manifest their importance only if they are connected into chains of value, clusters, cooperative processes etc. They have to be linked in clusters and similar business forms which represent "flexible business networks" as new forms of economic subjects that are quickly adjusting to the changes in the global market. In particular that refers to the improvement of design, quality, service and prizes of products. They are becoming the key factors of the competition position of every economy in the global market and therefore all rules of management and development are changing.

## 7. CONCLUSION

Everything mentioned above indicates that leaving the “vicious circle of poverty” in Bosnia and Herzegovina should be accomplished through innovations and developing entrepreneurship in all areas of economy and society. Stimulating the development of small enterprises as promoters of new entrepreneurial ideas and enabling them to grow into larger forms is very important. The new advanced form of organization will be the best answer to the strong foreign competition in Bosnia and Herzegovina.

Correctness of this approach to the development of entrepreneurship based on knowledge and strengthening the role of small and medium enterprises is confirmed by the successes of the above mentioned countries and regions, that recorded fast economic growth in the process of globalization, computerization and technologization of the global economy.

These countries proved to be the readiest in finding the solution for newest developmental problems imposed by the latest global economic crisis. Those solutions (which is very important) are not the old, restrictive clichés, but new innovative-developmental approaches.

In Republic of Srpska and Bosnia and Herzegovina these processes are at the beginning and it takes a lot of time, knowledge, resources and experiences of other countries in creating favorable ambient for the development of entrepreneurship and self-employment based on innovations, new technologies and new ideas. Without that it is hard to expect that we will leave the “vicious circle of poverty” and deep economic crisis in which we are.

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## CONTEXTUAL INFLUENCE ON THE ENTREPRENEURSHIP POVERTY REDUCTION RELATIONSHIP IN NIGERIA: A MULTIVARIATE ANALYSIS

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### Abstract

Poverty reduction is the millennium development goal of the United Nations and in deed of all developing countries in Africa. Previous research has shown that there is a positive relationship between entrepreneurship and poverty reduction on one side and economic growth and poverty reduction on the other. This study's contribution is the focus on the impact of entrepreneurship on poverty reduction as a spill over effect of national growth.

### 1. INTRODUCTION

Nigeria is known all over the world for its mass-poverty and poor economic growth (world bank 2011).further, poverty is wide spread in Nigeria, which is one of the stylized facts in Sub-Saharan Africa (Schoumaker, 2004, Fissuh and Harris 2010).

The poverty trap had a continual dependence on external injections of resource such as socio-economic family dependency without the potential for Nigerians to reach endogenously stable consumption/production equilibrium. Poverty traps are associated with poor human development, thus cumulating in unending spiral of human misery (Adams and Raymond, 2008, Mckenzie and woodruff, 2006)

It has been noted that it is not sufficient simply to focus on raising growth rates of GNP, in the expectation or hope that the national growth will trickle down' to improve levels of living for the very poor on the contrary, economists argued that direct attacks on poverty by means of poverty focused policies and plans especially in areas of entrepreneurial development can be more effective in both the short run and Long run (Todaro, 2000)

Entrepreneurship can help to reduce absolute poverty by commanding sufficient resources to satisfy basic needs (Todara, 2000). Further, scholars seen to have reached consensus about 1980s being the Turing point when entrepreneurship rates reversed their long term downward trend (blau,1987 act and Audretsch, 1993, act, Carlson and Karlsson, 1999, Carrere and Thurik, 2009, Vestal, Thurik and Ennekers, 2002)

### 2. OBJECTIVE OF STUDY

The major significance of this research is that a number of important gaps exist in the areas of impact of entrepreneurship on poverty alleviation. It must be noted that, previous research has show that there is a positive relationship between enterprises levels of entrepreneurship and their financial performance, that is the creation of value in form of wealth maximization for the owners as a strategy to reduce poverty. Little research has hither to focus on measuring the relationship between entrepreneurship and poverty reduction in Nigeria. Such research had concentrated mostly on areas as purpose, structure intensity and value creation. Thus, this research will concentrate mostly on a comprehensive study of entrepreneurial activity in order to assess time-varying and time-invariant determinants of firm-creation, and its relationship to economic growth and poverty reduction.

### 3. EMPIRICAL LITERATURE

The entrepreneur is a person who is working to take risks: or a person who by exploiting market opportunities, eliminating disequilibrium between aggregate supply and aggregate demand or as one who owns and operates a business (Tyson, Petron, Rogers 1994). Further entrepreneurship can best be defined as "a force that mobilises other resources to meet demand the ability to create and building something from practically nothing" that is, the process of creating value by' pulling together a unique privilege of resources to generation.

#### 4. THEORITICAL BACKGROUND

Schumpeter (1934) pioneered the theory of economic development and value creation through the motion of technological and innovation. Entrepreneurship theory. Theoretical insights from industrial economy (Hanna and Freeman 1989, Carroll and Hanna 2000) and also researches in institutional economic nelson, 1996; north 1984) as well as empirical studies describing the ongoing politically defined changes in the institutional constraints (Ducket, 1998, Guthrie, 1999, Nolan 2001) suggest a dynamic approach to formulating an expost analysis of the development of the development of the private business sector. Further, the dynamic capability perspective (Teece et.al 1977) emphasise the proactive potential of the firm by referring to certain types of resource and capabilities.

In the first case, Nimi et.al, (2003) found that the degree of engagement in export (measured by the additional determinants of change in poverty status. They are classified as trade-related determinants of poverty dynamics. In similar vein, Dawson, hanky and Laterithe (2009), opined that market directed opportunity entrepreneurship are more strongly associated with higher educational attainment. Exploit an opportunity “(Jones, sarong 1980, Timmons, 1989, Stevenson, (1985).

Entrepreneurship is an important element in organizational development and economic growth (Antoncic and Hisrich 2001; Drucker 2002). In Developing countries, entrepreneurship is seen to be vital to address the issue of job creation, economic growth and the exploitation of opportunities (von Broembsea, Herrington and wood, 2005). Entrepreneurship is essential for the continued dynamism of the modern market economy and a greater tare of new business can foster completion and economic growth (flapper, leaven and Rajan, 2007).

Even though the impact of entrepreneurship Baumol, 1990, Thurik and Wennekers 2002), but then the importance of entrepreneurial behaviour in developing countries, such as Nigeria is emphasised by intensified competition in global economy, the need for economic growth and the impact of entrepreneurial behaviour on future growth and poverty reduction. Most researchers argued that the strength of entrepreneurial value creation (poverty reduction through financial performance), will increase over time as levels of entrepreneurship increase (Hayton 2005. Goosed, De coming and Smith 2002; Zahra, Nielsen and Bogner 1999). Entrepreneurship in Nigeria is predominant in the service sector, which includes numerous low-value but labour-intensive sub-sectors ahs arguably made a contribution to employment.

#### 5. METHODOLOGY

In assessing models of entrepreneurial evaluation and impact assessment questions revolved on data collection and verification discussions on the use of parametric versus non-parametric approaches to measuring outcomes and the appropriate outcome variables, to measure, at this time, there does not appear to be a common standard for evaluation, with each program using its own sets of measures (Crombruggbe, Tenikue and Sureda, 2008; Hollis and sweet man, 2001,). In some cases a Multnomial (or binomial) logistic regression to panel has been used to study poverty dynamics and the correlation with entrepreneurship, for example, Glewwe et.al (2002) and Justirio Litchfield (2003b) but the most common methods in the research employed, survey, or used data from surveys taken by researcher is regression analysis to report model fit (Phan 2009).

Following the methodology adopted by Pierre Erasmus and Retha Scheepers (2008), also multiple regression was used to assess the degree of relationship between levels (types) of entrepreneurship and poverty reduction; subset and step wise regression analysis were not employed since there are few numbers of predictors.

#### 6. MODEL SPECIFICATION

The econometric specification that will capture poverty reduction and other control variables that effectively impact on the strategy is adapted from the work of simpler k; et.al (2004); and Fissuh and Harriec M., (undated); Thang N., (2006) and Wodon Q., (undated). Thus

$$Pov = F(Eq + Z) \text{-----}(1)$$

$$Et = F(Ri \text{ Ed, Lv,}) \text{-----}(2)$$

Where Pov = poverty

Et = Entrepreneurship

Ri = Return on investment

Ed = Educational Development of entrepreneur.

Lv = Level of Entrepreneurship.

Z = Vector of all control variables that affect poverty; other than entrepreneurship.

From theory, the a priori expectation is an inverse relationship between poverty and the predictors for alleviation.

Hence:  $pov = \beta_0 E_t^\beta \beta_0 E_t^\beta Z^\beta Z^\beta e^u e^u$

$$pov = \beta_0 \beta_0 + \beta_1 \beta_1 E_T E_T + \beta_2 \beta_2 Z + M \text{ ----- (3)}$$

Normally harvesting will be combining. Thus giving.

$$\log Pov = \log \beta_0 \beta_0 + \beta_1 \beta_1 \log E_T E_T + \beta_2 \beta_2 \log Z + M \text{ ----- (4)}$$

$$\log E_t E_t = \log \beta_0 \beta_0 + \beta_1 \beta_1 \text{ e.g. } R_i R_i + \beta_2 \beta_2 \log E_d E_d + \beta_3 \beta_3 \log L_v L_v + M \text{ ----- (5)}$$

A priori, we expect

$$\beta_0 \beta_0 > 0, \beta_1 \beta_1 < 0, \beta_2 \beta_2 > 0, \beta_3 \beta_3 > 0$$

## 7. RESULTS

With the assertions by Hangton and Khandker (2009) and Glewee (2009). Our main focus of analysis will be the estimation of main statistical inferences like mean R2, the t- statistics and the P- values, deviations and slim-squared error.

### 7.1. DESCRIPTIVE RESULTS

(a) Mean: Edu =21.6

Ent = 22.4

Retn =30.6

(b) Deviation: Edu = 8.53

Ent =14.46

Retn =10. 06

(c) Probability: Edu =0.55

Ent = 0.71

Retn =0.70

(d) Sum sq. error: Edu =108.00

Ent =112.00

Retn = 153.00

### 7.2. REGRESSION RESULTS

The adjusted R<sub>2</sub> will be employed to measure the proportion of the variation in the dependent variable (poverty reduction) accounted for by the explanatory variables financial returns on investment, Educational level of the entrepreneur, and entrepreneurship level in terms of amount of capital invested. Thus from the regression output:

$$Pov = 6.10 - 0.019Rt - 0.010Ed - 0.014El$$

$$Se = (0.632790) (0.49923) (0.220429).$$



### 7.3. DISCUSSION OF RESULTS

The mean score, here, corresponds to the average of score on the 5-point Likert- type scale used for the characteristics of poverty reduction. The statistical reliability of our t values is not in doubt as reflected in our data displayed in 7.1. Also the output of our sample data variation through the sum squared for error (that is the within- treatment variation) as described in 7.1, under descriptive results.

Section 7.2 discussed earlier displays the regression output. The coefficients for most of the poverty reduction strategies (that is contributory determinants) are all negative. Education of the entrepreneur however is a better determinant with 10% increase leading to 61% boost in poverty reduction. The adjusted  $R^2$  is low and negative. This suggests serial correlation i.e. multicollinearity among the explanatory variable; most likely to result from specification error as is normally expected of cross-sectional data. The negativity of the  $R^2$  notwithstanding, the fit is excellent as depicted by the standard error of the estimates for the three parameters, but then here entrepreneurial level is more preferred as a contributing strategy for poverty alleviation, even though education is equally important. The value of the test statistics (t) for all the predictors dedicates linear relationships with the dependent variable. The large t-values for education again is an indication of level of education as the best predictive value.

### 8. CONCLUSION

Entrepreneurship is omnipresent- entrepreneurs are present in all settings. Cultural explanations for a lack of entrepreneurship over look what people have in common-namely alertness for profit and to improve their general situations. Under developed countries do not lack entrepreneurship. Rather entrepreneurial activities exist but are not directed toward productive ends conducive to economic progress.

The connection between entrepreneurship employment growth and subsequence reduction in absolute poverty is remarkably robust. It is stronger for transportation. Distribution and service but never the less not strong for direct productive activities.

Theories that emphasized the supply of entrepreneurship in order to reduce poverty and contribute to national growth face both theoretical and empirical challenges. Challenge arising from the output of this research is harder. To show how entrepreneurship can reduce poverty, there must be well measured exogenous variables that capture and drive entrepreneurship supply. This illustrates that using broad-brush measures like overall education levels is likely to be insufficient.

The financial returns on most form of entrepreneurship are probably comparable, rather than higher in production and export activities which had been theorized by scholars as preferred types. Despite all the challenges encountered in this research, it must be noted that there is truth to chinitz's hypothesis and that at least some of the connection between entrepreneurship and poverty reduction reflects heterogeneity in the various determinants that could be employed to reduce poverty in Nigeria.

However, it is very significant to note that established theory indicates the importance of providing a supportive climate for enterprises pursuing a growth strategy and the eventual poverty reduction opportunities.

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## APPENDIX 1

Table 1. Survey data on entrepreneurial characteristic and determinants of poverty alleviation policies.

Enter characteristic	Code	Rt	Ed	El
Transportation	1	39	25	37
Services	2	36	29	30
Production	3	26	22	4
Distribution	4	37	25	31
Exports	5	15	7	10
Total (%)	100	100	100	100

Source: researcher's survey, 2011.

## APPENDIX 2

Table 2: Regression output; descriptive statistics

Sample: 1-5			
	EDU	ENTERP	RETURN
Mean	21.60000	22.40000	30.60000
Median	25.00000	30.00000	36.00000
Maximum	29.00000	37.00000	39.00000
Minimum	7.000000	4.000000	15.00000
Std. Dev.	8.532292	14.46720	10.06479
Skewness	-1.182668	-0.364522	-0.789933

Kurtosis	2.871734	1.373287	2.045794
Jarque-Bera	1.169015	0.662021	0.709685
Probability	0.557380	0.718198	0.701284
Sum	108.0000	112.0000	153.0000
Sum Sq. Dev.	291.2000	837.2000	405.2000
Observations	5	5	5

Table 3: regression output: least squares method.

Sample: 2001 2005

Included observations: 5

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	6.102297	5.393561	1.131404	0.4608
RETURN	-0.019951	0.632790	-0.031529	0.9799
EDU	-0.100386	0.499323	-0.201044	0.8737
ENTERP	-0.014440	0.220429	-0.065508	0.9584
R-squared	0.571846	Mean dependent var		3.000000
Adjusted R-squared	-0.712617	S.D. dependent var		1.581139
S.E. of regression	2.069189	Akaike info criterion		4.282752
Sum squared residue	4.281541	Schwarz criterion		3.970303
Log likelihood	-6.706881	Hannan-Quinn criter.		3.444168
F-statistic	0.445203	Durbin-Watson stat		1.790466
Prob(F-statistic)	0.769109			

**(Footnotes)**

- 1 Correlation GII vs. number (no. observations: 240), correlation GII vs. duration (no. observations: 232)
- 2 WIPO - World Intellectual Property Organization

Part Three:  
Family business, Education, Culture,  
Gender

## MANAGING INTERRELATIONS BETWEEN FAMILY AND BUSINESS

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### Abstract

In recent decades, family businesses have enjoyed the special attention of researchers and scientists in the areas of entrepreneurship, management, economic development and small business. The interest of researchers in these areas is understandable because of the unquestionable contribution of family business to the sound economic development in comparison with the non-family business. More or less, researchers from those areas focus primarily on economic and management issues of family business as a relatively modest emphasis on family-related problems is being put.

Incorporating family relationships in the relations arising in the processes of the business itself, including its governance, poses specific problems whose solution depends on the success of the business. Assuming that it is hardly possible to fully distinguish between family and business issues in a family enterprise, leads to the idea that it is necessary to establish business relations skillfully managing a 'family – business', instead of making a completely separated relationship.

Relations between family and business cover issues such as:

- Selection and Employment of family members;
- Rewarding family members;
- Erection of management positions of family members;
- Transfer of ownership in the family business between two or more generations as well as landmark relatives from one generation;
- Relations with sisters-in-law, brothers-in-law and lovers;
- Allocation and division of property;
- Representativeness of the family in managing the family business.

This report will provide an overview of theoretical concepts, research results and own case studies in respect of approaches, methods and practical solutions in managing the relationships 'family – business'.

**Keywords:** Family business, Management



## 1. NATURE OF FAMILY BUSINESS

The family business is widespread on the continent. According to the European Commission about 60% of European companies are family businesses (Mandl, 2008). For this reason and because of contribution to economic development, its nature, specificities and characteristics represent a significant interest to researchers, consultants and trainers.

In economic theory there is no consensus about the nature of the family business. In 2009 an expert group of the European Commission first adopted a common European definition of family business. According to this definition a company, regardless of its size, can be categorized as a family business, provided it meets the following requirements (Mandl, 2008):

- Majority share of ownership of a family company is owned directly or indirectly by the individual who established the company or acquired the relevant shares or share capital of the company, or possession of her / his spouse (s), parents, children, direct descendants of the children.
- The majority of decision-making rights are directly or indirectly associated with the family.
- At least one representative of the family is actively involved in the company's activity (ie, not all are waiting dividends).
- Companies, whose shares are quoted on the stock exchange, meet the definition of family business if the person who established or acquired company (equity) or family members hold at least 25 percent of the shares.

The 'European' definition is based on 90 different definitions of family business. The concentration of family ownership and influence on management (strategic control) is placed in its base. In this regard it is considered that there is a family business where over 51% of the ownership of an enterprise is in the hands of the family. Additional features are set to differentiate a family from a non-family business. For example, involvement of family members in the daily activities of the entity (i.e. formal or informal employment of family members with managerial activities), major contribution of the company to generating family income, and continuity between generations (i.e. intention to ensure sustainability of the enterprise regardless of the life of its assets).

This seemingly clear picture of the nature of the family business does not reflect the main difficulty associated with its operation, namely: family firms grow at the border of two qualitatively heterogeneous social systems – family and economy. The social function of each is different. For example, the task of the family is to grow and develop its members, and business – to meet the needs of society products and services. Each of them, though, has its own set of values, cultural norms and ethical principles and specific rules of governance and modes of communication. As these systems have innate differences, but interact intensively, the boundaries between them are blurred and sometimes show a sense of confusion and frustration (Todorov, 2011, pp. 158-160).

Recognizing the importance of the alleged peculiarity, R. Donnelly (1964) suggested more concrete understanding of family business with a requirement that it (business) has developed at least two generations of a particular family. This not only allows the formation of long-term company policy, but also taking into account the interests of the family as a whole.

Understanding of 'classical' family company in which ownership and control are in the hands of the family as well as the making of all important decisions, was adopted not only in developed European economies, but in the U.S. There, however, attention is also aimed at the so-called 'managerial capitalism' (Colli, 2003, pp. 9-12). From the perspective of 'managerial capitalism' there is a theoretical possibility for family enterprises to be defined as such, bearing in mind their size. In broad terms, the family firm may even be regarded as a step in the lifecycle of an enterprise, which includes the period from launch to acquisition of a public character by the company. In other words, family firms are primarily small and medium-sized enterprises, which are characterized by slow growth, a flat organizational structure and simplified business model. These companies rely heavily on self-financing or limited external funding from local, often non-bank sources, which affects the generated profit margin (profitability).

Of course nowadays there are opposing views based on the number of examples of large family businesses with significant earnings (profitability). They combine features of the traditional family company with advanced features of capital markets. These include most of medium and large family businesses, dominated by transnational companies in an industry. They are known throughout the world to rely on international financial institutions and investors, attracted by its profitability. It is

therefore not properly being considered that family businesses are less profitable than non-familial managed by hired professional managers.

According to David Sirmon and Michael Hitt (2003) success of family firms is more dependent on how well managed the following aspects of business are:

1. Human Resources. The main among them is the family human resource or 'inner circle' of the company. When the skills of family members are coordinated (presumably deeper division of labor), the probability of success improves significantly.
2. Social capital. Family members are carriers of valuable social capital for businesses in the form of social contact with the outside environment to enrich the company's internal environment.
3. Financial capital. The family company usually has a stable capital in the form of assets and debt financing from family members. Family relationships between investors and managers reduce the threat of liquidation.
4. Survivability capital (capital for survival). The family firm has to manage the so-called capital for survival or it is the willingness of family members to provide free labor or money, so that the entity does not tolerate failure or a bad reputation.
5. Low management costs. Family business should be able to maintain a certain level of management costs. In non-familial firms, these costs include maintenance of accounting, security systems, regulations and other mechanisms to curb abuses and monitor the work habits of employees. Family firm can minimize or eliminate these costs, because employees and managers relate to and trust each other.

Clear separation of these unique characteristics of family businesses and their inclusion in a well-implemented management strategy would significantly improve the chances of business success, compared with non-family enterprises.

However it is the fact that family firms in the process of decision making is more complex than that of non-family. It is directly or indirectly involved in a wide range of stakeholders, thus increasing the likelihood of conflict. A good idea about the complexity of relationships gives a family business model, developed by K. Gersick, E., J. Davis, M. Hampton and I. Lansberg (1997) who represent a family business as combination of three cycles – family, business itself, and ownership.

The presented model can be used to identify possible sources of interpersonal conflict in the line 'family – ownership – business'. For example, owners – family members who do not work in the company may require increased dividends, perceiving it as an acceptable return on investment. Family members, working in the company but not being owners, are likely to declare themselves against such a move. They are behind the idea of reinvestment in order to create better opportunities for their professional development. Both parties may be brother and sister or have another family connection. Another common conflict situation is related to the question of jobs and wages of family members. A person who has more than one link with the business (through the marital relationship, participation in ownership or personnel of the company), for example (family circle) will defend the position to give chance to all children of the family. Employees who are not family members would accept the appointment only to those relatives who are better than all other candidates and advancement based on individual qualities.

## 2. ADVANTAGES AND DISADVANTAGES OF FAMILY BUSINESS

The relationships between 'family' and 'business' have both its positive and its negative consequences on the performance of a family enterprise. Reasons for this are various targets and related functions of the systems 'family' and 'business'. Giving more consideration or preference to one of the two systems inevitably leads to undesirable consequences for others. However, good management of relations between the two systems would create significant benefits for the family business. Below we will refer to a summary of the main advantages and disadvantages of family businesses, which will serve as a starting point in the search for basic principles of good governance of the relationship between family and business. This generalization can highlight the following advantages and disadvantages:<sup>1</sup>

Advantages of a family business:

- Aligning goals in life and business. Opportunity for achievement of business purposes in the best way, feeling them as a life vocation.

<sup>1</sup> Leach, P., T. Bogod, Guide to the Family Business. 3-th ed. 1999. BDO Stoy Hayward, UK.

- Knowledge – applying own knowledge and making money from it, which brings satisfaction to the family.
- Flexibility of time, work and money – can quickly adapt to changing environmental conditions and unforeseen circumstances.
- Forward-thinking –the family business almost always has a family vision for its development in the horizon of 10-15 years. In Japan, family businesses may even have a planning horizon up to 20 years (one generation). Perspective planning in family businesses is not always linked with written plans. In most cases, it is informal.
- Sustainable culture – every family member knows by tradition how things happen; how they conducted negotiations; which are the major competitors; what are the ethical rules, etc. These ordinances are passed from generation to generation and have a sustainable character. They are learnt unconsciously in most cases.
- Quick decisions – because of informal (family) relations, as well as linking ownership and management.
- Reliability and proud – family firms are generally solid and reliable structures and market-oriented. They have traditions, which make them attractive to business partnerships. Reputation and traditions bring pride to the family and generations. For example, when breweries companies, which have arisen as a family enterprises, in advertising rely on tradition and reputation.

Traps (disadvantages) of a family business:

- Numbness - in terms of traditions in the family business. Knowledge of the older generation, which adopted novelties with difficulty.
- Business challenges – for different generations in the family business, business challenges have different meaning and character.
- Success – success of the previous generation can be discouraging to the next. So-called ‘Old Glory’.
- Emotional problems – problems in the family as an emotion may impact negatively on business and relationships in the company.
- Leadership and home affairs – the struggle for leadership in family businesses and the imposition of internal order can be a ‘trap’ for the development of the company.

### 3. FAMILY BUSINESS IN BULGARIA – CHARACTERISTICS OF ITS DEVELOPMENT

The period in the economic development of Bulgaria after World War II is characterized by the forcible entry of the Soviet economic model, in which for ideological reasons, there was no place for private, including family business. The nationalization of industry in 1947 practically put an end to many family businesses, some of which had decades of history. Only with the adoption of new economic regulations in the 80s and mostly entered immediately before the political changes in force Decree 56 of 1989 created real conditions for the revival and establishment of new family businesses. The result is a boom in the creation of new enterprises, many of whom are family businesses. After more than 20 years of transition to market economy, it would be naive to assume the existence of an equal start in the establishment of new family businesses. Today, there are significant concerns that not all family businesses are the result of full family initiative and entrepreneurial qualities of the founders. Thus now we can talk about several types of family businesses. The first type – perhaps the most popular, companies are created by families who have no family tradition, but started their business, seeing in it the preferred alternative for realisation, for both the founders and the other family members. Among this type, many cases of forced entrepreneurship could be found – especially in areas where the chances of finding attractive jobs are very limited.

The second type of family firms are those created on the basis of restoration of the proprietary rights on old family assets (usually buildings that served as the basis for family business decades ago). In this type it is not uncommon for some family tradition to recover as far as contemporary situation permits. In general, these companies have an advantage over the first type in two respects – the capital base and family traditions.

The third type of family firms are companies created by people with strong positions in the transition,

whether in politics or in business life. Using established contacts, some patronage, and vast opportunities created by privatization, these people managed to gain significant business assets at a low price and then, in the case of a successful entry into the business began to attract their heirs to the business.

The above summarized distinction aims to give us a starting point for our further analysis in the management of family and business relationships, outlining several important moments in giving priority to family or to business. For example, in the first type of companies we could not expect significant sacrifices in the family as far as business is the only one tool for achieving and maintaining family well-being and in this plan one can hardly expect that business management will be placed entirely on principle bases. Rather, the business would tolerate change and development to meet the family needs more. In the second case of family firms – those, whose roots are in the more distant past, could suggest that more family relationships will be subject to business, or at least will see the family reach a consensus on the balance between family and business. Most interesting is the third type of family businesses in which to launch the family business has less merit and commitment respectively. Benefiting from its strong position, the founder has sought primarily to strengthen the business and his family is rather perceived as a user of any goods to which the business would contribute. Naturally, such a situation can even lead to neglect of family relationships in the name of preservation and development of the business.

Important practical issues that arise from the nature of family business are the following:

- Separation of family relations from the relations required by the business;
- The selection, appointment and remuneration of members of the family;
- The selection, training and promotion of family business successor.

In the first type of companies it is natural that the first question remains open as far as business is subject to the welfare of the family, almost all capable of working family members are involved in business, and it would be unrealistic to require strict separation of family and business relationships. In these companies, solving the second problem is mostly based on family relationships and has less than rational practice of non-family enterprises. Finally, the third question is left to solve itself, relying on tradition, natural processes in the dynamics of a family, not ruled out if the potential successors decide to accept it as a family business or take on their own way.

In the second type of firms it can be expected that the established precedents in the past in solving those groups of problems serve as an important milestone even today, providing a smaller degree of drama in the management of family business. Surprises here may occur mostly in line with the relationship-in-law and wives, especially when they are too ambitious and express large claims for participation in the process of moving business from one generation to another. Such enterprises are particularly sensitive to the expression of key employees who are not family members, thereby limiting potential of enterprise management. The fact is that in Bulgaria there is no significant number of this type of family businesses, not so because of more than four decades of de facto ban on private business, but more due to exhaustion of the potential of a family to raise and train successors to the wide range of opportunities provided by the present of a limited number of successors.

The third type of companies is most often characterized by a later phase of involving family members as employees, which helps the company to acquire characteristics of a family business. Although such companies avail of a number of formal rules and procedures (given their larger average size or their inheritance as privatized entity), as a rule, family members are given privileged position, high salary, regardless of their personal skills and efficiency. This practice, of course does not mean that because of their successors, the creator of such an enterprise would be prepared to risk its ruin by incompetent leadership from the unprepared successors – rather, he would entrust the actual control in the hands of professional managers, but ensure his heirs' enviable status and income (if possible). Concerns can be expected at a later stage, when the owner of such an enterprise is hampered by limitations arising from age, but his successors have not yet proven quality at reasonable entrepreneurs. And it is not excluded that an entity will be left in the hands of professional managers (something extremely difficult in Bulgaria) and the heirs are forced to distance themselves from making the most important decisions in order to keep the business as a reliable source of family income.

For a better understanding of the Bulgarian specifics in the management of family and business relationships it is necessary to put a brief presentation of the modern Bulgarian family.



#### 4. THE BULGARIAN FAMILY AS SOURCE OF PROBLEMS IN A FAMILY BUSINESS

For the purposes of this study it is hardly necessary, and also hardly possible to search a complete and comprehensive picture of the state of the Bulgarian family. The lack of a need for a composite portrait could be argued with research interest in only one part of families – those who are involved with their own family business. Although these families would have revealed significant differences, especially in terms of their social characteristics, the common between them is the expected relatively high family cohesion necessary for successful realization of the family business. On the other hand, the ability to seek full and complete account of the family in Bulgaria is strongly limited by the existence of diverse cultural groups, differentiated by class, ethnic, religion, and even geographically. So, here we consider more important to identify and analyze in the context of the family business, only those trends highlighted in recent decades that characterize most families involved in their own business. Narrowing the focus on families involved in family business, we will place emphasis on the relationship between the founders of the business (most often parents in a family) and their children as people who are assigned to certain hopes to engage in the problems of the business.

Among the few studies of contemporary family made over the last decade we will have a look at the study of Alpha Research conducted in 2006 (Angelova, 2006). Among the main conclusions, reached by this study pertaining to the family business, the following should be highlighted:

- The relatively late creation of families and children by the highly educated seeking or making their career, young people;
- Increased criteria to assumed responsibilities to the opportunities for living, educating and developing their children.

As to the data for the preferred age for having children, the study shows 30 for men and 26 for women. Simple arithmetic shows that when the heirs reach maturity, the founders of family businesses are in an active age, with very foreseeable limit to possibilities. In the best case for withdrawal from the business the most mature heirs are those of the age of 35, which will correspond to their early married years. The logical question is: will there be sufficient time to prepare a credible successor in the business, given the time necessary to acquire university education, the time at which a person makes their life decision from so-called ‘modern hedonism’, which aims to provide ‘more free time limited by commitments and responsibilities, their maximum satisfaction of consumer attitudes, etc.’. Not coincidentally, in some of the developed countries they accept that the achievement of sufficient maturity for running a business is only to 40 years – age, at which the successful so far life experience is accumulated to reach the emotional liberation needed for making thoughtful, rational and objectively measured decision in running a business.

The second important characteristic of these Bulgarian families is that a significant part of the lives of the founders of the family business occurred in the years of so-called ‘socialism’ – social structure in which the opportunities for material security and personal prosperity were greatly restricted. These restrictions, including the ability to create their own business, eventually led to two important effects, which are evident today. The first is the limited number of children produced within a family – most often two, sometimes three, and very rarely exceeding four. (Here we do not mean Roma people, whose livelihoods almost preclude the family business.) The second important effect is the special sensitivity to physical security of the heirs, which in the case of reaching significant capabilities of parents, most often exceeds reasonable levels of property security of children at the time of their maturity.

Finally, it should focus on some peculiarities in the education of children in the Bulgarian family. A survey among parents proves that the parents’ beliefs that the values their children perceive depend first and foremost on the family, and to a much lesser extent on the society, especially on the educational institutions. This belief is paradoxical largely because of the very limited time that parents have to their employment, but on the other hand is completely understandable given the negligible opportunities provided by the society for self-growth and development of the individual. The latter refers not only to the teenage years, but primarily to the first decade of post-secondary education in which man builds the most important skills for individual development. And while the existence of man is linked to parental support it is much more likely to perceive values instilled by the parents, especially when life’s achievements of parents are high and their experience – positive.



Expected consequences for the family business from those features of the Bulgarian family can be summarized in the following features:

- Successors often inadequately trained and not mature enough to ensure continuity in family businesses;
- Very limited options for selecting a suitable successor to the business among the direct heirs;
- Reduced motivation of heirs because of the premature saturation with material collateral in traditional and public plans;
- In the case that direct heirs are involved in the family business, they tend to occupy high privileged positions, regardless of their personal achievements and higher than other employees in the business for payment;
- The formation of unreasonable self-importance and claims by heirs to the others.

## **5. RESEARCH THESES – COMBINATION AND SEPARATION OF FAMILY AND BUSINESS RELATIONS IN THE BULGARIAN FAMILY BUSINESSES**

Undoubtedly, the success of a family business depends largely on the enjoyment of the advantages and overcoming the disadvantages of nepotism in the business set out above. In family businesses in Bulgaria these advantages and disadvantages reflect also some national and historical peculiarities, shown above too.

In this study we will try to formulate a number of theses whose proof will rely on empirical studies conducted in the spring of 2011. The directions in which the theses will be formulated are:

Guidelines, which will be exhibited are:

- Selection and Employment of family members;
- Rewarding family members;
- Erection of management positions of family members;
- Transfer of ownership in the family business between two or more generations as well as landmark relatives from one generation;
- Relations with sisters-in-law, brothers-in-law and lovers.

Thesis 1. In the selection and employment of family members there is no desire to objectify, instead each member is allowed to participate in business, regardless of abilities and skills possessed. Justification of such an approach is based on the expected loyalty, higher confidence compared to non-family members, and the expected higher degree of sacrifice and obedience of the family members in crisis situations.

Thesis 2. Remuneration of members of the family engaged in the business will be based on the capabilities of the family firm, most often at the expense of workers nonmembers of the family, and no direct connection with the contribution of staff member of the family. The justification of this approach can be sought in two directions - 1. Family business to be perceived as desirable employer (compared to others) and 2. To emphasize the importance of family members as potential successors to the rest of the management staff.

Thesis 3. The rise to management positions of family members of the founder is based on the principle 'in his image and likeness', thus giving preference to one heir, whose character and behavior are most similar to the notion of 'right' manager. The justification of this approach lies in the fear of taking 'evasive maneuvers' that can 'sink the ship'.

Thesis 4. The issue of transfer of ownership in the family business in Bulgaria is approached with extreme caution, as the aim is to avoid any prejudiced vanity of a member of the family from which serious conflicts may arise, and even disruption of family relationships. In general, if the situation still requires concentration of ownership, transfer to a preferred successor shall be accompanied by appropriate compensation to other heirs.

Thesis 5. The small number of direct descendants requires the involvement in business of the brothers-and-sister-in-law who are traditionally not seen as equal sons and daughters. There are cases in which the founders of the family business, suspend relations with their legitimate wives (husbands) and do not conceal their links with other partners, which is also not fair to the family members. These re-

compositions of the family complicate management relations in the family business, but are one more proof that the business gives way to relations with relatives in the value hierarchy.

The rest of the report will present examples from various research studies with which to illustrate the negative (problematic) impact of the actual management of family and business relationships, so to indicate the advantages justifying these practices.

## 6. EMPIRICAL EVIDENCE IN SUPPORT OR REJECTION OF THE THESES

Given below are examples taken from case studies conducted during the study course in Family Business with the help of the students of entrepreneurship at the University of National and World Economy. Studies aimed at identifying management problems arising from the nature of family businesses as well as taking steps to resolve them.

Below in tabular form will be summarized the case studies, the characteristics of the relations 'family – business' and its interpretation in the light of the proposed theses.

Table 1.

Case	Relations 'family – business'	Relevance to the theses
Case 1. Early and rapid growth of a heir in the company hierarchy leads to conflicts between him and his father, company founder, and other stakeholders – managers, employees and institutions. The reason for this is too much trust and bias in assessing the qualities of his son in his appointment in the company to a high position, but without clear borders.	The conviction of the founder of the business that a family member (his son) deserves preferential growth leads to irrational and somewhat unprincipled concession of government power in business. The idea of good relations in the family is not only compromised but can also lead to negative consequences in business management.	The case is typical evidence confirming the thesis 1 and somewhat thesis 2 and thesis 4.
Case 2. The designation as successor in the management of family firm of the more prepared for this role brother, and ignoring the second potential successor, creates deep family conflicts – both between brothers and between the ignored brother and his parents.	In this case the founder of the family business has tried to be rational in terms of company management, but the consequences are negative family relationships. On the other hand, this is a good example of typical Bulgarian attitude of the heirs to the established by the previous generation – regardless of their own contribution.	The case does not correspond directly to those exposed, but is sufficiently indicative of the impact that neglecting family relationships might have in a family business.
Case 3. Appointed staff to the highest levels is mainly from family or in personal relationships with the leading core of the company. But they are not adequately prepared for their given position. Their incompetence leads to making wrong strategic decisions that are as a stumbling block to the development of the company.	Another example in which the principles of good governance have been sacrificed in the name of welfare of the family.	The case is yet another proof of Thesis 1.
Case 4. The selection of unmotivated successor in the management of family firms in the conditions of very limited choice and a significant age difference between generations.	Despite the knowledge that the chosen successor has not the needed motivation, the founder of the company is not looking for options other than a blood heir, proving the prioritization of family over other alternatives for continuation of the business.	Although the case cannot directly confirm the proposition 3, it is determined indirectly by showing that owners of family business practically do not allow non-members of the family as successors in management.
Case 5. Displacement from leadership position of the founder of a family business, by a relative employed in a managerial position, but who does not hold shares in the business.	The initial rationality manifested in combining the advantages of the relationship and the principles of good governance leads to a situation in which the owner of expert power displaces power based on ownership. Thus the balance between family and business relationships is a challenge to the leadership function in business management.	The case is related to Thesis 4 and Thesis 5 - in terms of how under conditions of limited selection of members of the management team to find a rational balance between control and manage a family business.

Case 6. Appointment of son and daughter to different functional positions in the hope that everyone will also maximize their abilities in tandem and will accept the company's management after the withdrawal of the holder. Instead, conflict arises between son and daughter on corporate strategy and a struggle for leadership begins.	An exceptionally typical example in which family relationships are revealed as more important and significant for the good governance of family business, which should ignore kinship. Also here appear the interests of potential heirs, whose growth is rather the result of parental care, rather than systematic preparation.	The case presents an attempt to implement the set out in the Thesis 4, but the real consequences of this situation are negative. Explanation for the latter could be found in typical Bulgarian tradition inability to achieve consensus and teamwork in the management of an activity (in this case business).
Case 7. In an already executed transfer of management from father to son, after a long absence from the country, the daughter of the company founder and sister of the current manager claims to hold share in the family business and management position without having the necessary experience and education for the latter.	Like the previous case, here we see a rationality in business relations, which, however, faces particular understanding of participation in the family business of a member of the family. Obviously a mistake is made in respect of interests in the family.	In this case we have a refutation of the thesis 4, but it underlines the need for an approach to the succession described in this thesis.
Case 8. Involving the children in a diversified business, in which one of the promising activities is not desired by the heirs.	In this case the founder of the company places great emphasis on business development, while seeking to raise his sons as future successors in the management of the company, seeking a balance between business interests and the stated interests of the children.	The ambition of the founder of the family business to bring business to his sons, which they perceive as an adversity largely confirms Thesis 3.
Case 9. Significant draining of financial resources from the company to meet the various whims of the family, including the significant role on a lover of one of the brothers, founders of the family firm.	After building a substantial family business, in this case, we see the use of the opportunities created by the business to meet the needs of acceptable and unacceptable to the families of the founders, reaching the level of stripping business. The situation is complicated by the admission to the business of the lover of one of the founders, whose conduct further deteriorates relations within the business.	Although the case study confirms Thesis 2, the interference of the lover also draws attention to the Thesis 5 - to what extent access to such business entities is justified and rational.
Case 10. Provision of employment and income of family members, regardless of their abilities and skills, which in a crisis situation results in the need of cuts in particular among family members.	The pursuit of solving family problems and meeting family needs here is confronted with the economic capacity of the family business to provide the desired standard of family members.	The case clearly confirms Thesis 1 and Thesis 2.
Case 11. After the tragic loss of the son, prepared for the successor of the business of the family, firm founders are faced with the choice – to prepare their daughter, who lacks the necessary education and experience or seek professional manager to take over management of the company.	One tragic event destroys the balance achieved in the relationship 'family – business' moving the attention on the feasibility of the desired continuity of management.	Although in a specific way this case advocates thesis 3 and to some extent reflects on the raised in Thesis 1.
Case 12. Rewarding members of the family employed in family business based on their needs rather than on the basis of their contribution, and the resulting conflict from such practice.	Here we have an exclusive orientation to promote good family relationships and obviously a serious disregard of economic and managerial rationality.	The case is a forceful reaffirmation of Thesis 2.

The cases studied not only rejected those formulated, but also highlighted the conflicts arising from the accentuation on family relationships in the family business. The existence of the advantages of family business cannot be denied, but in the cases studied, these advantages seem more relative than absolute when comparisons are made with non-family enterprises.

Without denying the social significance of family enterprises in the Bulgarian economy (not only) of the cases studied, the analysis leads to the thought that the family business is more poorly managed because of giving preference to family considerations at the expense of principles of good governance. Explanations for the dominance of family considerations over economic management and rational

management of the relationship 'family – business' may be seeking a relatively short period of existence of these enterprises and the vulnerability of the small business (as is the business of most family businesses). An attempt for the cases studied to be analyzed by the type of family business described in the preceding section leads to the following conclusions:

- In the first type of family businesses there is a greater tendency to neglect the business in the name of good family relationships;
- In the second and third type is found a trend of subordination of the family relations to the requirements of good business management.

Explanation could be found in the relative importance of the family business for the welfare of the family – as it grows, the more important is consideration of the family relationships to the requirements of the business.

## 7. CONCLUSION

Managing the relationship between family and business is one of the most critical points in the management of family business in Bulgaria. Neither practical nor even theoretically sufficient guidelines for good management of these relationships exist at the moment in Bulgaria. The collision of two systems – family and business is inevitable, but only negative consequences not always to be expected. The consequences of this collision could become good lessons for improving the management of family business – both as tools for prediction of critical situations and as a basis for a system of principles by which these critical situations can be avoided. This requires further research to combine knowledge management with knowledge of the Bulgarian family as a system of values, attitudes, and practices.

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## FAMILY BUSINESS REPRESENTATIONS IN POPULAR CULTURE: THE CASE OF RUSSIA

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Being a significant source of growth, prosperity and welfare, family businesses are of prime importance for the economies of countries all over the world. It is widely acknowledged that family firms differ from non-family businesses in many aspects, such as financing, organization structure and human resources. The majority of associations with family firms is formed by the family business scholars and owners and illustrates therefore an “insider-perspective”. Despite the increased attention to theoretical and empirical research in family businesses in the last years, the relevance of external images of family firms has been neglected by scholars. Maintaining the ways in which the wider population perceives family firms is significant not only for better understanding the roles of family businesses in society and preserving respectability, but also for attracting the best talents, achieving a sustainable competitive advantage and ensuring the survival of family firms. One of the ways to study external images of family businesses is to examine their portrayals in popular culture.

In this paper we analyze the public perceptions of family businesses through times in the cultural and historical context of Russia, using popular culture as a field material. The main reasons for choosing Russian family businesses as objects for the present study are the current low level of knowledge about the development of family firms in Russia and their remarkable historical development. This paper is the first step to close the existing research gap addressing the following research questions: What is the image of modern family businesses in Russian popular culture? How did the political, economic and social changes influence the public’s perceptions of family firms over the years? Are there any misconceptions about family firms promoted through the mass media?

To answer these research questions, we conduct a qualitative study of Russian fiction and movies before the October Revolution, during the Soviet era and after the fall of the Soviet Union. The theoretical framework of the study is based on the identity-oriented approach and the sociological understanding of images. Our study includes a review and content analysis of 9 novels and 10 movies released from 1882 till 2010.

**Keywords:** Family business, Russia, Popular culture, Image

**1. INTRODUCTION**

Being a significant source of growth, prosperity and welfare, family businesses are of prime importance for the economies of countries all over the world. It is widely acknowledged that family firms differ from non-family businesses in many aspects, such as financing, organization and governance structure, survivability and human resources (Chrisman et al., 2006; Colli, 2003). The specific characteristics such as the long-term orientation, risk aversion, sustainability and fair working conditions are consistently referred to family firms. The majority of perceptions and associations with family firms is formed by the family business scholars, members and other experts and illustrates therefore an “insider-perspective” (Krappe et al., 2011). Despite the increased scholarly attention to theoretical and empirical research in family businesses in the last years, the relevance of external images of family firms has been neglected by research.

An understanding of the ways in which the wider population perceives family businesses helps to better appreciate the roles of family firms in a broader social context. Maintaining public perceptions is significant not only for preserving respectability and attracting the best talents, but also for achieving a sustainable competitive advantage and ensuring the survival of family businesses (Carnegie and Napier, 2010). One of the ways to study the external images of family firms from the perspective of the broad public is to examine their portrayals in popular culture. Fiction and films can be described as “the canon of the modern age, the set of cultural references with which everyone in society is familiar” (Zakaria, 2003). Fiction can be used as an enriching field for management research (Phillips, 1995) because it presents a common image of an occupation at a certain time in a certain place and at the same time influences actual practices and career choices of people (Czarniawska and Rhodes, 2006). Film, as one of the most massive and influential artifacts of modern popular culture, has also the power to depict and then change the public attitudes to a particular profession and its role in society



(Lee, 2001). Serving both as a mirror of widely held public beliefs and as a lens for shaping social perceptions (Dyer, 1993), representations in fiction and movies have an essential influence on any social group.

In this paper we analyze the public perceptions of family businesses through times in the cultural and historical context of Russia, using fiction and movies as a field material. Studying the image of a profession in popular culture and choosing a cultural perspective are the well-known methods of management research. However, the external images of family businesses in general and those of Russian family firms in particular have been scarcely explored by scholars. Considering the role of family firms in modern society and the rapidly growing body of literature and empirical studies, the implementation of this research approach is deemed to be appropriate also for the field of family business. This paper is the first step to close the existing research gap in order to provide a better understanding of family business images in Russia and reveal misconceptions about family firms promoted to the audience through the mass media. Besides, we explore how the political, economic and social changes in Russia influenced the public perceptions towards family businesses over the years. Finally, we seek to explain the reasons why the negative portrayals of family firms in Russian popular culture are the rule rather than the exception and present possible solutions of this problem.

There are two main reasons for choosing Russian family businesses as objects for the present study. The first reason is the current low level of knowledge about the development of family firms in Russia. A significant amount of empirical studies about family businesses in various nations has emerged in the last twenty years (Bewayo, 2009; Welsh and Raven, 2006; Andersson et al., 2002; Klein, 2000; Flören, 1998; Astrachan, 1993). The first discussion about the re-emergence of family firms in the former soviet countries has already been started in the late 1990s in the Family Business Review (Donckels and Lambrecht, 1999; Pistrui et al., 1997; Poutziouris et al. 1997) and is still topic of current research (Kowalewski et al., 2010; Barkhatova, 2008; Dyer and Mortensen, 2005). However, family firms in Russia remain little studied, thus this topic needs to be brought to the research agenda.

The second reason for selecting Russian family businesses is their remarkable historical development. On the one hand, modern family firms in Russia lack tradition and experience because establishing a business was forbidden during the Soviet era. On the other hand, there are a lot of examples of Russian families (e.g. Demidovy), who carried on successful businesses for many generations before the October Revolution 1917 and whose names are still well-known all over the country. This contrast asks for evaluation of how the political, economic and social changes have influenced the representations of family businesses in popular culture and consequently the public perceptions of family firms over the years.

The reminder of the paper is structured as follows. The second part starts with an overview of previous studies devoted to the image of family firms in popular culture in different countries, followed by the description of the theoretical framework applied. Next, the data collection, analysis and methodology used are explained. The paper concludes with the presentation and discussion of the results of the qualitative study as well as some recommendations and ideas for future research.

## 2. PREVIOUS RESEARCH

Our study contributes to a body of empirical research that investigates how representations in popular culture shape and change the public perceptions regarding different professions such as lawyers (Hilyerd 2009; Greenfield, 2001), PR professionals (Ames, 2010; Miller, 1999) and accountants (Dimnik and Felton, 2006; Hoffjan, 2003; Beard, 1994).

The main part of previous research was dedicated to the images of (family) businesses in the English speaking countries, primarily in the US. For instance, Ribstein analyzes portrayals of businesses in more than 100 Hollywood movies and reports that “the family firm is the epitome of a worker-friendly company” (Ribstein, 2005). Family business is expected to provide the same continuity between the individual and the community as the family itself. As an example serves the movie *Sometimes a Great Notion* (1971) where a family business comes into conflict with the community because of the attitudes of the founders. Family business as a long-term player that cares about employees is depicted in *Other People's Money* (1991). A family-owned wire and cable manufacturer is targeted to be taken over by the financial raider Garfield, who is shown as an inhuman capitalist warring only about the profits and shareholders' interests and ignoring the employees' needs. On the contrary, the patrician manager of the family business Jorgenson always chooses a long-term oriented and “moral” perspective, refusing to reincorporate the company to Delaware, pay greenmail or borrow money (Ribstein, 2005).

Examining American fiction of the first half of the 20<sup>th</sup> century, Halsey points out that family business members are often portrayed as people who care for their customers by building personal relationships (e.g. “Dangerous Business” by E. Balmer) (Halsey, 1959). Sarachek explores images of entrepreneurs in recent American fiction and concludes that (family) business members are usually depicted as “hardworking but ruthless exploiters of customers, employees, society and competitors” (Sarachek, 1995). Graham Masterton’s “Rich” can serve as an example for such portrayals.

The most recent study dealing with the external images of family businesses was conducted by Krappe et al. Researchers interviewed 111 people across Germany with no explicit knowledge about family businesses and concluded that family firms have an overall positive image in the wider population (Krappe et al., 2011). In contrast to the results of Krappe et al., Ceja and Tàpies found out that family businesses have a less favorable image compared to non-family companies. In this study 213 MBA students from 20 different countries with low or moderate knowledge about family businesses were interviewed. According to the results, family businesses are believed to have more difficulties in attracting talented managers and issuing equity. Moreover, they are perceived to be more nepotistic, reluctant to implement new technologies and slower in the internalization process than non-family businesses (Ceja and Tàpies, 2009).

As the development of family businesses in Russia has attracted little attention from scholars, we did not succeed in finding any studies explicitly devoted to the external images of Russian family firms. In order to explore the entrepreneurial potential of Russian society Chepurensky et al. interviewed 1,756 people from 12 different regions of the Russian Federation. Among general findings there was a specific side result that 75% of respondents perceive family firms in a positive way. Moreover, the general public feels sympathy for family business members because they work very hard in order to make their business run properly (Chepurensky et al., 2003). The PhD thesis of Milehina is devoted to the general image of business people and their language in Russian popular culture. She concludes that Russian business people are portrayed mostly in an unfavorable way and their negative characteristics are especially emphasized (Milehina, 2006). Similar results show also other studies dealing with the images of business people in Russian fiction (Harseyeva, 2009; Sarubina, 2003; Levadovsky and Levadovskaya, 2002).

### 3. THEORETICAL BASIS

The identity-oriented approach towards brands serves us as a primary theoretical basis. The identity-based understanding of a brand takes into account both the brand perception by external stakeholders (referred to as image) and the self-reflection of a brand by internal stakeholders (referred to as identity) (Burmahn et al., 2009). Identity is often described to be the way how internal stakeholders view the central features of an organization which distinguish it from others (Albert and Whetten, 1985). On the contrary, the image is not what a company believes to be, but the feelings and understanding of an organization that are constructed by external stakeholders as a result of conscious or unconscious observation and experience (Bernstein, 1984). There is a generally held view that the two perspectives should match in order to create a strong brand (Meffert et al., 2008; Davies and Chun, 2002).

Applying the identity-oriented approach in the context of Russian family businesses, it is interesting to analyze the degree of compliance between the self-reflection of family firms and their perceptions by the wider population. Obviously, the self-reflection of family businesses is based mainly on the concept of family and contains such well-established characteristics as strong efforts in sustainability, economic efficiency, fair working conditions and social responsibility (ASBR, 2011). As already mentioned, one way to understand the public perceptions of family firms is to examine their representations in fiction and films. This paper seeks to explore if there is a gap between the external and internal perspective in Russia.

### 4. FAMILY BUSINESS IN RUSSIA

In the last ten years only a few PhD theses and sporadic journal articles (Slutsky, 2000; Barhatova, 1999; Babayeva, 1993) dealing with the development of family businesses in Russia are to be found. Besides, there are hardly any studies and no official statistics about the number and turnover of family firms. The vast majority of family firms operates in the service or trade sector and plays an important role in gastronomy. Experts certify a high development potential for family firms in tourism and the municipal economy. As many Russian family firms are currently confronted with the problem of first succession, practitioners have a constantly increasing interest in research on specific features of family businesses. This fact is confirmed by the foundation of the Family Business Association

in Russia (ASBR) in October 2010. Major objectives of this association include the organization of seminars and workshops about different aspects of family business, representation of interests of family business members, collaboration with legislative authorities for improving the regulatory framework, etc (ASBR, 2011).

## 5. METHODOLOGY

The first step was to identify movies and novels with plots involving family business in Russia. We conducted searches of published book and movie reviews as well as Internet databases, including kino-teatr.ru, feb-web.ru and klassika.ru. Three criteria should be fulfilled to include a movie or a novel into our study.

Firstly, movies or works of fiction should take place in Russia, so that family business representations do not involve cross-cultural perspectives. Secondly, all works of fiction and movies are appropriate for general public, broadly accessible through libraries and retail stores. Moreover, they should meet basic quality expectations. It is obvious that popular movies are likely to attract wider audience and have more potential to shape the public perceptions of family businesses than unknown films (Felton et al., 2008). Thirdly, a family business should play a significant role in the plot development. Although the data collection method used does not allow for developing an exhaustive set of all images of family businesses, the selected sample is suggested to adequately represent the major trends of family business depictions in Russian popular culture over the years.

Using the research methodology described above, a set of 9 novels and 10 movies was identified (s. Table 1). A qualitative content analysis of plot summaries was conducted in order to analyze the data. The movies and works of fiction were coded for time period, employee treatment, role in the unfolding narrative and overall description.

## 6. ANALYSIS AND RESULTS

The data were analyzed according to three time periods in order to investigate the development of family business images in Russia over the years. The category "Time period" is measured by release date for movies and year of first publishing for novels and ranges from 1882 till 2010. The first time period includes titles published before the October Revolution 1917 and contains four novels and two movies. Titles released between 1917 and 1991 are covered by the second time period. Establishing a company and working of family members in the same department was de facto forbidden in the Soviet Union. This fact explains the lack of novels and movies about family business during the Soviet era. The third time period deals with modern movies and fiction published after the fall of the Soviet Union in 1991 and includes five movies and two novels (s. Table 1). Although Russian modern authors and filmmakers are particularly interested in portraying the new business generation, the majority of them concentrates on the development of big corporations. Consequently, family business is still rarely in the focus of attention.

The employee classification measures how employees are treated in a family firm and what dominates the working environment. In only two novels family firms are portrayed as organizations that take care for their employees and provide social working conditions. The most novels (6/9) emphasize unsafe and oppressive labor practices dominating the working environment in Russian family firms. In the majority of movies analyzed (7/10) the question of employee treatment is not explicitly considered. The extent to which a family business plays a role in the plot of a movie or a novel is covered by the role classification. The category "Main/ involved" contains movies and novels that are primarily based on the longtime story of a family business (e.g. *Ugryum-reka* by V. Shishkov). Titles where family firms play a supportive role dominate the dataset of the study.

Initially movies and works of fiction were also coded for efficiency, sustainability, social responsibility, flexibility and global interaction. In order to provide a better understanding and handling of the results, we decided to abandon these categories and develop the aggregate classification "Overall description". It evaluates how favorably or unfavorably a family firm is portrayed in the plot summary. The content analysis of plot summaries shows that family businesses are mostly portrayed in an unfavorable way in Russian fiction before the October Revolution 1917 and during the Soviet era. Business activities in general and family business in particular are associated with cutting corners, exploitation of employees, moral decay, deceptions and even crimes. Depictions of business in this way have reached the zenith in the Soviet era, when almost all negative characters in fiction and movies were businesspeople trying to cheat the Socialist state.

Family business members with a positive image are rather the exception in novels at that time. Usually they present an unreachable ideal of business people (e.g. Sergey Privalov in “Privalovskiyemilliony” by D. Mamin-Sibiryak). Due to Russian mentality, such characteristics as entrepreneurial spirit, prudence and rationality were not highly estimated and consequently insufficiently pictured in Russian fiction. On the contrary, in memoir literature and biographical studies devoted to family firms operating from 1917 till 1917 (Platonov, 1995) and from 1800 till 2000 (Musskaya, 2003), they are depicted as organizations that act conservatively, care for employees and take on social responsibility.

As for the modern works of fiction and movies released after the fall of the Soviet Union, the majority of them deals with the legalization process of the underground commerce that Russia inherited from the former Soviet system. Due to conditions of privatization and unfair reallocation of state-owned assets in the early 90s, business activities are still considered to be partly criminal and fraudulent. Nevertheless, a favorable trend of portraying family business as a positive phenomenon can be observed in the last years. Several movies and novels show that family businesses do not seek for short-term gains, are willing to invest money in further development and feel responsible for their employees as well as for society.

Table 1: Images of family business in Russian fiction and movies

Classification	Codes	Fiction	Movies
Time period	Before the October Revolution 1917	Kitaj-gorod by Boborykin P. (1882); Privalovskye milliony by Mamin-Sibiryak D. (1883); Gornoye gnesdo by Mamin-Sibiryak D. (1884); Foma Gordeyev by Gorky M. (1899)	Deti kuptsa Volschina (1915); Idi sa mnoy (1917)
	Soviet era (1917 - 1991)	Delo Artamonovych by Gorky M. (1925); Ugryum-reka by Shishkov V. (1928-1933); Bruski by Panferov F. (1928-1937)	Konets roda Korostomyslovych (1920); Vo vlasti solota (1957); Deti Vanyushina (1973)
	After the fall of the Soviet Union	Tolko goluby letayut besplatno by Latynina Yu. (2004); Generalny director by Vetluschskih E. (2010)	Pro businessmena Fomu (1993); Dryan horoshaya, dryan plohay (1998); Na boykom meste (1998); Next 2 (2002); Undina (2003)
Employee Treatment	Fair working conditions, care for employees	Kitaj-gorod (1882); Generalny director (2010)	
	Unfair working conditions, worker oppression	Privalovskye milliony (1883); Gornoye gnesdo (1884); Foma Gordeyev (1899); Delo Artamonovych (1925); Ugryum-reka (1928-1933); Bruski (1928-1937)	Deti kuptsa Volschina (1915); Vo vlasti solota (1957); Na boykom meste (1998)
	Not mentioned	Tolko goluby letayut besplatno (2004)	Idi sa mnoy (1917); Konets roda Korostomyslovych (1920); Deti Vanyushina (1973); Pro businessmena Fomu (1993); Dryan horoshaya, dryan plohay (1998); Next 2 (2002); Undina (2003)
Role in the unfolding narrative	Main/involved	Delo Artamonovych (1925); Ugryum-reka; (1928-1933); Generalny director (2010)	Deti kuptsa Volschina (1915); Vo vlasti solota (1957); Na boykom meste (1998)
	Limited/ not much	Kitaj-gorod (1882); Privalovskye milliony (1883); Foma Gordeyev (1899); Gornoye gnesdo (1884); Bruski (1928-1937); Tolko goluby letayut besplatno (2004);	Idi sa mnoy (1917); Konets roda Korostomyslovych (1920); Deti Vanyushina (1973); Dryan horoshaya, dryan plohay (1998); Next 2 (2002); Undina (2003)
Overall description	Either negative or very negative	Delo Artamonovych (1925); Ugryum-reka (1928-1933); Gornoye gnesdo (1884); Foma Gordeyev (1899); Bruski (1928-1937); Tolko goluby letayut besplatno (2004)	Deti kuptsa Volschina (1915); Konets roda Korostomyslovych (1920); Vo vlasti solota (1957); Deti Vanyushina (1973); Na boykom meste (1998)
	Either positive or very positive	Kitaj-gorod (1882); Privalovskye milliony (1883); Generalny director (2010)	Idi sa mnoy (1917); Pro businessmena Fomu (1993); Next 2 (2002)
	Indifferent/ Mixed		Dryan horoshaya, dryan plohay (1998); Undina (2003)



## 7. CONCLUSION

Despite the importance of family businesses for the modern economy and society, researchers have given little attention to its image in popular culture. While portrayals of accountants and PR professionals in fiction and movies have been analyzed in every detail, there has been little comparable study devoted to the external images of family firms. The present article sheds light on how family businesses are depicted in Russian popular culture and how certain characteristics of family firms are communicated to the general public.

The study contributes to existing knowledge in three ways. Firstly, it shows that the portrayals of family businesses in Russian popular culture are overwhelmingly and consistently negative. Such characteristics as “cheating”, “greedy”, “immoral”, “criminal” and “cutting corners” are common associations with (family) business. Positive depictions of family firms are rare, yet a trend of its portraying in a more favorable way in the last years is not to be overlooked. Secondly, we present how family business images have evolved between 1882 and 2010 due to fundamental politic, economic and social changes in Russia. We conclude that Russian popular culture fails to create a positive image of (family) business. Even if a family business member is described positively, favorable characteristics are regarded as a mask to conceal the true character greedy for power and money that suddenly comes to the fore at the end of a novel or a movie. Consequently, it is possible to say that Russian popular culture continues to promote a one-sided negative image of (family) business over 120 years. Thirdly, the results of the study illustrate that there is a significant gap between the self-reflection of family firms and the public perceptions towards them in Russia. The positive characteristics of family businesses are hardly reflected by the general public, and the external image of family firms needs to be urgently improved.

Therefore we recommend Russian family businesses to take appropriate measures in order to break with the long-time tradition of their negative depictions in popular culture. One of the possibilities would be to educate the general public by making the strengths of family firms better known. Furthermore, international co-operations with European or American family businesses that have already succeeded in creating a strong brand could help to improve the image of Russian family firms. Media trainings for family business members, increased online presence for attracting young people and state programs for supporting family firms are further examples of possible measures.

Generally, research on the external images of family businesses offers a better understanding of the public perceptions towards family firms and of the reasons that form the basis for these perceptions. Besides, it allows for improving ways of managing and representing family businesses to the wider population (Krappe et al., 2011). Further research could investigate additional datasets to verify the results of the study. Another area of future research could be to analyze the external images of family businesses in Russian newspapers and magazines. As the print media react to changes in society quicker than movies and fiction, it would be interesting to compare the development of family firm images in newspapers to those in fiction and movies. The next possibility for future research could be to explore the differences in portrayals of family businesses across different countries.

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## CHALLENGES AND PROBLEMS OF BUSINESS SUCCESSION IN BULGARIAN FAMILY FIRMS

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### Abstract

Usually family business is accepted as a small scale business, predominantly micro and small firms, typical for traditional and labour intensive sectors such as agriculture, manufacturing/crafts, construction, tourism and retail trade. The general characteristics of Bulgarian family firms are their smaller size in comparison with the average size of European SMEs, simpler structures of ownership and management. Nevertheless, it could be outlined the significant contribution of family firms to employment creation and long-term stability of Bulgarian economy. In relation to the business succession issues, Bulgarian families declare as their priority passing into the hands of the next generation stronger and more competitive business. However, the youth of entrepreneurship in Bulgaria, the lack of family business tradition, and insufficient support from both the public organizations and NGOs hinder the survival and transfer of family businesses. Moreover Bulgarian family firms as all private businesses in the country are still at a very young age and are managed mainly by the first generation entrepreneurs. Therefore, just now the issue of transfer of ownership and management to the next family generation appears. In this respect the paper presents some management challenges of family business succession and on this base reveals specific characteristics and discusses succession problems of Bulgarian family firms. The paper is based on the case studies and results gathered within the frame of university research project Managing Business Succession in Bulgarian Family Enterprises (funded by the University of National and World Economy) and Family Business Succession Programme of Bulgarian Association for Management Development and Entrepreneurship.

**Keywords:** Family business succession, Management challenges of business succession, Succession problems of Bulgarian family firms

### 1. INTRODUCTION

The most important objective of company management is to ensure business survival and successful long-term development. In contrast to non-family firms, for family firms this objective requires the realization of business succession, which is the biggest challenge for the family firms' development. In this regard, the survival and success of family businesses depends on the succession results. However many entrepreneurs and their families neglect the preparation and planning of business transfer, without realizing that this is the ultimate criterion of success for the family entrepreneurship (Aronoff, McClure and Ward, 2003).

Bulgarian private business sector, which includes also family businesses, is still in its youth, but it is already affected by succession difficulties. There is a necessity to pass on the business to a second generation, in some cases also to third generation within the family. The first generation of entrepreneurs, who started their business in the first years of democracy, is due to transfer the control of the company within the next ten years. Despite of that, so far in our country, this significant problem with a practical importance is not examined on its managerial aspect. On the one hand, the main reason for that is the non-existence of this problem for the 50-year period of socialist economy and respectively the lack of experience and traditions in management of family businesses. On the other hand, in the early stages of development of private business sector, the public interest was focused on more pressing issues. Last but not least, politicians, researchers and practitioners neglect

this problem, considering it as a purely practical issue, which should be solved in virtue of evolution forces and therefore it doesn't require any external support.

## 2. FAMILY BUSINESS SUCCESSION AS A MANAGEMENT CHALLENGE

As a narrow definition, business succession is a transfer of business ownership and management over the next generation in the family (Todorov, 2011). In regard to this, the main objective of managing succession is successful business transition in the hands of the next generation within the family by securing and even developing the economic potential of the business and in the meanwhile keeping the family commitment. The complex nature of business succession suggests that it shouldn't be simply regarded as a one-time activity but as a process that requires good preparation, planning and on-time starting. Often the realization of this process has a heavy impact on the interests of all family business stakeholders. This is the reason why the business transition cannot be governed solely by only one person, even if that person is the company founder himself. Except from family members, other important participants in the business transfer include potential successors, members of the wide family, shareholders, members of the management team, key employees and etc. On the one hand, various views and interests of all involved parties make succession management difficult, but on the other hand, they can be involved in this process by using their knowledge and abilities and by sharing with them the responsibility for achieving the desired results.

To be successful, succession planning can be divided on two interconnected processes – the management succession process and the ownership succession process (Walsh, 2007). Moreover, business succession literature focuses on various important issues that most family businesses face in the succession process such as withdrawal of the current leader (who is the business founder in some cases), choice of a successor, preparation of the next generation to assume responsibility for the business, professionalisation of the company management and strengthening family commitment, etc. Therefore, effective management of business succession requires finding adequate answers for a sequence of difficult and interconnected issues concerning various aspects of transition process. Despite of the presence of general guidelines for managing succession, there are no universal answers that can help achieving the desired results. This is why these problematic issues represent a management challenges and the way they will be solved determines the success of business transfer.

In the cases when the challenges are left without corresponding governance and answers, including late reaction, this could provoke a rise of significant problems for business succession and also for the family and the firm. Implementing good management practices can seem obvious, but family businesses require taking into account and overcoming additional difficulties. For the purpose of the present paper, succession challenges are discussed in the frames of four main issues that are faced by all family businesses, not taking into account the specificity of the external environment in which they operate. They are 1) transferring the leadership role in the family business, 2) securing the family commitment and harmony, 3) transferring the management and maintaining the competitiveness of family business and 4) transferring the business ownership and family estate. In this frame, we discuss how Bulgarian family firms manage these challenges and the most common problems coming from their management failures are identified and analyzed.

The discussion and analysis of the succession management, including its challenges and problems were made on the basis of the data and results from the survey of Bulgarian family firms (UNWE, 2010). The survey covered:

- 88 randomly selected family firms where a total number of 66 owners and 77 prospective heirs were interviewed. In 36 of the cases both the founder of the business and its heir were interviewed. In this way we were able to make comparison between their views concerning the planning and management of the succession.
- 21 case studies made on the base of detailed interviews with various stakeholders in investigated firms. The subjects of these case studies are selected randomly from within the whole group of studied family companies.

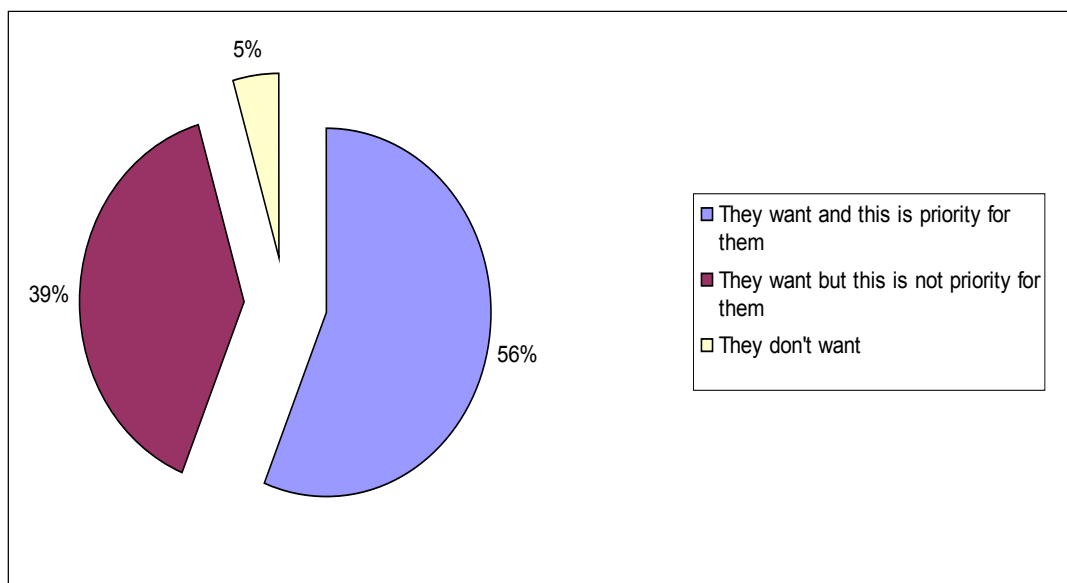


### 2.1. Transferring the leadership role in the family business

Transferring the leading role is the most important challenge because when the family firm owner/current leader doesn't want or is not ready to transfer the management control to next generation, we can hardly speak of successful succession. In the case of Bulgarian family firms this challenge often means transferring the leading role on behalf of the entrepreneur-founder of the company to an heir apparent, very often his own children.

Family firm owners share the opinion that they have a willingness to transfer the business to family members (see Figure 1). However for most of them this is not a priority (39%), which can be interpreted in two ways 1) the moment for this has not yet come or 2) they wouldn't transfer the business to next generation at any cost. Only 5% of owners declare they are not willing to transfer the business. Despite of founders' willingness for business transition, transferring the leadership role however is not that easy and unproblematic. The reason lies in the specific personalities of Bulgarian entrepreneurs. They can be defined as strong leaders, who succeeded in the creation and development of businesses despite of the severe conditions of economic and political transition period during the last 20 years. We should truly take into account the fact that in the context of a small volume internal market, lack of public support, tough bureaucracy and numerous administrative barriers, lack of business and managerial experience and with minimum start-up capital, only individuals with strong entrepreneurial and leadership skills could develop a private business. However this type of family entrepreneurs has their disadvantages regarding the necessities of succession. Often they hardly accept that somebody else can manage better than them the business that they have built. Accepting that other people's views and management decisions are better than their own is even harder for the founders. It is no surprising that such entrepreneurs aspire to stay on the top of the business as long as they can. This makes it very difficult for the next generation to take over the business in a smoother way and to increase the firm potential for successful development.

Figure 1 Owners' willingness for transferring the business to the next family generation

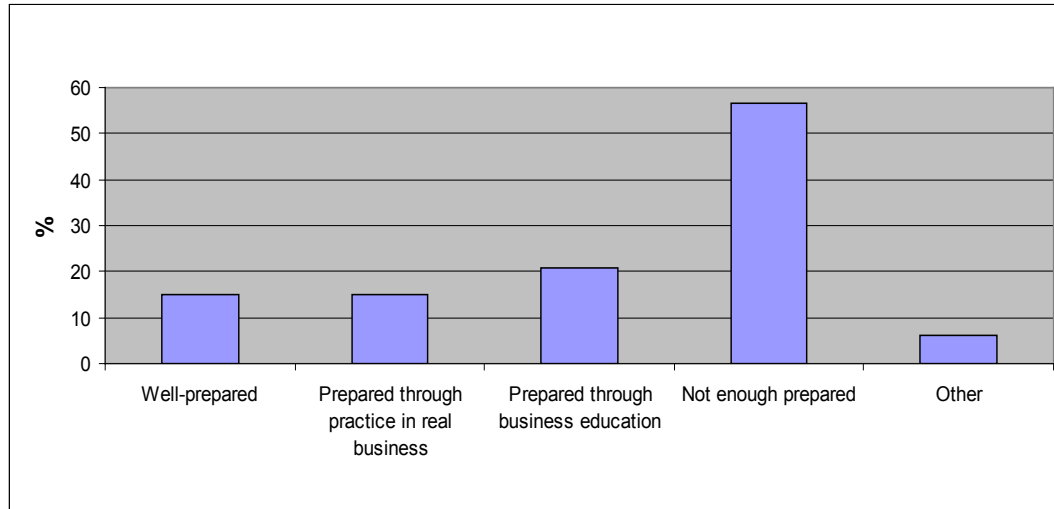


This is confirmed by the case studies evident, which show that the owners are not very confident in the transition outcome of the succession process in their family businesses. Some of them share they have witnessed the process of succession among their colleagues and point out that they have not seen yet a successful transition. None of the successors could master the business and the company founders cannot explain this phenomenon. No doubt in Bulgarian family companies, there is a strong desire to keep the business within the family, but the owners do not have enough trust in their successors' abilities. Such attitude towards the succession process for sure will affect negatively the final outcome. Possible solutions of the leadership challenge could be found mostly in two main directions.

The first is effective preparation of successors, including trough training and education of successors on behalf of the business owner/ current leader. The retirement of the current leader depends on the presence of a prepared successor. Figure 2 shows the readiness of successors to take over family firms. According to the opinion of the owners, in half of the family firms, successors are not prepared enough to assume the business control. The objectiveness of this assessment could not be put under doubt because the opinion of the owners is also shared by their successors. Of course there are well

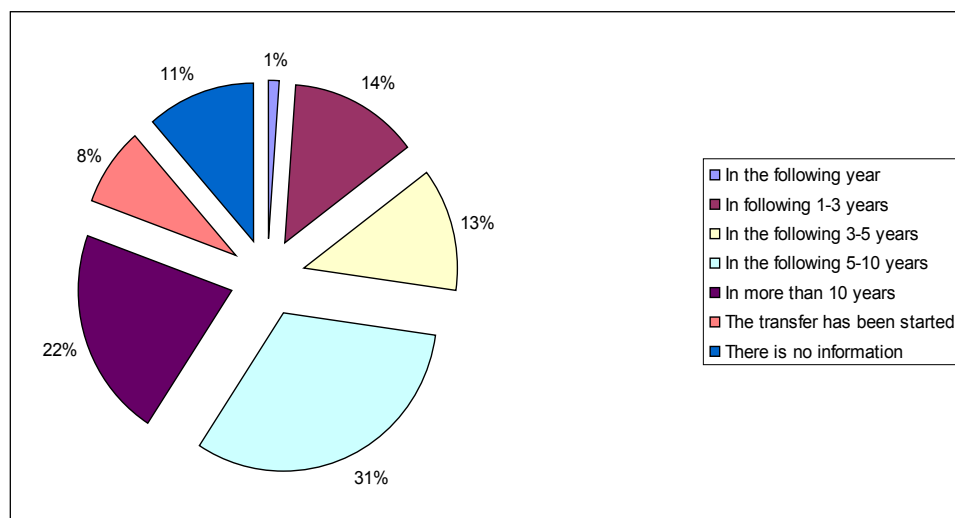
prepared successors too, mostly due to their formal education in the domain of business management and economics, and in a smaller extent due to practice in real business. We should bear in mind that in Bulgaria there is a lack of traditions in preparing successors, and also lack of specialized institutions and programmes in the domain of family business development and management. In this context there is no surprise that the preparation of successors is identified as a major problem for succession of Bulgarian family firms (Todorov, 2009).

Figure 2 Preparedness of family business successors (multiple entries possible)



Directly linked with this problem is the late beginning of the succession process. According to the plans and the intentions of the owners, family business transfer is planned to start in about 5 years – in about half of the interviewed firms. Around 1/4 of the firms plan to start the transfer in a middle-term (from 1 to 5 years) and less than 10% have already started the succession or they expect to start it in less than a year (see Figure 3). Regardless of the youth of Bulgarian family business, including the companies in the study these results are unsatisfactory. This is because more than half of the interviewed family business owners are over 51 years old and a well-prepared succession process must last about 15 years (Aronoff, McClure and Ward, 2003). The late start of succession process is a weakness and a precondition for the rise of various problems. A significant part of families make efforts for the preparation of successors by involving them in the business activity or by formal education, but this only witness that the preparation of successors is not regarded as being part of the succession plan.

Figure 3 The planned start of the business transfer according to the plans or intentions of the owners

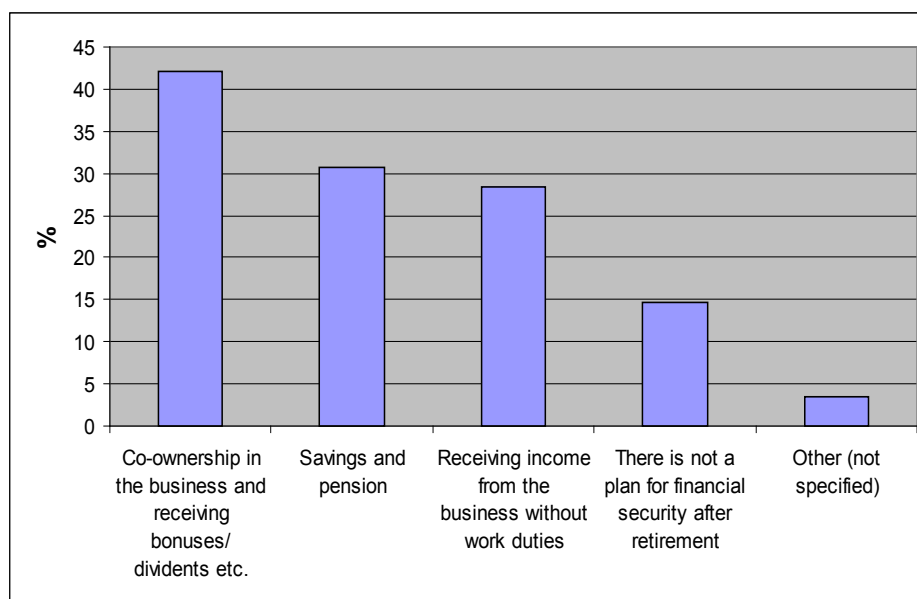


The second direction of the solution is ensuring financial independence of the owners after they leave the business. Financial security has a great significance for the decision of owners to undertake the retirement. Regarding that Bulgaria is less economically developed in comparison with the average European level, this is even a more delicate and emotional issue. Study results show that more than

80% of owners have planned their financial security after they leave business. This indicates their willingness and intention to make the transfer happen and to leave the company control. However, the analysis of the planned approach and instruments for securing financial security is more important. Around 1/3 of owners count on dividends and bonuses from business ownership, 1/4 count on personal savings and pensions, and another 1/4 will depend on incomes from the company without involvement in the company activities and development. In 15% of the cases there is a total lack of such a plan. The results show that in the majority of firms (almost 70%) the owners will rely on income sources, linked to the business. Experience and practice prove that it is very difficult for owners that are financially dependent on business results to leave the business (Bowman-Upton, 1987). This confirms again the withdrawal desire but also shows a lack of preparedness needed to a successful business succession.

The analysis of presented data and results show that in the case of Bulgarian family firms the challenge of leadership transfer turns out to be a source of major problems for business succession. Most often they are linked with late start of the succession process and unprepared successors. The presence of significant problems at this point limits the possibility for finding adequate answers of next management challenges.

Figure 4 Plans for personal financial security of owners after their retirement (multiple entries possible)

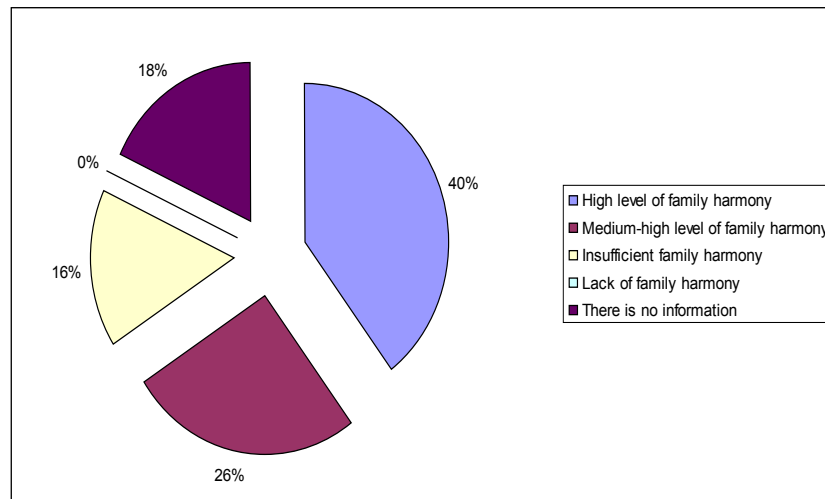


### 3. SECURING THE FAMILY COMMITMENT AND HARMONY

Family business succession provokes changes that affect the interests of the members of the family in various ways. Every member of even a not very big and united family has his own perception of business success on one hand and of personal success and happiness on the other. Often this leads to contradictions which could cause severe family conflicts and in this way to ruin the established relations in the family. In this line, succession that ensures the competitiveness of the business, but ruins the family or provokes family conflicts could be defined as non efficient. In the same time, protecting family harmony should not be done at the expense of compromises in business development. In this regard Bulgarian families demonstrate a high level of agreement on basic issues concerning management and realization of business succession. This is shown by the results on figure 5. In most of the cases, both main parties (owners and successors) in succession consider family agreement as high or moderately high. This conclusion is also proven by the fact that owners and successors share the same or almost the same views on important topics such as deadline of the start and the end of succession process, preparedness of successors, guidelines for preparation of successors and etc.

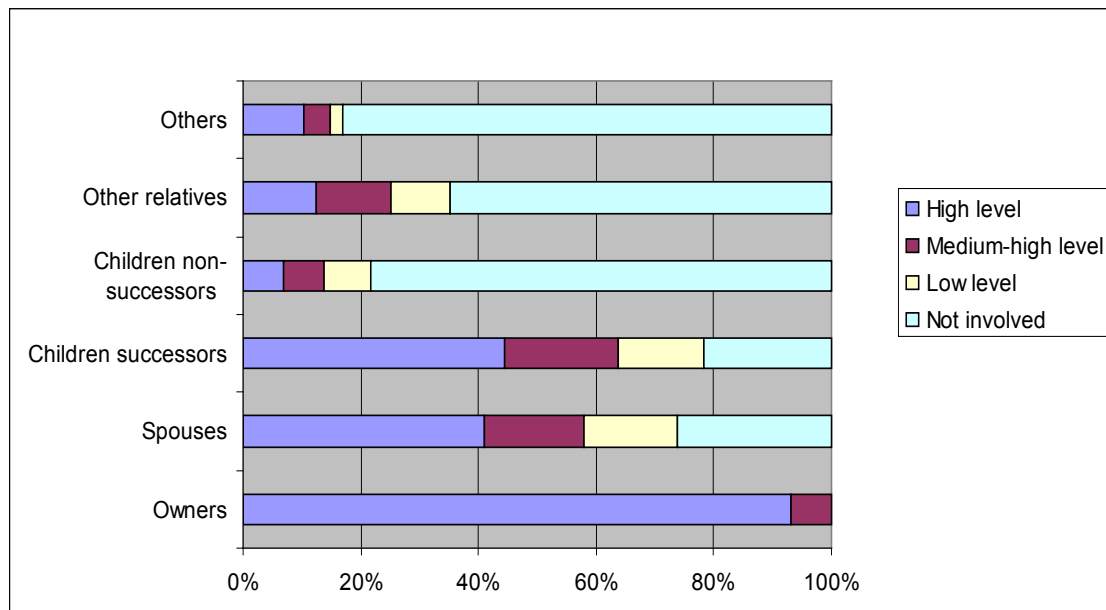
There are small shares of companies, in which there is lack of agreement (16%) or the succession issue has not yet been discussed (18%). The case study results show that the reasons for disagreement between owners and successors are mainly about 1) which is the most appropriate time for starting the transfer and 2) which is the most effective strategy for further business development. These differences are most evident in the firms, where successors are around or at a mature age (over 35 years old) and they already possess some entrepreneurial experience. This confirms the rule that an easier start of the succession process makes chances for success higher.

Figure 5 Family agreements regarding the main issues of business succession



High level of unity of the family could serve as a starting point and a base on which to realize a successful transfer of family business by keeping and developing its potential for further development. Family's involvement in the business activity is important in order to ensure family commitment and overcoming conflicts. Results show that except from owners, his/ her spouses and children successors are strongly involved in the functioning of the family firm – this is valid in about 60% of family firms. In about 15% of the cases, children in the family, which do not perceive themselves as potential successors, are involved actively in the activity of the family firm, and in about 25% of firms other relatives from the extended family take part. It is interesting that children successors are the second most important and active interested party within the family, but most often close relatives are involved instead of the children non-successors. In a small part of the firms (less than 15%), strongly involved are also other interested parties such as employees, nephews, sons-in-law and etc. Involvement of a wider circle of family members helps for limiting problems, arising from disagreements about business responsibilities and family necessities. Successful balance between the interests of the family and the requirements of the business does not mean that there are no problems at all but contradictions are solved more easily by compromises made by family members. The high involvement of family members in the business aims and activities of the firm assists to the maintenance of that balance.

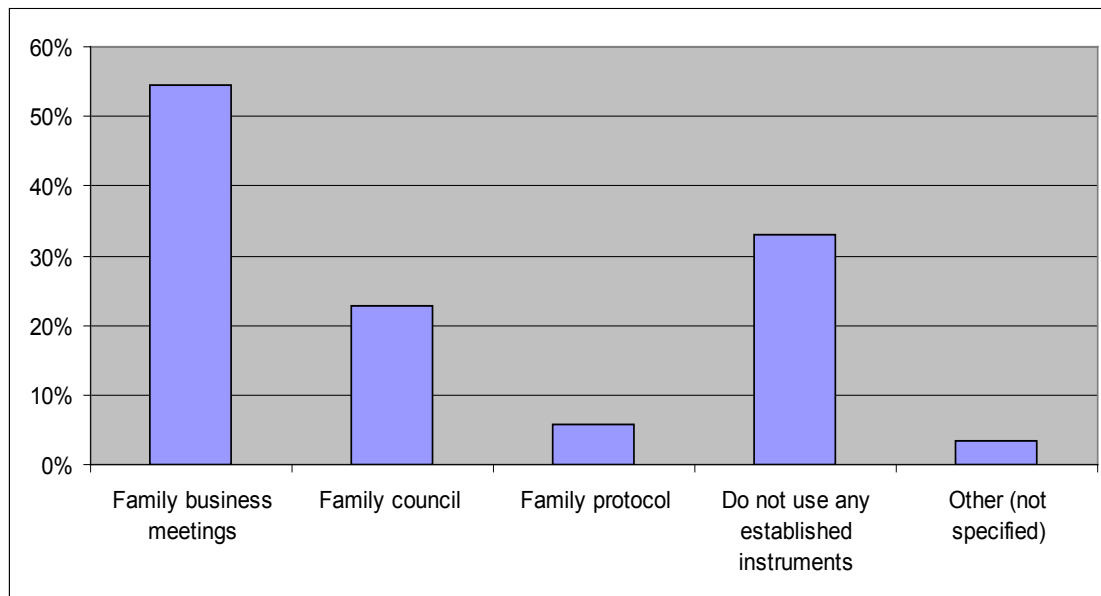
Figure 6 Involvement of family members in family business activity and development



The solution of family harmony challenge is mostly concerned with improving the communication within the family business and acquiring skills for conflict resolution. Despite of the unity of

Bulgarian business families, it is not certain that they are able to make shared decisions and to solve future conflicts. About 1/3 of the family businesses do not have instruments like the Family protocol (regulating the relationships of family members in relation to the enterprise), the Family council (a special body intended to facilitate the resolutions of conflicts and problems that are not foreseen in the Family protocol) or formal family business meetings. It is widespread conducting regular family business meetings (in 55% of firms), but they are mostly informal (see Figure 7). These meetings take place without preparation in an informal ambiance and without rules for discussing and making decisions. In 22 % of firms, there are regular meetings of the Family council and only 5% of firms have a Family protocol. Moreover Bulgarian families have no defined internal rules and procedures to organize family relationships and resolve conflicts. In general, usage of suitable instruments for effective communication and conflict resolution is not widespread and in this area there is significant potential for improvement.

Figure 7 Use of specialized instruments for managing family company and resolving family conflicts (multiple entries possible)



#### 4. TRANSFERRING THE MANAGEMENT AND MAINTAINING THE COMPETITIVENESS OF FAMILY BUSINESS

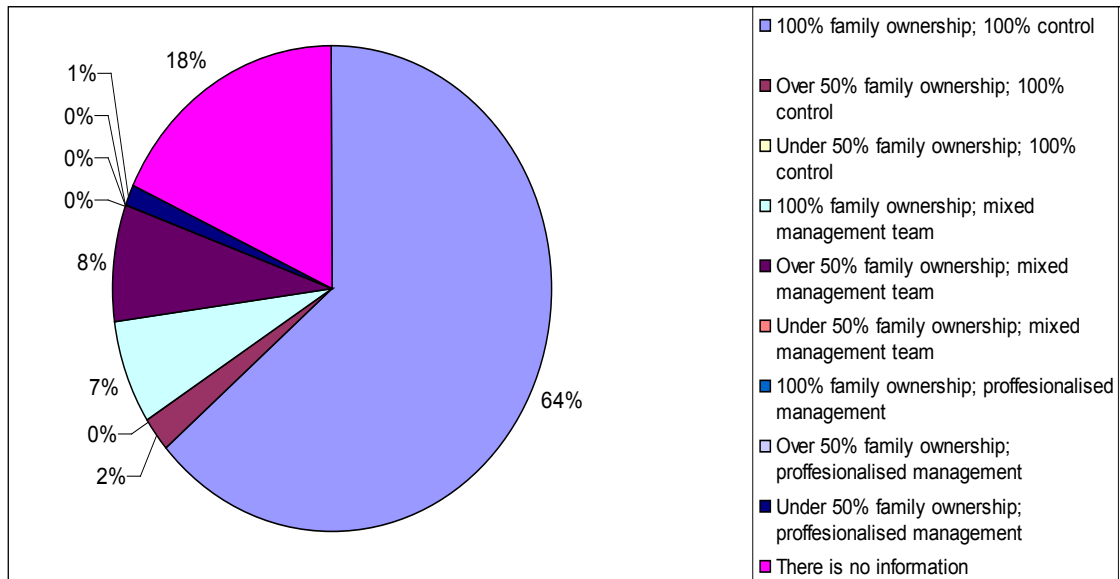
At best, the business succession should be viewed as a chance to strengthen and develop the family firm, although the complexity of this process could affect negatively and even destroy the vitality of the business. The presence of a mission and a strategy for developing family business, also a well developed management team is a prerequisite for realizing changes, linked to succession and in a long term this is the base for sustainable development, regardless of which generation heads the firm. The results in Figure 8 definitely show that in Bulgarian family firms ownership and control are concentrated in the hands of family members (although 18% of respondents didn't answer this question). In 64% of the interviewed firms family owns 100% of the business and family members have full management control. In the other two most widespread cases 1) the family owns entirely the company but also external managers are part of the management team (7%) and 2) the family owns more than 50% of the firm and the management team is made of family members and external managers (8 %).

Concentration of ownership suggests that family firms applied a clear development strategy, strict hierarchy and simple organizational structure, which would favor the achievement of an efficient management. Moreover in such firms usually there are no problems and disagreements, which are common for family businesses affected by the influence of a wider circle of interested parties. This simple configuration of ownership and management in family firms has a positive impact on present management and development of the firm, but during a transition process it could become a reason for a difficult problem – who will be the next family and business leader. Very often there are no family members who have the potential effectively to replace the business founder, taking the full control over the firm.



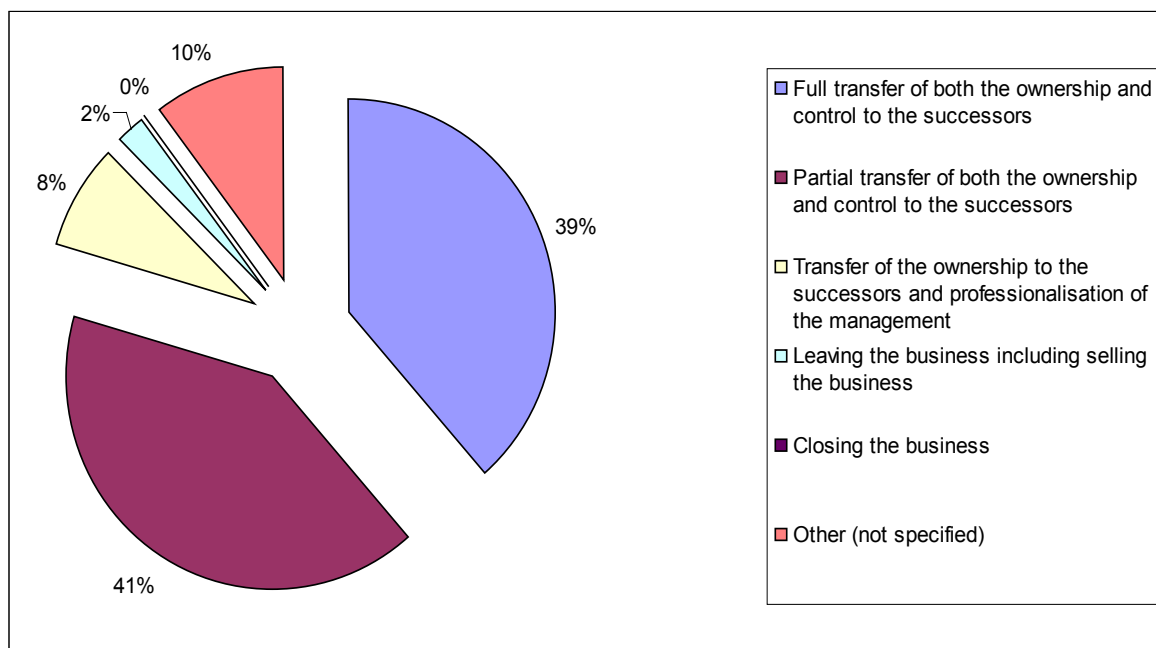
On the other hand, the necessity of management control transfer is an opportunity for change of the management model of business in the process of succession. In Bulgarian family firms the most important step which could be undertaken in this line is a professionalisation of management during the succession process. Moreover professionalisation of management is the key for ensuring business competitiveness in the long term.

Figure 8 Family ownership and control in Bulgarian family firms



This however is not an easy task for small sized firms, which are run by small families. In this context, it is logical that succession plans of the studied firms are concentrated in two main groups. 39% of firms plan a transfer of ownership and also of a management to successors, and 41% plan a partial transfer of ownership and management to successors. In some rare cases, a more complicated situation is being expected – ownership will be transferred to successors but management will be transferred to professional managers (8 % of firms, see Figure 9). In some isolated cases, business withdrawal or company closure is expected.

Figure 9 The characteristics of owners' plans and intentions for business transfer of family firms



Data shows that there is a high share of companies who plan a partial business transfer and this could be interpreted as a intention for management professionalisation or at least taking into account the need of professionalisation. This also means that in Bulgarian family firms two complex and linked processes should be coordinated – business succession and management professionalisation, which

would be a challenging task for family firms' management. No doubt this requires a good preparation and well-grounded succession plan. But although that two thirds of interviewed family firms have a succession plan, only in 10 % of them the plan is in written form. In most of the cases this plan consists of owners' general view and intention on realizing the process, without a clear understanding about its main parameters and expected results. Moreover, this view is not properly shared with the rest of the interested parties. In 69 % of the firms, family members are informed about the details of the succession plan and only in 11 % of firms – all interested parties are informed. Conversely in 12% of the firms none of the stakeholders, apart from owners, has been informed about succession plans or intentions. This threatens the success of the business transition because involving main interested parties (family, successors, managers, key employees and personnel) in the process is a key for achieving the desired results.

The analysis shows that the management succession will be concentrated in the hands of the business owners and partly in the hands of their successors. This approach suggests that the business transfer could be done with a high speed and efficiency, but also could endanger the motivation and interests of the successors, key associates and managers within the firm and also could threaten the long term business development.

## 5. TRANSFERRING THE BUSINESS OWNERSHIP AND FAMILY ESTATE

There are two main ownership transfer issues to be considered 1) how to distribute the ownership among family members and 2) how to realize the transfer with minimum taxes and transactions costs. At present, the second problem doesn't exist for Bulgarian family firms because succession regulation and taxes are favorable and don't impede this process (spouses, children, grandchildren and great grandchildren are liberated from succession taxes).

It is not that easy to solve the first issue, because a fair division of ownership (everybody should take what he deserves) contradicts with the principle of equality of all family members. On the other hand an equal division of ownership is rarely fair.

For an adequate management of ownership transfer it is necessary first of all to make decisions of the already mentioned three succession management challenges. For example the ownership transfer is strongly depended on transfer of management control. But because in most of the studied companies there is a lack of succession plan and full clarity about its main parameters, the problem with ownership transfer remains also without clarity and an adequate solution. Despite of the presence of evident problems and the lack of knowledge how to cope with them, 83% of the interviewed firms do not use any consulting services concerning the problems of business succession.

The case study results show that almost all parents want to divide their family business ownership equally among their children successors regardless of the degree of their involvement in the business development. On the other hand, owners point out rational reasons when choosing the successors that will take over the control of the firm – motivation, involvement, preparedness and etc. The mechanisms for realizing this decision remain unknown and also it is not clear how potential family conflicts coming from this decision will be solved. Again there is a contradiction between the desire of the owners to be fair and to provide a good life of their direct successors and their willingness to secure a good future for their business. In this regard, there is an inclination to neglecting the needs of the business in order to suit the need and interests of the family. As an exception there are owners intending transfer of the control over the business to more prepared and interested relatives and associates instead of closest relatives. In these rare cases however the owners expect a rise of severe family conflicts and they have no clear plan or even view how to implement such an unconventional decision. This suggest that the main reason for ownership transfer problems is the lack of an integral succession plan, which could provide a basis for balancing all aspects and decisions concerning business succession management.

Last but not least the family business is part of a family's estate but family business literature examined these closely connected issues separately. As an example, there are cases from the practice, when the business is left in the hands of most interested and prepared family members, and family estate distribution is used as an instrument for achieving equality among all successors. In this way the rise of future problems could be avoided. Unfortunately, in succession management of Bulgarian family firms these two aspects of ownership transfer are mixed and this is a barrier for finding more flexible solutions of ownership challenge.

In general, Bulgarian families intend to use simple ways for business succession, which protects them from significant problems when transferring the ownership. However this limits them in finding the

best possible solutions and forms of business transfer. Finding the right decisions can be made easier by following two main principles. First the ownership transfer decisions should be made in a way that would provide competitiveness for the business and then fairness and equality within the family should be guaranteed by dividing the family estate.

## 6. CONCLUSION

In Bulgarian family firms ownership and management control are concentrated in the family members and respectively succession management is mainly in the hand of the business owners. In addition, business owners partly use the assistance of heirs and often ignore the expectations of the key employees and other stakeholders. Such a style of succession management allows high speed of succession process implementation and maintaining family harmony. But it also could endanger successful motivation and training of successors, managers and key employees and the long-term survival of the business. In part, these specifics could be explained by the small size of family firms, but it should not be underestimated the impact of national business culture on the management of Bulgarian family firms. In summary, this impact is presented by the lack of entrepreneurial tradition, underdeveloped culture of cooperation and partnership, high power-distance and mistrust between superiors and subordinates, owners' voluntarism when making important business and management decisions, etc.

The presented empirical data and the analysis that were done show that despite of the desire of families to keep the business and the presence of prerequisites for realization of an efficient transfer, there is a lack of a suitable management of succession challenges. As a result we witness several major problems in regards to business succession implementation. The most important of them is the unpreparedness of successors to take over family business and to replace the owners. Other significant problems are the necessity of professionalisation of management and the distribution of ownership, the loyalty and motivation of the staff, the introduction of modern management practices such as use of external consulting assistance, establishment of family councils and instruments for family conflict resolving.

On the other hand, Bulgarian family enterprises can benefit from various advantages in the process of business succession such as the family commitment, the high degree of agreement between the owners and successors regarding the major issues of succession implementation, the strong desire of owners and successors to keep the business in the family and to achieve business excellence and success. Also, the lack of tradition could be viewed as an opportunity for Bulgarian family firms to transfer and adapt best management practices in accordance with their specific characteristics and needs.

With regard to the identified problems and opportunities, we can make the following simple recommendations, aimed at improvement of management of succession challenges in Bulgarian context:

- starting the succession process as early as possible;
- counting on planned succession instead on evolutionary approach;
- focusing on preparation of successors and to combine various opportunities for this inside and outside of the family;
- improving family firms management with the external help and consulting although that at present such services are difficult to afford;
- getting over the idea that everyone has to have an equal share in the ownership.

Realization of an effective succession requires finding suitable answers to some well known challenges that all family firms face. The lack of management solutions, which could be valid for all firms and conditions leads to mistakes in succession management and to the rise of significant problems. Identifying the most common problems of business succession in the family firms and finding the reasons for their rise give us the base for improvement of succession management and achieving better succession results in accordance with the specific national or local circumstances.

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## HOW TO EVALUATE THE IMPACT OF ACADEMIC SPIN-OFFS ON REGIONAL DEVELOPMENT

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### Abstract

The triple helix concept emphasizes the role of university and its relations with firms and institutions at regional level. However, the impact of technology transfer activities depends on how universities organize them and on the characteristics of the regional context. The paper analyzes academic spin-offs as a way of commercializing research results and discusses the beneficiaries of spin-offs and their impact at regional level. Spin-off creation is the most complex way of commercializing academic research, compared to patenting and R&D collaboration, but with the highest potential impact on the regional context.

The paper discusses how to measure the impact of spin-offs at regional level and analyzes empirical data about Italy. The Italian experience shows that the quantitative impact of spin-offs on local economies is rather low; however, there are qualitative direct and indirect effects that must be taken into consideration in the short and in the longer term.

### 1. INTRODUCTION

Over the last decade there has been an increasing interest toward academic entrepreneurship, i.e. the direct involvement of academic scientists into the development and commercialization of their research. The commercialization of scientific and technological knowledge produced within publicly funded research institutions such as universities, laboratories, research centers is increasingly considered by policymakers as fuel for developing and sustaining regional economic growth. This paper focuses on one of the most promising ways to transfer research results to the market place: the creation of academic spin-offs. Some scholars argue that the involvement of academic scientists in commercial activities solves some imperfections in the transmission of knowledge, and motivates researchers to undertake projects with greater economic and social relevance (Etzkowitz et al.).

After ten years experience of spin-off promotion by universities and local institutions, there is a growing concern about the evaluation of the impact of spin-offs on universities' technology transfer and local economies.

Up to now the empirical analyses of the phenomenon has focussed on analyzing the characteristics of spin-offs and their growth (Iacobucci et al.), the difference between those universities that have been most active in the creation of spin-offs and those that have been least active (Lockett, Wright, and Franklin), the factors that foster the creation (Clarysse et al.; Iacobucci et al.), the beneficial impact on the growth of other local high-tech start-ups when these are able to detect, absorb, and use this knowledge (Colombo and Piva).

Nevertheless, the empirical evidence indicates that most academic spin-offs are not gazelles. Most university spin-offs start small and remain small, reflecting founder aspirations, capabilities, and resource endowments. Leitch and Harrison (2010), based on detailed analysis of university spin-offs in Northern Ireland, concluded that academic spin-offs are technology lifestyle businesses not dynamic high-growth potential start-ups, and it is suggested that the prominence given to spin-offs in the analysis of technology transfer and in discussions of the economic impacts of universities is misplaced. In this regard, there is a growing recognition that the overall significance of the now widely accepted technology transfer model is based on the atypical experience in technology hotspots, such as Silicon Valley and the Route 128 area (Nicolaou and Birley). Much of the US context that European policymakers have sought to emulate involves atypical high tech clusters that are generally absent from Europe. The spin-off process in such contexts is likely to be very different from that in more developed high tech entrepreneurial environments such as Boston or Silicon Valley where the capability to select the best projects and allocate resources to them already exists. This experience has



often been exaggerated.

There is a need for assessing the effective role played by these firms in an advanced economy.

Knowledge-based economies are innovation driven: there is widespread agreement that knowledge, technological innovation, and industrial competitiveness are linked. In the context of concerns in countries such as Italy that economic performance is held back by a lack of innovation, universities should be crucial stakeholders in the innovation process to drive economic development. Innovation is defined by Lawton Smith (Smith and Ho) as an industry-based concept and has become increasingly complex as firms increasingly seek external inputs into in-house innovation to develop new technologies and to promote market differentiation and expansion. The universities are a resource for high-tech firms, especially in the early stages of product development, so we have to consider the local context where the universities are located.

The performance of spin-off change significantly is we consider different local context and these disparities depends on many factors:

- the importance that university gives to the third mission, encouraging university entrepreneurship;
- reputation and research eminence of individual universities (Di Gregorio and Shane);
- the culture of the university, its attitude toward spin-offs and the competence of the technology transfer offices (TTOs) (Lockett, Wright, and Franklin). TTOs have a key role to play in making their ventures 'investor ready'. 'Readiness' includes the potential competence of spin-off companies to overcome the four different critical junctures needed for survival: opportunity recognition, entrepreneurial commitment, credibility and sustainability (Vohora, Wright, and Lockett);
- the sector of activities reflects the research conducted in University: the greatest concentration is in the life sciences followed closely by information technologies depends of this.

In this sense, the impact of spin-offs tends to be local as most spin-offs stay within the same geographical area as the institution from which they originated (Shane). To the best of our knowledge, little attention has been paid to evaluate the role of spin-offs on technology transfer activity by universities and to their impact on local systems.

The aims of the paper is to cover this knowledge gap:

- developing an analytical framework to evaluate the impact of academic spin-offs on university technology transfer and on regional development;
- applying this framework to the Italian context.

The empirical analysis is based on a sample of 26 spin-offs created between 2000 and 2010 from Università Politecnica delle Marche, for which balance sheet data and information about governance were examined. The analysis of the ownership and management team, and its change over time, was made through an examination of information provided by Chambers of Commerce.

The paper is organized as follows. Section 2 provides a discussion of the role of spin-offs on the technology transfer activities of universities and propose a framework to analyze their impact on local innovation system by developing a set of indicators. Section 3 provides information on the overall phenomenon of academic spin-offs in Italy and the empirical results found applying this set of indicators to spin-offs set-up by in the Università Politecnica delle Marche. Section 4 discusses the main findings of the analysis.

## 2. LITERATURE BACKGROUND

There are a wide range of arguments concerning universities' economic benefits for knowledge societies. The literature considers universities as key actors in an innovation system where universities work together with industry and government to evolve new competitive industrial forms (Etzkowitz and Leydesdorff).

In the triple helix model presented by Etzkowitz (2008), interaction among universities, industry and government is identified as being the key to innovation and resultant economic growth.

The relationship between university-industry depends on such factors as sector and its stage of evolution, firms' absorptive capacities, institutional autonomy, and the eminence of the university and

its response to political power exerted at international, national, and subnational levels. The potential impact of universities through skills made available to the local labour market, and the consequent raising of the level of innovation in a locality's firms, is contingent on a similar range of factors (Smith and Ho). By analyzing Oxford's spin-offs they show that:

- innovation process is more efficient if firms use external sources of knowledge to improve their own technological performance;
- universities are one of these external sources;
- the academic literature suggests that the innovation process is more effective if it is localized hence, proximity of firms to universities is critical to the transfer of knowledge between them;
- governments throughout the world have adopted the normative position that universities, their staff, and students should be more entrepreneurial and should contribute directly to economic development through business activities such as the formation of spin-off companies, and the patenting and licensing of technology.

The growing importance of the university third mission (technology transfer) emphasises the role played by universities at local level. In this sense, there is also an increasing regional literature, looking at the multi-faceted benefits which universities bring to their territories (Boucher, Conway, and Van Der Meer).

This is true especially in the case of university-firm relations, giving the importance of face-to-face interactions (Hewitt-Dundas). This is even more true in the case of spin-offs, that are normally located very close to the parent institution. This is due to several reasons: a) the incubator role played by universities in the start-up phase (use of university structures); b) the involvement of academicians; c) the continuous collaboration between spin-offs and university departments.

Technology commercialization can take place through various forms or mechanisms. The common forms of university-industry technology transfer concern:

- formal mechanisms (patenting, university licensing, strategic alliance through formal and informal research partnerships or joint ventures, and the creation of university spin-outs or spin-offs);
- informal mechanisms (knowledge transfer, consulting and joint publications with industry scientists).

Compared to other ways of transferring research results - licensing of intellectual property (patents) and joint research and development projects involving universities and enterprises - spin-off is characterized by the following: a) the start-up of a new company, b) the transfer to that company of specific technological knowledge developed in universities, c) the involvement of staff from the research institute in the ownership and management of the new initiative (O'Shea, Chugh, and Allen).

The effective capacity of the spin-off phenomenon to contribute to these objectives, and to have a significant impact on regional systems depends on two aspects: a) the capacity for rapid growth of at least some of these initiatives, b) the generation of positive externalities in the system, also by stimulating innovation in sectors which are already present in the area. On the other hand, there are growing doubts surrounding the real impact of university spin-offs, the 1000 new businesses in Italy set up to commercialize university research. At present there are no figures to prove that their costs – including public investment – were less than the revenues from products sales and intellectual property valorization (Harrison and Leitch).

A previous paper on the phenomenon of academic spin-offs in Italy (Iacobucci et al.) shows that these firms are small and remain small with few prospective of growth. This is true at national level. We chose to investigate the phenomenon of university spin-offs by Università Politecnica delle Marche to change the focus at local level where the impact is relevant. Large empirical literature finding supports this line of research giving growing importance to consider the knowledge spillovers from university research to industrial innovation localized (Audretsch and Feldman).

Spin-off creation is the most complex way of commercializing academic research in terms of process, people involved, risks, etc. It is expensive and resource consuming (as patenting) for universities but with little or no prospective financial returns but has (potentially) the highest impact on the local context, in terms of:

- Knowledge transfer: the ability to transfer new knowledge into commercially viable products and services;

- Financial benefits;
- Knowledge spillovers that their activity can generate at local level.

In terms of financial benefits it is relevant to evaluate who get them (university, academicians, firms).

In both cases (technology transfer and financial benefits) it is also relevant to evaluate the geographical span in which the benefits are obtained (local, regional or national) (Figure 1).

Figure 1- Geographical impact of technology transfer activities

	Local	Regional	National / Global
<b>Patenting and Licensing</b>			++
<b>Contract research and consulting</b>	++	+++	+
Spin-offs	+++	+	

Figure 2 shows the potential benefits of spin-offs activity and compare them with the other forms of technology transfer.

Figure 2- Pecuniary beneficiaries of technology transfer activity

	Contract research and consulting	Patenting and licensing	Spin-offs
University	share in external contracts	Fees	dividends and capital gains (when the university has a share in the spin-off)
Faculty	direct remuneration	Fees	Remunerations; dividends and capital gains
Former students and researchers			Salaries; dividends and capital gains
Firms			dividends and capital gains

In terms of financial benefits, the most important way of commercializing university research, is through contract research. Most of these benefits are appropriated directly by the academicians involved in the research and consulting activity. However, a significant share is retained by the university to cover general expenses and to contribute to the research infrastructure.

In the case of patents issued as a result of publicly fund research, the financial benefits goes to the university and to the inventors, depending on who is the owner of the patent.<sup>1</sup> In recent years there has been an increase in IP management by Italian universities (Balderi, Patrono, and Piccaluga). However, several studies demonstrate that even in universities that manage a large portfolio of patents the revenues from fees hardly cover the expenses.

From the university point of view, spin-offs are not likely to be a major source of income, as compared with licensing or other technology transfer activities, and neither is significant relative to other sources of income. There is the need to evaluate the quantitative and qualitative impact of this phenomenon and we propose a set of indicators to do it (Figure 3).

Figure 3- Set of indicators to measure the impact of academic spin-offs

Impact	Indicators
High-tech employer	Sector of activity Number of employees
Source of technological entrepreneurship	Sector of activity Promoters, owners, managers
Links with parent institutions	Grants and contracts with parent university
Global networks for finance, technology and markets	Ownership structure, international project in R&D, geographical market

<sup>1</sup> In Italy the so-called professor privilege allows academicians to choose whether to exploit directly the invention or leave the ownership (and costs) of the patent to the university and retain a share of royalties. In the case of spin-off there is a complex structure of financial beneficiaries: a) the owners; b) promoters and helpers; c) management.

Source of technological spill-over	Collaboration at local level Labour mobility
Stimulate business support services	Incubators, start-up competitions, entrepreneurship courses

Sectors of activities, number of employees and number of promoters could measure the capability of spin-offs to create hi-tech employment and entrepreneurship.

The number of grants and of contracts with parent university measures the links between spin-off and PRI.

The capability of spin-off to create global networks for finance, technology and market could be evaluated through the number of international projects in R&D, geographical market and ownership structure.

Labour mobility is an indicator of technological spillover. Inside the governance of spin-offs there is a lot of turnover in promoters, managers, researchers, etc.

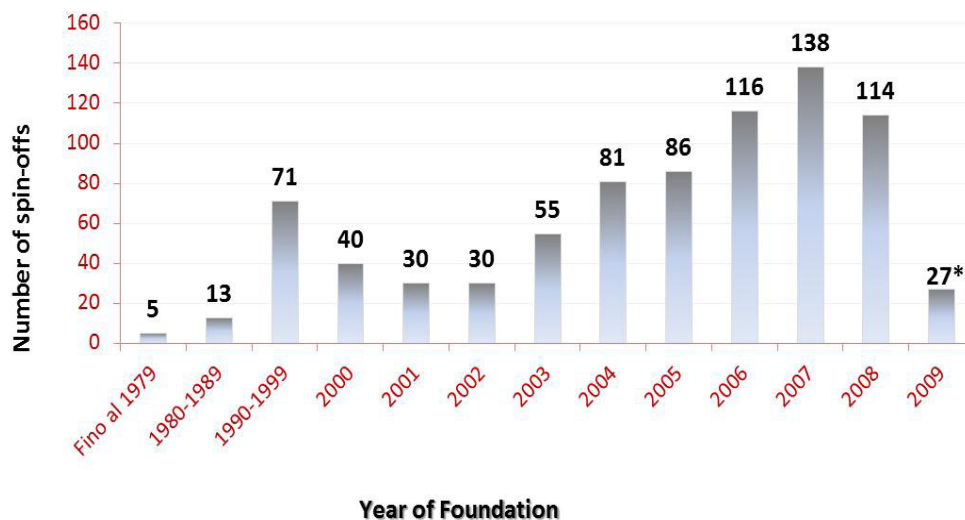
The number of incubations, start up competition and entrepreneurial education are linked with the development of spin-offs in terms of number and growth.

All potential benefits found in literature are analyzed in the following and put into system of indicators to evaluate the quantitative and qualitative impact on a specific local context, starting with an analysis of academic spin-off in Italy to put the case study of Università Politecnica delle Marche in the framework of national phenomenon.

### 3. EMPIRICAL RESULTS

At present, there is no precise information on the population of Italian spin-offs due to the different definitions, the difficulties in collecting information and the recent emergence of this phenomenon. The number of spin-offs calculated by various sources differs depending on the parameters used to define them: normative references, authorized or not authorized by the PRI, PRI equity participation, etc. Considering the birthrate of spin-offs in the time period indicated, it can be noted that since 2003 there has been a real spread of this phenomenon in the Italian PRI. The birthrate reached a first peak in 2004, suggesting a boom effect generated by the introduction of this model in the Italian system; this is seen especially in the PRI which are more sensitive to this form of research exploitation, in line with American and British models. In subsequent years, the slowdown of the phenomenon can be justified by a more rigorous regulation of spin-off authorisation adopted by the competent bodies through the introduction of stricter selection criteria (Figure 4).

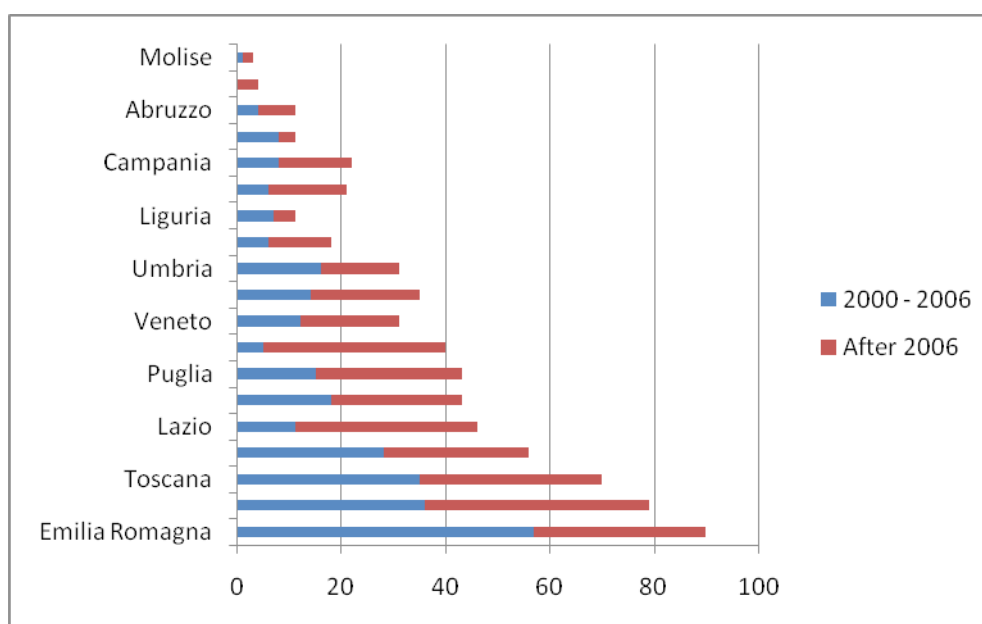
Figure 4- Spin-offs set up in the period 2000-2008



Source: Balderi et al. (2011)

There is a strong concentration of spin-offs at regional level, with most initiatives being in the Center and Northern parts of the country. As observed in other countries, spin-offs are not uniformly distributed between the different PRI: the 5 most important agencies have developed about one third of the initiatives; in addition, 80% of the spin-offs can be traced back to the first 18 PRI (NetVal, 2009) (Figure 5).

Figure 5- Spin-offs set up in the period 2000-2008 by Region



Source: Balderi et al. (2011)

The activity of the spin-offs by sector shows a stronger concentration in services than in manufacturing: 44% of the spin-offs operate in the field “Other business services”, followed by “Computer and related activities” which account for 22% and the “Research and Development” accounting for 12% of the total (Table 1).

Table 1– Sector of activity of spin-offs

Sector	%
R&D and services	44,1
ICT	22,2
Biomedical	9,8
Chemicals and pharmaceuticals	7,0
Electronics and Telecommunications	4,8
Machinery	1,3
Transportation	3,2
Other sectors	7,6
Total	100

Source: Balderi et al. (2011)

In Marche region there are 4 universities Table 2 the most important one is Università Politecnica delle Marche.

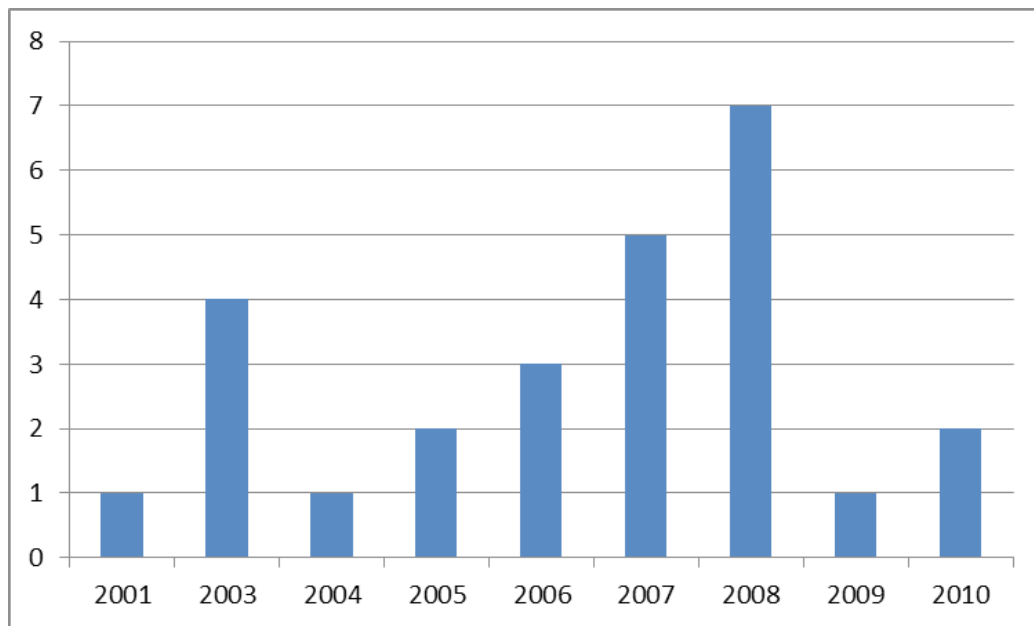
Table 2 – Universities in Marche Region

	Università Politecnica delle Marche	Università degli Studi di Urbino	Università degli studi di Macerata	Università di Camerino
Students	16400	12500	10500	6400
Researchers	523	420	316	280
Spin-offs	26	6	2	0



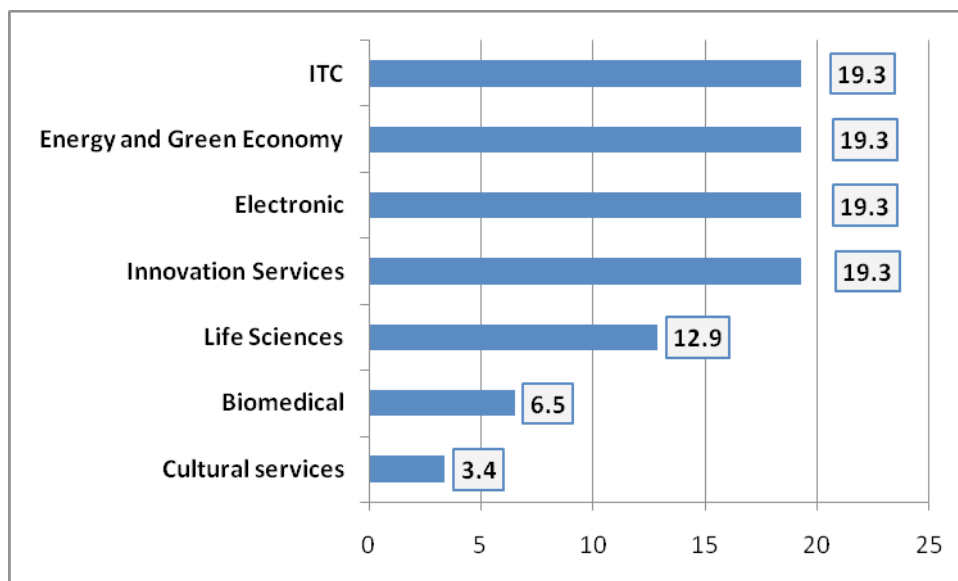
In the last decade, 26 spin-offs were set-up by professors and researchers of Università Politecnica delle Marche, 4 of these are dissolved or in liquidation (Figure 6).

Figure 6- Univpm spin-offs by founding year



The prevalent sectors of activities are, as expected, ICT, energy and green economies and innovation services and this reflects the sectors of activities of Università Politecnica delle Marche (Figure 7).

Figure 7- Univpm spin-off companies by sector



The concentration in high-tech sectors is particularly important for region in the view of the need for Marche business to change the specialization from low tech to knowledge based sector. Over the last decades we observe in the Marche region a decrease of employment in manufacturing in low tech sectors and a progressive shift from this one to other sectors, but the process is slow.

The first aspect analyzed is related to the volume of sales recorded by the sample companies for each years after the set-up. Given the nature of these enterprises, their success on the market is critically important for assessing their capacity to exploit research results. After three years of activity, i.e. after the 'incubation' period, the best performers of our sample show a significant rate of growth in sales. In 2001 just only a spin-off generates 65000 euros. In 2010 the 23 spin-offs of Università Politecnica delle Marche have a total revenue of more than 5 million euros (Figure 9).

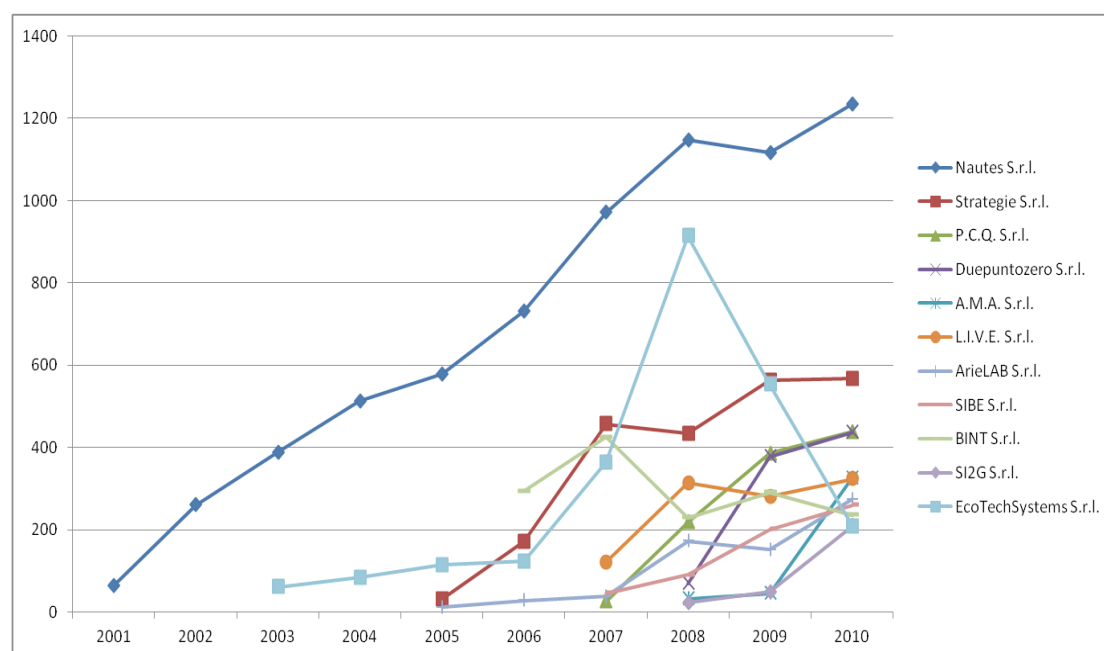
Figure 9 – Revenues of spin-offs by Università Politecnica delle Marche

	Spin-off	Year of set-up	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1	Nautes S.r.l.	2001	65,4	260,7	389	513,4	578,3	731,5	971,3	1.146,8	1.116,6	1.234,1
2	Strategie S.r.l.	2005					32,4	171,4	457,4	434,1	563,3	567,8
3	P.C.Q. S.r.l.	2007							26,5	219	386,4	438,4
4	Duepuntozero S.r.l.	2008								70	378,3	437,5
5	A.M.A. S.r.l.	2008								33	46,3	326,5
6	L.I.V.E. S.r.l.	2007							121,2	313,6	280,6	324,1
7	ArieLAB S.r.l.	2004					12	28,5	39,2	172,6	152,5	274,8
8	SIBE S.r.l.	2007							46,2	90,9	201,5	260,3
9	BINT S.r.l.	2006						294,1	426,1	229,8	291	236,6
10	SI2G S.r.l.	2008								23,5	49,3	209,8
11	EcoTechSystems S.r.l.	2003			61,7	84,8	115,1	124,4	363,7	914,2	553,6	208,3
12	IDEA Soc Coop.	2007							18,4	7,2	17,7	165,1
13	Smart Space Solutions S.r.l.	2008								10	93,1	127,7
14	Artemis S.r.l.	2003			68,5	19	27,7	27,1	81,1	39,9	85	120,6
15	NOW S.r.l.	2009									31,5	50
16	Tecnosuoli S.r.l.	2008								9,5	22,8	21,7
17	H.E.O.S. S.r.l.	2008								*	4,2	17,8
18	Oce. AN. Soc. Coop.	2003			1,8	23,1	30,2	133	56,8	32,5	14,8	16,6
19	CEDAR Solutions S.r.l.	2007							0	5,2	120,7	14,2
20	ASSET S.r.l.	2010										0
21	OPENMOB S.r.l.	2010										0
22	Seismotechnologies S.r.l.	2005					8	6	32	51,6	100,8	n.a.
23	Ingegna S.r.l.	2006							57,6	F		
24	VI.RA.BO. S.r.l.	2003			2	0,8	S					
25	Alpiquadro S.r.l.	2008								0	F	
26	Thermal TI De S.r.l.	2006						0	0	F		
	Total revenues		65,4	260,7	523,0	641,1	803,7	1.516,0	2.697,5	3.803,4	4.510,0	5.051,9

F = failure; S=sold out

The best performers of sample show a continuous process of growth with the exception of EcoTechSystem and BINT that operate in the service sectors and are affected by the economic crisis of the last years (Figure 10).

Figure 10– Best performers of spin-offs by Università Politecnica delle Marche



Apart from the growth of sales, another important aspect of spin-off growth is the ability to create jobs. Since the data concerning staff are not always given in the balance sheet notes, the amount of personnel costs was used as a proxy for wage and salary employment. The data shows how the spin-offs postponed some choices related to the organization of the company (in terms of human resources), sometimes even in the presence of a revenue which would be sufficient to justify them: around 30% of our sample has no personnel costs. We try to make an estimation of how many people are employed in spin-offs. We sum the total expenditure for personnel costs and divide for 30 thousands of euros, that is more or less the average salary for a full time employee.

The obtained value is underestimated because some people in spin-offs have contract of collaboration and the item “personnel costs” in balance sheet doesn’t include it.

These spin-offs have not implemented meaningful growth processes and maintain a generally cautious approach in structuring the organization.

Considering the ownership structure, almost all the research spin-offs have the legal status of limited liability companies, with a few exceptions of corporations and cooperative companies. The use of the legal status of a limited liability company is associated with a relatively limited initial endowment of capital, generally close to the minimum required for limited companies. Three years after set-up, the average stock capital continues to be relatively low.

The ownership structure of the spin-off is, in most cases, made up mainly by individual partners. These are supported by PRI shares, companies, finance companies and other institutions (Table 3).

Table 3– Spin-offs by ownership share of universities, companies and financial institutions at set-up (percentage of total)

Share of legal entity owners	0	< 10	10-19	20-49	> 50	Total
PRI	36	50	14	0	0	100
Companies	56	4	4	36	12	100
Financial Companies or Other Institutions	100	0	0	0	0	100

Source: UPM Spin-off database

The data show a clear difference between the financial commitment of the PRI and the other two types of investors. PRI are present in 64% of the spin-offs with an average share of about 10% and a participation value of around 5,000 euros. This is because the PRI generally enter into the capital of the spin-offs at the time of their creation and with a clearly minority share; the main purpose behind this presence is, in fact, to provide credibility for the new initiative rather than to enhance the investment. In contrast, in the case of firms and financial companies, entry in order to exploit the capital is prevalent. This leads to greater selectivity in entry and a greater financial commitment. If we analyze the spin-offs where there is the presence of industrial companies in social capital, in 36% of cases the share of capital is in class 20-49, while in 12% of cases it is more than 50%.

Analyzing the team of promoters, this is made up by several partners, 6 on average. Of these, 1 or 2 are faculty members that have the role to promote the creation of spin-offs and provide professional advice based on experience, during the incubation stage, while the other are researchers or former students. This means that, at least, for each spin-offs 4 persons try the entrepreneurial carrier and the probability that an entrepreneur starts another company is higher than one who doesn't try. Our findings suggest that teams evolve over time and change in composition, in this sense, many people try the entrepreneurial carrier.

On the basis of this data we try to identify a set of indicators to measure the impact of these 23 spin-offs on the local context.

An qualitative analysis conducted through interviews to promoters of spin-offs shows how the most part of the ones that have changed the team of founders have a process of growth more relevant. According to (Vanaelst et al.), the entrepreneurial teams evolve through the different stages of a spin-out process, suggesting that teams evolve over time and change in composition, and therefore, they cannot be studied as immutable entities.

Even in my case study Teams active in the first phase of the spin-out process appear to be unbalanced in terms of experience. Their experience is highly concentrated in research and development. In this sense, Teams in the first phase of the spin-out process, which are still deciding how to commercialize their knowledge, show a lack of entrepreneurial experience. Once the decision is taken to create a spinout, team members are attracted to the team that may have entrepreneurial experience. After the legal establishment of the firm, no clear finding on the nature of entrepreneurial experience was identified. If we try to evaluate the impact of academic spin-offs by Università Politecnica delle Marche using the available information to measure the impact using the set of indicators we could say that it tends to be relevant but local, remaining within the same geographical area of the institution from which the spin-offs originated. Figure 11 shows the available data for 2010 of 23 spin-offs.

Figure 11– Impact of academic spin-offs by Università Politecnica delle Marche

IMPACT	Short term
High-tech employer (full time equivalent)	34
Source of technological entrepreneurship	136
Volume of sales	5mln
High-tech employer	ICT, Energy, Innovation service, life science

The analysis suggests that the phenomenon of spin-offs has a marginal impact in quantitative terms in short term.

On the other hand spin-offs have positive qualitative impacts in several directions: they are important for University because they provide income streams to their universities, allowing new investment in basic science and they promote relations between local government, university and firms. Moreover,

spin-offs can be important drivers of regional economic development because they generate hi-tech entrepreneurship: they are source of 136 technology entrepreneurs that can help transforming local economies, through the emergence of local technology clusters. Furthermore, they represent a connection for other firms to access the expertise and skills within universities, encouraging the development of networks through which new technologies and knowledge can be shared. Following the “network paradigm” to analyze a territorial-system, a primary network is the one between small innovative firms and local sources of scientific knowledge as Universities and research centres. This relationship allows small firms to build up the technological environment that sustains their innovative capability. Academic spin-offs represent a significant example of network between research centres and small firms. Last but not least, they are companies in high-tech sectors, so they can contribute to production specialization to knowledge based activities, building learning activities which improve the quality of regional innovation environment.

#### 4. CONCLUSIONS

In most advanced countries, the phenomenon of academic spin-offs became significant in the '80s and the significant increase in licensing activities and the setting up of spin-offs by universities can be considered the result of the general growth in importance of scientific knowledge in productive activities and a progressive stance towards the university having a more active role in the economic development of the territory. This process started in US and many European countries, especially those in Northern Europe, have followed the trend observed in the U.S., albeit with some lag. The excellent performance of institutions such as Massachusetts Institute of Technology and Stanford University in stimulating the creation of new business ventures in their local environments is well known. European universities tried and followed this experience during the last twenty years and this has stimulated the attention of several authors who have investigated the creation and development of spin-offs in Europe, but the empirical results show that the idea of importance of university in national economic development remain based on advocacy rather than evidence. In this regard, there is a growing recognition that the overall significance of the widely accepted technology transfer model is based on the atypical experience in technology hotspots, such as Silicon Valley and the Route 128 area but the US context is completely different from European one and the effort to emulate atypical high tech clusters that are generally absent from Europe is a failure idea. Rather, many universities in Europe have traditionally operated in an environment where high tech entrepreneurship is relatively new or undeveloped. The spin-off process in such contexts is likely to be very different from that in more developed high tech entrepreneurial environments such as Boston or Silicon Valley so we have to evaluate this phenomenon using a different approach.

We chose to adopt a local approach due to the fact that there are several difference in local innovation system and these may depend on the relevance of the three main actors of triple helix model, university, industry and government, in terms of:

- quantitative importance on the regional innovation system;
- the orientation towards R&D and innovation;
- technology transfer activities by universities;
- R&D expenditures by firms;
- R&D funding;
- the relations between the three main actors;
- number and amount of university-firms relations;
- funds allocated by public institutions to firms and universities.

These differences in local system determine the development of spin-offs due to the fact that the factors fostering the creation of this kind of firms are several. Regulations have an impact on spin-off activity because they determine the degree to which universities have the autonomy to make their own rules regarding TT activities, as the reputation and research eminence of individual universities. Even the institutional factors as culture of the university, its attitude toward spin-offs and the competence of the technology transfer offices, could have an impact on this phenomenon. Moreover, the distribution of spin-offs across industry sectors is highly uneven and spin-offs are diverse in their activities because they reflect the prevalent sectors of research and activities of universities.

Our results reaffirm the consolidated literature about the localized nature of knowledge transfer.



If knowledge spill over tends to occur only within limited geographic areas, embedding economic activity based on this knowledge within the local context, universities can become important focal points for local economic developments.

In this sense the main results of our analysis could be sum up as following:

- Spin-off is not a way of commercializing university research, because the main beneficiaries (in financial terms) are former students and researchers. For the universities spinoff promotion generates costs with little prospective returns;
- Nevertheless, this phenomenon could have positive effect at the local level but we have to evaluate it on long term;
- The geographical span of the spin-off impact is mainly at local level;
- To evaluate the real effect it is important to consider the local context in terms of industry specialization and policy objectives.

Universities can play an active role in promoting and supporting spin-offs, seeing them as an opportunity to pursue several objectives: a) develop an effective way to exploit research results; b) contribute to production diversification and the development of the geographical areas where they are set up, c) provide a possible source of employment for their researchers. The policy maker's attention to spin-off is justified by the need to promote the commercial fallout of investment in basic and applied research and the need to promote the development of 'knowledge-based' business, which is increasingly regarded as fundamental for territorial competitiveness.

However the interactions between firms and between firms and universities tend to be contained in smaller areas.

This can be important from the point of view of policy makers, concerned on fostering economic development locally, and for university administrators to decide the importance of TT activities. A key issue to understand the potential impact of academic spin-offs in further research could be to analyze the phenomenon of academic spin-offs at local level, distinguishing short term from long term impact, using a qualitative approach and avoiding the quantrophrenia.

More empirical research is needed to assess the qualitative impact of spin-offs on local systems: for the short term impact it would be important to know the number and value of R&D projects in cooperation with other firms and the nature and importance of relations with the parent universities.

To measure the impact of spin-offs in the longer term, it would be interesting to analyze the companies set up by people involved in spin-offs creation (second generation spin-off, new technology entrepreneurship) and the labor mobility between spin-offs and other companies in the local system.

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## **TRIGGERING INNOVATION IN THE RESEARCH COMMUNITY**

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### **Abstract**

Innovation capabilities of companies depend on a variety of factors, such as R&D expenditure, knowledge management processes, culture, organization structure, management systems etc. In search of new, innovative ideas and solutions the undertakings tend to co-operate more and more often also colleges, universities and other public research institutions, in which research is actually one of their basic missions. If once the purpose and the pinnacle of scientific research work of scientists, employed at the universities and research institutes, was publication of research results in scientific magazines and presentations at the conferences (result of basic research), today the results of research are conveyed through patents, trademarks and other forms of commercial application to a much greater extent. In the research, presented in this paper, our aim was to indentify the strongest factors influencing the patent activity of the Slovenian researchers, employed at the universities and research institutes as the organizations of which the fundamental purpose and mission is research and scientific work as the source of innovations. We asked the researchers which factors either as incentive or as obstacle influence most their scientific research work and in this regard the patent activity in different phases of research process. Based on the results obtained through the research we can conclude that the Slovenian universities and research institution have still a lot of work to do in the field of increase of efficiency of the scientific research activity. However obstacles, which we have recorded in the research, are not to be understood and taken only as problems, preventing universities and other research organisation greater commercialisation of the scientific-research achievements and know-how, but also as a new opportunity, which is offered to them in this field.

**Keywords:** Innovation, R&D, obstacles to innovation, Patent activity, University research

### **1. INTRODUCTION**

Business performance and innovation are believed to be closely linked. In general there is clear evidence that innovation play a crucial role to long term profitability and growth in firms (Altman, 2008; Geroski & Machin, 1992; Neely & Hii, 1998; Roper, Du, & Love, 2008; Sharma & Thomas, 2008). Innovation abilities constantly fuel and renew competitive advantage as firms grow and mature (Miller, 1983; Zahra & Covin, 1993). There is little dispute that innovations are important for prosperity of firms, industries and society.

Innovation capabilities of companies depend on a variety of factors, such as R&D expenditure, knowledge management processes, culture, organization structure, management systems etc. and on people. People are the main source of innovations within companies and other organizations. Studies show that a large majority of all innovations are created by company employees (Trimborn, 2009). Employees' innovation behaviour is therefore crucial for companies, that wish to increase their business performance and is determined by both the employees' proactivity and organization's desire for employee innovation behaviour (Amo, 2006).

Considering the aforementioned it is of the key essence for the undertakings to establish an appropriate environment within the undertaking in order to encourage innovation or to implement measures increasing innovation of employees. Thereby, they should pay attention to the fact that encouraging innovation and only innovation resulting in inventions, is not sufficient. Innovation in an undertaking has to be such that inventions are also efficiently implemented in the undertaking (e.g. if the invention improves work processes, there should be energy savings or material savings or similar) or commercially utilized. Innovation consists of successfully implementing creative ideas within an organisation (Amabile, Conti, Coon, Lazenby, & Herron, 1996). In addition to systems of encouragement and implementation of the innovation within an undertaking, the outsourcing of

inventions is becoming more and more important. The undertakings tend to cooperate with colleges, universities and other public research institutions, in which research is actually one of their basic missions.

If once the purpose and the pinnacle of scientific research work of scientists, employed at the universities and research institutes, was publication of research results in scientific magazines and presentations at the conferences (result of basic research), today the results of research are conveyed through patents, trademarks and other forms of commercial application to a much greater extent.

In the research, presented in this paper, our aim was to identify the strongest factors influencing the patent activity of the Slovenian researchers, employed at the universities and research institutes as the organizations of which the fundamental purpose and mission is research and scientific work as the source of innovations.

## 2. CHANGED ROLE OF UNIVERSITIES AND RESEARCH ORGANISATIONS

Traditionally, the research at the universities and other research institutions has been distinctively scientific, i.e. directed toward discovering important scientific achievements and less intended for solving specific issues, which the undertakings, economy and society face in practice. This trend has been changing more and more. The scientific research work has been more and more application focused also at the universities and other research organisation and there is more cooperation with the economy. We can say that the gap between creating a scientific achievement and its applicability in practice is narrowing. Consequently, the number of academic inventions, presenting immediate commercial potential, is growing. Thus, the university know-how presents new source of industrial inventions. However, it is true that the problem of absence of links between the university and economy remains since research results are far more often recorded than the practical use of this knowledge in companies. Nevertheless, the recent researches in the Western World detect changing roles of universities and institutes. The researches at universities are more market-oriented; furthermore, the organisation of universities and institutes has been changing into the direction of »undertaking organisation«.

The changing roles of universities and institutes reflect in the entire research process – from the initial idea to the dissemination and consequently implementation of results. As aforementioned, today the pinnacle and the purpose of scientific research work is no longer only publication of research results, but the universities and institutes are more and more aware of possibilities, importance and opportunities, arising from different forms of commercial application of research results. To certain extent, the researchers attribute these changes to the competitive manner of financing and to some extent to the change of teaching process at universities, i.e. from learning to researching. Some (Neave, 2000) however, state that the adjustment of universities is a consequence of greater and greater competitiveness among universities. It is interesting information that there are more and more research institutions deciding to patent their inventions. In 2001 in Slovenia there were five patents awarded to the Slovenian researchers, registered at the ARRS, while in 2005 they were awarded 69 patents.

## 3. RESEARCH ON FACTORS, INFLUENCING THE PATENT ACTIVITY OF THE SLOVENIAN RESEARCHERS

For the purpose of our research the patent process has been, first, divided into three separate phases, i.e. phase of discovering knowledge, phase of dissemination of knowledge and phase of application or transfer of knowledge (commercialisation). We have divided the factors, influencing the patent process, into internal (internal satisfaction, acknowledgement of peers, prize money etc.) and external (state, culture of work, entrepreneur thinking etc.). Internal factors can be further on divided into the factors, influencing the scientist, and factors, influencing field of work or research. Into the first subgroup fall motivators (positive factors) such as internal satisfaction of the scientist, acknowledgment of peers or academic colleagues and prize money. In this group there are also obstacles (negative factors), which obstruct the scientists' way to the desired results, represented by time (spending of own, free time) and costs (own costs), which a research demands. The factors (motivators and obstacles) influencing the field of work and research are more specific and differ materially among professions.

The following step in our research was drafting a questionnaire for the comparison of patent activities of the Slovenian researchers whereby we assisted ourselves with the questionnaire, developed within the questionnaire of a wider European research of patent activity - PATVAL. The questionnaire has

been divided into four separate sets according to the content, namely: inventor's process, inventor's benefits, road from an idea to an invention, value and effect of the patent. On the sample of the Slovenian researchers, who have registered at least one patent in the data base COBISS, we have conducted the quality research on scientific research activity in Slovenia with the emphasis on patent inventions and commercialisation of patents.

The invitation for participation in the research has been submitted to 338 researchers, for which it was possible to obtain contact details (there were 476 registered researchers in the data base COBISS, who had at least one patent on 24 February 2010) and 72 valid questionnaires have been returned. The average age of respondents in the research amounted 42.8 years, among which there were 56 men and 16 women.

#### 4. RESEARCH RESULTS

In order to reach results regarding the impact of certain factors on the patent activity of Slovene researchers, the first part of the questionnaire, as Table 1 illustrates, examined the employment status of the participants in the time of innovation process that concluded with patent application. Almost half of participants were employed in companies (48.6 %), then at university (26.4 %), research institutes (16.7 %) and public entities (4.2 %).

Table 1: Employment status of the participants

		Frequency	Percent	Cumulative %
Valid	Employed in company	35	48.6	48.6
	Employed at university	19	26.4	75.0
	Employed at research institute	12	16.7	91.7
	Employed in public entity	3	4.2	95.8
	Other	2	2.8	98.6
	Self- employed	1	1.4	100.0
	Total	72	100.0	

Table 2 below illustrates the patent activity of participants. It indicates that almost half of the participants (45 %) registered one patent and 54 % of participants registered more than one patent. All together, 72 participants filled 180 patent applications, meaning that the average of patent applications per scientist is 2.5 applications. The comparison of sub-samples, formed based on the criteria of employment, has shown that the average of patent application per employee is half lower at universities and institutes compared to the average of applications of researchers, employed elsewhere. The average patent applications per researcher, employed at universities and institutes, are 3 applications per researcher, while the average of patent application per researcher elsewhere is 6 applications per researcher.

Table 2: Number of patent applications

	Frequency	Percent	Cumulative %
1	33	45.8	45.8
2	10	13.9	59.7
4	8	11.1	70.8
3	6	8.3	79.2
5	5	6.9	86.1
6	2	2.8	88.9
7	2	2.8	91.7
8	1	1.4	93.1
9	2	2.8	95.8
14	1	1.4	97.2
17	1	1.4	98.6
20	1	1.4	100.0
Total	72	100	



From the responses to the question of commercialisation of patents it follows that almost a fifth of respondents (16.7% that is 12 respondents) has not even tried to commercialize their invention, for which they filed a patent application, whereby 34 respondents replied affirmative to the question on the actual applicability of the patent application for commercial or industrial purposes (in the widest sense).

Table 3: The attempts to commercialize the invention

		Frequency	Percent	Valid %	Cumulative %
Valid	0	12	16.7	16.7	16.7
	1	40	55.6	55.6	72.2
	2	5	6.9	6.9	79.2
	3	2	2.8	2.8	81.9
	4	4	5.6	5.6	87.5
	5	3	4.2	4.2	91.7
	6	1	1.4	1.4	93.1
	8	2	2.8	2.8	95.8
	Unknown	3	4.2	4.2	100.0
	Total	72	100.0	100.0	

The most important part of our research were questions on factors which influence most their work either as a motivation or as obstacles in different phases of research process. In the period of generating the idea and research, "the satisfaction of working what I like" and "curiosity" were on the first place among the motivators. On the other hand, i.e. factors, which hinder the work of researchers to the greatest extent, are reporting manner (on results and means use), constraint and the pressure of the institutions and administrative and bureaucratic support of institution. As motives, which deviate most positively in case of employed at universities and institutes compared to others, the following are expressed: »Possibility of future references«, »Possibility of publication activity« and »Ensuring salary through research projects«. The employed at universities and institutes see a much stronger obstacle compared to others in »technical«, »professional« and »administrative and bureaucratic« support of their home institution.

During the period of patenting and invention the work of researchers has been most motivated by the references, gaining self-value and good connections with the industry; thus, mostly personal factors. The most restrictive factors were: knowledge of writing the patent application, access to capital market and regulation of relations between the innovators and institutions with regard to awards, arising from patents. The employed at universities and institutes state »Restriction of publishing before the publication of the patent« as the greatest obstacle. The results also show that universities and institutes support their researchers essentially worse from the administrative perspective compared to the economy. The employed at universities and institutes differ in a positive way compared to others in the category of »Marking of the patent in Cobiss«, »Gathering points for habilitation« and »References«, which is not surprising.

During the implementation of the patent in practice or its commercialisation the researchers (the entire sample) were most motivated by pleasure to participate and work with the economy and practice, presentation of knowledge and personal work in industry and realisation of own inventions in industry. Among those factors, which were the most hindering, were (besides the small size of the Slovenian market) also: financial pretentiousness, access to capital market and initial capital. Relating to the differences between the employed at universities and institutes and others the least motivating factor among the employed at universities and institutes was »Founding of own company«, »Realisation of knowledge in the form of cooperation with industry«, »Realisation of research capacities«, »Transfer of knowledge between the educational sphere and economy«, »Sale of patents to multinational companies«. The desire to commercialize academic know-how and opportunities for that is obviously much smaller by the researchers at universities and institutes compared to others.

The main reason for patenting (whole sample) is in the order: commercial exploitation (acquisition of exclusive right for economic exploitation of the invention), prevention against imitations (protection of present and future inventions with patenting the »coincidental inventions«) and reputation (patents as element of assessment of successfulness (evaluation) of inventors or research group).

Table 5: List of motives for patenting an invention

E5_1	Commercial exploitation (acquisition of exclusive right for economic exploitation of the invention)
E5_2	Licensing (acquisition of exclusive right for licensing the invention for generating licence income)
E5_3	Cross licensing (improving own negotiation position in the trading with patent rights with other companies)
E5_4	Prevention against imitations (protection of present and future inventions with patenting the »coincidental inventions«)
E5_6	»Blocking patents« (prevent that others would protect similar inventions)
E5_7	Preventions to be sued by others for application of the invention, created by us, but patented by others
E5_9	Time (we have filed the patent application in order to “buy” time for preparing the European patent application or to prepare successful commercialisation)
E5_8	Reputation (patents as element of assessment of successfulness (evaluation) of inventors or research group)

At the end we took a closer look on relation among different motives for patenting an invention. Based on correlation analysis, presented in Table 5, we can conclude two inter-related groups of motives and third independent motive. In the first group there are significant and strong relations among three variables:

- E5\_1 Commercial exploitation (acquisition of exclusive right for economic exploitation of the invention)
- E5\_2 Licensing (acquisition of exclusive right for licensing the invention for generating licence income)
- E5\_3 Cross licensing (improving own negotiation position in the trading with patent rights with other companies)
- In the second group there are significant and strong relations among five variables:
- E5\_3 Cross licensing (improving own negotiation position in the trading with patent rights with other companies)
- E5\_4 Prevention against imitations (protection of present and future inventions with patenting the »coincidental inventions«)
- E5\_6 »Blocking patents« (prevent that others would protect similar inventions)
- E5\_7 Preventions to be sued by others for application of the invention, created by us, but patented by others
- E5\_9 Time (we have filed the patent application in order to “buy” time for preparing the European patent application or to prepare successful commercialisation)
- Third motive represents the variable, which is only weakly related or non-related to other variables:
- Reputation (patents as element of assessment of successfulness (evaluation) of inventors or research group).

First group of motives, which lead the Slovenian research toward patenting, is strictly commercial: economic exploitation of results of invention. Second group of motives is also of economic nature, but more indirect – the author does not expect from the patent direct economic benefit, but it should strengthen his “strategic market position” – by blocking competition, decreasing risks, related to intellectual property and gaining time for competitive positioning. Both motives show distinctive »entrepreneur« relation of researchers to results of their work. The last motive – reputation – is, however, related to public service, performed by most of researchers and their role in society: patenting has a greater reputation in this case, visibility among the professional public and last but not least easier access to public means, in case of which previous achievements, including patents, present one of the criteria for selection. These findings present an interesting basis for a more in-depth research and analysis in the future.

Table 5: Relation among different motives for patenting an invention

		E5_1 Com- mercial exploitation	E5_2 Li- censing	E5_3 Cross licensing	E5_4 Prev. against imitations	E5_6 Blocking patents	E5_7 Pre- ventions to be sued	E5_9 Time	E5_8 Reputa- tion
E5_1 Commercial exploitation	Corr.	1	.359**	.365**	0.09	0.103	0.186	0.046	0.165
	Sig.		0.002	0.002	0.451	0.389	0.118	0.699	0.165
	N	72	72	72	72	72	72	72	72
E5_2 Licensing	Corr.	.359**	1	.427**	0.079	0.004	0.041	0.107	.263*
	Sig.	0.002		0	0.511	0.972	0.731	0.371	0.026
	N	72	72	72	72	72	72	72	72
E5_3 Cross licensing	Corr.	.365**	.427**	1	.375**	.393**	.304**	.327**	0.219
	Sig.	0.002	0		0.001	0.001	0.009	0.005	0.064
	N	72	72	72	72	72	72	72	72
E5_4 Prevention against imitations	Corr.	0.09	0.079	.375**	1	.535**	.417**	.320**	0.145
	Sig.	0.451	0.511	0.001		0	0	0.006	0.225
	N	72	72	72	72	72	72	72	72
E5_6 Blocking patents	Corr.	0.103	0.004	.393**	.535**	1	.653**	.484**	.243*
	Sig.	0.389	0.972	0.001	0		0	0	0.04
	N	72	72	72	72	72	72	72	72
E5_7 Preventions to be sued by others	Corr.	0.186	0.041	.304**	.417**	.653**	1	.444**	0.214
	Sig.	0.118	0.731	0.009	0	0		0	0.071
	N	72	72	72	72	72	72	72	72
E5_9 Time	Corr.	0.046	0.107	.327**	.320**	.484**	.444**	1	.258*
	Sig.	0.699	0.371	0.005	0.006	0	0		0.029
	N	72	72	72	72	72	72	72	72
E5_8 Reputation	Corr.	0.165	.263*	0.219	0.145	.243*	0.214	.258*	1
	Sig.	0.165	0.026	0.064	0.225	0.04	0.071	0.029	
	N	72	72	72	72	72	72	72	72

## 5. CONCLUSION

Inventiveness is no longer important only in the economy, but presents an important activity also at universities and other research organisations. The pinnacle of scientific research work is no longer only publication of results but also economic exploitation of these results. Innovation and patenting of inventions is becoming more and more important activity of universities and research institutions as such and the income from sold patent license presents more and more important item in their accounting items and financial reports.

In our opinion the results of this research are very important for drafting and applying research politics at universities and other research organisations especially in the part in which we identify factors, that have shown to be most restrictive in the procedures from birth to commercialisation of an invention. Based on recorded obstacles these institutions will be able to direct their policies and measures into removing or lessening these obstacles in the future, which will contribute importantly to a greater effectiveness of scientific research work.

First the result, according to which the average of patent application per employed is half lower at universities compared to average of applications elsewhere employed researchers, has to be stressed. These results can be explained by the fact that research at universities is still primarily focused toward publication of scientific achievements, which are basis for promotion in the academic career and not into commercial exploitation of the academic know-how. The research has shown also other important differences between the researchers, employed at universities, and those employed in other research organisations (in our case these were mostly research institutes).

In the phase of generating the research idea the most hindering factor turned out to be “technical, professional and administrative support of the home institution”. The employed at universities and institutes see much greater obstacle compared to others in the reporting manner (on results and means use), constraints and the pressure of the institutions and administrative and bureaucratic support of institution. During the patenting and invention the most restrictive factors turned out to be: writing a patent application, access to capital market and regulation of relations between the inventors and

institutions with regard to awards arising from patents. During the period of implementation of a patent in practice the most hindering factor turned out to be financial pretentiousness, access to capital market and initial capital. With regard to the differences between the employed at universities and institutes and others the least motivating factors among the employed at universities and institutes are »Founding own company« and »Realisation of know-how in cooperation with industry«.

Based on results, acquired through the research, we can conclude that the Slovenian universities and research institutions have still a lot of work to do in the field of the increase of scientific research activity. Obstacles, which we have recorded in the research, are not to be understood and taken only as problems, preventing universities and other research organisation greater commercialisation of the scientific-research achievements and know-how, but also as a new opportunity, which is offered to them in this field.

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## ENTREPRENEURIAL BEHAVIOUR AMONG STUDENTS – CASE STUDY OF UNIVERSITY OF DONJA GORICA, PODGORICA, MONTENEGRO

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### Abstract

Promotion of the entrepreneurial is one of the very important goals of Lisbon Strategy and is crucial for generations of new jobs and economic growth in Europe. Entrepreneurial behaviour is representing philosophy of development at the level of both individuals and the society. Entrepreneurship is not only a driving force for economic development that involves the creation of new jobs, improve competitiveness and economic growth. It also contributes to improved personal and self-fulfilment, and achievement of social goals.

It is important to encourage entrepreneurship in all age groups. However, given that the students are a vital and promising structure of society, with the most innovative and creative potential, strengthening entrepreneurship among them is a must at any higher education institution. The subjects of this paper are, precisely, the factors influencing entrepreneurial behaviour among students. In the focus will be situational factors and their impact on entrepreneurial orientation of students of young University (UDG) and their motivation towards this type of mentioned behaviour. These are the following situational factors, the perception of social reality and the current economic environment, family “background”, curricula and teaching activities in entrepreneurship, promotion of good practice.

In spite the mentioned survey, which will provide evidence of whether these elements have an impact on entrepreneurial behaviour, and more importantly, impact on the motivation of students to this type of behaviour, the subject of research will be, also, theoretical views with regard to these factors, with special emphasis on the question of whether formal education, in general, affects and encourages young people like this type of behaviour.

**Keywords:** Entrepreneurial, Higher education, Lecture, Curricula

### 1. INTRODUCTION

Education and scientific activities are the social activities of public interest. These activities with many and varied program activities and facilities condition and promote overall economic and social development. Special role and importance in the social and economic development is the development of entrepreneurship among young people. A special category of young people, who are carriers structure changes in the economy and society, the dynamic trends and the overall development, are students. The development of entrepreneurship among students is determined by various elements, among which are dominant: the perception of social reality and the current economic environment, family background, curricula and teaching activities in entrepreneurship, promotion of good practice.

Promotion of the entrepreneurial is one of the very important goals of Lisbon Strategy and is crucial for generations of new jobs and economic growth in Europe. Entrepreneurship should be accessible to all students, at all faculties and not only to those of economics or business studies. “Entrepreneurial University” is the one with employees at all levels committed, and students of all faculties encouraged to think and act as entrepreneurs. That is the only way to create society driven by knowledge, with small companies dominating and being highly competitive.



## 2. FACTORS INFLUENCE ENTREPRENEURSHIP

Entrepreneurship refers to individual's ability to turn idea into action, which includes creativity, innovation and taking of the risk, as well as the ability to plan and manage projects in order to meet set goals. The essence of this competence is ability to recognize the context in which an individual acts and proactively respond to given opportunities. A small number of individuals are born entrepreneurs, but studies show that education and training can significantly contribute to the development of entrepreneurial views, knowledge and skills. Competence entrepreneurship implies<sub>1</sub>:

- Knowledge of available opportunities in order to identify those that match personal, professional and /or business activities of a person.
- Skills, including: ability for cooperative and flexible work as a part of the team; be able to identify personal strengths and weaknesses; ability of proactive reacting and positive reaction to changes; ability to assess and take the risk when necessary and justified.
- Views, including disposition to take the initiative; positive attitude towards changes and innovations; the willingness to identify areas where a person can demonstrate the full range of entrepreneurial skills - for example at home, at work and in the community.

Entrepreneurial behavior carries expressed the need for innovation and the creation. Entrepreneurship in this behavior has a built leadership, the need and opportunity to the forefront, to first test new ideas (their own or other people) and to generate change, because they see opportunity for new breakthroughs and successes. He gazes into the future and a vision. Entrepreneur believes in a better, different and therefore the maximum focus on people as the most important asset and resource, only one of whose value increases the creative use, unlike all the other resources that are still using lower.

Phenomenon of entrepreneurship and entrepreneurial behavior are approached from different aspects. Among the many approaches to entrepreneurship and entrepreneurs, especially interesting that those who start from a psychological and personality traits of entrepreneurs. Authors Bartal and Mortin<sup>2</sup> were engaged to research the character traits have entrepreneurs, as well as the factors that influence the development of entrepreneurial behavior. Although we have to mention that when it comes to entrepreneurial characteristics that will indicate, the authors note the same and are attributed to managers. Character traits that are recognized by:

Entrepreneurial characteristics that they identified are:

- Strong need for achievement;
- Self-control;
- Lucidity.

Based on the theory of these authors, the following factors influence entrepreneurship:

- Family environment (some studies have shown that most entrepreneurs coming from families that are already engaged in some independent businesses, and that is only children or first children, are entrepreneurial oriented);
- Economic and social environment;
- Education (entrepreneurs are better educated than others, although very often less than the managers);
- Age (entrepreneurs are usually between 22 and 55);
- Work experience (download a new venture initiated by entrepreneurial ventures);
- Dissatisfaction with the business environment (entrepreneurs who start a business are often motivated by dissatisfaction expressed business environment);
- Negative experience (often entrepreneurship is the result of major changes such as marriage, divorce, layoffs, etc.).
- Positive impact (to start a new job individual, very often motivate by mentors, business partners or others.).

1 Working program "Education and training 2010" European Commission, available at [http://ec.europa.eu/education/lifelong-learning-policy/doc28\\_en.htm](http://ec.europa.eu/education/lifelong-learning-policy/doc28_en.htm) ; 08.08.2011.

2 Bartol, K. M., Martin, D.C „Management”, McGraw – Hill, Inc. New York, 1994.

### 3. ELEMENTS AND THEORY OF ENTREPRENEURSHIP

What are the basic elements that define entrepreneurship? Depending on the approach and the theory of differentiate. Entrepreneurship is associated with different features or elements, some of them have mentioned, we can add some. In the analysis of the characteristics that an entrepreneur needs to have, and their recognition is important to us, because of the development of the same among the students. Most authors repeat same characteristics: take the risks, self-initiative, self-confidence, adaptability, perseverance and others. Interesting is the attitude that Peter Drucker mentioned, entrepreneurship is a special feature of any individual, institution or company. It is not a personality trait: for thirty years I have seen people of various personal and character traits and types of temperament who are equally well find their way in entrepreneurship. Entrepreneurship is a way of behavior rather than performance.

Everything presented, so far, provides a basis for theory analyses of the so-called comparative theory of entrepreneurship, although the scope of work does not allow the detailed analysis. The comparative analysis starts from two basic characteristics of entrepreneur's personality: passive and active response: passive and active change, so you will create four basic theoretical models

Table 1. Comparative theory of entrepreneurship<sup>4</sup>

ENVIROMENT		
Passive		Active
Person		
Passive	The theory of possessing the most important essence: "What is important is the personality"	The theory of necessity "Time makes a man"
Active	The theory of the great figures: "Personality does the time"	The theory of joint action: "The orchestration of people is one that is important."

In this paper we want to show the development of entrepreneurial behavior caused by environmental and different influence rather than only, personalities. This statement is especially important in case of entrepreneurial behavior among young people. Because of this objective we think that is necessary to underline the importance of "entrepreneurial approach that is based on joint action", primarily because this theory emphasizes that both the individual and the environment are important aspects of the entrepreneurial function, which must never be neglected. This emphasis on understanding of entrepreneurship as a two-phase (person and environment) and two-dimensional (active and passive adjustment) process is particularly evident in the theories based on "four C" approach.

The theory of entrepreneurship based on the "Four C", presented by Tropman and Morningstar, can be understood through the four key concepts:

- Characteristics (Characteristics) and
- Skills (Competencies),
- Conditions (Conditions) and
- Context (Context).

This perspective includes the concept of psychological characteristics of properties; however it also adds a level of such individual characteristics. The concept of capabilities suggests that there are certain skills, behaviors that can be learned and that can be practiced. According to him, also there are certain conditions - within families, within the company, within the community - that are more favorable for the development of new ideas and introduce new products and new services. These are partially given, however, and they can be shaped. Finally, there are certain contexts - the forces of macro-environment, larger scale - which also may favor the entrepreneurial functions. Although less affected, they can also be shaped, and their types can be used and exploited. Each of these elements can benefit the development of entrepreneurship, but also can act against him. Some individuals may not have the required features or they have enough or may have the right features but not the ability or context or conditions may be negative.

<sup>3</sup> Drucker, P., "Inovacija i preduzetništvo", NIP „Privredni pregled, Beograd 1991. Str 51.

<sup>4</sup> Tropman, J.E & Morningstar, G., „Enterpreneurial System for the 1990s, Their Creation, Structure and Management, Quorum Books, New York, 1989. page 9. by Pokrajac S. „Inovacije i preduzetništvo”.

#### 4. UNIVERSITY AND ENTERPRENEURSHIP

The entire previous story so far represents a general or introductory story of entrepreneurial behavior, elements of personality characteristics that influence entrepreneurial behavior as well as theories that speak to this issue. Entrepreneurship is one area in a matter of personality, while the other enabling thing, and atmosphere. What are the incentives for students to entrepreneurial behavior and what is the role of the University?

Different authors variously perceived influences of formal education in this case the University on the development of entrepreneurial behavior. Results of research at the University of Amsterdam, "Entrepreneurship, elections and performance - the role of higher education" show that impact of education on entrepreneurial performance is positive and significant. Author of the theory of career socialization, Dyer, believes that despite a number of other factors, affects the educational experience has influence, in a way that will develop individual's career. There are those authors who argue that formal education inhibit and "stifle" creativity and entrepreneurship, especially with the unadjusted means of learning, complex programs and inadequate access<sup>5</sup>.

In the theoretical review of the entrepreneurship, the first part, we saw that having a certain education, skills, ways of thinking and initiatives necessary to becoming entrepreneurial behavior. In process of development and promotion of education, skills, development of certain ways of thinking and initiative is role of University when we talk about the development of entrepreneurial behavior among students.

Expert team who was working on the document "Entrepreneurship in higher education, especially within non-business studies" that is related on the whole EU level conclude<sup>6</sup>: „At higher education level, the primary purpose of entrepreneurship education should be to develop entrepreneurial capacities and mindsets. In this context, entrepreneurship education programmes can have different objectives, such as: a) developing entrepreneurial drive among students (raising awareness and motivation); b) training students in the skills they need to set up a business and manage its growth; c) developing the entrepreneurial ability to identify and exploit opportunities. Graduates' start-up is one of a range of possible outcomes”.

Based on same document high education have to put stress on on enterpreneurial education. Entrepreneurship education should not be confused with general business and economic studies; its goal is to promote creativity, innovation and self-employment, and may include the following elements,;

- Developing personal attributes and skills that form the basis of an entrepreneurial mindset and behavior (creativity, sense of initiative, risk-taking, autonomy, self-confidence, leadership, team spirit, etc.);
- Raising the awareness of students about self-employment and entrepreneurship as possible career options;
- Working on concrete enterprise projects and activities;
- Providing specific business skills and knowledge of how to start a company and run it successfully.

#### 5. DEVELOPMENT OF ENTREPRENEURIAL BEHAVIOR – CASE STUDY UDG

Looking at the situation regarding the development of entrepreneurship in universities, the situation leaves a lot of space for improvement. The document "Entrepreneurship in higher education, especially within non-business studies" concludes that In many countries entrepreneurship in non-business studies is a very new issue. In general terms, entrepreneurship is not yet sufficiently integrated into the curriculum of higher education institutions. The situation seems to be more positive in only few countries (such as Germany), while the spread of entrepreneurship is particularly weak in some of the Member States that joined the EU in and after 2004. Data from some European countries show that

5 Plaschka, P. R. and Welsch, H. P." Emerging Structures in Entrepreneurship Education: Curricular Designs and Strategies, *Entrepreneurship Theory and Practice*", 1990. Vol. 14, Issue 3: 55 –71.

6 Entrepreneurship in higher education, especially within non-business studies, page; [http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/education-training-entrepreneurship/higher-education/index\\_en.htm](http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/education-training-entrepreneurship/higher-education/index_en.htm); 10.09.2011.

7 Entrepreneurship in higher education, especially within non-business studies, page; [http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/education-training-entrepreneurship/higher-education/index\\_en.htm](http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/education-training-entrepreneurship/higher-education/index_en.htm); 10.09.2011, page 11.

the majority of entrepreneurship courses are offered in business and economic studies (for instance in Spain and in the UK). In the Western Balkans, there are some pilot projects for development of entrepreneurship in universities but this is still in the beginner stage. If we analyze the general situation regarding the study of entrepreneurship at universities in Montenegro, we can say that the module is taught only in the economic and business oriented studies. A strategic document<sup>8</sup> that provides guidance for entrepreneurial learning provides that universities have a major role in the development of entrepreneurship. Document refers that most students of the Faculty should have the opportunity to learn more about their operations relevant to their area of study. It should explore the possibilities for self-employment, as well as details related to the establishment of small businesses. Students should be able to learn how to create a business plan and to explore the basic principles of marketing, finance companies, company ethics and customer relations. Faculties should maintain a close relationship with local businesses and employers' associations. Experienced managers of companies should be invited to visit universities to discuss their work with students, and with them should be invited and those who recently founded his own company. It is relevant to mention the initiative of the South East European Centre for Entrepreneurial Learning (SEECCEL) which aims at developing the curriculum for entrepreneurial university in the region. It turned out that the main problem (both in the European Union and South East Europe countries) is the lack of personal commitment, interest and the lack of support of decision makers in these institutions.

University of Donja Gorica is a good example of entrepreneurship study in the business and non business studies. UDG is a new private university in Montenegro, with first faculties established in 2007. UDG was founded in 2007 as the result of entrepreneurial idea which was developed over the years by two distinguished university professors. UDG currently offers undergraduate studies at six faculties: the Faculty of International Economics, Finance and Business; the Faculty of Law; the Faculty of Information Systems and Technologies, the Faculty of Arts, the Humanities and Polytechnic. Besides these undergraduate programs, UDG also offers different Specialist and Master programs.

At the University of Donja Gorica entrepreneurship development through the required examination "Entrepreneurship" within the Faculty of International Economics, Finance and Business, Faculty of Information Systems and Technology and Polytechnics and the elective course "Entrepreneurship" in the Humanistic studies. The exam organized through three generations and organization of examination covered follow segments:

- Theoretical lessons;
- Preparation of business plan;
- Team work on project;
- Drafting the essay;
- Organization tribune and lecture with known entrepreneurs (local and international level)

How do students react to these segments of the exam, and that woke up the largest segment of the entrepreneurial orientation, which elements of economic and social life are recognized as motivating, research conducted among 35 students has shown us. Students were asking on the questions; whether the entrepreneurial way of thinking relevant to your professional development, whether social and economic environment stimulating enough to entrepreneurial behavior, have you gained during the teaching certain skills, as well as the element in the case believe the most successful<sup>9</sup> and others.

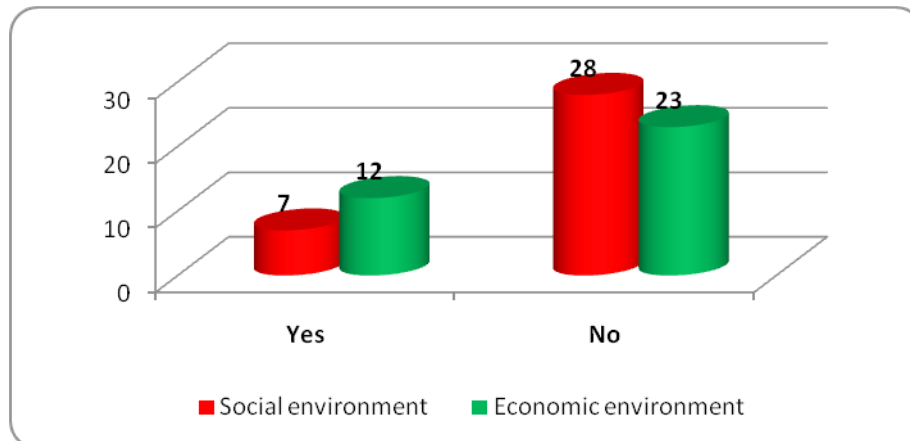
The general conclusion of result of questionnaire is that the organization of exam "Entrepreneurship" on the UDG has positive implications for entrepreneurial behavior and thinking among students. Students have a positive attitude when it comes to entrepreneurship. Specifically, all students believe that the entrepreneurial way of thinking and acting can improve their future professional and personal development. However, most students (28 of 35) states that social environment is not stimulating enough for entrepreneurship development. On the other hand, seven students said that encouraging entrepreneurship identified: all around me, especially through a number of different events (they mentioned most of the events on University), in business meetings and interviews with successful entrepreneurs, as well as the teaching of the UDG. Also, most students (23) think that the economic environment is not enough supportive for the development of entrepreneurship among young people. However, 12 students said that there is such kind of incentives, and given as an example: incentives in

<sup>8</sup> Strategy for lifelong entrepreneurial learning 2008-2013. page 7.

<sup>9</sup> Students were explained by the most successful element, one that has awakened in them the highest degree of interest in entrepreneurship.

information technology and tourism, Entrepreneurship forums and exchange of entrepreneurial ideas to the UDG-in, Business Incubators in Bar and Podgorica, “School of Entrepreneurship for Youth” to the UDG, a company that invest in business ideas of students, the European forums.

Graph 1. Encouragement of social and economic environment (absolute values)



Based on the graphic, we see what we have previously stated and that is that students feel that the economic and societal environment is not supportive enough for the development of entrepreneurship among young people.

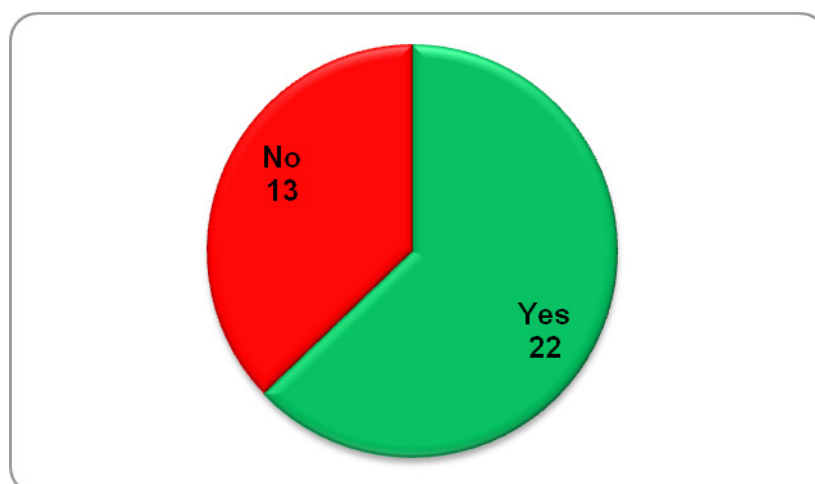
## 6. SITUATIONAL FACTORS AND THEIR IMPACT ON ENTREPRENEURIAL BEHAVIOUR

The subject of research among students UDG was, what are the perceived situational factors, perceived by students as important for their entrepreneurial behavior. Our aim was to check how these elements of the educational process, as well as other characteristics of the university environment, family environment, and their perception of economic and social environment, influence the direction towards entrepreneurship. In the final analysis, we wanted to collect data relevant to answer the question whether the field of entrepreneurship continues to be the same students' pursuit of entrepreneurial behavior and what are the elements that are viewed as the most successful that is covered with the lecture. Most successful element is one that has awakened in them the highest degree of interest in entrepreneurship.

The family is recognized as a motivator and an important element in the development of entrepreneurship among young people.

From 26 to 35 students in their families has someone who is recognized as entrepreneurs and 22 of them considered that the family had an impact on their entrepreneurial mindset. These impact on the thinking of students is reflected in the desire to after college start their own business or continue an existing, learning about how business and lifestyle, encouraging autonomy, accountability and risk, grit and determination, transfer of experience and their motto “If you do not try you never know whether you will succeed.

Graph 2. Do you think that your family influenced the entrepreneurial way of thinking?





When it comes to attendance Entrepreneurship lecture, 35 students found that this case was a positive influence on the development of their entrepreneurial way of thinking. In addition, all students stated that during the teaching of entrepreneurship have gained some entrepreneurial skills. The most successful element of the issue in entrepreneurship among students who woke up the highest level of interest in entrepreneurship, and they desire to have entrepreneurial skills, to gain knowledge and future-oriented entrepreneurship is: visits of successful entrepreneurs (first ranked response) and business plan (second-ranked response). The smallest impact was making paper. It is interesting that all the students agreed that the promotion of good entrepreneurial practices, the right way to motivate student to this way of thinking and acting.

Promoting positive practices in teaching are considered a good way to motivate the entrepreneurial way of thinking. In order to improve the existing education students in the Entrepreneurship highlighted several practical tasks, more frequent visits and visits of successful companies, while five students said that nothing would lever in the previous mode of delivery. Table 2. showing all the answers of students and evaluation of the same.

Table 2 Promoting Entrepreneurship

More practical tasks so that students find a practical solution to the problem and to become familiar with the procedures of business registration	7
More companies visits	6
It would not change anything, everything is great	5
More visits and lectures of successful entrepreneurial	4
By creating a business plan	2
Literature	2
Theoretical lectures	2
Students do not understand the subject too seriously	2
Making the essay did not have a large effect, it needs more attention and time to devote to the business plan and starting a business	2
It is necessary to ask specific questions that are based on literature and work in class	1
Way of lectures, less slides more or less a communication	1
Make clear that this is a very important subject for their further study as a way of thinking	1
Total	35

Students recognized the main barriers to the development of entrepreneurial culture among young people in the current social environment. Describe its impact “in the media more to promote policies, rather than entrepreneurship, which negatively affects the whole society, especially the youth.” They said that people, generally do not recognize importance of entrepreneurial behavior, do not children brought up in this spirit.

## 7. CONCLUSION

University has an important role in the development of entrepreneurship among students. The atmosphere in the university environment can be very stimulating for the establishment and expansion of entrepreneurial ideas. All the surveyed students recognize the importance of entrepreneurship, students are aware of the importance of having entrepreneurial skills. In addition, a very important element of entrepreneurial behavior is the family. The family may affect the independence, initiative, enterprise behavior of children. In addition to this economic and social environment as well as the perception of entrepreneurs and appropriate promotion, can enhance students' entrepreneurial behavior. Students find that UDG is a positive atmosphere regarding entrepreneurship, recognizing the importance of the many events that aims to awaken in them the entrepreneurial way of behavior, while the economic and social environment was recognized as not supportive.

Given the specificity of the concept of teaching entrepreneurship at the University of Donja Gorica, through this research, we get the relevant answers and explanations regarding the connection between entrepreneurial orientation of students and development of entrepreneurial culture among the population, with a general stimulating atmosphere during the study, the social environment, curriculum and ways of working and learning with them. Students in most cases prefer learning about

entrepreneurship through affirmative case studies and practical training.

As part of this study was done reviewing the current scope and content of entrepreneurship education and entrepreneurial atmosphere at the University of Donja Gorica with a view to their expansion and intensification. It is useful to consider how students evaluate the organization of exam "Entrepreneurship", where they see the essential elements for the further development of entrepreneurship among young people and where the barriers. Education in entrepreneurship at universities empowers young people to think this way and should be further nurtured. University of Donja Gorica will continue to work, is finding opportunities to increase the volume and quality of learning activities in which students were the subjects of the educational process, including creating conditions for the participation of a number of students in the entrepreneurial-business project, to create an entrepreneurial and business projects and their implementation as well as improvement of practical training related to entrepreneurship, which is recognized as essential.

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## WOMEN ENTREPRENEURSHIP IN A FASHION INDUSTRY

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### Abstract

#### INTRODUCTION

The importance of entrepreneurship has been widely recognized as an impulse to economic growth and their essential contribution to the economy. Today, the business environment is changing more rapidly. Competition in almost every industry has become more intensive. Considering the above, companies are becoming aware of the importance of adjusting their businesses to the target market in the best possible way in order to stay competitive.

Entrepreneurship in the field of fashion is a topic that, unfortunately, has not been targeted by a substantial number of authors. Entrepreneurship in the fashion industry represents a great challenge since the fashion business environment consists of many actors who are competing for the same market share. It is dominated by big players of the industries who put upon trends, and drive consumer preferences and the fashion core on a global scale. However, there is a great variety of small actors who compete in the fashion industry and contribute original concepts and ideas into the industry and they are the subject of this research.

Many fashion design entrepreneurs, who want to compete by running their own brands, are faced with many challenges including personal challenges and a variety of external obstacles. Running a stable venture within the fashion industry may be very complex and demanding, especially in a first few years of a new entrepreneurial venture. Very often additional barriers occur when it comes to women entrepreneurs. In many countries women decide to enter the business because of necessity, for example, when they stay out of job, instead of recognized market opportunities. However, there are many examples of successful women entrepreneurs, especially in demanding fashion industry who continuously succeed to run successful ventures.

#### RESEARCH METHOD

This article seeks to analyze the factors of significant influence on the entrepreneurship in a fashion industry, with special emphasis on the characteristics of women's entrepreneurship and the challenges that women face when starting ventures in the fashion industry. The authors will use the case study method to present the examples of successful women entrepreneurs who continuously succeed to cope with the challenges of the fashion industry. Selected case studies will show successful business strategies for managing small business ventures in the selected industry.

#### RESULTS

The results of this study will be used in two ways. Firstly, the results will give clear guidelines to all business women, as well as those wishing to engage in entrepreneurship, what are the most common difficulties that they face in running their business as well as clear guidance on how to deal with them. Furthermore, this work will greatly contribute to the students of vocational studies in connecting and applying the knowledge they gained at the entrepreneurship course on the real life economy and even maybe encourage them to start their own businesses.

**Keywords:** Women entrepreneurship, fashion industry, business strategies

## 1. INTRODUCTION

### *Aims and Objectives*

This article seeks to analyze the factors of significant influence on the entrepreneurship in a fashion industry, with special emphasis on the characteristics of women's entrepreneurship and the challenges that women face when starting ventures in the fashion industry. Also, through the example of a successful women entrepreneur, Neda Makjanić Kunić, who established and lead a fashion company "MAK", will try to present all the prerequisites that need to be fulfilled in order to achieve a successful fashion business, looking at the characteristics of the entrepreneur, characteristics of the people who work there, and external factors that have a significant impact on company.

### *Methodology*

Empirical information in this work was collected through a qualitative approach in order to gain a deeper understanding of the topic. Various conversations were performed in person with fashion designers, consultants and institutions. The selection of people was done in respect of the different backgrounds and experiences in the field of fashion and creative industry and the field of entrepreneurship with an emphasis on women entrepreneurship. For the purpose of writing this paper, the authors used the method of cases. Case study research excels at bringing us to an understanding of a complex issue or object which can extend experience or add strength to what is already known through previous research. Through this case study the authors tried to emphasize detailed contextual analysis of a Croatian fashion company and the experiences of its owner, successful women entrepreneur in the field of fashion industry.

### *Findings*

There is a need for stronger women networking, sharing information and knowledge in the world of global competition which is particularly present in fashion industry. Competitiveness in the fashion industry can only be achieved by continuous investment in technology that will deliver greater productivity and result in higher quality products. Innovation, creativity and product design are becoming the key prerequisite for success. None of this would result in success without proper market segmentation and orientation on profitable market niches.

## 2. ENTREPRENEUR AND ENTREPRENEURSHIP

The importance of entrepreneurship has been widely recognized as an impulse to economic growth and their essential contribution to the economy. An Entrepreneur can be defined as a person who identifies an opportunity or new idea and develops it into a new venture or project (Davidsson, 2006.). Being an entrepreneur is a very challenging job and requires knowledge, intuition and skill. The entrepreneur sets up a business to generate value, whether value can mean a financial, social or emotional outcome.

Entrepreneurs are acknowledged as being the driving force behind innovative change in our society and the fashion industry is no exception. According to definition above, it can be concluded that fashion entrepreneur can be defined as someone who sets up a new fashion venture, or starts a new fashion label. To achieve this, the fashion entrepreneur needs to be able to notice business opportunities and determine customer needs by coordinating resources to design, manufacture and supply fashion products or provide a service (Burke, 2008).

The fashion entrepreneur is the key, innovative person managing the entrepreneurial process. This usually involves planning, organizing, directing and controlling the input of suppliers, contractors and the design team members, together with accepting the associated business risks. The key words from these explanations are; innovation, opportunity, new venture, enterprise, management and risk taking (Burke, 2008).

According to OECD-Eurostat, Entrepreneurship is even higher on the policy agenda today than in the past, as governments look for remedies and ways out of the economic crisis (<http://www.oecd.org>). Entrepreneurs contribute to society in different ways for instance as creators of jobs and as a stimulator of economic growth (Davidsson P., 2006). Despite the rapid growth of women in professional and managerial jobs, the gender gap in entrepreneurship remains significant. On average, men are 50 percent more likely than women to become entrepreneurs. Compared to men, women entrepreneurs use smaller amounts of start-up capital, smaller proportion of equities, and more bank loans. Also, women-owned businesses tend to be smaller and to grow more slowly than those owned by men, suggesting gender-based differences in the value attached to business expansion (Minniti & Arenius,

April 29, 2003).

There are more women than men in the world, but in the economy, according to official sources of information and indicators, represents minority everywhere in the world. Minority status of women in the economy is different, depending on the work that women perform. Fewer women run business ventures, especially those technological intensive. Women are even better than men in the perception of entrepreneurial environment and spotting a business opportunity, but the possibility of realizing their entrepreneurial opportunities are significantly reduced due to a limited access to financial resources and insufficient support in the organization of family life (MINGORP, 2010.).

In Croatia, women are unfortunately entering the business, still in most cases out of necessity, for example, when they stay out of work, not from the identified market opportunities. After all data on this are clear, on an entrepreneurial venture of women coming ventures 2.5 men (www.glas-slavonije.hr, 2011).

Table 1. Structure of number of employees, total revenue and profit of companies (women entrepreneurship and other companies)

	Companies	2002.	2006.	2007.	2008.
	Women entrepreneurship	7,0%	10,9%	13,0%	13,0%
	Other businesses	93,0%	89,1%	87,0%	87%
Total revenue	Women entrepreneurship	6,5%	6,4%	10,5%	11,1%
	Other businesses	93,5%	93,6%	89,5%	88,9%
Profit	Women entrepreneurship	4,0%	7,9%	9,3%	9,3%
	Other businesses	96,0%	92,1%	90,7%	90,7%

Source: Research of a Croatian association of business woman KRUG, 2009.

In the table attached below, it can be noticed that the business managed by women are prospering slightly, but still presents a considerable minority according to other businesses.

### 3. ENTREPRENEURSHIP IN THE FASHION INDUSTRY

Entrepreneurship in the field of fashion is a topic that has unfortunately not been targeted by a substantial number of authors. However, economists have given it very little attention, tending to view it as, at most, a curious aspect of demand theory rather than as an important and interesting phenomenon in its own right. However, the argument for a positive valuation of fashion derives not from comparison of economies with and without fashion, but from reconsidering the value of these destabilizing dynamics and their value in a world of plenty and uncertainty.

As Renzo Rosso, creator of Diesel, stated: "Fashion is inspiration, creativity and intuition. But it is also organization, strategy and management. These two apparently contrasting sets of elements have to come together to ensure the success of a business idea." The challenges of a fashion entrepreneur can be differentiated between specific industry challenges and personal challenges. The fashion design entrepreneur as the heart of the company has to balance creativity and a hard fact managerial approach, as well as to consider industry related aspects. Fashion is ephemeral, dangerous, exciting and unfair. The fashion industry is an unpredictable and hypercompetitive market with short product life cycles (Saviolo & Testa, 2002).

There are many reasons why people follow fashion. First, they do so for attention, as a form of social communication through commodity signaling and demand for novelty. Second, following fashion is a cognitive efficiency, a way to economize on choices that are difficult or expensive to reverse. Third, it is fun, since being fashionable has its rewards when you get it right. Yet following fashion can still be messy and expensive, as fashion cycles cause the consumption abandonment of clothes, music, furnishings, appliances, cars, and so forth, long before those goods are physically worn out



or fully depreciated. Each fashion cycle begins with the origination of a novel, attention-arresting idea adopted by a network of individuals, which induces each to reorganize their own consumption systems. In modern economics, the standard view is that fashion is irrational and inefficient. From a Schumpeterian or a Hayekian perspective, however, it seems to play a more positive role in stirring consumers to action that results in the growth of experience and knowledge. Fashion is consumer entrepreneurship, and has the same class of dynamic externalities as business entrepreneurship. Just as an increase in the strength of competition may prompt decision-makers to explore new ways of increasing productivity, so may a change in the relative competitive strength between status-conscious consumers force them to rethink their consumption choice. Ongoing economic growth requires not just entrepreneurship and risk-taking from producers, but also from consumers, who must find the will to buy, learn, and take risk (Potts, 2007.).

It is a subjective market with the need to be cutting-edge and relevant in terms of the creativeness (as Jones 2008 cites Crewe and Beaverbrook 1998). Subjective in the sense that fashion is based to a great extent on individual preferences and the taste of people. Fashion is a part of people's social life and as an object of cultural value accounts for the well-being of people. Fashion is embedded in people's minds in their leisure and working time as a way to express identity.

The fashion companies have to focus on the unique selling proposition of the products and on the differentiation from competitors. A fashion company needs an innovative business idea and a unique design language to capture the attention of customers that have an infinite choice of different products from upcoming fashion companies. As Bruce et al (2002) expressed: "Design matters. In a world where customers have increasing choice about what they buy and from whom, what makes them choose one product or service over another? In a word it is design (Bruce & Bessant, 2002).

One of the most powerful elements in fashion is time. Apparel is developed for different seasons, special events and for different times of the day (Jones, 2005). High fashion designers are working according to the traditionally fashion industry calendar, which is divided into two major seasons – spring/summer and autumn/winter (Jones, 2005). The whole fashion industry has arranged its business around this standard, it is visible for instance in the timing of fashion shows, which take place two times a year.

Every company has naturally its own fashion cycle, whereby fashion design entrepreneurs mostly follow the international rhythm presenting two major collections a year to be part of the fashion business on a professional base. Managing the cash flow is especially a challenge in the fashion industry with its seasonal schedule. Due to the seasonality, the forecasting of the order volume is another challenging aspect. If a designer is new on the market, it is difficult to indicate how many clothing pieces will be sold. Establishing a sustainable company is hard since developing and producing a collection has to be pre-financed. A fashion designer gets the revenues back when selling the clothes but the next collection has to be started already in the meanwhile. Designers have to pay for the production costs of the clothes upfront. In the fashion design industry it is relatively easy to start up in contrast to other industries. The barriers to entry depend on the dimension of the venture, but for a small label it is possible to start basically with a sewing machine, compared to the clothing business where expensive machines are required (Burke, 2008).

New ventures need an adequate amount of capital to survive. A large number of businesses fail due to lack of enough finance backing the venture. There are further difficulties for small fashion businesses. Due to the small quantities of clothing pieces they are at the back of the queue when it comes to manufacturing. Fashion entrepreneurs usually have difficulties in accessing financial support because the business ideas are often considered to be high-risk investments and the margins are low. Additionally the value of a creative product is difficult to measure; the success of a collection mainly depends on the valuation and personal taste of the customers. Hence it is difficult to indicate the profit of a fashion business. It is hard for a fashion entrepreneur to predict the return on investment, which makes it less attractive to banks and investors. Investors or even business angel investors invest only if they see a large growth potential. Banks refrain from financing fashion entrepreneurs when they determine that the business and entrepreneurial skills of a designer are insufficient (<http://www.entrepreneur.com>).

### **3.1. Fashion Entrepreneurs' Portfolio of Skills**

The tasks of a fashion designer vary from company to company but as an entrepreneur, a fashion designer needs a large set of skills. It is a leave-taking from the traditional designer role into the balancing act of two elements - creativity with business skills and art with commerce. While they are often very confident about their creative work, they lack confidence entering the world of business.

Management, marketing, accounting and financing have to be considered as weak points of fashion entrepreneurs. Several factors can influence and challenge the foundation and growth of a fashion design company: individual network, personality, education, personal background, attitude, role and behavior of a fashion design entrepreneur (Burke, 2008).

Like in any other industry, entrepreneurship in the fashion industry combines the creation and management of a venture with the specific aspects of the industry, in this case fashion. As Dickerson stated to the point: “The constant in fashion is change” (Dickerson, 2003). Also, Drucker pointed out that there is the need for continuous innovation, which is very typical for fashion industry (Drucker, 1985).

Firstly, the design part consists of the aesthetic and technical product development process and the business part includes the business strategy and management of the label. Fashion entrepreneurs must be continuously innovative in their sphere of activity; fashion can be copied but not innovation. A fashion design entrepreneur is the key person that manages the entrepreneurial process and sets up a business to integrate their design ideas into the marketplace (Burke, 2008).

There is an increasing recognition by the fashion industry that entrepreneurial and small business management skills are an essential component of the fashion entrepreneurs’ portfolio of management skills, together with leadership, team building, communication and networking.

To become a successful fashion entrepreneur you need innovation to be able to identify opportunities in a climate of ambiguity and chaos, together with passion and enthusiasm for your products to encourage you to constantly improve your products’ features. You also need determination and persistence to drive your ideas through the many obstacles and challenges you come up against. In a competitive market, it is not sufficient only to be creative, it is also important to be entrepreneurial with small business and project management skills and to be able to build a network of useful contacts. The technical skills refer to the technical knowledge you need to design and make your products. Every profession has its unique range of technical and trade skills and, as a fashion apprentice, it will be necessary to learn trade to be able to produce professional products so that the venture and products are commercially viable.

Fashion design entrepreneurs have to be aware and in charge of all the different fields of the business:

- Research (market research, trend research, consumer behavior)
- Product development (aesthetically, qualitatively and technically)
- Sourcing
- Production
- Marketing
- Distribution
- Sales
- General management (business strategy, direction of the brand, positioning, pricing, corporate identity) (Burke, 2008).

Table 2: Fashion Entrepreneurs’ Portfolio of Skills – shows a structured subdivision of the key fashion entrepreneurship topics subdivided into their component parts.

Fashion Entrepreneur			
Fashion Industry	Entrepreneur Traits	Starting Your Own Business	Small Business Management
Technical Skills	Creativity, Innovation Etc	Business Plans	Source Of Finance
Opportunities	Spot Opportunities	Registration	Accounts
Design And Manufacturing	Networking Skills	Market Research, Trend Research	Small Business Management Skills
Retail And Distribution	Risk Management	Marketing And Branding	Project Management
Supply Chain Management		Sales And Negotiation	Leadership And Teamwork

Source: Burke, S. (2008) Fashion Entrepreneur, Starting your own fashion business, Burke Publishing, UK

It seems to be one of the most challenging tasks to be capable to balance and manage the two different elements. Jones (2008) cites in her article Yohji Yamamoto: “Fashion consists of both commerce and creation. You need to find the right balance, if not you cannot continue (Jones, 2005). Fashion entrepreneurship has been

the driving force in developing the fashion industry but, as a profession and an academic syllabus, it is still relatively new and has yet to formally establish a defining Portfolio of Skills.

Founding an own label is often considered as the highest creative goal a fashion designer can achieve. In day-to-day work as an entrepreneur, design is only a fraction of the whole. Much more time consuming are all the other aspects that have to be managed, which requires a large commitment of time and energy. A great stamina and openness is needed to accept this fact and to get along with it. If a company consists only of one person or a small team, lack of time is an eminent challenge. Designer Paul Smith stated: "The biggest mistake of beginners leaving the school is to believe that they are able to establish a label right away, with all the different fields which are connected to it. The creation of an interesting collection is only one aspect among several others, which are necessary to build a successful brand. (Jaeger, 2009).

## 4. CASE STUDY OF SUCCESSFUL WOMAN ENTREPRENEUR IN A FASHION INDUSTRY

### 4.1. Introduction to a company MAK

Neda Makjanić-Kunić (1959, Split) by profession professor of Special Education and Rehabilitation, but by life obsession a fashion designer. So however, she chose designer profession and founded MAK in 1986 as a small tailor's trade and stepped through the small door of the "men's" business world, applying the "learning-by-doing system". Despite having not completed the faculty of design, she has constantly been professionally developing, reading and following the fashion world, as well as the latest improvements in design and materials. Successfully balancing between the roles of a mother and a businesswoman, she succeeded to establish the fashion house MAK with her own ideas and forces. MAK employs about 60 employees. Design studio and production facilities are located in the most modern technology and modernly equipped textile workshop in the area of Dalmatia, and presents one of the most popular Split and the Croatian company with a tendency of further business expansion.

She entered in this business for the love of the profession who has followed her since childhood. Key features that make the successful entrepreneur should have firstly covering order, work and discipline, which should actually be a life philosophy. In addition, very important are persistence and knowledge of their work and above all, love the job you are doing and being a good team player. Women entrepreneurs should also continue to be confident and sure in herself and her plan. It is also extremely important to ongoing education and awareness about the important events related to the job.

Apart from the qualities and vision of entrepreneurs, very appreciable are the people who make the company. Good team and the respect of the employees are another important factor for success. There should be widened a positive energy, and a great respect and tolerance. In the company few employees work there for almost 18 years. Very often in these companies, is not exclusively dealing only with fashion and designing. Unlike the world's great drives with full teams of employees, in small firms a person must have knowledge of different jobs, such as creator, designer and tailor, as it is otherwise significantly difficult to survive, because for all whom work for the company must have some kind of control. In the fashion business like this, it is very important to have a professional and dedicated team that work together to achieve good results, so that the brand was distinctive and that the company would go ahead. There are lot professions that need to be obtained like technologists, engineers, managers, designers...

It is important to constantly improve, educate yourself and constantly strive to be among the best and be informed about important events, as well as institutional support that are available. Also, great attention should be paid to technology that is continuously progressing. To have a perfect production, each year there is a need to invest in facilities and renewal of existing machines, and the drive to modernize the procurement of new machinery which is very important for the design.

Great importance is attached to the product quality. They are very important materials, which must be especially good and precise stitching and such that the jacket, skirt or pants "speak the language". Semi-finished product is absolutely not acceptable. Today, if the product is not superior, you cannot compete with anyone given the large number of world famous brands. The market may also find a lot of "no-name" products, but competitive price, which also represents another form of significant competition.

#### 4.2. TARGET MARKET

In the fashion business is very important to carefully select and understand target market and appropriately adjust to it. Company MAK has found a chance to meet a segment of businesswomen. There was a lack of supply in the market, even in international brands offer, especially for women who wear a larger size, in which in some way can be seen as discrimination and humiliation of women. The company recognized that as their target group and addressed them with their collections. These are the business women who were difficult to find appropriate clothing in this region, including making the creation of larger sizes. These women have recognized and selected MAK as their brand.

MAK is a company that is recognized on the market for the variety of available and excellent design jackets, raincoats, coats, trousers and skirts. In particular, a great attention is dedicated to the quality of materials and quality of products performance in order to keep customers satisfied. Fashion house MAK puts a woman at the center of attention, and seeks to adapt to her needs in the best possible way. Profile of represented company clients are mostly business women from age 20 onwards.

MAK produces several renowned fashion lines:

- fashion line for businesswomen
- line of cocktail dresses
- casual sports line
- atelier line that occurs in association with many celebrities in pop music and media scene in Croatia

The company attaches great importance to every customer. Division of MAK fashion lines according to the profile of women who wear them can be classified as a business line that includes two collections - Basic (size 36 up to .44) and Lady (size.46 up to.52 and more). With a business line, MAK has Arty Chic line of 'cocktail' of models and dresses, atelier and the line that occurs in association with many celebrities in the media scene in Croatia. Also, the company offers certain types of personalized products in the form of business uniforms and offer conceptual design and implementation of agreed projects for hotels, restaurants, banks, business houses and travel agencies. Specificity in the development of business uniforms and suits is that there is no prototype, but is only done according to the client's wishes.

#### 4.3. MARKETING MIX

Major role for the successful business has carefully created a marketing mix. As noted above, a great attention is given to the product, its quality and adaptability to the customer. The product has to be extremely good, and if necessary, be further adjusted to the customer in the form of small fixes to better fit the customer. Most products are distributed through the company's own sales fashion salon network in the center of major cities, and part through a partners network whose bid is in line with the company's image, such as Concept stores in Zagreb, Karlovac and Zadar. Special attention is invested in quality service and personalized approach to each client, and the most important is that every woman feels special and gets the product that best suits her. For this reason, it is also a lot invested in quality personnel.

When it comes to promotions, the Company mostly relies on fashion shows and related media events, investing in the catalog, the classic forms of advertising in the media that the target group follows, and if necessary, in the forms of sales promotion like coupons, discounts and so on. In recent times, it is also investing in newer forms of advertising, such as various forms of Internet marketing. Here above all, we can sort out a comprehensive website that is a very good source of information for all interested in a company. Also more attention is given to creating a profile on the famous forms of social media in order to achieve an interactive contact with clients, thus opening up many new possibilities in communication with the target market and assist in achieving a personalized relationship of clients with the company and brand.



#### 4.4. ENTREPRENEURSHIP INFRASTRUCTURE

Furthermore, considerable attention is needed to add to the importance of supporting institutions that can provide assistance and incentive companies in their business. The owner of MAK is a long-time president of the Association Section of Textile Craftsmen Split-Solin and president of the Textile Guild of the Chamber of Crafts of Split-Dalmatia County. It is also a member of the Section of textiles, leather and fur at the CCTC and a member of association of Croatian business women "KRUG", where advocates for women's entrepreneurship in particular and women's equality in employment. These supporting institutions are the source of information and knowledge that can help improve the business, and a mutual place for exchange of experiences that contributes to an even greater positive synergy effects.

Special attention has lately given to encouraging women's entrepreneurship. Ministry of Economy, Labour and Entrepreneurship, the Croatian Bank for Reconstruction and Development and the Croatian Agency for Small Business (CASB) closed the circle, whose interest is to encourage women to more easily move into their own business. Reasons for lower participation of women in entrepreneurship lie, among others, the traditional views about the role of women in society as well as difficulties in accessing financial resources and insufficient contacts. Women often feel a lack of understanding of the social environment and lack confidence when it comes to engaging in entrepreneurial ventures and the risk of opening their own businesses. Many projects were introduced, such as "EntrepreneurSHEp Croatia" which aims to jointly contribute to promoting the development of women entrepreneurship in Croatia which is still underutilized. The Network of women's entrepreneurship ambassadors will help in increasing women's capacity to create vision, strengthening confidence in setting up and creating a successful business. Support to women entrepreneurs are provided in the form of payment of certain amounts of money, providing guarantees for loans to entrepreneurs, access to affordable loans, subsidies to the cost of kindergarten, etc.

#### 5. CONCLUSION

Fashion facilitates an economic growth, but it can also be concluded that the fashion industry is very challenging and demanding, and it takes a lot of knowledge and organization in order to achieve a successful business. Fashion cycles work to periodically loosen accumulated constraints on the demand side, facilitating economic growth and personal development. Fashion is part of how economies evolve, not of how they decay. This is particularly challenging for small businesses, and even more so for those who are led by women. Entrepreneurs in this regard particularly highlight the need for stronger networking of women at all levels and exchange of information and knowledge. They stress that women's entrepreneurial initiatives deserve support national, regional and local authorities, international organizations and projects, and need to be extracted, and to help measure their effects. On the one side it is necessary to build a quality team and relationships within the company, and on the other, company relationship with its customers, constantly listening them and adapting to new demands and trends. Competitiveness in the fashion industry can be held only by insisting on investments in technology that enables higher levels of productivity and product quality with key innovation, creativity and design. It is very important properly segmenting the market; successfully identify profitable market niches and the orientation of the expanding base of satisfied and loyal customers with products adapted to the requirements thereof.



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# Part Four:

## Strategies and business development

## THE TESTING OF STRATEGIC MODEL OF POSITIONING OF A NEW PRODUCT OF A SMALL ENTERPRISE OF A COUNTRY IN TRANSITION ON THE GLOBAL MARKET

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### Abstract

Globalization and contemporary communication standards on the global market present a particular challenge for a small enterprise of a country in transition. The possibility of continuity of growth in sale of original and competitive products account for the efforts exerted in making a strategic model of a new product positioning in the aimed niche on the global market. What are the key variables to which a small enterprise needs to pay attention in order to position itself in an acceptable niche of the global market?

The problem in the practice of commercialization is also national administrative barriers. Even these barriers are indirectly imposed by international corporations by conditions that economic integrations stimulate to future members. The aim of these regulations is to weaken the potential new competition on the global market. Small enterprises are also faced with offensive aggressive strategies of prolongation of life expectancy of more inferior products of similar purpose ruled by multinational corporations through the economy of volume. Even in a situation where big corporations are not present on the national market, they effectuate their operation by political lobbying or through the chosen national firms. The development of new products for the sake of commercialization on profit-limited, national markets of the countries in transition is rarely economically justified.

The development and commercialization of new products on the global scale are necessity, because of the narrowing of potential for sales on the national market, the alternative in recession is the decrease in employment and production. The authors have predicted the testing of suggested strategic model of positioning of a particular new product (home-made lasting cake- souvenir) of a small enterprise from the Republic of Croatia on the global market. It is a high quality product which has a limited number of competitors in the price class on the global market. Several market tests have been carried out with rigorous criteria which it has been concluded that the relation between the price and the quality of the product is especially competitive, while there is the demand.

Branding system for creating a recognizable, in this case, exclusive brand, presupposes the continuity of activities and investing in the brand in order to develop it to the appropriate level when the sale of the product from the phase of introduction to the market passes to the phase of growth.

The expected scientific contribution of the works consists in accepting or rejecting the basic hypothesis: Strategically model of exclusive sub segmentation of the new product of a small enterprise of a country in transition on the global market is effectively realizable on the tactical platform: logistics for providing materials, E-marketing- E-commerce – Branding- Elimination of organization incongruity.

**Keywords:** logistics, E-marketing, E-commerce, Branding, Elimination of organization incongruity

## 1. INTRODUCTORY REMARKS

Globalization and modern communication standards represent a constraint, but also the possibility for survival and growth of small business enterprises in transition countries. The potential continuity of sale growth of the original, national, competitive and globally recognized products will justify all marketing efforts and funds invested. Partial experience represents a research challenge, aimed to design widely applicable strategic model of new product positioning in the targeted niche in the global market. In such a scientific approach it is possible to identify and evaluate key variables on which a small company from a country in transition needs to pay special attention to be positioned in the targeted niche on the global market. Croatia is an example of a country in transition which has valuable indigenous agricultural products utilizable for the production of original, specific, food products for the global market. Taking into account the trends of those products in the context of the prices they achieve, this resource should be given more attention. As at the institutional level as on the local, especially considering the untapped potential and complexity of economic problems conditioned by recession in the recent years. The purpose of this paper is to point out this possibility for many small enterprises in the transition countries.

The Republic of Croatia is a way behind in implementing the protection of indigenous species of agricultural varieties of olives, grapes, carob, ect. These, and other, indigenous species have potential for the design of new food products of recognizable national brands. The core of this problem is the lack of partial protection of indigenous crops. This is a potential platform of organic production development, which would have all the necessary prerequisites for the creation of new food products of globally recognized brand. Setting up the production of such products under national surveillance would allow, at the final, realization of the complex market prices due to high standards of product quality. This would encourage the growth of production of indigenous crops, and additional investments in agriculture. Considering that in the Republic of Croatia still does not happen, the idea of implementation branding of indigenous agricultural products through the national image of Croatia is yet absent. Only at the fall of 2010 at the initiative of the *Community of olive oil mills and olive planters of Republic Croatia* brand of *Zlatna Oblica* is protected, brand that cover 90% of the total olive growing in the Croatian coastal region. Olive oil produced from those olive varieties in the chemical composition is superior to other olive oils due to specific microclimate conditions of climate, limestone formations and the evaporation of sea water into the atmosphere. Just that olive oil, produced from the *Zlatna Oblica*, is the foundation of authentic and original product, homemade cakes *Diocletian's Wreath* whose market potential was the subject of research in this paper. Product *Diocletian's Wreath* is an example of creative marketing story about use of indigenous agricultural products in the creation of long-lasting cookies that meets the criteria of national souvenirs. That story is a marketing and branding platform for high-quality range of ecological agriculture. Finally, in this *case study*, through research is recognized the potential of creating an improved model of the strategic positioning of new products of small enterprises in the country in transition to the demanding global market.

## 2. EXPLICATION OF THE RESEARCH PROBLEM

Preliminary research conducted in-depth interviews with company representatives of indigenous domestic cakes *Diocletian's Wreath* pointed to inconsistencies in organizational marketing and managerial terms. Possible justification for these omissions is the fact that their *core business* is processing olive oil, and the idea of creating this new product was created by accident. Commercialization of this product was not preceded by any market analysis and during the product development of *Diocletian's Wreath*, many important stages of that process were ignored. The consequence is the inability to meet the expressed demand for new product on global market. Moreover, carrying out a pre-test, for the purposes of this study, showed that customers rated the product very attractive considering the originality and the relationship between price and quality (retail price per kilogram of cake *Diocletian's Wreath* is about \$ 200). Competitive benchmarking cannot be executed, given that at the global level there can't be found indigenous products of similar price and quality (they are much more expensive.), and the proposed innovated strategic model is based partly on a generic benchmarking. Complexity of the business case and market and marketing potential is further indicated by the fact realized during the in-depth interviews with representatives of manufactures. All potential B2B customers in foreign markets that are contacted in various ways by the manufacturer, or otherwise obtain information about product, were buying the product impulsively, and they later claimed additional amounts. Unfortunately, this was often not possible due to the lack of an efficient system of procurement of required raw materials. A separate research showed lack of high quality raw materials on the local market on which the manufacturer of cake is directed. Ecologically-grown citrus,

required for continued production of *Diocletian's Wreath* at the local market supply is inadequate. On the broader *Dalmatian* market production of indigenous agricultural products (for this purpose) is fractionalized into many small producers. Research has found that there are no organized channels of their delivery. Recognizing the weakness identified in a particular business case we evaluated the necessity of improving the existing models of product management *Diocletian's Wreath* to ensure conditions of growth of production and sales of the product.

The basic hypothesis of the research

The basic hypothesis; H<sub>0</sub>, of the research states: *Considering previous business experience with new native food products, the existing model of product management cannot ensure the growth of production and sales, and existence of that product on the market is questioned.*

Auxiliary hypotheses are as follows:

H 1: without creating innovated logistics system of high quality raw material supply, future production of indigenous food products is uncertain;

H 2: E-marketing is appropriate and economically valid platform for promotion and increase of sales of new food products for small business with limited marketing budgets;

H 3: E-commerce platform is an efficient distribution of new food products on global markets;

H 4: Effective brand management of new food product is a precondition for achieving higher selling prices at the global marketplace;

H 5: Organizational alignment and balancing of all business function of a small company by the standards of the global market is an assumption of production continuity of new food products;

### 3. RESEARCH PROBLEM EXPLICATION

The research included testing of the existing model of a specific new product positioning, *Diocletian's Wreath*, on the global market. The study was conducted in-depth interviews with representatives of manufacturers and with relevant random sample of previous customers, and potential buyers of *Diocletian's Wreath*. Potential buyers included in the sample are the subjects that in carried-out pre-testing clearly voted affirmatively on the issue of purchase interest, no matter what their sample was not delivered, but the product is presented in *story board* model. Today's economic reality on the global market has obvious repercussions on the commercialization of new products of the majority of small business from the countries in transition. These companies are focused on the global market due to the limitations of national markets in transition countries. Total potential sales of new products in small national markets can rarely justify the necessary investment in the development of these products. This fact was the reason why the company that manufactures *Diocletian's Wreath* skipped certain phases during the product development. The consequences are the negative repercussions related to the growth of manufacturing and selling of the product. Based on the identified weaknesses, improvements of the product management models have been offered. Same are a platform to create an effective commercialization strategy and positioning of new food products of small enterprises on the global market. Problems of operational nature, which were confirmed in the study, are evident. Same result in an imbalance of the business functions of a small business. For all these problems the owners of small business are in a dilemma of continuing withdrawal of the global commercialization of *Diocletian's Wreath*.

### 4. RESEARCH RESULTS

The main findings of this research resulted in order to resolve dilemma which is connected to the existing operational management of the new food product:

- 1. The existing experience is based on the distribution system, which shows some obvious weaknesses. The former consumers expressed some skepticism, because of the continuity in supplying the product through the year. Inadequate effective supply chain system of the product components is the main problem of the growing sales of *Diocletian's Wreath*, but also maintaining the customer satisfaction in despite and determining value of product for additional price. In that context it is necessary to make total logistic system which will assure continuous production of the *Diocletian's Wreath* all year around, but also the efficient distribution of total product which is aligned with purchase inquires.
- 2. Modest marketing which is based on the national publicity is insufficient for effective



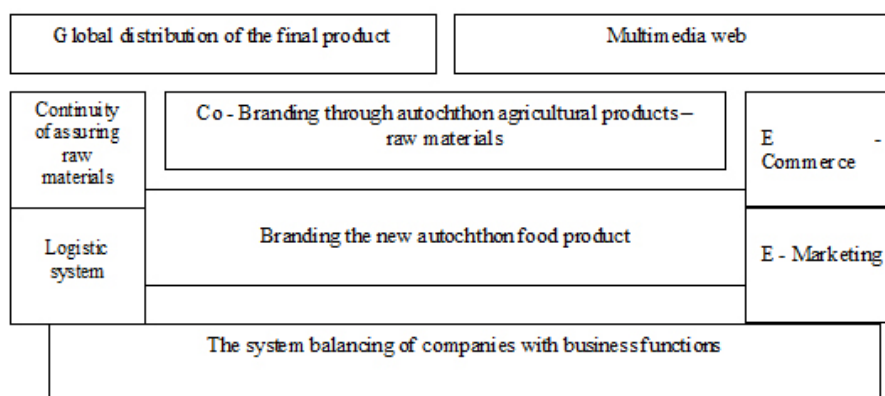
global commercialization of new food product. In this regard E-marketing is effective communication platform for targeted segments on the global market. E-marketing allows co-branding of new product with original indigenous and specificity of its country such as indigenous ecological agricultural products – components of new food product.

- 3. E-commerce, for the small enterprise, is acceptable as distribution model of a new food product, according to synergistically efficiency of E-marketing, and the fact that the *Diocletian's Wreath* production is not in core business of the small enterprise. Such trading model is recommended because of many potential segments where they can become permanent customers on the global market, such as catering companies – wider range, businesses – for representation, the representative bodies – for business gifts etc.
- 4. The indigenous branding of the national food product should be based on the co-branding elements that produces final product – indigenous food product with ecological stamp.
- 5. The organizational system of the small enterprise should be improved, so all business functions must be aligned, connected, and together contributes to efficient business and core business.

## 5. THE RECOMMENDATION FOR IMPROVING THE MANAGEMENT MODEL OF THE NEW FOOD PRODUCT

On what should be based improved strategic management model and the positioning of indigenous food products? Nowadays, innovative solutions, user friendly characteristics, distribution, and consolidation of recognized product and its origin country, represents imperative for efficient management model of the new product on the global market. (Aaker, 2001) However, small enterprises are fraught with the problems and barriers that occur in the commercialization of specific product in competitive environment. The corporative behavioral regulations are also present on the markets in transitional countries. A large chain store focuses on the economy of scale, and highly valued indigenous products are competitive. These products sometimes indicate unacceptable food product quality, and which are massively wanted on the market. Therefore, large, financially strong companies see the problem in branding the components of such products. The linkage between corporate capital and government structures, in this proven research, is still worrisome state of corruption, which is fundamental problem on the markets of the transitional countries. Branding of the indigenous agricultural sorts and products is still just consequence of individual efforts of small producers and community produces in these markets. On the global market, multinational corporations attempt to maintain control of commercialization activities of successful products of small enterprises in transitional countries, so in that way it won't discomfit price and quality ratio, and established standards. These premises clearly illustrate the problem of global commercialization of new indigenous agricultural products of exceptional quality, which are originated from transitional countries. Administrative barriers of economical affiliations are also problems. On the example of the Republic of Croatia, this problem should be solved by joining the European Union. (Šerić, 2003) Small enterprises are faced with offensive and aggressive strategies that are extending lifetime with quality of inferior products with similar usage of multinational corporations who manages the economy of scale. However, new imperative for the future sales growth will be the effective strategic management model of new products on the global market.

Figure 1: The recommendation of innovative model



Source: authors, on the basis of the conducted research, spring 2011.

## 6. CONCLUSION

The global market in the spite of exceptional receptive capacity of the original new products in price and quality ratio is not assured for the efficient positioning, in acceptable niche. The main characteristics of such product which differentiated it in comparison with similar products which are distributed by the multinational companies, represents a base for designing a new management model of the product. Nowadays, the corporate regulation models are present on the partial markets in transitional countries, and may have a negative repercussion on the logistical system of the small enterprises. If the same system works as the improvisation, which is unfortunately very often in small enterprises in transitional countries, it could lead to market failure in despite of the competitive characteristics of the new product. The strategic model by exclusively sub-segmentation of the new food product of a small enterprise from a country in transition on the global market is effectively implemented on a tactical platform consisted of – raw material logistic assurance for branded product, promotion based on E-marketing, distribution based on E-commerce, and feedback in order to eliminate organizational inconsistency.

For the logistical system it is necessary to assure the continuum of supplying raw materials indigenous eco-agricultural products, and establish an efficient flow distribution channel of the targeted market segments in the global market. For this food product it is important to comply with criteria and conditions on the markets of the European Union and United States of America. In that case our food product could be easily traded on such markets. Partially, problem could be related to national determinants and its regulations whose are regulating distribution of food products. The attitude of the national government legislation is unadoptable to encourage the export of the Croatian products, and is obvious for the new Croatian food product.

Small enterprises in transitional countries do not have sufficient funds for market budgeting, so for proper communication on target global market segments are required. Due to these facts a conservative promotional model cannot lead to success. The acceptable marketing solution is E-marketing. Originality and developing of a new efficient concept and an excellent CEO imply a successful realization of such communication system on targeted market in despite of the lower costs of such communication system. An attractive visual solutions and multimedia applications, such as E-marketing, could assure qualitative information about specifics and originality of food product. E-Marketing application which quality level is nor appropriated, could not assure success.

For such inappropriate developed E-Marketing system, it makes sense to develop an E-commerce system. So, in this case the exclusive food product could be qualified as national souvenir. According to market testing of its organoleptic characteristics and its exceptional quality it incorporates and strengthens the image of such product. For this product it is appropriate sub-segmentation strategy in first phase of the global commercialization. E-commerce is good solution for sub-segmentation strategy, in case of small enterprises, until it reaches a stage of rapid sales growth. In that case should be invested, parallel, in brand strengthening and in targeting exclusive distributors on the targeted national markets. For this phase it is necessary to execute and redesign total logistic system, according

to specific market cognitions.

The branding system, in order to create recognizable, exclusive brand of the indigenous food product, assumes activity and its continuity and investments in such brand. So, in that way brand could be developed by the level which will assure the continuity of sales growth on the global market.

Finally, the lack of organizational system that could resolve existing discrepancies and imbalances business functions of the small enterprises, according to standards of the global markets, was the pattern – food product, and also matter of this research. The rejection of the system determinants, regarding to their economic justification, or unjustifiable does not resolve the problem, from the aspect of the business owner, it just prolong it. Market testing that had been conducted indicates on the justifiability of the commercialization of new food product on the global market. With delaying and aligning standards that are allocated presents a potential risk of subsisted market of new food product, where is additional interest on the global market occurred.

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## PROCESS-ORIENTED ORGANIZATION OF PUBLIC UTILITY COMPANIES HAVE BETTER BUSINESS PERFORMANCE THAN FUNCTION ORIENTED ORGANIZATION

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### Abstract

Abandoning the traditional functional model of business organization and implementing the concept of process-oriented organization, managements of companies engaged in public utility operations can significantly improve business performance. Traversing to process-oriented organization and business process management within the company contribute to a clear division of responsibilities. In such a way that the owners of single process, the core process, support process or management process is appointed. Also, thus during the course of an action is shortened which makes the overall operations more efficient. The entire organizational structure is more flexible. It is more easily and quickly adaptable to external changes in the environment that are not under the control of management. This contributes to lower number of hierarchical levels in an organization that should be shallow but with a very developed lateral communication. Organizational structure takes on the characteristics of the process-oriented one. It is done by combining managerial and non-managerial activities, training and education of employees, grouping employees in teams and by developing multiple competencies. Process-oriented organization creates a competitive advantage over the slow traditional organizational structure through implemented business process management. In transitional countries, awareness and knowledge of the importance and benefits of implementation of the process concept in an organization is very small, so it is high time traditional organizations started leaving the functional model and building process-oriented organization. Today, in modern times, when changes in business environment are more frequent and increasingly demanding, it is not possible to operate without a developed IT support. The degree of development of IT support affects the timely elimination of "bottlenecks" in the business, rationalization of operations, transparency of business processes and cost savings in human resources. Automation of business processes, rationalizes the number of executors of an action, which creates financial requirements for implementing a new system of rewarding employees. The concept of process-oriented organization of public utility company is based on the changes. A great degree of flexibility that exists in these organizations enables the various business units to create their own solutions for conducting business and to carefully monitor and record the process efficiency. Changing approach to business and implementing process changes, sharing the ideas about the processes as well as the results lead to the basis of management, and this is precisely the knowledge and organizational learning. The aim of the organization of public utilities is to make them more flexible, easier, cheaper and more efficient through the various functions of expertise. All these changes should be accomplished through a management process that must be planned and in long-term build on one-time change of organizational structure. Top managers in utility companies should be named the owners of certain processes, and authorized to work and budget. Thus the business focus is corrected the focus of process measurement systems become process goals. Possible further success may be based on compensation policy of the selected company. After completing the organizational and functional redesign of the selected utility company, it can be said that the organizational culture that is now radically changed, and that in the middle of business are teamwork business and end-user satisfaction, rather than hierarchy managerial authority. After all changes are made, the chosen utility company becomes process-oriented enterprise whose management structure is in balance with its key core process management. Thanks to such changes benefits for the company are numerous, and it is reflected in better overall business performance.

**Keywords:** organizational structure, business process management, business processes, public utility companies, process-oriented organization.

## 1. THE CHARACTERISTICS OF ANALYSED PUBLIC UTILITY COMPANIES

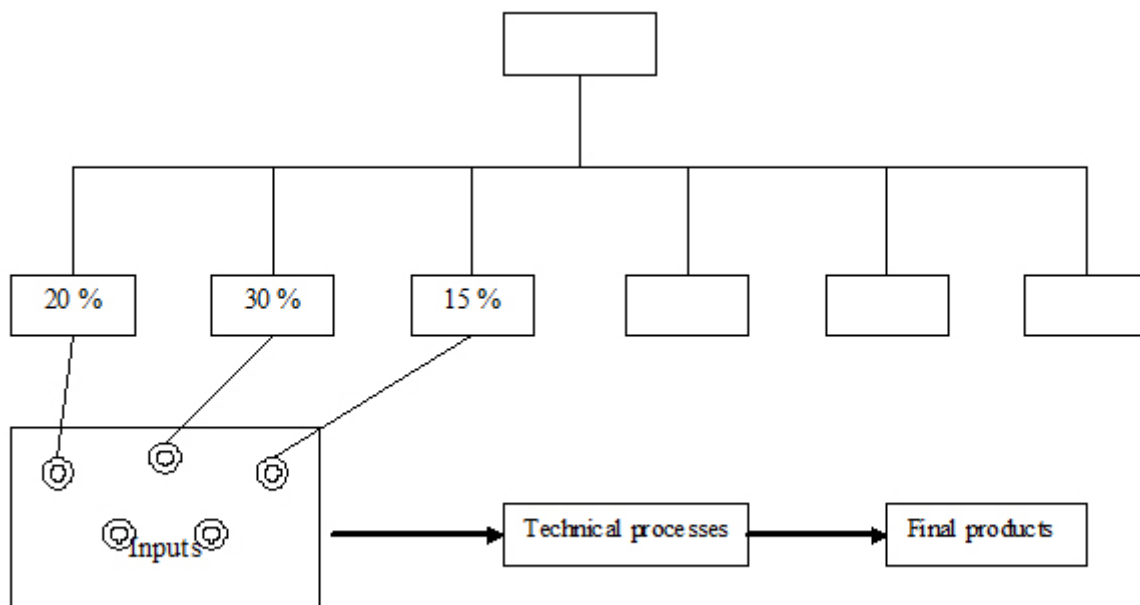
The basic mission of public utility companies is meeting customer needs of the population in a certain area. Therefore, it is not the profit, but the satisfaction of the users of public services that is the measure of success. Public utility companies are still largely the ownership of the local government and self-government, depending upon the territorial organization of the country. Our research analyses a sample of public utility companies whose founder and majority owner is the City of Split. A total of ten utility companies have been analysed, nine of which are exclusively services companies and one is a productive enterprise. All of the observed companies use budget funding and co-financing of joint business activities and only one is entirely market-oriented and does not use budget funding. Public utility companies have many advantages, one of the most important one being a better market position in respect to the competition. Public utility companies use their dominant position and a market niche to better satisfy and fulfil the demands of their users. Nevertheless, there is a downside to having a dominant position and it has to do with satisfying momentary political interests of majority owner who often, for populist reasons, set the service or product price well below its real market price wittingly accumulating a loss compensated through political loyalty of end users. Unlike the traditional functional organization, process-oriented public utility companies are characterized by an increased flexibility, lower business expenses, a simpler and shallower management based on micro-managers, that is, on process owners responsible for all business related ventures, a developed IT support system, a simple and flexible possibility of improving information flow, a short-term possibility of multiple enhancing service and production capacities with an emphasis on developing and upgrading support (not core) processes. The central figure in the business process is the man himself which means the dynamic of the process is determined by the weakest link in the production of the service chain.

In public utility organizations the significance and investment in development and process upgrading can be shown as following:

- operative processes
- support processes
- management processes
- direction finding processes

The order of the above process activities appears in all the observed organizations and has been confirmed during data acquisition process.

Figure 1. – Business workflow in a function-oriented organization





## 2. THE COMPONENTS OF THE BUSINESS PROCESS MODEL IN PUBLIC UTILITY ORGANIZATIONS

Every business process model describes the workflow strategy of all business processes taking place inside an organization. Particularly important is consumer presence and involvement in the business process because their feedback is key when it comes to improving the overall business performance, and from the process point of view it helps to locate and remove bottlenecks in production and service type activities. Of course, it is not necessary for consumers to be the end users of the products and services, internal consumers can also give input (employees, contractors etc.).

Each business process models is defined by its goals, activities and sub-processes, resources, information, owners and challenges (Buble, 2010).

Business **goals** in the observed business organizations are to be reached by adapting a process approach and require a radical re-designing of business activities which requires resources (three months minimum), financial assets and sufficient knowledge and skills of available human resources.

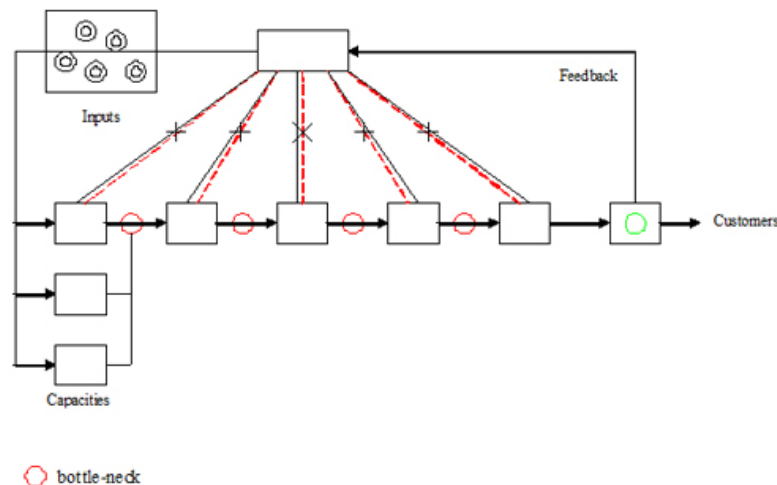
Transforming input into output in order to better satisfy the needs of end users is dependent upon the available production and service capacities and other basic resources, stagnations and breakdowns and feedback.

**Resources** in the observed public utility companies, a lack of knowledge and skills was noted in a part of human resources management regarding IT, unsuitable age and educational structure, a low internal and external employee fluctuation rate, an undeveloped personnel selection, training and motivation system of employees. Financial, material and technical resources are satisfying, as in most of the observed organizations. The human and IT potential represent the main limiting factor of improving process business.

**Information** essential to business activities is available to the majority of those involved in the business process with notable time delays due to insufficient IT implementation which later causes a financial expense and a burden for financial indicators. In process oriented organizations communication is immediate, timely and very shallow making it possible for such systems to have a lateral way of communicating and an information flow on the same level inside the chain of business activities (Bosilj Vukušić, Hernaus, Kovačić, 2008).

Business process **owners** have a micro-managerial role, assuming a model of business already exists. They are responsible for making sure all business activities (all sub-process and whose beginning, course, the ending and process) whose duration can be easily determined inside the chain are done properly. Owners who have been assigned business processes in public utility companies are often in charge of effectively managing processes arranged in groups of technical, financial and personnel activities. The owners assigned for a business process have a key role in the concept of Business Process Management.

Figure 2. – An overview of process- oriented activities in public utility companies



### 3. RESEARCH RESULTS

In the observed utility organizations which have partially or entirely implemented the concept of process oriented organization an improvement of both financial and non-financial business performances is clearly visible. Knowing that financial and accountancy criteria are only one way of measuring the total performance of decision makers, during the analysis and the observation of business organizations, special attention has been paid to non-financial criteria and performances due to demands of today's age of technology.

Particularly focus was placed on customer satisfaction, service providers' innovation, product and service quality and product efficiency and on main carriers of business activities (Kaplan, Atkinson, 1998). It would be fair to conclude that the importance of improving the non financial performance is the true indicator of progress in achieving long-term goals, superior to short-term financial criteria. Some of the observed organizations have a quality system implemented which additionally strengthens process business. All stagnations are noted, efforts are made to remove or minimize the manipulating factors which occur during various business activities and important feedback is sent to the management. This feedback later becomes the basis for the planning of the removal of bottlenecks and eventual parallel strengthening of one or a group of activities for which there is reasonable doubt they might be negatively influencing the effectiveness of the entire process (Prahalad and Hamel, 1990). Utility companies whose business organization is traditionally function-oriented continue doing their business through three basic sectors: technical, financial and personnel sector. The functioning, grouping and communicating inside such an organization is vertical which leads to a great loss of time in transferring operational information and a great deal of delays. We have come to a conclusion that companies which have adopted process-oriented business and have arranged their activities according to logical order of business activities have longer operative lines, lesser delays, faster and more effective information flow and a well defined distribution of assignments and responsibilities for each business activity. A direct connection has also been confirmed between the activities undertaken by the process management and the success of the business performance. All the results resulting as outputs in the process business can be quantified, bottlenecks are easily notable and, when needed, can be temporarily removed creating inexpensive parallel systems which do not require additional resource involvement. The characteristics of process-oriented business organizations are evident in the business activities dynamics, determined by the slowest link in the chain which sets the dynamics of the entire system.

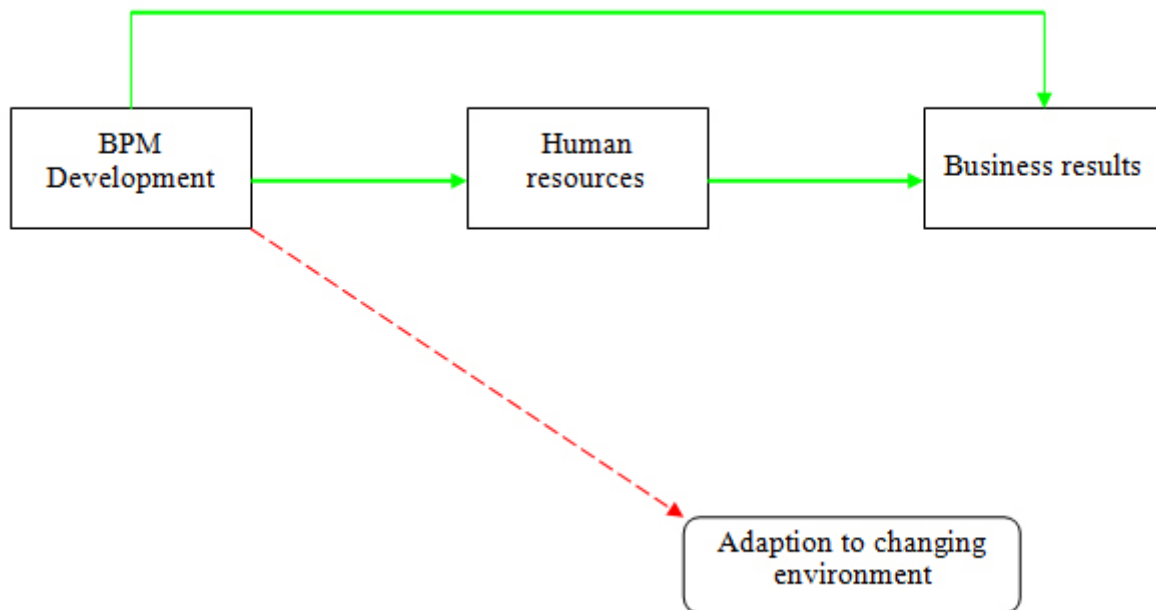
In the short run, by creating parallel processes, the output capacity for the end consumer can be greatly multiplied. This is due to the fact that the use and the need for products and services depends very much on the season. All of the above mentioned contributes to a larger organizational flexibility which is then more capable to adjust to market demands and changes.

Managing business processes in process-oriented companies in a rational and effective way and using human resources as the basic group around which process teams are organized, can have a direct influence on the business performance. A direct connection between BPM and business processes and a double indirect connection between BPM and human potentials and human potentials and business performances has been noted.

Other confirmed advantages of process oriented companies include fast feedback, a shallow and timely communication between all participants in the process, an overall lesser business expenses, a better motivation and compensation system. Emphasis is placed on improving support processes. A developed IT system allows a basic support to everyone and to all types of business processes during business activities. The weakest link is easily detected and the entire business activities system rests on small homogenous teams whose owners have a micro-managerial role and have to be in constant contact with the users, and the influence of the rigid division of managerial functions into three basic levels is not that strong.

The total business expenses of abandoning the traditional function-oriented organization and switching to process-oriented organizations have been reduced by 25 to 40 %.

Figure 3. – The connection between business process management and business results



#### 4. CONCLUSION

Comparing the **business** of public utility companies whose work is done entirely through function, that is process-oriented organization, it has been confirmed what was thought before analysing the advantages and disadvantages of each business organization concept. Analysing all the indicators available, taking into consideration all available resources of each organization, market idiosyncrasies, activities organizations undertake, the ownership structure, a broader social and economic significance, the specifics of internal and external surrounding, the conclusion can only be the following: there is no economically justified reason why all organizations shouldn't implement the process business concept, contributing in such way to a higher effectiveness and flexibility of the organization, improving financial and non-financial business performances, achieving a more dominant and recognizable role among its end users. The only threat in the business of public utility companies, which does not actually depend on the type of business involved, has to do with pleasing political interests of the majority owner who scarifies economic business principles in order to give irrational short-term pleasures to potential voters which finally leads to creating losses and creating negative business practices.

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## **STRATEGIC MANAGEMENT OF ENTREPRENEURIAL CULTURE**

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### **Abstract**

The success of any organization, in addition to achieving planned company goals by an adequate strategy, is reflected in how others see the organization. This implies the existence of specific entrepreneurial culture, which is reflected as a set of values and beliefs of employees, as well as the image of the company to the public. Entrepreneurial culture is an essential element that is an invisible link that connects the company and its employees. Only with its compliance with other elements of the organization and implementation of appropriate strategy, it enables the efficient and effective operations.

**Keywords:** strategy culture, organization, values, beliefs

### **1. INTRODUCTION**

When we say culture that an organization possess, we are referring to a wider range of appearance and phenomena such as social phenomena related to the education system, the dominant values in society, the legal system, human rights and customs of the people that are manifested in organizations.

Culture of a company must be as flexible on the one hand, and sensitive to cultural differences that members of the organization are faced with outside the organization. Modern business requires a way of doing business outside the borders of the mother country so it is necessary to meet other cultures. If you ignore the impact of culture on business in another country then it leads to unsuccessful negotiations and a negative operating result.

Because of this it is necessary to modern strategic management culture.

### **2. THE ORGANIZATIONAL CULTURE CONCEPT**

Every organization has an invisible quality - a certain goal, the character, the way of doing things - which may be stronger than any person or formal system.

Just ten years ago, the word culture is used in conjunction with theater, art galleries and the like. However, in recent years we are increasingly talking about corporate or organizational culture, and many authors suggest that the only thing that is common to all successful companies is very distinctive organizational cultures. (Mihailovic, D., 2000, p.133)

Culture can be defined as the characteristic beliefs and behaviors that exist within the organization. Corporate culture is a set of formal and informal behavior, which the company has adopted as its way of doing things. The formal part will include a formal written statement of values and organization chart. Informal parties concerned with how the work is done - whether through written procedures or through direct communication. Basically, organizational culture is described as a peculiarity or characteristics of an organization, or simply as "the way things are arranged in the organization." (Jovanovic-Bojinov, M., Zivkovic, M., Cvetovski, T., 2003, p. 290).

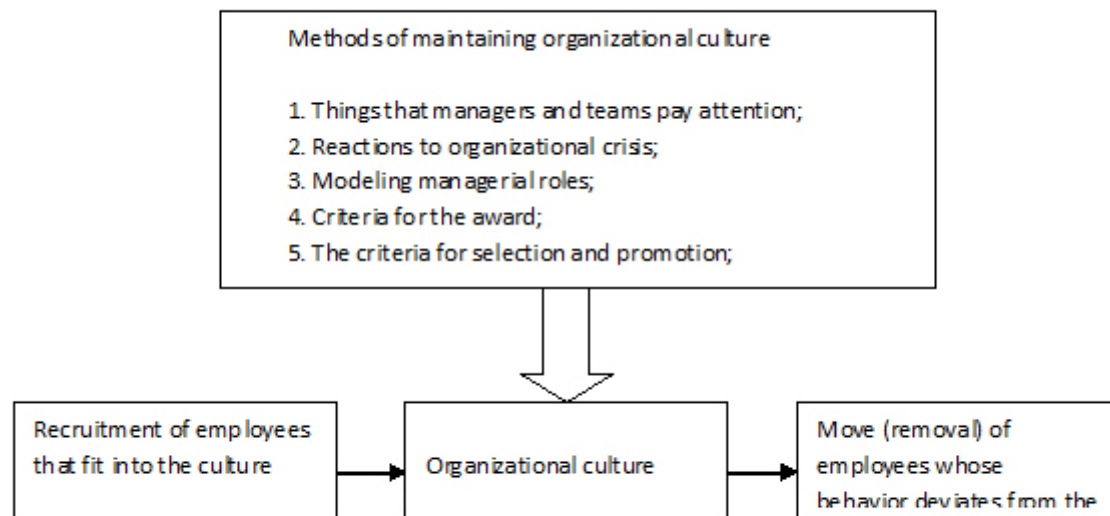
The main characteristics of culture are:

- It is acquired (no genetic or biological origin).
- It is divisible (culture is a social, not a single category and as such has been developed and divided into individual members of society).
- It is trans-generational (passed from generation to generation).
- It is symbolic (based on a human characteristic of presenting one thing with the help of others).
- It is adaptive (based on the ability of humans to adapt to environment and events).

- Principled (a general form of acceptable behavior based on the non-standardized) principles
- Communication (facilitates communication and contributes to greater closeness between experts in a culture)
- Differentiation (includes members of different cultures which often have different representations or beliefs about the same thing)
- Cumulative (the culture has opened and tentatively character and is in constant process of shaping, and each generation adds something, and leaves its own stamp on culture)
- Dynamics (culture is subject to change over time) (Jovanovic, M., 2004, p. 158).

National culture, customs and social norms of the country in which the organization operates are also shaping the organizational culture. In other words, the culture of the larger society affects the culture of the organization that operates within it.

Figure 1. Methods of maintaining organizational culture

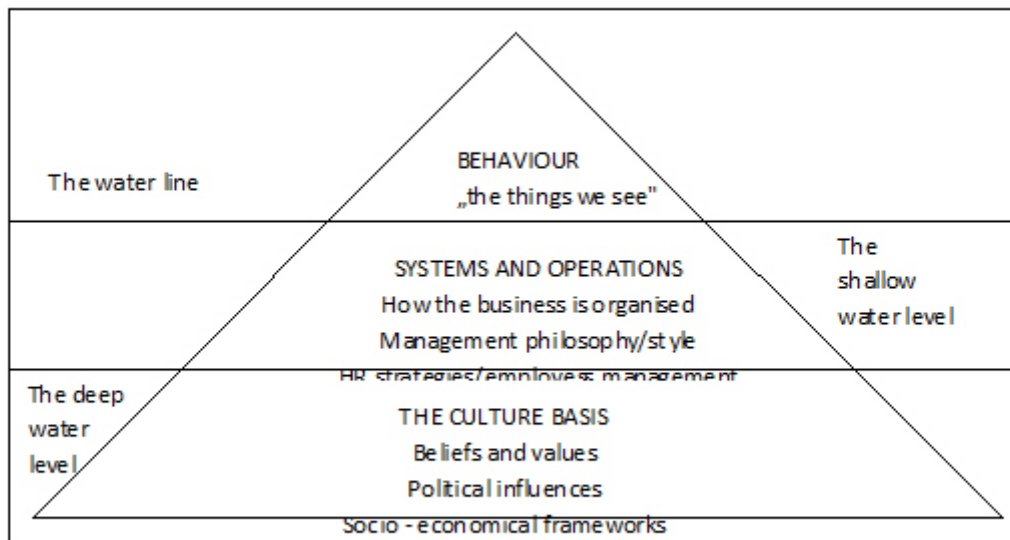


Source: M.Jovanovic-Bojinov, M.Zivkovic, T. Cvetovski, 2003., P. 313



Culture can be seen as an iceberg, or with the iceberg we can see its top, and we do not find the way it was created (Figure 2).

Figure 2. The iceberg model



Source: M. Jovanovic-Bozinov, M. Zivkovic, T.Cvetovski, 2003., p. 299

### 3. MANAGEMENT OF THE ORGANIZATIONAL CULTURE

Given that cultures arise and manifest themselves in different ways in different organizations, we can not say that one culture is better than another, only that it is different in certain ways. Cultures evolve over time.

In other words, it means that there is no “ideal culture”, but only the appropriate culture. Managing of the organizational culture is one of the important areas of governance, and corporate management, and it can be said it includes three major activities:

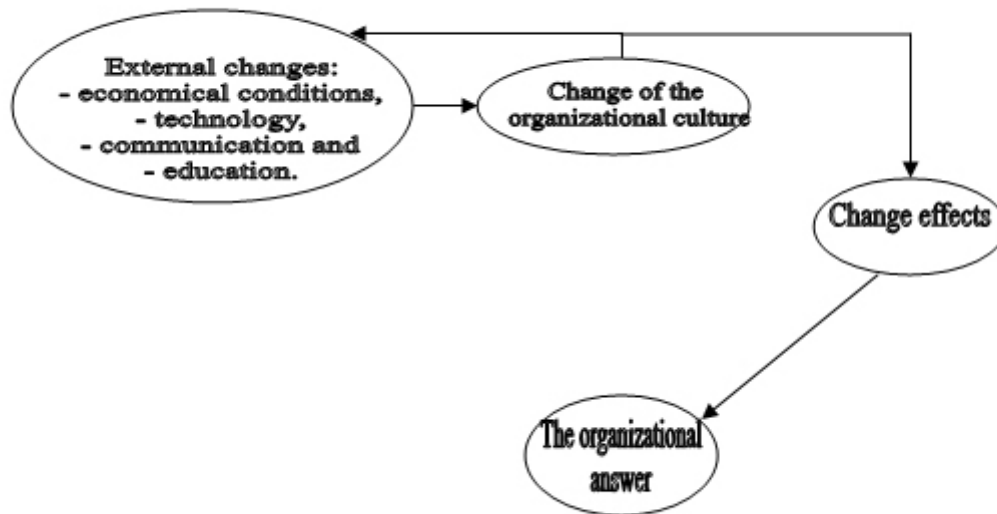
- creation,
- maintenance and
- change of the organizational culture. (Jovanovic-Bojinov, M., Zivkovic, M., Cvetovski, T., 2003, p. 309)

In order to have a successful management of the organization, it is needed to manage the organizational culture in an appropriate way. This means covering the following activities:

- creation;
- mastering and
- cultural change.

The very process of creating a culture consists of several stages. It moves from an idea in mind of the founder, who shares his vision with closest associates, and then transfers it to other employees. Mastering the culture means putting collective goals above own goals, and the integration of each individual in the group. The final stage is a change of culture and this stage requires a lot of time. Change process itself is viewed in the figure below (A. Hadzic, 2006, p.150).

Figure 3. The organizational culture changes process



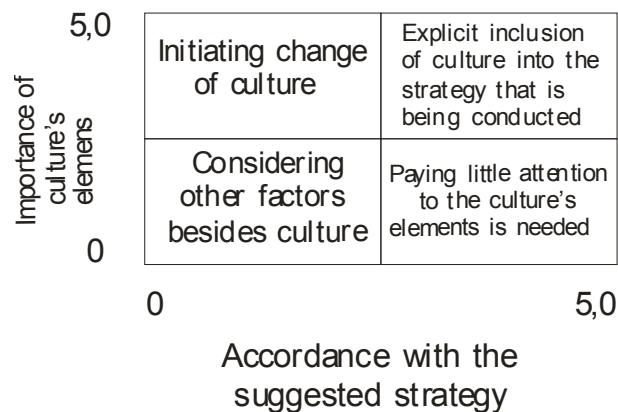
Changing culture is not an easy task, requiring complex and time-consuming procedures. The mere change in organizational culture takes place through the following phases:

- **Diagnosis** - in this initial phase the values and attitudes in the company have to be determined, which is usually done through quantitative and qualitative research methods;
- **Planning**-determining the desired attitudes and values and their incorporation into the vision and strategy of the company;
- **Analysis** - defining the differences between existing, prevailing values and those that intend to achieve;
- **Implementation** - changes in values and attitudes, ie, forming the desired culture.

#### 4. STRATEGIES TO CHANGE ORGANIZATIONAL CULTURE

In order to align the organizational culture with strategic initiatives, the existence of coherence between strategies and culture is very important. Since culture has an enormous effect on implementing the strategy, they have to be in a kind of harmony. This is shown in Figure 4.

Figure 4. Accordance of strategy with culture



(M.Milisavljevic, 2005, p.459)

The picture shows the elements of culture that influence the conducting of the strategy, and this influence is ranked from 0 to 5. On the other hand, the accordance of strategy with culture is shown, also ranked from 0 to 5. On the basis of two parametres, there are four possible situations:

- If the sum of these two factors is high, culture and strategy are in great harmony. In such situation, the company's management is expected to clearly and precisely include culture in the process of strategy conducting.
- If the sum of these two factors is low, this can lead to two possible situations: harmony is in danger, which will require certain changes in culture; or culture is not so much important, and therefore not paid too much attention to by the management of the company.
- If the sum of these two factors is somewhere in between (neither high nor low), attention is focused on other, more relevant factors of the strategy.
- Great interdependance between culture and strategy forces the management to pin down all the relevant factors whose change is important for the implementation of the planned strategy.

We can conclude that the accordance of culture with strategy is inevitable. However, if there is no accordance, the company has the following options at its disposal:

- it can ignore culture, which is risky;
- it can manage culture by changing the way the strategy is being applied and thus try to harmonize it with culture;
- it can modify culture and make it adapt to the strategy, which is also risky because changing culture takes time and
- it can adapt the strategy to culture; this is the method used by those companies that use strategies of external growth. (M.Milisavljevic, 2005, str.459)

In addition to this, one must answer the following questions:

- What are the elements of a new culture that must be implemented to make the organization successful?
- What are the key elements of the existing culture?
- What are the new habits we need to create in the organization to draw from the old to the new times? (Simic, I., Management,, 2008, str.356)

The speed at which the organization changes the culture depends on how you answer these three questions:

*1. What are the key elements of a new culture that the organization should adopt to be successful?*

What are three or four key "peculiar" characteristics which new organization should have? Otherwise, the new employees on their first day on the job should be able to hear this phrase and easy to understand the implications for their behavior. For example, company can tell employees that the three basic characteristics are:

- treating people with respect,
- reliability,
- provision of customized / flexible customer service.

*2. What are the key elements of the old organizational culture?*

There are two groups of characteristics that are particularly important when the organization is trying to change organizational culture. First are the characteristics that are in strike that comply with new initiatives. They will become a part of a "personality" of a new culture. Second, there are those that organization needs to leave behind.

For the organization it is important *to face the truth of what they should left behind*. Many organizations are trying to move towards a culture that has been led with goal, in faster steps. This situation could mean that the emphasis on giving recognition, "family" style of a culture and so no longer fit into the new tendencies. This change is painful to do. Trying to avoid facing the issues will only worsen the situation.

*The organization must bury the old culture.* Every culture that had ever been studied had some form

of funerary rituals. There must be a reason for it. It gives people a chance to say goodbye. It marks the end of the old ways of life and start a new life for people affected by the death. The funeral is not the end of mourning, because it takes more time.

*An organization needs to respect the past.* We should not carelessly offend these people suggesting that the old way of doing things was not good. They are very sensitive to the past, especially during the time they leave it behind.

3. *What are the new habits you need to create in the organization so that it could move from the old to the new modus operandi?*

*We need to create new patterns of behavior* that match the new key features that an organization develops. This problem is what we have in mind when using the term “walk and talk”. Answers to the first question are “speech - talk”. This is the place where we shape and reinforce what we say is important in the new culture. Answers to the third question is directed to “walk - walk”. Do you behave in ways that are consistent with what you say is most important? *The organization needs to change as much as possible visible (external) symbols*. We need to change the names, colors, logo, dress code, rewarding, plans and everything else for what was thought to be tangible (real) symbols of new way of functioning.

*It is necessary to change the language.* This is one of the most important elements of culture. If the organization come up with a new set of words that highlight new features, it will gain people’s attention.

We need to create new *rituals* that will enhance the new key features. Change forms of meetings, change the way you use voice mail or e-mail, add celebrations of new successes, honor the heroes of culture. (Simic, I., Management., 2008, p.357)

*We need to create new habits.* Habits require repetition in order to inculcate. It is necessary to find numerous ways to replicate the new behaviors. It is necessary to attract as many people as possible who would put forward this new behavior. For organizations, it is important to remember this sequence:

- determine what is important,
- behave accordingly to it,
- turn attention to it and
- reward it.

## 5. THE INTERACTION OF NATIONAL AND ORGANIZATIONAL CULTURE

The relationship between national and organizational culture is very complex. Although national culture affects organizational culture and the behavior of members of the organization, the ways in which this is achieved are still not clear enough. The reasons lie in the fact that different national cultures in various ways and in varying degrees influence certain organizations. It is this fact that justifies the different opinions of those authors who have explored further the relationship of national and organizational culture.

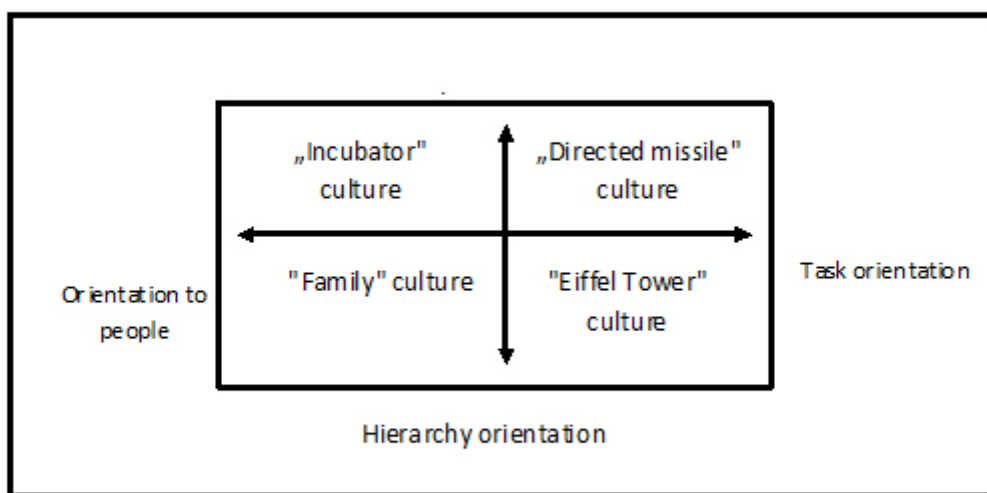
There is a conventional understanding of the relationship of national and organizational culture that is characteristic to those authors who believe that national culture does not have significant impact on organizational culture, or that the so-called strong organizational culture is in the state to annul or eliminate the effect of national culture.

However, certain scientific studies have shown that, in terms of relations between national and organizational culture, there is the reverse situation, respecting that national culture have a significant impact on organizational culture. Thus, for example, Hofstede’s study found that cultural values which employees have brought into the organization can not be easily changed. Research conducted by Andre Laurent have confirmed these Hofstede’s conclusions. The results of his research has actually shown that organizational culture does not diminish national differences between employees. And not only does not diminish them, but it reinforces them. (Nikolic, S., fourth edition, p.165)

These and many other examples clearly show that the management in terms of internationalization of business, must have different approaches to managing organizational units located in different countries and in different national cultures. This is due to the fact that different national cultures in various ways influence the organizational culture, respectively on behavior of specific members of the organization.

Due to the large impact of national on organizational culture, it is possible to speak of specific types of organizational cultures that exist within different national cultures. A significant contribution to identifying the cultural specificities of individual organizations, located in different national institutional framework, have been given by Fons Trompenaars. The author, in 1994, based on two continuum: gender orientation - orientation towards hierarchy and orientation to people - orientation to the task, has defined four types of organizational culture, which figure in the different national cultures. These are:

- “incubator” culture.
- “family” culture
- “directed missile” culture and
- “Eiffel Tower” culture.



Source: S. Nikolic, p. 166

## 6. CONCLUSION

Every organization has a specific program or method, or a strategy by which it achieves its planned objectives. What particularly emphasizes the specific organization is its specific culture. In recent years, many articles and books had been written on culture in organizations. This culture is usually called corporate or organizational culture.

For culture is said to be moral, social and behavioral norms of an organization that are based on beliefs, attitudes and priorities of its members. Culture is a complex pattern of beliefs, expectations, ideas, values, attitudes and behaviors shared by members of an organization. If there are no appropriate choices that will create a culture, then there is a dysfunctional behavior. The conclusion that inevitably comes from all that had been said is that managers and all employees must not ignore the culture, but they have to influence its development and improvement.



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**THE NETWORKING STRATEGIES' CONTRIBUTION TO THE SMALL AND MEDIUM SIZED ENTERPRISES' PERFORMANCES****Biljana Predić**

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E-mail: [danijela.stosic@eknfak.ni.ac.rs](mailto:danijela.stosic@eknfak.ni.ac.rs)**Abstract**

In the modern business environment, a typical enterprise is a small or a medium sized (SME) one. Not only their number, but also the contribution to the employment and value generated are the indicators of how important they can be to a national economy. That's way the competitiveness of the small and medium sized enterprises' sector is crucial to the competitiveness of the economy as a whole. However, in building, maintaining and improving their competitiveness, small and medium sized enterprises are faced with certain obstacles. The smaller size of small and medium sized enterprises is one of the main sources of the barriers that these enterprises are faced with in realising higher business performances. Overcoming the barriers and improving competitiveness on that basis more often requires for small and medium sized enterprises to network – either mutually or with big companies. Small and medium sized enterprises can improve their competitiveness by creating and maintaining the network of relationships with other market participants. These network-like structures can be an adequate frame for small and medium sized enterprises to access the needed resources and competences. Basic logic that underlines the networking strategies is the idea that the cooperation is needed in order to compete in the modern economy. The aim of this paper is to show possible effects of the networking strategies, and to examine the realisation of these effects in a case of small and medium sized enterprises' clustering. In order to test the impact of the clustering on small and medium sized enterprises' performances the Nišava District Textile Cluster has been chosen. This particular cluster has been chosen because the Nišava District was once known for its developed textile industry. However, this district, as well as its textile industry is now underdeveloped, so there is a clear need to examine the effectiveness of certain existing business models developed for their recovery. The dynamic of cluster members' growth and development indicators during the four year period shows that some improvements have been achieved. Nevertheless, further statistical analysis does not confirm the existence of positive effects of this cluster on its members' business performances, i.e. their growth and development. The short cluster's lifespan, effects of the world economic crisis and the most important – the inadequate structure and the support of the examined cluster are seen as the main reason for this positive effects' absence.

**Keywords:** clusters, networking, SMEs, growth and development, competitiveness

**1. INTRODUCTION**

Small and medium sized enterprises (hereon SMEs) comprise a majority of the enterprises in the Republic of Serbia, as well as in the EU countries. Out of all enterprises in the EU and in the Republic of Serbia 99.8% (Eurostat, 2011a, p. 11) and 99.4% (Statistical Office of the Republic of Serbia, 2011a, p. 14) are the SMEs, respectively. Both in the EU and in the Serbia about two thirds of employees are employed in the SMEs (Eurostat, 2011a, p. 11; Statistical Office of the Republic of Serbia, 2011a, p. 14). Also, a half, or more than a half of gross value added is generated in the SMEs (Eurostat, 2011a, p. 11; Statistical Office of the Republic of Serbia, 2011a, p. 15). These figures illustrate the importance of the SMEs for one economy. So, the growth and the development of these enterprises can be a significant impulse for the growth and the development of the economy as a whole. Anyway, in realising their growth and development goals, the SMEs are faced with certain barriers that are mostly sourced in their smaller size. These barriers are mostly financial, but also technical, and commercial in their nature.

The growth and the development limitations sourced in their smaller size are the impulse for the SMEs' networking – either with the big companies, or with each other. As a way for overcoming the barriers that they are faced with, the networking strategies can be the best way for the SMEs to realise their growth and development goals and to improve their competitiveness. In that sense, the goal of this paper is to identify the importance that networking strategies can have for the SMEs' performances, i.e. for developing, maintaining and improving of their competitiveness, and to analyze the practice

and the effects of the textile SMEs' networking in the Nišava District. High unemployment is one of the key problems in the Serbian economy, and especially in certain administrative districts in the Serbian territorial organization. The need to examine whether the business models that can contribute to the improvement of the SMEs' performances are implemented, and how they are implemented in the local business practice is becoming more and more important in the set of efforts aimed at resolving the issue of high unemployment. Given the significant contribution of the SMEs to the employment growth (The European Commission, et al., 2007, p. 38; Audretsch et al., 2009, p. 19; Eurostat, 2009), one should expect that the improvement of the performances and the competitiveness of these enterprises can help to reduce the high unemployment rates in the Republic of Serbia and its Nišava District. The unemployment rate in the Republic of Serbia has been constantly increasing in the 2008-2011 period (Statistical Office of the Republic of Serbia, 2009, 2010, 2011b; Republički zavod za statistiku, 2011), and it is considerably higher if compared to the average unemployment rate at the EU27 level. The unemployment rate in Serbia in April 2011 amounted to 22.2% (Republički zavod za statistiku, 2011), being at its maximum level in the last five years. The registered unemployment rate in Serbia is 12.7 percentage points higher than the average unemployment rate in the EU27 member states that in August 2011 amounted to 9.5% (Eurostat, 2011b). In the general environment of high unemployment the position of the Nišava District regarding this issue is even worse. The unemployment rate in the Nišava District is following the overall growing trend, and is above the average unemployment rate in the Republic (Statistical Office of the Republic of Serbia, 2009, 2010, 2011b). Regarding the unemployment rate, the Nišava District is at the top of the districts with the highest unemployment rates in Serbia. The unemployment rate in the Nišava District in 2010, as well as in 2009 was as much as 7.7 percentage points above the average unemployment rate in Serbia (Statistical Office of the Republic of Serbia, 2010, 2011b). In addition to the higher unemployment rates, the fact that the average salary in the Nišava District is lower than the average salaries at the national level indicates that the District's competitiveness is undermined (Statistical Office of the Republic of Serbia, 2011c). The analysis of the SMEs' networking practice in the Nišava district is supposed to indicate the potential, but also the realized contribution of the certain networking strategies to the performances of the networked entities. Assuming that the improvement of the labour-intensive sectors' performances is particularly important for the reduction of the high unemployment, and a long tradition of the textile industry in the Nišava district, the Nišava District Textile Cluster has been selected for the assessment of the practice and the effects of the SMEs' networking.

After presenting certain basic characteristics of the SMEs' performances and the barriers for their improvement, the term and the business network's possible contribution to the business competitiveness of its members will be analyzed. Special attention will be paid to the analysis of the effects that certain types of networking strategies can have on the competitiveness' improvement, and thus on the SMEs' growth and development. In order to examine the actual contribution of the clustering to the textile SMEs' performances in the Nišava District, the methodology and the results of the research will be presented in the second part of the paper. After analyzing the results, certain conclusive remarks and recommendations for the improvement of the SMEs' cluster networking in the Nišava District will be presented.

## 2. THE IMPORTANCE AND FORMS OF THE SMEs' NETWORKING STRATEGIES

Barriers for the performances' improvement and for the SMEs' growth and development are mostly related to their size and the fact that the resource base and the organizational capacity of these enterprises are limited – both in quantitative and qualitative terms (Predić and Stošić, 2011). The endangered liquidity and other finance related challenges, the evident need for training the managers and other employees, outdated technology, regional imparity regarding the IT and technological capacity (with the obvious lagging of the SMEs from the Eastern and Southern Serbia region), an unsatisfactory level of compliance with the requirements of the quality standards, and the low level of R&D activities are some of the basic characteristics of SMEs' functioning in the Republic of Serbia (Republička agencija za razvoj malih i srednjih preduzeća i preduzetništva, 2009; Nacionalna agencija za regionalni razvoj, 2010, 2011). Also, the SMEs' productivity is lower than the average productivity in the economy as a whole (Eurostat, 2011a; Statistical Office of the Republic of Serbia, 2011a).

One of the possible ways for the SMEs to overcome the shortcomings of their smaller size are the strategies of networking. The underlining idea of networking is to cooperate in order to compete more effectively. Creating a network-like structure of relationships may be easier, faster and/or more cost efficient way of building, maintaining or improving the competitiveness of these enterprises. Business networks are more or less complex structures of business and other entities and their mutual relations (Kambil and Short, 1994; Holmlund and Törnroos, 1997; Podolny and Page, 1998; Yeh-

Yun Lin and Zhang, 2005; van Lieere, 2007; Aoyama et al., 2010). Relations between the members of the business networks include multidirectional informational, financial and material flows between related parties, so these relationships are more substantial and complex than purely transactional ones (Holmlund and Törnroos, 1997). The development, maintenance and improvement of the business networks' relationships are based on the reciprocity in the exchange (Powell, 1990), trust (Johnston and Lawrence, 1988; Holmlund and Törnroos, 1997; Podolny and Page, 1998; Child, Faulkner and Tallman, 2005) and partners' commitment to the relations (Dore, 1983; Anderson and Weitz, 1992).

A business network, as a platform for competing in modern environment, provides access to the resources, competencies, technology and knowledge located outside the boundaries of an individual company (Henderson, 1990; Powell, 1990; Podolny and Page, 1998; Gulati, Nohria and Zaheer, 2000; Child, Faulkner and Tallman, 2005; van Lieere, 2007). A business network can be a framework for members to jointly perform their business activities, for costs and risks sharing and, therefore, for achieving higher levels of the efficiency and the effectiveness, the economies of scale and scope along the entire value chain (Powell 1987; Johnston and Lawrence, 1988; Gomes-Casseres, 1994; Kumar, 1996). For its members, the business network may be an important internal supply and/or sale market (Dore, 1983).

The basis for the competitiveness' improvement through cooperation has been looked upon in different theories and concepts. Although different, the theoretical frameworks explaining the cooperation motives do not have to be seen as mutually exclusive. Moreover, the multi-dimensional nature of doing business requires a comprehensive analysis of the cooperation motives. In this sense, the cooperative arrangements are seen as a way for companies to respond to the external challenges in situations where there is no an internal potential to respond appropriately by the eclectic theory of motivation for cooperation (Child, Faulkner and Tallman, 2005). In the environment of dynamic changes, globalized supply and demand which intensifies the competition and makes the consumers more demanding, business networks are becoming increasingly an important frame for building, maintaining and improving the business competitiveness (Ohmae, 1989; Powell, 1990; Snow, Miles and Coleman, 1992; Kumar, 1996; Child, Faulkner and Tallman, 2005). By providing the opportunity to realize the benefits of the bigger size, based on the of resources and skills networking, as well as carrying out joint activities, with no loss of independence and flexibility typical for the small companies, business networks are one way for the SMEs to overcome the barriers that they are faced with in achieving their growth and development goals. For the SMEs, a membership in business networks can be a way of improving the organizational knowledge given the fact that business networks can be a frame for various aspects of the organizational learning to take place (Child, Faulkner and Tallman, 2005, pp. 275-279).

The SMEs' networking is a complex phenomenon with a numerous forms of manifestation, different structures and motivation base. Depending on the size of the networking partner, the SMEs can follow the strategy of mutual networking, or the strategy of networking with the big companies. Direct competition with large companies often is not the best way for the SMEs to improve their performances. Instead, the better way to improve their competitiveness is to become a part of some kind of vertical business network by partnering with big companies (Predić and Stošić, 2011). Networking with big companies can be a chance for small ones to modernise themselves and to realise their growth and development goals by reaching the selling and procurement markets, and also a form of a needed technical support (Taymaz and Kiliçaslan, 2005). In a network with a dominant partner, which is characterized by the stable and secure sale and cash flows (Child, Faulkner and Tallman, 2005), the SMEs can find a solution for their liquidity problem, and, sometimes, even for their survival.

The SMEs' mutual networking in a form of horizontal or vertical cooperation can be a base for their competitiveness' improvement (ibid). Horizontal cooperation should contribute to the economy of scale and scope, while the vertical cooperation should be a frame for the positive effects of the specialisation based on the core competences of the each of the vertically connected partners. By networking with each other the SMEs can improve their position relative to the Porter's five competitive forces (Porter, 1980) by creating a critical mass of resources and competences. Thus mutual connected, the SMEs can overcome the shortcomings of their smaller size and as a group of networked partners they can become stronger negotiators and competitors. Also, the SMEs' mutual cooperation can be a base for lowering the resource dependence from the environment and therefore for improving their competitive position. One of the most common forms of the SMEs' mutual networking is clustering. Porter (1998, p. 78) defines clusters as a group of interrelated firms located in a limited geographic area. Cluster members are parts of a same supply chain (input providers, producers, distributors), but can also be from related industries. The networked members' value chains create cluster's value system that becomes a joint assets and a source of a cluster's competitiveness. Clusters can contribute to the productivity and innovation capabilities of its members, and also can intensify the competition



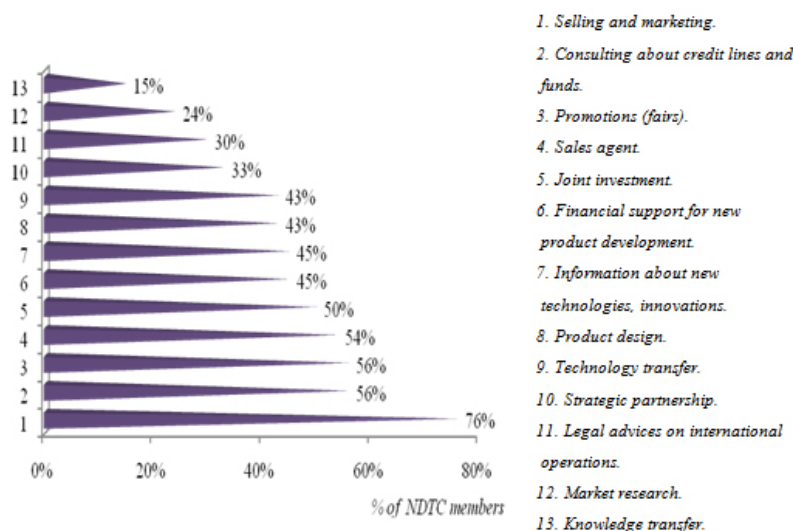
by facilitating the new business formation (ibid, pp. 81-84). The geographical proximity of the cluster members is the basis for realizing the agglomeration effects, i.e. the enhancement of the cost efficiency through carrying out activities in a limited area (Pandit and Cook, 2003). The geographic concentration of the cluster members indicates the concentration of the resources' supply and demand, facilitates the development of trust and the transfer of knowledge, and also the establishment of specific infrastructure and institutional support to the cluster members (Porter, 1998; Pandit and Cook, 2003; Karaev, Koh and Szamosi, 2007). Easier access to the resources and to the selling market can be the main impetus to the SMEs' growth and development. The cluster's reputation can be a substitute for the missing corporate reputation, since the SMEs in most cases do not have a developed reputation (at least not one widely known). The transfer of the cluster's image to its members (Pandit and Cook, 2003) is one of the possible basis for improving their performances and competitiveness. Clusters' reputation can contribute to the SMEs' internationalization goals (Zyglidopoulos, De Martino and McHardy Reid, 2006). The reputation that certain cluster has is its members' common property and a resource that competitors outside the cluster can hardly imitate. Given the described cluster's characteristics and the possible clustering effects, it is reasonable to expect that this model of SMEs' mutual networking can have certain contribution to the improvement of the SMEs' performances.

### 3. The Nišava District Textile Cluster

With an idea to help improving the competitiveness of the textile SMEs' in the Nišava District, the Nišava District Textile Cluster (NDTC) was founded in the 2008. The intention was to improve members' market position by reducing the shortcomings of their smaller size and developing a recognizable textile brand. This business network was founded by the textile enterprises located in the Nišava District<sup>1</sup>. As a framework for networking and, on that basis, for improving the competitiveness of its members, this cluster is an organized association of companies whose representatives are members of the cluster's Assembly, the Managing Board and the expert boards. At the time when this study was realized the total number of cluster members was 46. Except one member (*Nitex*), all other cluster members are the SMEs with 30 employees, on average. It is important to notice that, except one, all of the cluster members are located at the same phase of the value generation chain – production of the final goods. Input suppliers or service providers<sup>2</sup>, are not cluster members, although the cluster was initially designed as a framework for developing both the horizontal and the vertical connection between the value creators. Furthermore, the NDTC is located in a university centre but, still, no academic or research institution support the cluster's activities.

The main motives for joining the cluster (Figure 1) lead to a conclusion that the cluster's members need an overall business support. The main areas of the needed support refer to marketing (market research, promotion, selling), production (technology), finance (joint investment, information about credit lines and funds and other financing sources), research and development (knowledge transfer and innovations).

Figure 1: Networking motives for the Nišava District Textile Cluster members (based on the Cluster's internal documentation)



1 Nišava District is divided into 6 municipalities and the City of Niš, which is divided into 5 municipalities. The municipalities of the District are: Aleksinac, Svrlijig, Merošina, Ražanj, Doljevac, Gadžin Han. The municipalities of the City of Niš are: Medijana, Niška Banja, Palilula, Crveni Krst, Pantelejš.

2 Only one of the members is provider of associated services, i.e. equipment maintenance.



#### 4.METHODOLOGY

In order to analyse the cluster members' performances and to assess the NDTC contribution to the improvement of their competitiveness, the sample of 12 cluster members' has been chosen. In forming the sample we were limited by the available data – the data that were the basis for following the dynamic of the chosen indicators in the period before (2006/2007), and the period after (2008/2009) joining the cluster. Besides the internal documentation of the Nišava District Textile Cluster, as a data source for calculations, graphical illustrations and related analysis, The Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs has been used. This Register can be found at the official web site of the Serbian Business Registers Agency (2010). The structures of the sample and of the cluster as a whole show similarity, as it can be seen from the Table 1. Therefore, the sample has been taken as a representative one.

Table 1: Comparative review of the sample's and the cluster's structure

	Average number of employees	Export (%)		Product range (%)*				Age (%)			Loth jobs (%)	
		Yes	No	WM	W	K	M	Up to 5 years	5-10	>10	Yes	No
Sample	32	66	33	30	30	30	10	42	33	25	23	77
Cluster	30	46	54	29	24	13	10	38	14	34	37	63

\*Confection: Women and Men - WM; Women - W; Kids - K; Men -M

Results obtained on the basis of: The Nišava District Textile Cluster's internal documentation

The cluster's contribution to the SMEs' performances has been assessed by analyzing the networked enterprises' indicators of growth and development. Namely, because of their "resource poverty" (Welsh and White, 1981, p. 18) the SMEs are faced with certain problems in the field of measuring their own performances. When they do measure them, SMEs are largely focused on monitoring the financial and, eventually, the operational performances (Hudson, Lean and Smart, 2001; Davig, Elberth and Brown, 2004; Garengo and Bernardi, 2007; Cocca and Alberti, 2010). The problem of lacking the data that could be the basis for a holistic analysis of the SMEs' performances methodologically has focused the assessment of the NDTC contributions to its members' performances on the monitoring and evaluation of their growth and development indicators. Namely, Serbian enterprises have a legal obligation to determine and to submit data on this indicators' value, so this data can easily be found in the mentioned Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs (The Serbian Business Registers Agency, 2010). This assessment of the clustering contribution to the SMEs performances has been based on the assumption that the improvement of the performances leads to the growth and development of these enterprises.

The growth and the development of the NDTC members have been analysed on the basis of the dynamics of the chosen indicators. Changes of the total assets, number of employees and operating income have been chosen as the adequate indicators of the NDTC members' growth. Namely, the Serbian Accounting and Auditing Law (National Assembly of the Republic of Serbia, 2006) defines the operating assets, number of employees and operating income as criteria for determining the size of the enterprises. Therefore, the value changes of these criteria indicate the enterprises' size change, i.e. their growth. Back to the NDTC members' growth assessment, it can be noticed that the value of the total assets, not the operating assets as the Accounting and Auditing Law suggests, has been chosen as a growth indicator. This was done due to the available data. So, before judging the growth of the NDTC members on the basis of the total assets dynamic, instead of following the value of the operating assets, the relevance of the chosen indicator had to be assessed. According to the official form of the Financial Statements prescribing the rules on the content and the layout of the financial statements (The Serbian Register Agency, 2011), the Total assets position (AOP 024) includes both the Operating assets (AOP 022), and the Loss above equity (AOP 023). Thus, the value of the total assets can be a substitute for the operating assets value only if there is no loss above equity. Closer review of the data that refer to the chosen sample of the NDTC members showed that except in the case of one cluster member (enterprise number 9<sub>3</sub>), in other enterprises there is no loss above equity registered during the entire analysed period. Bearing this in mind, it has been concluded that the value of the total assets can be an adequate basis for the operating assets dynamic analysis.

Relative to the other available data, the net profit is the most complete indicator of the business success. So, the dynamic of the NDTC members' net profit has been accepted as an adequate indicator of their development. Assessment of the NDTC members' growth and development has been based upon the yearly dynamic of the chosen indicators during the period between 2006 and 2009. The

3 This enterprise has registered loss above equity only in one year of the analysed period. In this year the loss above equity of this enterprise was 11% of its total assets value.

members' growth and development indicators were followed during the 2008 and the 2009 because these were the years of the NDTC most active engagement in realising its support activities. The two previous years, i.e. the 2006 and the 2007 were chosen as years that have preceded the period of cluster membership. In order to achieve a higher comparability level of the results obtained, the financial indicators' values, which are given in the RSD by the used data sources, have been expressed in the EUR values. The values have been recalculated on the basis of the average exchange rate in the year which the indicators relate to (Narodna banka Srbije, 2010). In order to examine if there was a NDTC membership contribution to the growth and the development, the values of those indicators have been grouped into two time series – one referring to the period before (2006/2007), and the other to the period after (2008/2009) the analysed enterprises have joined the cluster. In order to determine whether the differences in the indicators' levels before and after entering the cluster are statistically relevant the data were analysed by using an appropriate statistical test. For the purpose of choosing the statistical test, the hypothesis about the normality of the data distribution for all chosen indicators has been tested. The results have shown that the data do not have normal distribution – for the both data series regarding all chosen indicators ( $p < 0.05$ ). The results from the two periods (2006/2007 vs. 2008/2009) have been therefore compared using the nonparametric Mann-Whitney test. Conventional probability value  $p < 0.05$  has been considered significant.

## 5. RESULTS

Table 2 shows the total assets by enterprises – the NDCT members, and the average total assets values by years of the analysed period.

Table 2: The total assets by enterprises and the average total assets for the sample, per annum of the 2006-2009 period

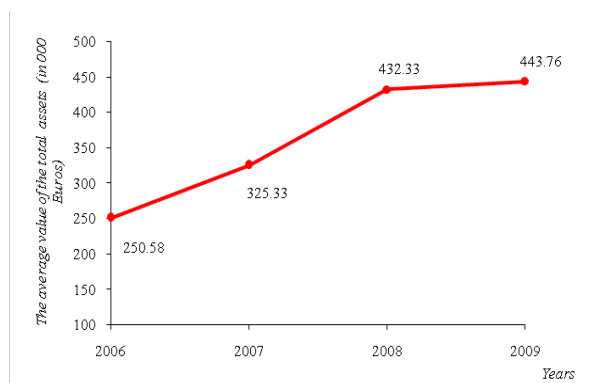
Enterprise	Year			
	2006	2007	2008	2009
1. Balextra	101*	148	143	104
2. Cameleon	48	142	191	181
3. David	275	279	303	310
4. Kassker	354	427	642	727
5. Randeli	193	240	419	403
6. Statex	364	363	357	313
7. VK Group	513	787	1259	1489
8. Vogeli	114	188	329	384
9. Alter ego	151	215	275	322
10. Hajdi Baby	188	285	414	393
11. Pećarac	698	819	839	683
12. Pepeljuga	8	11	17	15
X ± SD	250.58 ± 202.54	325.33 ± 247.63	432.33 ± 339.19	443.76 ± 387.99

Results obtained on the basis of: The Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs

\*in 000 Euros

It can be noticed that the average total assets value is increasing during the entire analysed period. After the more intense growth during the first two years of the period (2007, 2008) the average values of the total assets continued to increase with less intensity (Figure 2).

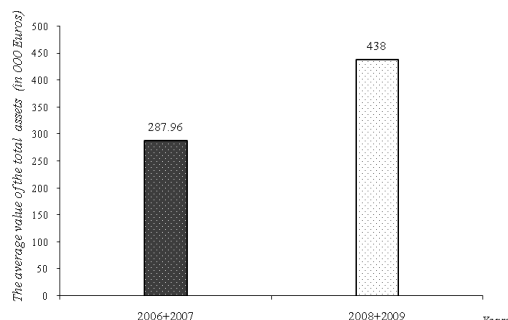
Figure 2: The average value of the total assets for the sample of the NDTC members during the 2006-2009 period



As it was mentioned before, during the relevant period, besides one, no other of the analysed NDTC members have registered loss above the equity. Bearing that in mind, the recorded growth of the average value of the total assets can be contributed to the growth of the average value of the operating assets of the cluster members.

The total assets values for the analyzed enterprises have been grouped into two data series in order to determine the relation between the average values of the total assets in the period before (2006/2007) and the period after (2008/2009) joining the cluster. Comparative analysis of the average values of the total assets in the period before and the period after joining the cluster shows that the total assets increased in the later (Figure 3). This difference in the total assets value can lead toward a conclusion that cluster membership contributed to the growth of the total assets of the NDTC members. Testing this conclusion required a test of statistical relevance of the recorded difference to be taken. Even though it's obvious that the total assets increased in the period after joining the cluster, Mann-Whitney test shows that this difference in average values is not statistically significant ( $p=0.078$ ).

Figure 3: The average values of the NDTC members' total assets before (2006+2007) and after joining the cluster (2008+2009)



The value of one of the criteria which determines the size of an enterprise – operating assets (or the total assets in this case) is constantly increasing during the analysed period. Based on this criterion only, the NDTC members grew in the period after they had joined the cluster.

The number of employees by enterprises, as well as the average number of employees in the sample is shown in the Table 3.

Table 3: The number of employees in the analysed enterprises and the average number of employees per annum of the 2006-2009 period

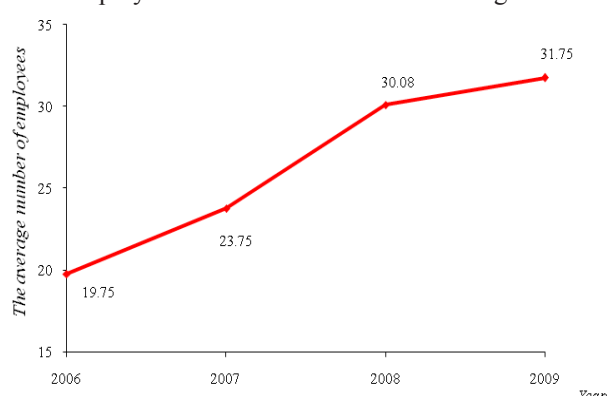
Enterprise	Year			
	2006	2007	2008	2009
1. Balextra	17	19	24	26
2. Cameleon	11	15	28	41
3. David	48	57	63	67
4. Kassker	50	45	45	44
5. Randeli	7	7	14	20
6. Statex	22	23	22	18

7. VK Group	28	40	69	83
8. Vogeli	18	18	29	32
9. Alter ego	11	27	35	19
10. Hajdi Baby	17	23	20	22
11. Pećarac	7	10	9	7
12. Pepeljuga	1	1	3	2
X $\pm$ SD	19.75 $\pm$ 15.47	3.75 $\pm$ 16.38	30.08 $\pm$ 20.20	31.75 $\pm$ 23.78

Results obtained on the basis of: The Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs

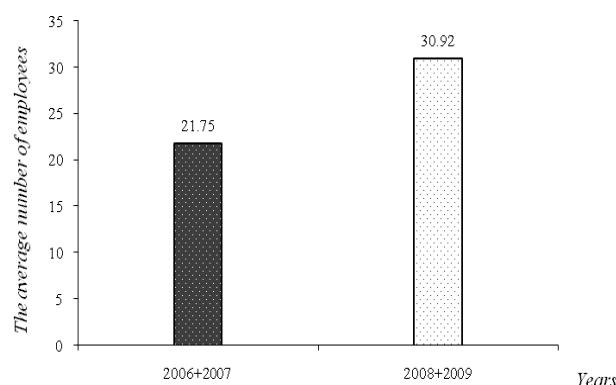
During the entire analysed period the average number of employees is rising. As it was the case with the average value of the total assets, after the more intense growth during the 2007 and 2008, the growth of the average number of employees is slower in the rest of the period (Figure 4).

Figure 4: The average number of the employees in the NDTC members during the 2006-2009 period



Once again the average value of the indicator is higher in the years after entering the cluster, relative to the years before joining the cluster (Figure 5). So, when it comes to the number of employees as a criterion of a size, it can be stated that the NDTC members grew after they had joined the cluster. However, Mann-Whitney test shows that the difference in these average values is not statistically significant indicating that the cluster membership was of no importance for the recorded employment growth ( $p=0.095$ ).

Figure 5: The average number of the employees in the NDTC members before (2006+2007) and after (2008+2009) joining the cluster



The third size indicator is the average yearly value of the operating income. The values of this indicator by enterprises and the average values for the sample are shown in the Table 4.

Table 4: The operating income by enterprises and the average operating income during the 2006-2009 period

Enterprise	Year			
	2006	2007	2008	2009
1. Balextra	104*	120	161	139

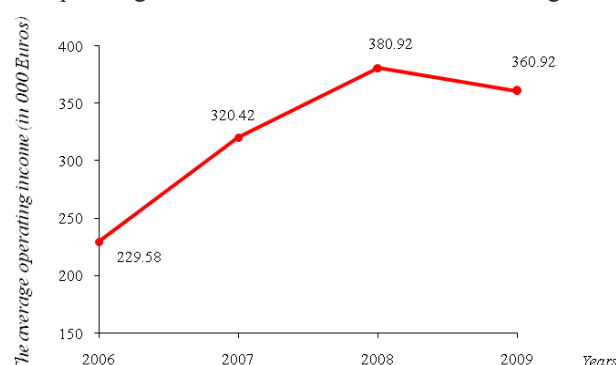
2. Cameleon	44	133	169	190
3. David	228	257	300	259
4. Kassker	211	346	378	400
5. Randeli	672	621	717	580
6. Statex	249	438	345	292
7. VK Group	649	1053	1464	1645
8. Vogeli	111	272	464	444
9. Alter ego	234	302	275	83
10. Hajdi Baby	196	232	206	173
11. Pećarac	43	56	74	116
12. Pepeljuga	14	15	18	10
X $\pm$ SD	229.58 $\pm$ 217.23	320.42 $\pm$ 285.17	380.92 $\pm$ 388.68	360.92 $\pm$ 436.37

Results obtained on the basis of: The Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs

*\*in 000 Euros*

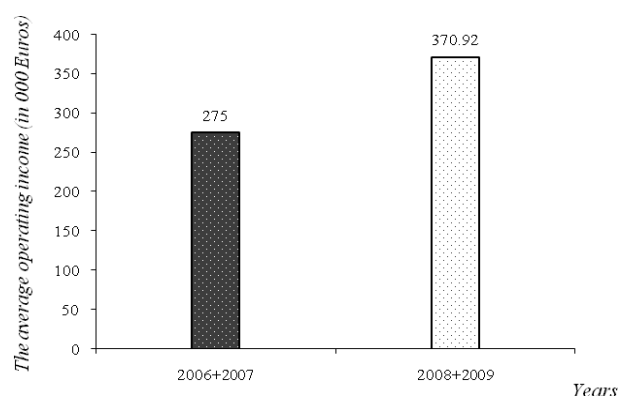
During the first two years of the period (2007, 2008) the average value of the operating income had increased (Figure 6). This growth was stopped during the 2009 when the 5% drop of the average operating income was registered.

Figure 6: The average value of the operating income of the NDTC members during the 2006-2009 period



Although there is an evident difference in the average value of the operating income in the years after the analysed enterprises have joined the cluster, relative to the period before entering the cluster (Figure 7), the Mann-Whitney test once again shows no statistically relevant difference in those average values ( $p=0.409$ ).

Figure 7: The average value of the operating income of the NDTC members before (2006+2007) and after (2008+2009) joining the cluster



Compared to the other available data, net profit is the most complete indicator of the company's business success. As the whole business activity of an enterprise can be seen through the prism of its net profit, the dynamic of this indicator has been chosen as a base for assessment of the NDTC



members' development in the analysed period. Table 5 shows the net profit by enterprises and the average net profit for the sample per annum of the analysed period.

Table 5: Net profit by enterprises and the average net profit during the 2006-2009 period

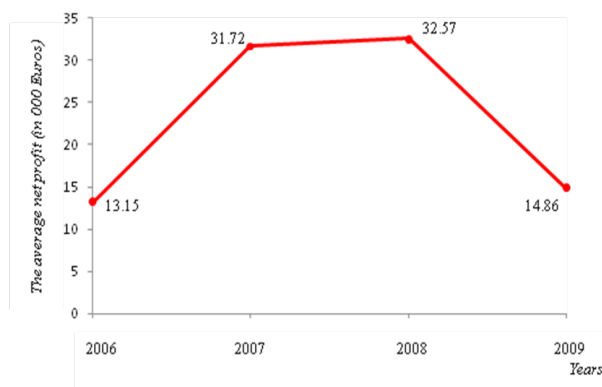
Enterprise	Year			
	2006	2007	2008	2009
1. Balextra	2.80*	4.65	4.41	2.71
2. Cameleon	0.25	36.31	25.41	2.40
3. David	2.38	2.65	4.87	4.59
4. Kassker	1.59	5.39	0.94	4.60
5. Randeli	30.74	22.96	28.28	21.33
6. Statex	2.21	3.38	5.35	1.64
7. VK Group	101.87	279.77	312.41	115.61
8. Vogeli	1.50	5.41	4.75	23.47
9. Alter ego	0.08	2.14	0.76	0
10. Hajdi Baby	4.78	6.41	3.38	1.16
11. Pećarac	8.14	11.05	0.06	0.19
12. Pepeljuga	1.40	0.47	0.22	0.56
X $\pm$ SD	13.15 $\pm$ 29.17	31.72 $\pm$ 78.80	32.57 $\pm$ 88.64	14.86 $\pm$ 32.73

Results obtained on the basis of: The Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs

\*in 000 Euros

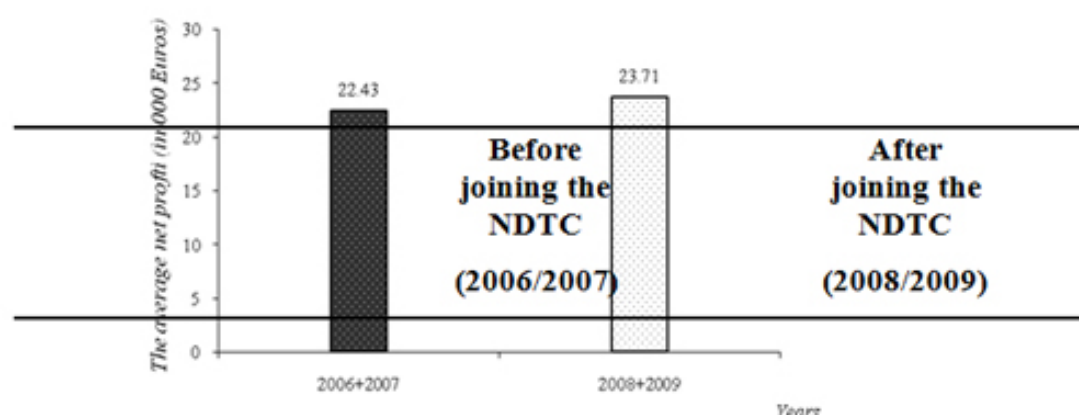
Similar to the operating income dynamic, after an initial growth during the 2007 and 2008, the average value of the net profit has been decreasing since 2008 (Figure 8).

Figure 8: The average net profit of the NDTC members during the 2006-2009 period



Values of the average net profit grouped into two time series show that the average net profit had increased in the period after the analysed enterprises had entered the cluster (Figure 9). As it was the case with the indicators of growth, the Mann-Whitney test shows no statistical relevance of the recorded difference in the net profit average values ( $p=0.477$ ).

Figure 9: The average net profit of the NDTC members before (2006+2007) and after (2008+2009) joining the cluster



## 6. THE RESULTS ANALYSIS

Assuming that the performances' improvement would be reflected into the growth and development indicators' dynamic, the contribution of the cluster networking to the set of the SMEs' performances has been evaluated on the basis of the growth and development of these enterprises in the period before and after joining the cluster. The presented dynamic of the total assets (the operating assets) and the number of employees shows that the sample enterprises have constantly grown in terms of these two indicators of size during the analysed period (2006-2009). When it comes to the operating income value, as the third criterion of the size, after an initial growth during the 2007 and 2008, this indicator has decreased in the last year of the analysed period.

It can be assumed that the income drop has been mostly caused by the effects of the economic crisis and especially by the reduced consumers' buying power which affected the cluster's members market. Even though a certain growth has been achieved, most of the sample enterprises have not still changed their size status, except one enterprise that has become medium sized, while all other remained in the group of small enterprises. Regarding the development of the NDTC members, it has been judged upon the dynamic of the members' net profit. Similar to the operating income, the average net profit has increased during the 2007 and 2008. During the 2009 the economic crisis affected the cluster members' operations and led to the drop in the realised net profit.

In order to examine the NDTC contribution to the recorded dynamic of the analysed indicators, the values of each of the analysed indicators have been grouped into two time series – referring to the period before and the period after joining the cluster. This analysis shows that the enterprises grew in terms of all three growth indicators in the period after they had joined the cluster, relative to the period before (Table 6). Also, as the value of the average net profit is higher in the period after entering the cluster, it can be stated that the NDTC members did develop their businesses after they had become cluster members. Still, Mann-Whitney test shows that these differences in average values are not of any statistical importance.

Table 6: Summary of the indicators' values before and after joining the NDTC

	Before joining the NDTC (2006/2007)	After joining the NDTC (2008/2009)
Total n	12	12
Total assets	287.96	438.0
Number of employees	21.75	30.92
Operating income	275.0	370.92
Net profit	22.43	23.71

Results obtained on the basis of: The Register of the Financial Statements and Data on Solvency of the Legal Entities and Entrepreneurs

Although the increase in all chosen indicators of the growth and the development (total assets, number of employees, operating income, and net profit) in the period after joining the cluster is evident, the statistical (Mann-Whitney) test shows that these increments are not of any statistical importance. The Mann-Whitney test results suggest that cluster membership did have no effect on the growth and the development of the NDTC members.

A possible explanation of the fact that no evidence of statistically important difference was found could be the short period between the establishment of the NDTC and the measurement of the chosen indicators' levels. It can be argued that none of the possible positive effects of the cluster membership can be realised in the given time frame. At the same time, the existence of the positive differences in the levels of the measured indicators, could call for further analysis of the cluster contribution to the growth and the development of its members. But, the organisation and the pool of the NDTC support activities are more probable reasons for failure of this cluster in trying to help its members to improve their market position and competitiveness. As it was mentioned earlier, the NDTC members need an overall business support – along the entire value chain. On the other hand, a closer examination of the NDTC support activities reveals that the cluster's support to its members was limited on the marketing support. Moreover, even the support related to marketing was restricted to helping in organising fair presentations, conducting sales promotion activities (printing catalogues and other publications) and other forms of communicating with the environment. The help in the market research activities, in defining the positioning strategies, and in the development of the recognizable brand, although proclaimed, these forms of support were left out the marketing support that cluster members had received.

Limited scope of the support that the NDTC did provide for its members was not enough to back their growth and development goals. Moreover, the possible effects of a vertical networking were not realised due to the fact that almost all the NDTC members are located at the same phase of the value generation chain – production of the finished goods. A cluster that does not connect successive members of the supply chain has a limited potential in ensuring an internal supply and selling market. Moreover, when all the cluster's members are producers of finished goods, the effects of complementary competencies can not be expressed. Spreading the scope of the NDTC support along the value chain (to the production, human resources, finance, research & development), but, also, spreading the cluster itself along the supply chain (to include suppliers, service providers, marketing channels) could lead to the realisation of the cluster networking positive effects.

## 7. CONCLUSION

The SMEs' participation in the total number of the enterprises, employment and gross value added generation shows the importance of these enterprises for a national economy. But, the possibilities for the SMEs' growth and development are limited, mostly because of their smaller size. Creation of the network-like structure of relationships with the partners of a same, or a bigger size becomes a way for these enterprises to overcome the barriers that limit the potential for improved performances and competitiveness. The theoretic considerations of the networking logic indicate that the networking strategies can be an important way for the SMEs to improve their competitiveness.

Clusters as a form of mutual networking of the textile SMEs in the Nišava District are supposed to be a way to improve the competitive position, but often also a way for these enterprises to survive the competitive pressure. The former big textile companies in the South Serbia region didn't survive the transition process. Non-existence of the big leaders which would pull the growth and the development of the related SMEs indicates the necessity for SMEs' mutual networking in order to improve their performances and competitiveness. However, although both the theory and the international practice affirm the networking strategies as a way of the SMEs' growth and development, the results of the study undertaken indicate that the domestic practice shows some problems in understanding and implementing these strategies.

Overcoming the operative barriers and improving the competitiveness of the SMEs were the main motives for forming the Nišava District Textile Cluster. Still, the expressed need of the cluster members for an overall business support was not fulfilled. Exclusively horizontal networking, one-dimensional cluster's support activities and the negligence of the academic potential of the region are possible reasons for the absence of the cluster's contribution to the performances, and therefore to the growth and development of its members. But, this absence of the cluster's contribution can also be explained on the base of the short period of cluster's existence and the fact that the period

that has been analyzed as a period of cluster membership is at the same time the period of the world economic crisis manifestation. Nevertheless, it seems like the structural shortcomings and narrow base of the cluster's support activities cannot be annulled by the characteristics of the analyzed period. Crisis or not, the question is whether there can be any positive contribution of the cluster that is organized like the analyzed cluster is, and the cluster which only form of support is limited to the local promotion. Moreover, solving the specific problems of the SMEs asks for a wider institutional base. This primarily refers to the need for a broader support that academic institutions located in the city of Niš can give to the cluster. Staff training, knowledge, information and modern management practice transfer are some of the areas in which help of the academic institutions can back the SMEs' business performances, their growth and development.

Clustering is becoming a significant form of the SMEs' mutual networking in the Nišava District (Ministry of Economy and Regional Development, 2010). The results of the conducted research of the NDTC contributions to the performances, i.e. growth and development of its members suggest that the realisation of the full clustering potential presuppose an adequate cluster's structure, and a well targeted range of the cluster's support. In the process of structuring the business networks in general, and of clusters as well, it should be kept in mind that the realisation of the effects of the members' value chain complementarities requires an adequate range of vertical connections and cooperation. Therefore, the cooperation should exist with downstream and upstream members of the supply chain, in addition to the horizontal SMEs' relations established in order to solve common problems. Recognizing the more prominent focus of the economic entities to the certain value chain activities, and, thus, the greater interdependence and complexity of the value generating process – it becomes clear that the completion of the value that will be delivered to the consumer requires cooperation along the entire supply chain. When it comes to the business networks that are organized like the analyzed cluster is, the spectrum of the cluster's support should be defined on the basis of the cluster members' identified needs and requirements. The narrow focus of the support activities will not contribute to the cluster members' performances when their competitiveness is endangered in multiple ways. It is therefore necessary to extend the cluster's support, or at least to focus it on the support needed to overcome those problems that are in the core of the weakened competitiveness. Anyway, the support must be based on the users', i.e. cluster members' real needs.

Using the research and development potential should be one of the pillars of the SMEs' clusters that are located in the university centres. The transfer of knowledge, support to the innovation activities and help in defining solutions to the specific problems are some of the possible academic community's contributions to the improvement of the cluster members' competitiveness. The University of Niš, with its thirteen faculties with more than 1,500 professors and associates, and with about 30,000 students (University of Niš, 2011), is an important scientific and research potential of the region. Cooperation with the faculties in organizing various training programs for employees and managers, then, in joint realization of the research and development projects aimed at specific SMEs' needs, as well as the recruitment of skilled labour force are some of the areas of the cluster members-academic community needed cooperation.

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**WORKING CONDITIONS AND EFFICIENCY  
IN MANUFACTURING ENTERPRISES OF THE SPLIT-DALMATIA COUNTY (REPUBLIC OF  
CROATIA)**

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**Abstract**

Organisational efficiency of an enterprise depends on the workers' attitude and the existing working conditions. Therefore good working conditions lead to good attitude to work and regularly result in numerous benefits: higher productivity, better capacity utilization, higher coefficient of inventory turnover, shorter inventories period, reduced scrap, shorter production cycle, shorter delivery time, shorter delays, minimized idle run in production process, improved work energy and health in workers, lower rate of absenteeism, lower costs due to injuries at work and occupational diseases, lower rate of sick leaves, reduced fluctuation costs, and better work satisfaction and motivation in general.

This paper presents a research into basic elements of working conditions (temperature, humidity, airing, lighting, noise, vibrations, radiation, cleanliness, colours, tidiness and organization of the workplace, and other important conditions mentioned by the surveyed workers) and organizational efficiency (product and service quantity and quality, utilization of available human and capital resources, ability to predict problems and ways of solving them, workers' familiarity with innovations, adaptability to changes, workers' adaptability in contingencies) in manufacturing enterprises of the Split-Dalmatia County (Republic of Croatia). Measuring of work conditions was carried out by a six-scale (0-5) Likert-type questionnaire, whereas perceived organizational efficiency was measured by a five-scale (0-4) Likert-type questionnaire. The research was carried out on the sample of seven manufacturing enterprises from different industries with the total of 144 respondents.

The analysis of results was carried out on two levels:

- Overall working conditions in all the surveyed manufacturing enterprises (determining descriptive data, arithmetic means and standard deviations, and correlating each element of working conditions to organizational efficiency).
- Working conditions in each of the seven manufacturing enterprises to determine specific working conditions statistically significant for a particular industry.

The research results determine the frequency of particular positive and negative working conditions in manufacturing enterprises of the Split-Dalmatia County as well as statistically significant correlations of particular working conditions to organizational efficiency at two analysis levels (overall for all enterprises and for each one in particular).

**Keywords:** working conditions, organizational efficiency, manufacturing enterprises, Split-Dalmatia County, Republic of Croatia.

## 1. INTRODUCTION

Correlation between working conditions and business results (organizational efficiency) and the impact of working conditions on organizational efficiency have been researched in terms of different contents of working conditions in companies. Namely, the concept of working conditions has a wide content. Thus, for example, the research of working conditions can focus on detrimental and beneficial factors influencing performance which can be divided into three groups:

- Objective physical-chemical working conditions that have a direct impact on human body such as temperature and its oscillations (cold, heat), air humidity, lighting, vibrations, air purity and pollution (fumes, dust, dirt), noise, radiation (ultraviolet, x-ray, radioactive, magnetic and other forms of radiation originating from equipment, e.g. in welding), lighting, available space, cleanliness of materials to be processed, suitable tools and appliances, cleanliness and tidiness of the work area, etc. (Rasanen et al., 1997; Bulat, 1976; Stevenson, 2009; Fischer et al. 1998; Gavhed and Toomingas, 2007; Kroemer and Grandjean, 2000; Drobac, 2006; Saurin and Ferreira, 2009; Slack et al., 2010)
- Psycho-physical working conditions by which the worker responds to performance requirements referring to the effect on human physiology (static work, dynamic work, physical work, intellectual work) and referring to repetitive activity of the same group of muscles, to holding and carrying objects, walking, cognitive-emotional engagement that can result in stress, etc. (Cf. Rasanen et al., 1997.; Bujas, 1964.; Platonov, 1966.; Laird and Laird, 1964.).
- Psychosocial working conditions that indirectly affect human organism and are influenced by the working group. These may be: conflicts between co-workers, conflicts between subordinates and superiors, perception of job insignificance, competition between co-workers, perception of work (dis)organisation, job (in)security, job content, social conditions of work, way of work planning, perception of workspace (in)convenience, e.g. colours, music, spatial layout, feeling of alienation and monotony, feeling of frustration and irritation, lack of trust between employees, and generally poor working and psychosocial climate and corporate culture resulting in reduced or wrong motivation (Laird&Laird, 1964, Cohen et al., 1992; Stevenson, 1993; Rasanen, 1997; McCormick and Ilgen, 1996.; Petz, 1987.; Greenberg and Baron, 1997; Frieling et al., 1997, Laitinen et al., 1998; Fredriksson et al, 2001; Skargren and Oberg, 1999; Ostry et al., 2001; Bošković, 2006, Jablonska et al., 2006).

Besides the above mentioned working conditions there are also those that can be classified over all the three categories, such as: stressful job (various forms of stressors), workspace tidiness, working time (long hours and tiredness of commuters), shift work and night work, (im)possibility of rest and total regeneration of employees, teamwork, safety at work, job security, equality of blue-collar and white-collar workers, occupational and health safety, ethical-legal protection (violation of employee's rights may result in stress, resistance and lower productivity), strain due to inconvenient appliances, tools and other equipment (Veljović et al., 2006; Cigula et al., 2002).

Good working conditions are indispensable in living and working improvement systems and beside their ethical dimension they lead to optimal effort in workers which causes increased labour productivity (Bulat, 1976). Consequently, it is obvious that working condition are a complex issue undoubtedly affecting labour efficiency. Therefore it is important to determine which are they and how to treat them in order to improve organizational efficiency.

The aim of this research was to determine the correlation between working conditions and organizational efficiency, and to determine which working conditions are vital for efficiency in a particular industry.

In accordance with this aim, the research problems were defined in the following way:

- What is the correlation between working conditions and organizational efficiency in manufacturing companies of the Split-Dalmatia County in Republic of Croatia?
- Which are the crucial (statistically significant) working conditions in manufacturing companies from different industries (manufacturing of car parts, metal processing, textiles, shipbuilding, fish processing, manufacturing of dairy products, alcoholic and non-alcoholic beverages)?

## 2. RESEARCHING CORRELATION BETWEEN WORKING CONDITIONS AND ORGANIZATIONAL EFFICIENCY IN MANUFACTURING ENTERPRISES OF THE SPLIT-DALMATIA COUNTY

### 2.1. Research method

The starting point of this research was that working conditions in manufacturing enterprises could be examined by a comprehensive questionnaire. For that purpose a questionnaire was created dealing with physical working conditions (see Appendix 1). It was also assumed that organizational efficiency could be validly measured as perceived organizational efficiency, and for that purpose an already tested and for manufacturing enterprises adapted questionnaire was used (Domović, 2000, Bogdanović, 2010, see Appendix 2). Socio-demographic characteristics of respondents were also collected, such as sex, age, qualifications, position within the organization hierarchy, and net monthly salary (see Appendix 3).

The starting hypothesis was that there was positive and significant correlation between good working conditions and organizational efficiency, while there is negative and significant correlation between poor working conditions and organizational efficiency. To determine this correlation it was necessary to carry out the correlation research. Working conditions were measured on the Likert-type scale (0-5), while organizational efficiency was measured on the Likert-type scale (0-4). Reliability of the internal consistency type of organizational efficiency was preliminarily determined on Croatian manufacturing enterprises, which was high, i.e.  $\alpha=0.97$  (Bogdanović, 2010), and on the smaller sample of manufacturing companies in the Split-Dalmatia County it was a bit lower but satisfactory  $\alpha=0.85$ . Using questionnaires as measuring instruments physical working conditions were determined in various enterprises of the Split-Dalmatia County as independent variable and organizational efficiency as dependent variable.

### 2.2. Procedure and respondents

The questionnaire was sent to target enterprises. Also, where it was possible the researchers personally communicated with them in order to get an insight into real working conditions in the particular industry. The research comprised 144 respondents from seven manufacturing companies in the Split-Dalmatia County of whom 68% were males and 32% females. Their age structure was: 15% were 19-30, 16% were 31-40, 42% were 41-50, 24% were 51-60, and 3% were above 60. The dominant age group was 41-50. In terms of qualifications their structure was as follows: 5% with elementary education, 72% with secondary education, 9% with two-year post-secondary school qualifications, and 14% with university qualifications. In terms of organisational positions 69% were blue-collar workers, 27% were white-collar workers and 4% were managers. In terms of salary their structure was: 24% under 3,000 kunas, 52% between 3,000 and 5,000 kunas, 19% between 5,000 and 7,000 kunas, 3% between 7,000 and 9,000 kunas, 1% between 9,000 and 11,000 kunas, and 1% between 11,000 and 13,000 kunas. The dominant salary range among respondents was 3,000-5,000 kn.

## 3. RESULTS AND SHORT DISCUSSION ON THE EMPIRICAL RESEARCH RESULTS

### 3.1. Sample characteristics

The research comprised manufacturing companies in the Split-Dalmatia County in the Republic of Croatia (N=7). The sample structure in terms of the number of respondents is shown in the Table 1.

Table 1. The structure of the sample with respect to the number of respondents

Name company	Frequency	Percent	Valid Percent	Cumulative Percent
AD Plastik	16	11,1	11,1	11,1
Adriacink	18	12,5	12,5	23,6
Galeb Omiš	18	12,5	12,5	36,1
Brodotrogir	41	28,5	28,5	64,6
Sardina Postira	20	13,9	13,9	78,5
Mljekara MILS	18	12,5	12,5	91,0
Dalmacijavino	13	9,0	9,0	100,0
Total	144	100,0	100,0	

Source: research data



In terms of size the manufacturing companies comprised in the survey are classified in compliance with the Croatian Accounting Law (NN, 109/07). Consequently, three companies are of medium size (50-250 employees), while four companies are large (more than 250 employees). The share of respondents follows the size of the company therefore companies with the largest number of respondents are also of the largest size and vice versa (e.g. 28.5% of respondents are employees of Brodotrogir, the largest company among seven, while 9% of respondents are employees of Dalmacijavino, the smallest company among them).

### 3.2. Working conditions and efficiency of surveyed companies

In response to the first research problem, i.e. the question concerning the general correlation of working conditions and efficiency of the surveyed companies, correlation analysis was carried out, whose results are presented in the Table 2.

Table 2. Means, standard deviations and correlations of individual working conditions and company performance of Split-Dalmatia County with their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	3,16	0,66	1,000	-
High / low temperature	2,81	1,25	-0,174	0,038*
Bad (polluted) air	2,50	1,48	-0,288	0,000**
Sultriness / high humidity	2,61	1,24	-0,198	0,018*
Good lighting	3,06	1,61	0,272	0,001**
Pleasant colours in the workspace	2,33	1,55	0,413	0,000**
Noise	3,38	1,28	-0,078	0,355
Vibration	2,82	1,54	-0,211	0,011*
Radiation	2,36	1,75	-0,218	0,010*
Workspace cleanliness	3,17	1,37	0,368	0,000**
Well arranged workspace	2,49	1,37	0,405	0,000**
Organization of work	2,69	1,18	0,501	0,000**
Untidiness	3,48	1,45	-0,259	0,002**

Source: research data

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

The Table 2. firstly shows the arithmetic means of measured efficiency and working conditions. Organizational efficiency of the surveyed manufacturing companies proves to be average<sup>1</sup>, i.e. at the level of  $M=3.16$ .

The arithmetic means of particular working conditions are  $M=2.33-3.48$  and indicate that in the Split-Dalmatia County the existing working conditions may be favourable and unfavourable. The standard deviations of all working conditions are  $s=1.18-1.75$  which indicates that variations may be quite large, or that the perception of working conditions varies from company to company. Consequently, in the course of further investigation working conditions were analysed in each of the companies as a representative of a particular industry.

The unfavourable (poor) working conditions are averagely present ( $M=2.50-3.49$ ) as: untidy working space  $M=3.48$ , noise  $M=3.38$ , vibrations  $M=2.82$ , sultriness  $M=2.61$ , uncomfortable temperature  $M=2.81$ , and bad air  $M=2.50$ . If these general results on poor working conditions could lead to any conclusions, then such frequently mentioned poor working conditions should be purposely eliminated. The only unfavourable working condition that was not mentioned to a disturbing extent (according to criterion  $M < 2.50$ ) was radiation with  $M=2.36$ .

An insight into favourable working conditions showed especially low grading ( $< 2.50$ ) in: workspace colours  $M=2.33$ , workspace tidiness  $M=2.49$ . Untidy workspace clearly indicates that organizational environment is inappropriate in terms of tidiness, and with inappropriate colours (which is not so much a question of cost as the concern of management) this may be seen as a connotation of negligence<sup>2</sup>, which is surely one of the crucial reasons for average efficiency in the surveyed companies ( $M=3.16$ ).

1 Average is here derived from the school grades scale (1-5), which is the grade *good* ranging from 2.50 to 3.49.

2 This perception of working conditions could be confirmed by the personal experience of researchers when visiting some of these companies.

Working conditions averagely graded are: work organization  $M=2.69$ , cleanliness  $M=3.17$ , good lighting  $M=3.17$ .

Naturally, these average results obtained for favourable working conditions also depart from the optimum ( $M=5.00$ ), therefore they should also be targeted for improvement.

Furthermore, the unfavourable working conditions presented in the Table 2 (excessive temperature, bad air, sultriness, noise, vibrations, radiation, and workspace untidiness) are negatively correlated with efficiency in all the surveyed companies and are all statistically significant, except noise ( $r=-0.078$ ,  $p<0.05$ ). Thus the correlation of noise with efficiency proved to be almost zero, which could be explained by the lack of disturbing noise in most of the surveyed manufacturing companies. The highest negative correlation with efficiency was shown by bad air ( $r=-0.288$ ;  $p<0.01$ ), workspace untidiness ( $r=-0.259$ ,  $p<0.01$ ), radiation ( $r=-0.218$ ;  $p<0.05$ ) and vibrations ( $r=-0.211$ ;  $p<0.05$ ).

All the favourable working conditions (good lighting, pleasant colours, workspace cleanliness, tidiness, and good work organization) were positively and significantly correlated with efficiency, and were all statistically significant. The highest positive correlation ( $r>0.350$ ) with efficiency was found in: good work organization ( $r=0.501$ ,  $p<0.01$ ), pleasant colours in the workspace ( $r=0.413$ ,  $p<0.05$ ), workspace tidiness ( $r=0.405$ ,  $p<0.01$ ), cleanliness ( $r=0.368$ ,  $p<0.01$ ). Good lighting also proved to be an important factor of good productivity, although in terms of correlation it ranked only fifth ( $r=0.272$ ,  $p<0.01$ ).

These general findings on favourable and unfavourable working conditions and their correlation with efficiency may lead to some conclusions. In manufacturing companies of the Split-Dalmatia County the working conditions proving to be highly correlated with good efficiency are ranked as follows:

- **Good work organization.** This proves to be the crucial work condition as it has highest positive and statistically most significant correlation with organizational efficiency ( $r=0.501$ ,  $p<0.01$ ). The respondents graded this working condition with a suboptimal average grade ( $M=2.69$ ), which means that this condition absolutely has to be improved.
- **Pleasant colours in the workspace.** Workspace in some manufacturing companies seems to be quite poorly maintained, bleak and cheerless (which is the personal perception of researchers when visiting these companies). The respondents recognized this by grading it  $M=2.33$ . Pleasant colours are also positively and statistically significantly correlated with efficiency ( $r=0.413$ ,  $p<0.01$ ). This working condition could be improved at a relatively low cost of regular maintenance using some pleasant colours instead of the standard ones.
- **Well arranged workspace** (good ergonomic arrangement of the workspace, easily accessible materials and equipment, work free of unnecessary effort, non-physiological positions and tiredness due to repetitive activities of the same muscle groups) proves to be the third statistically significant work condition in terms of correlation with efficiency ( $r=0.405$ ,  $p<0.01$ ). Unfortunately, according to the arithmetic mean ( $M=2.49$ ) it is not at a satisfactory level in the surveyed companies and should be improved.
- **Workspace cleanliness** proves to be statistically significant and positive correlate of organizational efficiency ( $r=0.368$ ,  $p<0.01$ ). It can be generally stated that cleanliness increases effectiveness and commitment. It can also indirectly affect efficiency and in the surveyed companies it was graded  $M=3.17$ . Cleanliness in food processing industry is a crucial working condition, so this result would there be considered poor rather than average. Therefore this working condition is to be treated with regard to the industry.
- **Good lighting** proves to be statistically significant and positively correlated with efficiency ( $r=0.272$ ,  $p<0.01$ ), and in the workspace where appropriate lighting is to be provided to ensure productivity it is also a crucial working condition. In the surveyed companies it was averagely graded ( $M=3.06$ ).
- **Bad (polluted) air** (due to fumes, smoke in welding, dust, paint and varnish evaporation, bad smells, poor ventilation, etc.) has the highest statistically significant negative correlation with efficiency in manufacturing companies ( $r=-0.288$ ,  $p<0.01$ ). In the surveyed companies it is recorded at an average level ( $M=2.50$ ).
- **Untidiness** also has statistically significant negative correlation with company efficiency ( $r=-0.259$ ;  $p<0.05$ ). Untidy workspace with heaps of waste or materials lying about in a disorganized manner or poorly maintained premises (e.g. broken windows, dampness, peeling walls, defective machinery, etc.) may negatively affect company efficiency. The respondents

have also identified this factor at a high level ( $M=3.48$ ), which certainly calls for action.

- **Radiation**, although not occurring in all companies, has a high weight in some of them (e.g. in welding or caused by some appliances) so this factor also has statistically significant negative correlation with efficiency ( $r=-0.210$ ,  $p=0.01$ ). For all the surveyed companies it is relatively low  $M=2.36$ , but with highest standard deviation  $s=1.75$  (varying in different companies). As already noted, this condition has to be considered partially, i.e. for those companies where some kinds of radiation do occur.
- **Vibrations** caused by machinery are also negatively correlated with efficiency ( $r=-0.211$ ,  $r<0.05$ ), although ranked only ninth, because employees in the surveyed companies were not exposed to them unlike for instance forestry workers, ploughmen, or compressor workers. Vibrations are recorded at a medium level ( $M=2.82$ ) with a rather high standard deviation  $s=1.54$ .
- **Sultriness/high humidity** due to inadequate or entirely missing air conditioning (summers in the Split-Dalmatia County are hot, which with high humidity can create discomfort) was reported as a negative factor in some companies, so this condition proves to be statistically significant and negatively correlated with organizational efficiency ( $r=-0.198$ ,  $p<0.05$ ). Overall sultriness was recorded at a medium level ( $M=2.61$ , with  $s=1.24$ ), therefore it may be concluded that where premises are air-conditioned this will not be a problem.
- **Temperature**, i.e. excessive heat/cold has statistically significant negative correlation with company efficiency ( $r=-0.174$ ,  $p<0.05$ ), although not so pronouncedly as could be expected, because in some companies premises are adequately heated and air-conditioned ( $M=2.81$ ,  $s=1.25$ ).
- **Noise** is statistically significantly correlated with efficiency in overall results ( $r=-0.078$ ,  $p>0.05$ ) which is to some extent surprising, because the findings recorded in literature are contrary to that. The probable reason for that may be the awareness of management and attention paid to this problem, even though this factor is recorded at a medium level ( $M=3.38$ ).

As has already been noted, the same working conditions are not equally important for efficiency in all the surveyed manufacturing companies because this primarily depends on the type of industry. Therefore it was necessary to examine working conditions and efficiency in each of the companies belonging to a particular industry in order to determine which working conditions are important, which are marginal, and which are statistically insignificant. With the obtained results it is possible to give recommendations to each of the companies (as the representative of a particular industry) about the working conditions that should be upgraded to increase productivity.

### 3.3. Working conditions in particular enterprises and their effectiveness

This section presents the findings on working conditions and efficiency for each manufacturing company with regard to the respective industry. In other words it responds to the second research problem: Which are the crucial (statistically significant) working conditions in manufacturing companies from different industries (manufacturing of car parts, metal processing, textiles, shipbuilding, fish processing, dairy, alcoholic and non-alcoholic beverages)?

The Table 3. shows the findings for AD PLASTIK PLC, Solin.

Table 3. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise AD PLASTIK PLC., Solin (production of parts for cars from artificial materials) with their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	3,37	0,60	1,000	-
High / low temperature	2,25	1,39	-0,187	0,487
Bad (polluted) air	2,00	1,63	-0,460	0,073
Sultriness / high humidity	2,26	1,39	-0,157	0,560
Good lighting	3,25	1,62	0,269	0,313
Pleasant colours in the workspace	2,75	1,18	-0,085	0,754
Noise	2,44	1,37	-0,556	0,025*
Vibration	2,69	1,45	-0,426	0,100
Radiation	2,93	1,39	-0,208	0,457

Workspace cleanliness	4,00	1,10	-0,406	0,119
Well arranged workspace	3,07	1,10	-0,247	0,374
Organization of work	2,81	1,05	0,595	0,015*
Untidiness	2,94	1,57	0,017	0,950

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

It is obvious that manufacturing of plastic car parts in AD PLASTIK PLC, Solin records significant correlation of two working conditions with efficiency:

- Noise ( $r = -0.556$ ,  $p < 0.05$ ) and
- Work organization ( $r = 0.595$ ,  $p < 0.05$ )

Consequently, for this company it is recommended to take action that will reduce noise and enhance work organization. The employees stated the following problems related to the noise and organization of the working process:

- inadequately connected work areas,
- pressure due to tight deadlines,
- inadequate regulation of heating and air conditioning appliances.

They also complained about:

- neon lighting,
- excessive heat during summer
- poor interpersonal relations,
- inequality in rewarding and implementation of regulations.

The Table 4. presents the findings for ADRIACINK PLC, Split.

Table 4. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise ADRIACINK PLC, Split (metal production) and their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	3,43	0,37	1,000	-
High / low temperature	3,00	1,28	-0,306	0,217
Bad (polluted) air	2,89	1,23	-0,496	0,036*
Sultriness / high humidity	3,06	1,16	-0,346	0,160
Good lighting	3,61	1,29	0,504	0,033*
Pleasant colours in the workspace	3,61	1,04	0,589	0,010*
Noise	4,00	0,84	-0,327	0,185
Vibration	2,89	1,37	-0,31	0,605
Radiation	2,61	1,94	-0,059	0,815
Workspace cleanliness	3,83	0,99	0,505	0,033
Well arranged workspace	3,72	1,07	0,333	0,177
Organization of work	3,18	0,88	0,637	0,006**
Untidiness	2,67	1,19	-0,105	0,679

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

It is obvious that in the metal processing industry work conditions statistically significantly correlated with company efficiency are:

- Bad air ( $r = -0.496$ ,  $p < 0.05$ ),
- Good lighting ( $r = 0.504$ ,  $p < 0.05$ ),
- Pleasant colours ( $r = 0.589$ ,  $p < 0.05$ ),

- Work organization ( $r=0.637$ ,  $p<0.01$ ).

The employees stated the following problems related to:

- bad air (poor ventilation in the plants, poor ventilation in general, especially when dealing with acids, sultriness)
- work organization (inadequate organization of the work process from preparation to assembling, lack of space, occasional shortage of equipment)

The employees also complained about:

- extreme heat in summer
- lack of motivation due to low salaries

The Table 5. presents the findings for GALEB PLC, Omis, which manufactures textile products.

Table 5. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise GALEB PLC., Omis (textile manufacturing) with their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	3,27	0,54	1,000	-
High / low temperature	3,39	1,42	-0,453	0,059 (border)
Bad (polluted) air	3,28	1,49	-0,420	0,083
Sultriness / high humidity	3,28	1,67	-0,463	0,053 (border)
Good lighting	3,06	1,73	0,259	0,300
Pleasant colours in the workspace	1,59	1,73	0,428	0,087
Noise	4,00	1,46	-0,422	0,081
Vibration	3,67	1,68	-0,203	0,420
Radiation	3,18	1,94	-0,155	0,554
Workspace cleanliness	2,83	1,62	0,586	0,011*
Well arranged workspace	1,94	1,55	0,256	0,305
Organization of work	2,67	1,37	0,338	0,170
Untidiness	4,22	1,26	-0,180	0,475

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

Here it is obvious that working conditions that are significantly correlated with company efficiency in the textile industry are:

- Workspace cleanliness ( $r=-0.586$ ,  $p<0.05$ ), and
- Two marginal (weakly significant)<sup>3</sup> work conditions:
- Sultriness/high air humidity ( $r=-0.463$ ,  $p=0.053$ )
- Excessively high/low temperature ( $r=-0.453$ ,  $p=0.059$ ).

The workers complained about:

- cramped workspace in the plant, too many people in a small area,
- dampness, draught, excessive noise, dust, run-down premises,
- lack of air-conditioning, need for at least better ventilation,
- lack of resolution and agreement in management negatively affecting the work process and workers who are expected to do the work disregarding conditions,
- inadequate involvement and rewarding of employees, obsolete and run-down work chairs.

3 As the level of significance depends on the chosen criterion that in social research is most frequently defined on the risk level of  $p<0.05$ , smaller deviations from the settled level are here termed as marginal or weakly significant differences, as the settled statistically significant difference could have been e.g. the risk of  $p<0.055$  or  $0.75$ . Although some norms have to be complied with, the term marginal/weakly significant difference denotes the difference which de facto exists with a somewhat higher risk of making wrong general conclusions based on the sample.



The Table 6. presents survey results for BRODOTROGIR PLC, Trogir.

Table 6. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise BRODOTROGIR PLC., Trogir (production of ships) and their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	2,82	0,67	1,000	-
High / low temperature	2,93	1,08	-0,276	0,085
Bad (polluted) air	2,85	1,32	-0,405	0,009**
Sultriness / high humidity	2,68	0,99	-0,228	0,157
Good lighting	1,98	1,42	-0,320	0,843
Pleasant colours in the workspace	1,41	1,29	0,434	0,006**
Noise	3,29	1,15	-0,380	0,016*
Vibration	3,10	1,46	-0,398	0,011*
Radiation	2,63	1,46	-0,323	0,042*
Workspace cleanliness	2,10	1,26	0,328	0,039*
Well arranged workspace	1,80	1,23	0,486	0,002**
Organization of work	2,20	1,27	0,363	0,021*
Untidiness	3,66	1,56	-0,194	0,231

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

Working conditions significantly correlated with work efficiency in BRODOTROGIR, which is involved in shipbuilding, are:

- Bad air ( $r = -0.405$ ,  $p < 0.01$ ),
- Pleasant colours ( $r = 0.434$ ,  $p < 0.01$ ),
- Noise ( $r = -0.380$ ,  $p < 0.05$ ),
- Vibrations ( $r = -0.398$ ,  $p < 0.05$ ),
- Radiation ( $r = -0.323$ ,  $p < 0.05$ ),
- Cleanliness ( $r = 0.328$ ,  $p < 0.05$ ),
- Tidiness ( $r = 0.486$ ,  $p < 0.01$ ),
- Work organization ( $r = 0.363$ ,  $p < 0.05$ ).

The employees of BRODOTROGIR complained about:

- lighting,
- disposition of materials, tools, and cranes,
- ventilation,
- weather conditions (outdoor work)
- poor work organization
- noise, dust,
- radiation (in the welding process)
- welding and grinding without ventilation,
- run-down machinery
- polluted air
- heat and cold
- idleness, lack of discipline, disagreements among workers
- excessive bureaucracy,

- low wages,
- poor education of staff,
- poor quality tools
- inadequate safety
- working hours (six hours during summer)
- lack of coordination between working units
- problems with purchasing of materials and tools
- lack of working discipline.

The Table 7. shows the survey results for SARDINA POSTIRA Ltd, Postira.

Table 7. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise SARDINA POSTIRA Ltd, Postira (production of fish products) and their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	3,87	0,34	1,000	-
High / low temperature	2,75	0,85	-0,510	0,829
Bad (polluted) air	1,35	1,23	-0,010	0,966
Sultriness / high humidity	2,05	1,28	-0,014	0,952
Good lighting	4,42	0,90	0,095	0,698
Pleasant colours in the workspace	3,17	1,25	0,374	0,127
Noise	3,60	1,10	0,259	0,269
Vibration	2,15	1,60	0,002	0,994
Radiation	1,00	1,41	-0,439	0,060
Workspace cleanliness	3,84	0,83	0,356	0,135
Well arranged workspace	3,35	0,81	0,320	0,169
Organization of work	3,55	0,51	-0,017	0,943
Untidiness	2,80	1,24	-0,113	0,635

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

As shown in the Table 7, in this company there are no working conditions that are statistically significantly correlated with efficiency. In spite of such findings, it is to be noted that the workers complained about:

- poor air-conditioning in the plant,
- heat and cold,
- noise,
- dampness and sultriness,
- hard physical work,
- obsolete production equipment.

The Table 8. presents the survey results for DALMACIJAVINO Ltd, Split.

Table 8. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise DALMACIJAVINO Ltd, Split (production of alcoholic and nonalcoholic beverages) and their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	2,50	0,41	1,000	-
High / low temperature	2,38	1,66	-0,045	0,883
Bad (polluted) air	1,77	1,09	0,391	0,186
Sultriness / high humidity	2,31	1,18	0,000	1,000
Good lighting	3,85	0,99	-0,204	0,505

Pleasant colours in the workspace	2,35	1,85	0,353	0,237
Noise	2,46	1,39	0,253	0,405
Vibration	2,38	1,45	0,243	0,423
Radiation	2,15	1,82	0,539	0,057 (border)
Workspace cleanliness	3,54	0,88	-0,120	0,709
Well arranged workspace	2,08	1,12	0,180	0,556
Organization of work	2,38	1,19	0,548	0,053 (border)
Untidiness	3,92	1,32	0,000	1,000

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

It is obvious that in this company, which manufactures alcoholic and non-alcoholic beverages, there are two working conditions of marginal statistical significance with efficiency:

- Radiation ( $r=0.539$ ,  $p=0.057$ )
- Work organization ( $r=0.548$ ,  $p=0.053$ )

The employees in this company complained about:

- lighting,
- vibrations,
- heat/cold,
- lack of responsibility in senior management,
- disorganisation, poor communication, obsolete technology, inadequate staff structure,
- ventilation and air-conditioning.

The Table 9. shows the survey findings for MLJEKARA MILS Ltd. Split.

Table 9. Means, standard deviations and correlations of individual working conditions and efficiency of enterprise MLJEKARA MILS Ltd., Split (production of milk and dairy products) and their statistical significance

Work conditions	Mean (M)	Standard deviations (s)	Effectiveness (Pearsonov r)	Statistical significance (p)
Effectiveness	3,05	0,47	1,000	-
High / low temperature	2,61	1,20	-0,345	0,160
Bad (polluted) air	2,78	1,52	0,130	0,607
Sultriness / high humidity	2,50	0,79	-0,230	0,359
Good lighting	2,82	1,59	-0,034	0,897
Pleasant colours in the workspace	2,47	1,179	-0,031	0,906
Noise	3,56	1,04	0,002	0,995
Vibration	2,44	1,50	0,030	0,905
Radiation	1,83	1,76	-0,222	0,376
Workspace cleanliness	3,56	1,15	0,193	0,443
Well arranged workspace	2,18	1,19	-0,327	0,201
Organization of work	2,50	1,10	0,322	0,193
Untidiness	4,06	1,11	-0,274	0,270

Source: research date

Note: \* correlations significant at  $p < 0.05$

\*\* correlations significant at  $p < 0.01$

As can be seen from the Table 9., in this company, which manufactures dairy products, there are no working conditions that are significantly correlated with efficiency.

However, the employees complained about:

- obsolete equipment,
- noise, vibrations, bad smells,
- dampness,
- low ceilings, poor ventilation, cramped workspace,
- slippery floors.
- poor interpersonal relations,
- work organization.

As already noted, the surveyed enterprises belong to different types of manufacturing industries and therefore it is possible to provide some recommendations for each industry in terms of particular working conditions.

The results obtained in this study and its heuristic value reveal a wide possibility of research concerning work rationalization<sup>4</sup>, involving technical, economic and psychosocial rationalization. It is obvious that the reason for suboptimal competitiveness of Croatian companies can be attributed to suboptimal working conditions and suboptimal work rationalization. Therefore any research into working conditions will be seen as an important contribution to improvement of productivity and efficiency in manufacturing companies.

#### 4. CONCLUSION

Working conditions are an important factor of efficiency in each job. Therefore they are considered to be a factor of productivity, which is one of the factors of company competitiveness. The correlation between different working conditions and business performance, or organizational efficiency, has been investigated and proved in a large number of research studies. In those studies both harmful and desirable elements were highlighted, which can be divided into three, or rather four basic groups: a) objective physical-chemical working conditions, b) psycho-physiological working conditions, c) psychosocial working conditions, d) mixed working conditions.

This research focused on the first group of working conditions that may be called physical-chemical working conditions. The aims of the research were to determine the correlation of working conditions with organizational efficiency, classify the conditions crucial for organizational efficiency, and give recommendations for their improvement on the sample of manufacturing companies of the Split-Dalmatia company in Croatia. The aims of the study were achieved by determining statistically significant correlations of working conditions with organizational efficiency on two levels: a) overall (including all the surveyed companies, and b) for each particular company as a representative of an industry. In accordance with these aims the research problems were set, for which the responses are here summarized.

- The response to the first problem, i.e. the issue of general correlation of working conditions and efficiency of all the surveyed manufacturing companies, was obtained by correlation analysis. For all the surveyed manufacturing companies the following working conditions were ranked as crucial for efficiency:
- **Good work organization** proves to be the key working condition due to its highest statistically significant positive correlation with organizational efficiency ( $r=0.501$ ,  $p<0.01$ ).
- **Pleasant colours in the workspace** are statistically significantly and positively correlated with efficiency ( $r=0.413$ ,  $p<0.01$ ).
- **Well arranged workspace** (good ergonomic arrangement of the workspace, easily accessible materials and equipment, work free of unnecessary effort, non- physiological positions and tiredness due to repetitive activities of the same muscle groups) proves to be the third statistically significant work condition in terms of correlation with efficiency ( $r=0.405$ ,  $p<0.01$ ).
- **Workspace cleanliness** proves to be statistically significant and positive correlate of

<sup>4</sup> Total work rationalization in companies involves : a) Technical rationalization (of the production process), b) Economic rationalization (of other stages of reproduction, such as purchasing, finance, sales), c) Social, or more precisely psychosocial rationalization (of human resources). All the three kinds of rationalization can be considered important elements of total work rationalization in an enterprise (cf. Žugaj, 1996).

organizational efficiency ( $r=0.368$ ,  $p<0.01$ ).

- **Good lighting** proves to be statistically significant and positively correlated with efficiency ( $r=0.272$ ,  $p<0.01$ ).
- **Bad (polluted) air** (due to fumes, smoke in welding, dust, paint and varnish evaporation, bad smells, poor ventilation, etc.) as an unfavourable working condition has the highest statistically significant negative correlation with efficiency in manufacturing companies ( $r=-0.288$ ,  $p<0.01$ ).
- **Untidiness** also has statistically significant negative correlation with company efficiency ( $r=-0.259$ ;  $p<0.05$ ) Untidy workspace with heaps of waste or materials lying about in a disorganized manner or poorly maintained premises (e.g. broken windows, dampness, peeling walls, defective machinery, etc.), as well as outdoor work that should be performed indoors due to weather conditions may negatively affect company efficiency.
- **Radiation**, although not occurring in all companies, has a high weight in some of them (e.g. in welding or caused by some appliances) so this factor also has statistically significant negative correlation with efficiency ( $r=-0.210$ ,  $p=0.01$ ).
- **Vibrations** caused by machinery are also negatively correlated with efficiency ( $r=0.211$ ,  $p<0.05$ ), although ranked only ninth, because employees in the surveyed companies were not exposed to them.
- **Sultriness/high humidity** due to inadequate or entirely missing air conditioning (summers in the Split-Dalmatia County are hot, which with high humidity can create discomfort) was reported as a negative factor in some companies, so this condition proves to be statistically significant and negatively correlated with organizational efficiency ( $r=-0.198$ ,  $p<0.05$ ).
- **Temperature**, i.e. excessive heat/cold has statistically significant negative correlation with company efficiency ( $r=-0.174$ ,  $p<0.05$ ), although not so pronouncedly as could be expected, because in some companies premises are adequately heated and air-conditioned.
- **Noise** is not statistically significantly correlated with efficiency in overall results ( $r=0.078$ ,  $p>0.05$ ).
- As all working conditions are not equally important in all types of manufacturing companies (due to different manufacturing industries) the research into correlation of working conditions with efficiency was extended in terms of particular companies, which responded to the second problem set in this study.

So the findings for AD PLASTIK PLC, Solin (**manufacturing of car parts**) show that working conditions statistically significantly correlated with efficiency are: noise (negative correlation), and work organization (positive correlation). Besides these, the workers also emphasized: lighting, heat, poor interpersonal relations, and perception of inequality in rewarding and implementation of regulations for all employees.

In the **metal processing industry** the findings for ADRIACINK PLC, Split show that the working conditions statistically significantly correlated with efficiency are bad air (negative correlation), good lighting, pleasant colours, and work organization (positive correlation). The employees complained about bad air and work organization (inadequate organization of the working process from preparation to assembling, shortage of space).

In the company GALEB PLC, Omiš, (**manufacturing of textile products**) working conditions significantly correlated with efficiency are workspace cleanliness (negative correlation), while sultriness/humidity and excessive temperature are marginal. The two marginal working conditions have negative correlation. The workers also emphasized inadequate working conditions such as cramped workspace, dampness, noise, lack of air-conditioning, inadequate involvement of workers, obsolete and run-down work chairs, lack of resolution and agreement in management.

The working conditions significantly correlated with work efficiency in BRODOTROGIR PLC, Trogir, (**shipbuilding**) are: bad air, noise, vibrations, radiation, work organization (negative correlation), and pleasant colours, cleanliness, tidiness (positive correlation). In this company employees complained about lighting, ventilation, exposure to weather conditions, noise, dust, excessive cold/heat, bureaucracy, poor quality tools, inadequate safety, etc.



In SARDINA POSTIRA Ltd, Postira (**fish processing**) and MLJEKARA MILS Ltd, Split (**manufacturing of dairy products**) there are no working conditions that are statistically significantly correlated with organizational efficiency. However, their employees complain about poor air conditioning, excessive temperature, noise, dampness and sultriness, hard physical labour, ventilation, interpersonal relations, work organization.

Finally, in DALMACIJAVINO Ltd, Split (**manufacturing of alcoholic and non-alcoholic beverages**) only two working conditions are marginally correlated with efficiency: radiation and work organization (positive correlation). Employees in this company complained about lighting, vibrations, heat/cold, lack of responsibility in management, poor communication, disorganization, ventilation, and air-conditioning.

According to the obtained results it is obvious that the work in manufacturing companies of the Split-Dalmatia County can be significantly improved in terms of technical rationalization by upgrading working conditions, and that it can be better organized. This should enhance productivity and organizational efficiency, which should lead to better competitiveness of Croatian manufacturing companies.

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## OTHER SOURCES

30. Interviews with employees of manufacturing companies surveyed.

### Appendix I.

Please state: **NEVER=0; SELDOM=1; SOMETIMES=2; OFTEN=3; VERY OFTEN=4; ALWAYS=5** your agreement with the following statements:

No	Statement	0	1	2	3	4	5
1.	In the company it is too hot/cold.						
2.	In the company the air is quite bad.						
3.	In the company it is sultry.						
4.	The lighting in the company is very good.						
5.	The colours make the premises a pleasant place to work in.						
6.	It is noisy in the company.						
7.	Appliances and engines create vibrations.						
8.	Electrical appliances and computer equipment emit radiation.						
9.	Workspace is quite clean.						
10.	Workspace is well arranged.						
11.	Work organization is adequate.						
12.	Workspace should be tidied up.						

In your opinion, which working conditions are bad for company efficiency?

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Appendix 2.

*In the following questions please mark your opinion on your company efficiency.*

1. How would you estimate the output of products and services in your company?  
a) very low; b) low; c) medium; d) high; e) very high
2. How would you evaluate the quality of products and services offered by your company?  
a) very poor; b) poor; c) medium; d) very good; e) excellent
3. To what extent do the employees in your company use the available resources (people, capital, equipment), i.e. how efficiently do they do their work?  
a) very inefficiently; b) inefficiently; c) with average efficiency; d) very efficiently; e) extremely efficiently
4. How well are possible problems predicted in your company in order to reduce or prevent their negative consequences?  
a) very poorly; b) poorly; c) averagely; d) very well; e) excellently
5. How well are employees in your company informed about innovations that could affect the manner of working?  
a) not at all; b) to some extent; c) averagely; d) very well; e) excellently
6. When there is change in your company how fast do employees accept them and adapt to them?  
a) very slowly; b) slowly; c) neither slowly nor quickly; d) quickly; e) at once
7. How many employees in your company, in your opinion, readily accept change and adapt to it?  
a) hardly anybody; b) less than a half; c) about half of them; d) significantly more than a half; e) almost everybody
8. How would you evaluate the performance of employees in your company when faced with sudden crises and disruptions?  
a) very poor; b) poor; c) average; d) very good; e) excellent

Appendix 3.

Please state your basic socio-demographic characteristics

Sex	Male Female
Age	<19 19-30 31-40 41-50 51-60 >60
Qualifications	Incomplete elementary school Elementary education Secondary education Post-secondary professional education University degree Higher university degrees (MrSc, PhD) Other:
Hierarchy	Blue-collar worker White-collar worker Manager
Net monthly salary	a) up to 3,000 kn b) 3,000-5,000 kn c) 5,000-7,000 kn d) 7,000-9,000 kn f) 9,000-11,000 kn g) 11,000-13,000 kn h) > 13,000 kn

## QUALITY OF MANAGEMENT AS A FACTOR OF FIRM MARKET EXIT IN DIFFERING MACROECONOMIC ENVIRONMENTS<sup>1</sup>

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### Abstract

In this paper we study the quality of management as a factor of firm market exit in differing macroeconomic environments. We also analyse whether the impact of the quality of management on firm market exit depends on the characteristics of the macroeconomic environment. For this purpose, we use a logistic regression for rare events to estimate non-nested microeconomic models of firm market exit for two periods, i.e. 1995–2000 and 2000–2005 in which Slovenian macroeconomic conditions differed significantly. The results confirm that firms with low quality of management resulting in their inferior technical and cost efficiency are more likely to exit the market. We also find that technical efficiency has a more significant influence on firm market exit compared to cost efficiency in a favourable macroeconomic environment, while cost efficiency has a more significant influence on firm market exit than technical efficiency in unfavourable macroeconomic conditions.

**Keywords:** Market exit, Quality of management, Non-nested microeconomic models

### 1. INTRODUCTION

In this paper we study the quality of management as a factor of firm market exit in differing macroeconomic environments. We address two issues. First, we identify the set of factors impacting firm market exit. We focus on the impact of the quality of management on firm market exit. Our research is based on the premise that the quality of management is reflected in the firm's efficiency and can thus be proxied by technical and cost efficiency measures. Namely, in achieving technical and cost efficiency the key role is assigned to the ability of managers to influence the quantity of employed production inputs and to select such input combinations that minimise the long-run costs of production. We hypothesise that firms with low quality of management resulting in their inferior technical and cost efficiency are more likely to exit the market. Second, we analyse whether the set of market exit factors and their impact on firm market exit depend on the characteristics of the macroeconomic environment. Also in this case the role of quality of management is of special interest. We hypothesise that in a favourable macroeconomic environment cost efficiency plays a prevailing role in explaining firm market exit. In a less favourable macroeconomic environment, such a role is assigned to technical efficiency.

In order to analyse the abovementioned two issues, we develop an empirical model of firm market exit based on a neoclassical theory of the firm (Panzar, 1989) and contributions of the existing body of literature in the firm market exit field. We thus specify several non-nested microeconomic models of firm market exit. To differentiate between those factors that can be influenced by firm management and those factors that are considered non-discretionary, our categorisation of explanatory variables includes four groups, i.e. internal, external, demographic and environmental factors. The specifications of models differ in their selection of variables representing individual groups of factors and in the way

<sup>1</sup> This paper is based on the doctoral dissertation of Ksenja Pusnik, written under the supervision of Professor Maks Tajnikar and is written in memory of Ksenja, who lost her battle against cancer at the beginning of 2011.

these variables are measured. The internal factors group includes the quality of management that is the main focus of this paper and is proxied by technical and cost efficiency measures. Technical and cost efficiency measures are estimated using parametric stochastic frontier analysis. Models of firm market exit are estimated using a logistic regression for rare events (King and Zeng 1999), based on a panel of the population of Slovenian firms. To identify the explanatory power of estimated models we use the classification test, the Bayesian information criterion and an artificial model nesting test.

In order to assess how the quality of management influences firm market exit in differing macroeconomic environments non-nested microeconomic models of firm market exit are estimated for two periods in which Slovenian macroeconomic conditions significantly. The 1995–1999 period represents the second phase of Slovenia's transition to a market economy when the transition process imposed tight macroeconomic conditions and the 2000–2006 period is the period when the Slovenian economy may be considered a consolidated market economy. The distinction between the two periods in the model estimation allows us to examine how macroeconomic conditions impact the success of managers in ensuring the survival of their firms. We hypothesise that the tight macroeconomic conditions reduce the importance of management when it comes to preventing a firm's market exit.

The paper contributes to the existing body of empirical firm market exit literature by estimating non-nested microeconomic models of the firm and selecting the ideal model specification by using the classification test, the Bayesian information criterion and an artificial model nesting test. Further, we introduce a new classification of firm market exit factors, i.e. internal, external, demographic and environmental factors. Among these factors the focus is on the quality of management that is proxied by technical and cost efficiency measures. As such, the paper contributes to the relatively small body of research investigating the impact of the quality of management and efficiency on firm market exit in non-banking sectors. An advantage of this paper is that the analysis of the impact of efficiency and other factors on firm market exit is based on the population of Slovenian firms regardless of their industry membership. In addition, the impact of market exit factors is investigated for two periods, allowing us to study differences in the impact of the quality of management in differing macroeconomic conditions. Moreover, our study is one of the few studies dealing with business failure and market exit issues in Slovenia.

The remainder of the paper is organised as follows. A review of the literature on the determinants of market exit and our research hypotheses are presented in Section 2. In Section 3 the data and methodology are described. Estimation results form Section 4, while in Section 5 the results are discussed.

## 2. LITERATURE REVIEW AND HYPOTHESES

There is a vast body of empirical literature investigating market exit factors that is based on various theories from economics, business sciences and entrepreneurship, which are relevant to understanding firm market exit. These relevant theories include the transaction cost theory (Coase, 1937; Williamson, 1985), the neoclassical theory of the firm (Panzar, 1989), the theory of industrial organisation (Bain, 1954) and the dynamic growth theory consisting of Gibrat's Law (Gibrat, 1931), the passive learning theory (Jovanovic, 1982, 1994), the active learning theory (Ericson and Peakes, 1995), the life cycle theory (Churchill and Lewis, 1983), Schumpeter's theory of innovation (1934) and the resource-based theory of the firm (Penrose, 1959; Barney, 1991).

Considering that the empirical literature draws from and combines many different theoretical approaches, there is a wide array of theoretically proposed market exit factors. Since in this paper we focus on the quality of management as a factor of firm market exit in differing macroeconomic environments and that we assume the quality of management can be proxied by firm technical and cost efficiency, we primarily review those empirical contributions that include firm efficiency and macroeconomic characteristics in the range of market exit factors.

An efficiency measure obtained by data envelopment analysis (DEA) was introduced as a quality of management measure in the model predicting the failure of banks. Their contributions marked the beginning of intense research efforts to link efficiency to bank failure. Several authors (Barr, Sieford and Siems, 1993; Yeh, 1996; Pille and Paradi, 2002; Cielen, Peeters and Vanhoof, 2004; Kao and Liu, 2004; Paradi, Asmild and Simak, 2004; Premachandra, Bhabra and Sueyoshi, 2009) confirm that technical efficiency significantly differs between non-successful and successful banks and that these differences are evident a few years prior to failure. Another group of authors employ either DEA or Stochastic Frontier Analysis (SFA) efficiency measures as regressors in the probability function of a bank market exit (e.g. Barr, Sieford and Siems, 1993; Wheelock and Wilson, 2000). Most studies



confirm the positive impact of technical inefficiency on the probability of banks suffering a business failure. Wheelock and Wilson (2000) arrived at the same conclusion for the link between cost efficiency and the business failure of US banks.

In the past few years, research into the impact of efficiency on market exit has also extended to non-banking sectors. Becchetti and Sierra (2003) report a significant positive impact of the SFA technical efficiency of manufacturing firms in Italy in the 1989–1997 period on the probability of firm survival. Similar results, but based on DEA technical efficiency measures, were obtained by Tsionas and Papadogonas (2006) for a sample of 3,404 manufacturing firms in Greece, Psillaki, Tsolas and Margaritis (2008) for a sample of French firms in the textile and research industries and Pušnik and Tajnikar (2008) for a sample of small firms in Slovenia. Cost efficiency as a variable in the market exit prediction model in non-financial sectors has to our knowledge only been used by Pušnik and Tajnikar (2008), showing that both DEA technical and cost inefficiency measures hold predictive power concerning market exit.

Contributions that examine environmental characteristics as determinants of a firm's market exit show that the probability of a firm's market exit increases with the uncertainty of the legal and regulatory environment (Denis and Denis, 1995; Foreman, 2003; Bhattacharjee et al. 2004), instability of the macroeconomic environment (Cybinski and Forster, 2002; Bhattacharjee et al., 2002, 2004), unexpected macroeconomic developments (Denis and Denis, 1995), a low level of economic activity (Lussier, 1996), globalisation (Coucke and Sleuwaegen, 2008; Harris and Li, 2010) and is also impacted by the location of the firm (Wheelock and Wilson, 2000; Pušnik and Tajnikar, 2008). Research on the impact of the firm's industry membership on market exit yields mixed results. Cefis and Marsili (2005) show that firms from high-tech industries have the greatest probability of survival. On the contrary, Phillips and Kirchhoff (1989) do not find significant differences in firm survival rates between industries.

Studies investigating efficiency and environmental characteristics as factors of market exit represent a small part of studies in this field. Namely, the majority of empirical studies investigates the impact of a number of different financial and non-financial factors on market exit. The most common determinant included in empirical research is the firm's financial operations. Foreman (2003), for example, explains, when studying US local telecommunication, which firms fail within two years by considering certain financial ratios such as earnings per share, return on assets, retained earnings to assets, total debt proportion, and working capital to sales. Pompe and Bilderbeek (2005) find that virtually every ratio category (profitability, activity, liquidity, and solvency ratios) has some predictive power with regard to bankruptcy. Certain ratios perform similarly with different populations. Opler and Titman (1994) find that a firm's capital structure must also be considered as a factor in the announcement of bankruptcy. Analysing German private and public corporations, Köke (2002) finds that firms are more likely to fail when financial performance is generally poor. A positive effect of the leverage variable on the likelihood of exit was found by Fotopoulos and Louri (2000).

A negative relationship between firm size and the likelihood of exit was found by Brüderl and Schüssler (1990), Shleifer and Vishny (1992), Dunne and Hughes (1994), Audretsch and Mahmood (1995) and Köke (2002). The age of a firm is also considered one of the key firm exit determinants. The general consensus of empirical studies examining the impact of age on exit is that (after infancy) the likelihood of exit declines with age (Carroll, 1983; Freeman, Carroll and Hannan, 1983; Williams, 1993; Watson and Everett, 1996; Nucci, 1999; Thornhill and Amit, 2003). Studies also show that firm survival is linked not only to a firm's size at the time of its establishment (Phillips and Kirchhoff, 1989) but also to the growth achieved in the period closely following the firm's establishment (Phillips and Kirchhoff, 1989; Köke, 2002; Cefis and Marsili, 2005; Foreman, 2003). Empirical support can also be found for a negative relationship between market growth and firms' exit rates. However, there is also evidence to the contrary (see Tsionas and Papadogonas, 2006).

Following theory and empirical evidence regarding firm market exit we assume that a general firm market exit model includes four groups of factors:

$$ME = f(IN, EX, DE, EN), \quad (\text{eq. 1})$$

where *IN* denotes the group of internal market exit factors, *EX* the group of external market exit factors, *DE* the group of firms' demographic factors, while *EN* denotes environmental factors. Market exit (*ME*) describes liquidation of the firm due to a business failure, the deliberate termination of business activities or as a result of a merger, acquisition or takeover.

The group of internal factors includes those firm characteristics that affect firm costs through the employment of inputs and can be directly influenced by firm management. Namely, according to the

microeconomic theory of the firm (Panzar, 1989) finding a proper combination of inputs for the firm to achieve an equilibrium is the task of the firm's management. It is thus management's role to select those techniques that enable the firm to maximise its technical efficiency and to take input prices into consideration when choosing such a combination of inputs that results in allocative and cost efficiency (Farrell, 1957; Fried, Lovell and Schmidt, 2008). To attain allocative and cost efficiency the firm's management varies the quantity of all inputs. These management decisions about input use thus shape the firm's long-run equilibrium at a minimal average cost. External factors define the firm's position in the market and primarily influence the firm's revenues. These factors impact the firm's market exit through market prices and output quantities sold. The achieved market prices and quantities sold depend on market competition. The firm's management can thus only affect them to a limited extent and has to make decisions within limitations imposed by the market. External factors therefore cannot directly and wholly reflect the quality of a firm's management as they are conditional on market characteristics. This is why they mostly impact revenues. Actually, they impact the firm's profitability considering that internal factors control for the firm's cost level. Demographic factors are those characteristics of a firm which have their origin in the past and are a result of past decisions of firm management and past market and environmental characteristics. Consequently, demographic factors can no longer be influenced by firm management and market characteristics at the time the firm's market exit is observed. Environmental factors reflect the firm's economic, legal, political, technological and social environments.

We test two main hypotheses to satisfy the aim of this paper, i.e. to examine the quality of management as a factor of firm market exit in differing macroeconomic environments. First, we hypothesise that a technically and/or cost inefficient firm is more likely to exit the market. Second, technical efficiency is hypothesised to have a more significant influence on firm market exit compared to cost efficiency in a favourable macroeconomic environment while cost efficiency has a more significant influence on firm market exit than technical efficiency in tight macroeconomic conditions.

Besides efficiency and the macroeconomic environment, the specification of our model (eq. 1) also includes other market exit factors that have been proposed by the empirical studies mentioned above and are theoretically supported to a smaller or larger extent. This is why the four groups of factors in our model also include those factors that are not directly referred to in our research hypotheses, but are important for the model to encompass all relevant firm market exit factors.

### 3. DATA AND METHODOLOGY

The primary data source for our study is the database of firms' financial statements collected by the Agency of the Republic of Slovenia for Public Legal Records and Related Services, which covers the whole population of Slovenian firms for the 1995–2005 period. We narrowed the dataset by excluding firms for which an industry was not defined, firms with zero employees, firms with a negative value of equity or with zero sales revenues, and firms with zero assets or zero fixed assets. We further narrowed the datasets by excluding firms with missing values in our panel. We argue that, given the purpose of our analysis, such an approach to dealing with missing values is more appropriate than other more arbitrary methods such as imputation. Further, the disadvantages of this approach do not impact our results due to the large number of firms in our database.

In order to test our hypothesis about the impact of macroeconomic conditions on the influence of management on a firm's market exit, we split the analysed period into two panel datasets that represent differing macroeconomic conditions. The first panel represents the 1995–2000 period characterised by tight macroeconomic conditions and the second panel is based on the 2000–2005 period of a consolidated market economy. The first panel comprises data on 16,121 firms and 80,605 observations and the second panel data on 17,405 firms and 87,520 observations. Firms in both panel datasets are divided into two mutually exclusive groups, i.e. exit and non-exit firms. In the observed period of six years, exit firms are those that were in business in the first five years of the analysed period and had closed their operations, thereby exiting the market in the sixth year of the analysed period (2000 for the first panel and 2005 for the second panel). Non-exit firms are those that were in business for the whole six-year period. Both panels are unbalanced in favour of non-exit firms. Namely, in 2000 there were 2.48 percent of exit firms and in 2005 their share amounted to 2.19 percent. The use of unbalanced panels distinguishes our research from other studies adopting a balanced-sampling approach (e.g. Becchetti and Sierra, 2003; Masten and Masten, 2009).

For both analysed periods we proposed different empirical firm market exit specifications, all following the structure of the general model from Equation 1. The empirical specifications thus follow the same classification of the market exit factors as the general model. However, the proposed empirical

specifications stem from different theoretical frameworks. Due to the theoretically based variation in the sets of factors we have to consider the proposed models as non-nested models when selecting the most appropriate, i.e. ideal model for explaining firm market exit in Slovenia. We follow the model selection approach instead of the hypothesis testing approach. In the model selection approach, each competing model is evaluated by means of a numerical criterion: for a given sample observation, the procedure consists of selecting the model that optimises the chosen criterion. When using such an approach models with different specifications can be selected as the most appropriate for two different time periods. This is also the case in our research as we study quality of management as a factor of firm market exit in two time periods that differ with respect to their macroeconomic conditions.

The factors proposed by different theories as being relevant to market exit vary. In empirical research the most notable differences can be found in the selection of the array of external and internal factors. This is why for each of the two investigated periods our empirical specifications are obtained by keeping demographic and environmental factors unchanged, while testing two different sets of external factors and two different sets of internal factors. Further, the selection of a particular factor within individual sets of factors may differ between the two studied periods due to the model selection approach. For both periods and all empirical specifications of the market exit model, the dependent variable (*ME*) is defined in the same way as a binary variable with a value of 1 for exit firms and a value of 0 for non-exit firms.

The first set of internal factors includes long-term and short-term internal factors. Measures of technical and cost efficiency are regarded as long-term factors and asset turnover indices as short-term internal market exit factors. Asset turnover indices (*INATI*) included in the first set of internal factors are days sales outstanding (*INDSO*), days payables outstanding (*INDPO*), price of debt (*INDP*) and days inventory in stock (*INDIS*). Cost (*INCE*) and technical efficiency (*INTE*) measures are obtained by Stochastic Frontier Analysis using the number of employees and the value of fixed assets as inputs, the value of business revenues as an output measure and annual gross wages per employee and the sum of depreciation and costs of financing relative to the sum of fixed assets and inventory as factor prices (Pušnik, 2008). In the second set of internal factors short-term internal factors remain unchanged, while labour productivity measured as the ratio between business revenues and the number of full-time equivalents (*INLP*), capacity utilisation as a ratio between business revenues and the value of fixed assets (*INCUI*), the ratio between firm cost and its business revenues (*INCTR*), average monthly wage (*INW*) and price of capital approximated by the ratio between the sum of depreciation and cost of financing on one hand and total liabilities of the firm on the other hand (*INPC*) are included as long-term internal factors as an alternative to measures of technical and cost efficiency.

The first set of external factors also includes long-term and short-term factors. Long-term factors are represented by a set of dummy variables reflecting a firm's position in its industry and the industry's position in the whole economy. A set of dummies is obtained based on a comparison of the firm's and industry's wage and profit rates and a comparison of the industry's and economy's wage and profit rates. Such comparisons enable us to divide the analysed firms into 16 groups (*EXDI6*) (see Tajnikar and Pušnik, 2008). A firm's liquidity measured by the quick ratio (*EXQR*) is used as a short-term external factor. The second set of external factors differs from the first one in the selection of the long-term external factors. The set of dummy variables is replaced by variables reflecting the firm's long-term market position that have an impact on the firm's generated revenues. These variables include return ratios (*EXRR*) (either return on equity (*EXROE*) or return on assets (*EXROA*)), and profitability ratios (*EXPR*) (either relative break-even point, defined as the ratio between firm's actual revenues and its revenues at the break-even point (*EXBEP*) or return on sales (*EXROS*)).

All empirical model specifications include the same demographic and environmental factors. Demographic factors are represented by the firm's financial leverage (*DEFL*) and firm size (*DESIZE*) measured either in terms of the value of revenues (*DESIZE1*) or with the value of a firm's fixed assets (*DESIZE2*). Environmental factors include industry (*ENNACE2*) and a firm's region (*ENREG*), included as two sets of dummy variables.

To eliminate the impact of annual changes in price levels and/or to control for industry membership, some of the independent variables are defined in terms of the deviation of the variable from the industry average, where industry is defined according to the 2-digit NACE classification of industries. Further, we estimate the 5-year trend of independent variables and use the trend regression coefficient values (see Appetiti, 1984) instead of annual values of independent variables to eliminate the collinearity between the values of selected variables in consequential years.

For both periods all empirical firm market exit models were assessed by the cross-sectional binominal logistic regression for rare events data of King and Zeng (1999, 2001), which eliminates the impact

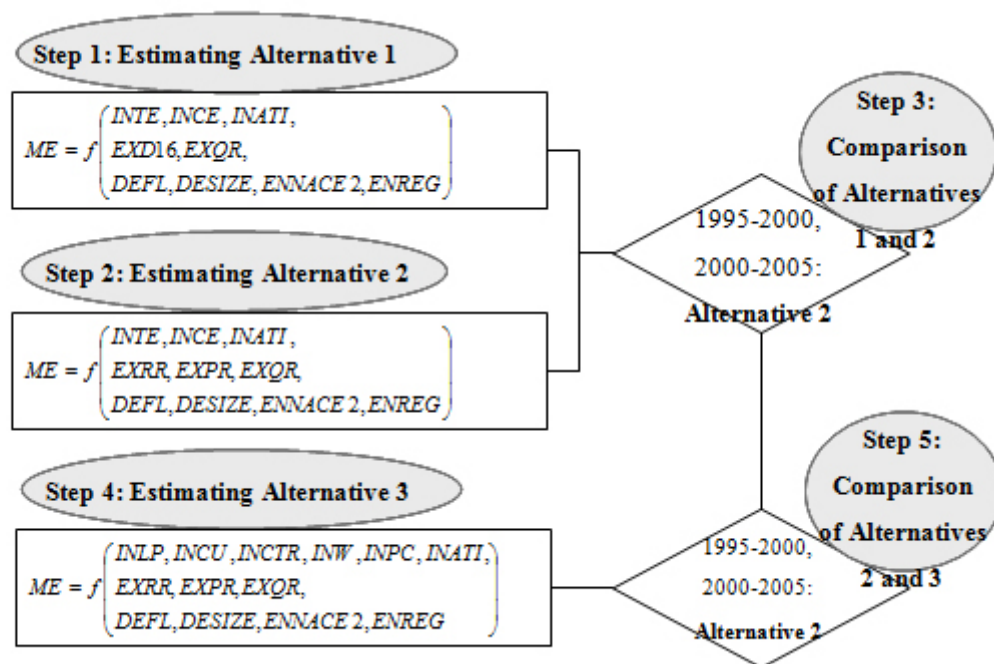


of sample size and/or rare events on estimates of coefficients and the probability of firm exit. In choosing the ideal model specification for both of the investigated time periods we use second-degree empiricism, which represents a selection from among so-called non-nested models. The choice of alternative models was based upon a classification test, Akaike's (1973) information criterion (AIC), Bayes' information criterion (BIC) (Raftery, 1995), an artificial model nesting test, Vuong's (1989) parametric distribution-free test for non-nested models and Clark's (2003) non-parametric distribution-free test for non-nested models<sup>2</sup>.

#### 4. RESULTS

Following the model selection approach using the above described criteria we selected the ideal model for explaining the market exit of firms in Slovenia. The model selection is shown in Figure 1, depicting that the ideal model to be used for analysing market exit is described by Alternative 2. The model under Alternative 2 includes technical and cost efficiency measures as long-term internal firm market exit factors and financial return and profitability ratios as long-term external firm market exit factors. The model with the financial return and profitability ratios as long-term external firm market exit factors was selected because it performs better than the model using the firm's relative position in its industry and the industry's position within the whole economy. Similarly, technical and cost efficiency measures are included because the comparison of alternative models that differ in the definition of long-term internal factors shows that the model with efficiency measures outperforms its counterpart including financial indicators. This result of the model selection process implies that the technical and cost efficiency measures are superior to the standard financial ratios that are widely used to capture the internal factors influencing firm market exit.

Figure 1: Selection of alternative non-nested models



The ideal model under Alternative 2 includes technical and cost efficiency measures as long-term internal firm market exit factors and financial return and profitability ratios as long-term external firm market exit factors. This ideal model is used to study the market exit determinants for the case of firms in Slovenia in differing macroeconomic conditions. This means that we employ it to investigate firm market exit in the 1995–2000 and 2000–2005 periods. However, the empirical specifications of the ideal model for the two periods differ in the definition of some variables reflecting return and profitability. Namely, for the 1995–2000 period return is measured by the return on equity (*EXROE*) and profitability by the relative break-even point (*EXBEP*), while for the 2000–2005 period we use the return on assets (*EXROA*) and the return on sales (*EXROS*) as return and profitability measures. Further, size is measured differently in the two periods. In the first period size is defined in terms of the generated revenues (*DESIZE1*) and in the second period in terms of the value of fixed assets (*DESIZE2*). Accordingly, Equation 2 represents the empirical specification of the ideal model used

<sup>2</sup> The results of all tests are available on request from the authors.

for the analysis of firm market exit in Slovenia in the 1995–2000 period. Equation 3 shows the empirical specification of the ideal model for the 2000–2005 period.

$$ME = f \left( \begin{matrix} INTE, INCE, INDSO, INDPO, INDP, INDIS, \\ EXROE, EXBEP, EXQR, \\ DEFL, DESIZE1, ENNACE2, ENREG \end{matrix} \right) \quad (eq. 2)$$

$$ME = f \left( \begin{matrix} INTE, INCE, INDSO, INDPO, INDP, INDIS, \\ EXROA, EXROS, EXQR, \\ DEFL, DESIZE2, ENNACE2, ENREG \end{matrix} \right) \quad (eq. 3)$$

Table 1 shows the results obtained from the logistic regression of the empirical specifications of the ideal market exit models for both studied periods. The models are estimated first for the 1995–2000 period and then for the 2000–2005 period. The results are shown in three columns for each of the analysed periods. The first depicts the results of the logit regression, the second the estimates obtained by the logit regression for rare events, and the third the estimates of the logit regression for rare events based on the empirical specification obtained with the backward elimination procedure that improves the model by dealing with the issue of multicollinearity (Chatterjee and Hadi, 2006).

The econometric tests presented in Table 1 confirm the statistical significance of all of the proposed econometric specifications regardless of the applied regression form. However, according to the AIC and BIC tests for both of the analysed periods the results of the logistic regression for rare events based on the backward elimination procedure outperform the other models. Still, they confirm the robustness of the regression coefficients we obtained.

Table 1: Results of the market exit models of Slovenian firms

Dependent variable <i>ME</i>	1995–2000			2000–2005		
	Logit	Logit-rare events	Logit-rare events (backward elimination)	Logit	Logit-rare events	Logit-rare events (backward elimination)
INTE	-2.512	-2.469		-10.079 <sup>a</sup>	-10.920 <sup>a</sup>	-11.483 <sup>a</sup>
INCE	-9.386 <sup>a</sup>	-9.322 <sup>a</sup>	-9.886 <sup>a</sup>	0.190	-0.011	
INDSO	-0.001	0.001 <sup>c</sup>		0.001	0.001	
INDPO	0.016 <sup>a</sup>	0.015 <sup>a</sup>	0.016 <sup>a</sup>	0.010	0.009	
INDP	0.203	0.203	0.245 <sup>b</sup>	0.052	-0.042	
INDIS	-0.016 <sup>b</sup>	-0.014 <sup>c</sup>	-0.015 <sup>c</sup>	0.001	-0.004 <sup>a</sup>	
EXQR	0.004	0.008 <sup>b</sup>		0.007	0.005	0.012
EXROE	-11.343 <sup>a</sup>	-11.790 <sup>a</sup>	-11.372 <sup>a</sup>			
EXROA				-2.778 <sup>a</sup>	-2.709 <sup>a</sup>	-2.806 <sup>a</sup>
EXBEP	0.001	0.028 <sup>a</sup>				
EXROS				-0.001	-0.001	
DEFL	-0.003	0.003 <sup>b</sup>		-7.8E-06	-0.001 <sup>a</sup>	
DESIZ1	-3.7E-11	1.2E-08				
DESIZ2				-2.2E-10	1.7E-08 <sup>c</sup>	
ENNACE2 dummy set	yes	yes	yes	yes	yes	yes
ENREG dummy set	yes	yes	yes	yes	yes	yes
Constant	-3.297 <sup>a</sup>	-3.284 <sup>a</sup>	-3.651 <sup>a</sup>	-3.753 <sup>a</sup>	-3.728 <sup>a</sup>	-3.894 <sup>a</sup>
Log-likelihood	-1,742.95		-1,764.54	-1,696.16		-1,721.88
LR $\chi^2$	237.04		193.87	260.51		209.06
AIC	3,601.9		3,551.1	3,514.3		3,463.8



BIC	4,046.1	3,635.3	3,986.3	3,541.1
p-value	0.000	0.000	0.000	0.000
No. of observations	15,647		16,949	

Note: a, b and c denote significance at 0.1%, 1% and 5%, respectively

## 5. DISCUSSION

The results confirm our first hypothesis that technically and/or cost inefficient firms are more likely to exit the market. Namely, for both of the analysed periods the technical and cost efficiency regression coefficients have the expected negative sign. This confirms our main hypothesis that technical and cost efficiency are a decisive market exit factor. Considering our argument that technical and cost efficiency reflect and measure the quality of management, our results confirm that the quality of management is one of the key factors in explaining firm market exit. Even though a firm's management plays many relevant roles within the firm, our research demonstrates that those management decisions that refer to input selection and their relative combinations are those which are most crucial for preventing a firm from failing and ensuring its survival.

The results also confirm our second hypothesis that technical efficiency has a more significant influence on a firm's market exit compared to cost efficiency in a favourable macroeconomic environment, while cost efficiency has a more significant influence on a firm's market exit than technical efficiency in unfavourable macroeconomic conditions. It is evident from Table 1 that in the 1995–2000 period cost efficiency is a statistically significant firm market exit factor. This is not characteristic for technical efficiency in this period. Interestingly, the opposite holds true for the 2000–2005 period, when technically efficient firms were statistically significantly less likely to exit the market while cost efficiency did not have a significant impact. These results indicate that technical and cost efficiency reflect different internal market exit factors. Considering the definitions of cost and technical efficiency we could argue that in the first analysed period with tight macroeconomic conditions the market exit of Slovenian firms depended on either their allocative inefficiency or a combination of both their technical and allocative inefficiencies that are the two elements of cost efficiency. In this period, the market exit probability was thus impacted by management's decisions about the quantities and combinations of inputs relative to their prices. In the 2000–2005 period, i.e. the period of the consolidated market economy, the market exit probability depended mostly on the quantities of inputs employed and to a smaller degree on proper price-determined input combinations.

The latter results imply that during the period of the consolidated market economy those firms which exited the market were mostly technically inferior firms. Managers of such firms were able to influence the firm's cost level and allocate inputs according to relative input prices. However, they had limited influence on the technical efficiency due to obsolete techniques used in the firm's production. In the first period characterised by tight macroeconomic conditions managers also faced restrictions stemming from obsolete techniques. In addition, during this period management did not focus on properly allocating the inputs either because they were unable to do so or because incentives were not in place to stimulate such management decisions.

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## EVALUATING MERGERS AND ACQUISITIONS (M&A) AS A FORM OF COMPANY RESTRUCTURING

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### Abstract

With the increasing globalization of world markets and the internationalization of the activities of large corporations, the emergence of acquisitions and their mutual mergers have become common practice in all markets. In the last twenty years there was almost more a global company that has not been able to implement a strategy or taking recourse to a defensive mechanism in the event that the target of acquisitions. When the acquisition of the target company must pay its fair market value or higher cost, added value can be created solely on the basis of synergistic effects or effective management. Synergistic effect is present when the value of the combined company after the M & A is worth more than the sum of the value of individual companies before the M & A transactions. Gains on synergistic effect can be achieved on the basis of increasing cash flows, or after reduction of cost of capital.

The management company which intends to merge with another company must first evaluate whether the investment is profitable for them. In this sense, they must assess how companies target actually worth. Naturally, both sides of this work have different views about the value of the company that "target". Buyer intends to evaluate the company as expensive as possible, while the buyer will try to lower the maximum price possible. Among the numerous methods for assessing the value of the company, will use the discounted cash flow method (DCF). Budget obtained value target companies may be a more reliable indicator. In case of successful completion of mergers and acquisitions, the company acquired only bidder fails to value the target companies, but also the value of other benefits from combining. The aim of this study was to quantify the benefits of a value of mergers and acquisitions as a form of company restructuring. The aim of the paper is also based on the practical interpretation of mergers and acquisitions of two companies, to elaborate options for improving the effects of operating and financial synergies. The paper used the scientific method of deduction, analysis and comparative analysis of best practices. Interpretation of results should serve as a basis for professional and scientific discussion on the evaluation of mergers and acquisitions (M & A) as a form of company restructuring.

**Keywords:** Mergers, acquisitions, Synergistic effect, Enterprise restructuring, the DCF method

### 1. INTRODUCTION

The modern world, economic environment and the company itself, are in constant change and turbulence. A revolutionary advancement of new technologies have significantly reduced the production costs of goods and services, and companies that are unable to successfully respond to new challenges, they risk their independence and existence in the market. A large number of research studies deals with the problem of evaluation of mergers and acquisitions transactions, as well as analyzing the advantages and disadvantages of mergers and acquisitions. Global phenomena in business and development organizations, the consequences of the economic crisis and other parameters that follow the global economy the last two years, the company's management require different strategies and implementation mechanisms for survival and growth. In response to the development of these trends over the past twenty years, saw a record number of companies that are out of adjustment to new conditions and improve their operations through the application of methods found external growth. Companies in the Republika Srpska and Bosnia and Herzegovina, as well as all Balkan countries that aspire to become or have become part of the European Union, are also at the impact of the global economy and the trends that follow the American and European economies. To survive in the future to be competitive enterprises in developed countries of European Union in the future, our companies need to implement external growth strategy.

Organizational changes present new challenges and demands for everything from executives to production workers. If you are changing, especially in times of crisis, not managed properly, there is an additional loss of company. Restructuring within the organization is a model that includes a significantly wider range of measures to bring about the organization's ability to raise the internal market and its competitiveness. Mergers and acquisitions as a form of company restructuring, are the methods of transformation of enterprises in conditions of globalization that enable companies to adapt to the environment and opportunities to better position themselves to achieve greater value for their stakeholders. Restructuring is also often applied not only in crisis situations but also in changes



in ownership structure. The new management model is done through this strategy shift to increase corporate performance and increase its market value. The world is often the case that investment companies or funds to buy the company, whose market value is not high at the time, made their restructuring to increase their value and, then, the stock market to sell the company, thus making a profit.

The implementation process of mergers and acquisitions, inevitably requires the valuation of companies and transactions that result from these forms of company restructuring. In the analysis of the value of the company will use the discounted cash flow method. In implementing the process of mergers and acquisitions, including scientific research circles, economic forums and other areas of economic analysis, analysis of the value of companies is one of the basic parameters in the successful implementation of mergers and acquisitions. It should also be noted that the essence of every intelligent investment make a thorough analysis of the value of the company and its development potential in the future. The paper used the scientific method of deduction, analysis and comparative analysis of good practices. Interpretation of the results should highlight the importance, opportunities and guidelines for increasing the value for the owners in the process of mergers and acquisitions, as well as for professional and scientific discussion on the topic of enterprise restructuring through mergers and acquisitions in the region.

## 2. THE BASIC PRINCIPLES OF ENTERPRISE RESTRUCTURING BASED ON MERGERS AND ACQUISITIONS

Restructuring, reorganization and other major changes are very common in companies trying to grow or survive. In short, the restructuring of the organization, in modern terms, as a condition of a strategy of growth and development companies, as well as the condition for his recovery and survival. For decades, mergers and acquisitions activity were characteristic of the Anglo-Saxon model of corporate governance. In recent years, mergers and acquisitions transactions are often used as a mechanism of privatization of state or socially owned enterprises in countries in transition. The highest level of worldwide mergers and acquisitions activity was recorded in 2007. when the total value of mergers and acquisitions transactions amounted to about 4,800 billion U.S. dollars, say, four times the level of value from 2002. year. American transactions, participated in a total transaction value of mergers and acquisitions worldwide in 2007. year, with 33% in 2000. year by 50% (Todorovic, 2010., p. 133.). The highest level of transaction value of European mergers and acquisitions, was recorded in 2007. in the amount of 2,800 billion. U.S. dollars. Companies can provide significant value creation from the implementation of mergers and acquisitions, implementation of adequate planning transactions, formulating a clear vision focused on the integration goals, setting realistic time frame and timetable of the transaction and by understanding the diversity of corporate culture of companies.

According to data from Thomson Financial, the total value of transactions for 2006. amounted to 3790 billion dollars, which is 38% more than in 2005. year, 55 transactions had a value greater than \$ 10 billion. The European market was one of the most active, with 39% more transactions compared to 2005. year, with a value of \$ 1,430 billion. Transactions in the U.S. market amounted to \$ 1,560 billion, 36% more than in 2005. year ([www.acquisitions-monthly.com](http://www.acquisitions-monthly.com) (accessed 30.05.2011.)). Research Accenture / Economist Intelligence Unit Global data makes that 70% of top management of companies around the world are planning or implementing merger and acquisition year (Chanmugam, Auslinger, Park, 2004 ., [www.accenture.com](http://www.accenture.com) / SBA (accessed 20.06.2011.)). In Table 1., shows the largest transaction value of mergers and acquisitions of all time.

**Table 1.** The largest transaction value of mergers and acquisitions of all time

Bidder	Target	Branch	Value (in bn. \$)	Year
Vodafone	Mannesmann	Telecommunications	203	2000
AOL	Time Warner	Internet / Media	165	2000
BHP Biliton	Rio Tinto	Energy, Oil	152	2007
MCI	Sprint Corp.	Telecommunications	114	1999
Royal Bank	ABN Ambro	Finance, Banking	96	2007
Pfizer	Warner-Lambert	Health care	89	1999
Exxon	Mobil	Energy, Oil	79	1998
Glaxo	SmithKline	Health care	76	2000
American	Warner-Lambert	Health care	76	1999
Royal	Shell	Energy, Oil	74	2004
BellSouth	AT&T	Telecommunications	73	2006

Travelers	Citicorp	Finance	73	1998
Comcast	AT&T Broadband	Telecommunications	72	2001

**Source:** (Todorović, 2010., p. 123.)

There are a number of inconsistencies and overlap when it comes to the demarcation of the term mergers and acquisitions. However, even though it often is done in the public identification of mergers and acquisitions, these terms mean different things. Mergers, which is with us still use the terms merger, integration or merger, a transaction in which a single economic entity from the previous two or more entities. Merger is a merger of two companies into one company, which will be jointly owned by shareholders of both companies (Todorovic, 2010., p. 86.). The shareholders of a company (B) exchange shares possessed a given company for shares of another company (A). The company maintains its customer name and identity that merges all assets and liabilities of the acquired company ( $A + B = A$ ). So the customer company (A) makes the absorption of another company (B) which ceases to exist as a separate legal entity. The most common case of mergers when one company absorbs another. For mergers is particularly the case that it is a voluntary agreement the two companies where one company joins all assets (and liabilities) other companies, thus increasing its size. Owners of connected companies can replace their shares for shares of the new enlarged company. A related form of the consolidation, which differs only in that the merger of two companies created a completely new company, while two earlier cease to exist, and their owners are not damaged because they can exchange their shares for shares of the new joint company.

Another form of the acquisition transaction. This is a very broad term used when one company buys stake and acquires another company (Todorovic, 2010., p. 86.). In this way, it can take control and be in a position to decide on his future. When one company takes a different and simply become the new owner, this type of activity is called acquisition. From a legal point of view, a company that is the subject of takeover ceases to exist and the company continues to own the customer being in the stock market. Today it is the basis for achieving synergies and growth of large and strong companies, as well as improved performance and strategic goals. The acquisition of the target company may be effected in the form of a friendly transaction, a situation in which the director and the board of managers of the target company and its shareholders support the transaction and recommended the enemy in the form of transaction where the offer sent directly to the public shareholders of target companies are incompatible with the management team of bypassing the target company. Acquisition can take different forms and ways of implementation. For example, payment can be made in cash or securities, may be friendly and hostile, and may be directed to the full or partial control over the acquisition of another company. Also, it can be played in three forms: as a direct private offering and the preferred management company, as a public offer to buy shares as acquisition of physical assets. Thus, for example, the company Daimler-Benz and Chrysler ceased to exist when the two companies merged and formed a new - DaimlerChrysler. In Table 2., showing the movement of the basic parameters of transactions in DaimlerChrysler merger.

**Table 2.** The success of the DaimlerChryslermerger

Name	Daimler u bn \$	Chrysler u bn \$	DaimlerChrysler u bn \$
The market value before the transaction	52,8\$	29,4\$	82,2\$
Added value			18,0\$
The market value after the transaction			100,2\$
Percentage of ownership after the transaction	57,2%	42,8%	100%
The value after the transaction	57,3\$	42,9\$	100,2\$
Gains on certain groups of shareholders	4,5\$	13,5\$	18,0\$
The relative gains of shareholders in%	9%	46%	

**Source:** www.sec.gov.rs : Mergers and acquisitions, taken (15.05.2011.);

Based on data presented in the previous table we can see how much they amounted to the value of the basic parameters of the DaimlerChrysler merger transaction.

### 3. MOTIF SYNERGY MERGERS AND ACQUISITIONS

Various motives are combining different name for the potential sources of value in transactions. If the office of the real motives and potential sources of value to materialize, the transaction will bring benefits to shareholders, to be successful and add value. When the acquisition of the target company must pay its fair market price or higher price, added value can be created only on the basis of exploiting synergies and effective management, ie. better control and improved asset management strategies. Synergetic effects are present when the value of the combined companies after mergers or acquisitions worth more than the sum of the value of individual companies before merger or acquisition transactions.

Synergistic effect can be represented using the following equation (Todorovic, 2010., p. 138.)

*Relation 1.:*

$$V_{AB} > V_A + V_B \text{ ili } V_{AB} = V_A + V_B \text{ value of synergies}$$

With mergers and acquisitions transactions is possible business synergies and financial synergies. Business synergy is the dominant form of synergy in combining strategic enterprises. Increase cash flow is usually associated with business synergies, while reducing cost of capital effects generally associated with the financial effects. Business synergy manifested in additional, differential or incremental future free cash flows –FCFF combined entity than the sum of future free cash flows of companies A and B. Differential FCFF can be approximated by the difference of income differential and differential costs, differential and differential taxation of capital expenditures, we introduced the relation 2. (Todorovic, 2010., p. 138.).

*Relation 2.:*

$$\Delta FCFF = \Delta Revenues - \Delta Costs - \Delta Taxes - \Delta Capital expenditures$$

Sources of value in the case of differential income, represent the effects arising from the conquest of new markets and industries, improve product mix, improved promotion, use of co-branded, improvements in the distribution network, management know-how, improved flexibility of managers in exploiting perceived opportunities, effective transfer of key skills and others. Cost savings based on economies of scale and economies of vertical integration, which implies. Economies of vertical integration, refers to the cost savings that are achieved due to the internalization of transactions and raw material supply in the early stages of production and distribution process transactions or distribution of finished products in the later links of the production-distribution chain. Also, the business combination may result in tax savings, ie. If one of the companies entering the combine is operated at a loss, the tax base and the amount of tax paid by the combined entity would be less than the sum of the tax base or the amount of taxes to be paid in two separate companies. Investment needs of the combined companies should be lower than the sum of the investment needs of separate companies, which means that transactions of mergers and acquisitions of water cuts in capital expenditures. Sources of financial synergy can represent unused free cash flows and debit unused capacity. In the absence of profitable internal investment opportunities, mergers and acquisitions with positive net present value, may be a good alternative to the use of free cash flow (Todorovic, 2010., p. 142.). Therefore, combining the company with surplus cash and no good investment opportunities with companies that do not have sufficient cash to fund good investment opportunities are an important form of financial synergies. Unused debit facilities as a source of financial synergies of the combined entity, is reflected in the use of leverage to the target company failed to exploit. It is also important to emphasize that combining the companies from various sectors through acquisitions and conglomerated merdžre carries the possibility of reducing the instability of business profit and net cash flows.

In order to achieve their full synergistic effect it is necessary to the acquisition process are adequately designed, to approach the conclusion of the acquisition deal appropriately with the appropriate tactics, and integration postakvizaciona be implemented on the basis of the established planning acquisitions.

#### 4. ANALYSIS AND EVALUATION OF THE EFFECTS OF MERGERS AND ACQUISITIONS BASED ON THE DCF METHOD

By far the most commonly used method of valuation of companies in mergers and acquisitions transactions is based on discounting cash flows (Discounted Cash Flow - DCF). Also, based on discounting cash flows is the economic framework for investment decision making. Enterprise value represents the present value of cash flow projections over the period, increased by the amount the present value of cash flow projections beyond the period (Đuričin, 2007., p. 346.). The basic premise underlying the DCF method, implies that the value of the company capital is equal to the sum of net present value of future inflows, the potential owners can realize the unlimited long period. Applying the DCF method requires a response in at least three questions. First, how do you define cash flow? Then, what is the discount rate? How long is the period of cash flow projections?

Economic theory and practice recognizes two definitions of cash flow. Cash flow after debt service and cash flow before debt service. Net cash flow after debt service so as to compute realized gains or projected increase in the selected period of depreciation, then the sum obtained by deducting the amount of investment in working capital and fixed assets, as well as the amount of repayment of existing long-term loans (Leko, Vlahovic, acquaintances, 1997., p. 41.). Net cash flow before debt service obtained by the sum of the projected profit excluding financial income and expenses of financing and depreciation subtract the amount of projected investment in fixed and current assets (Leko, Vlahovic, acquaintances, 1997., p. 42.). The value of equity is the difference between the estimated long-term capital and long-term loans that existed on the date when the selected. The following work shall effect an empirical elaboration of using cash flow after debt service, so we will work to give the following basic principles of analysis of cash flow after debt service. The discount rate used in the calculation of equity value based on an analysis of cash flow after debt service, we get a budget based on cost of equity. To determine the cost of equity, it is possible to use three methods (Leko, Vlahovic, acquaintances, 1997., p. 54.) Method CAPM (Capital Asset Pricing Model), a method of general instructions and method of walling (Build up approach). In this paper, we as a method of determining the price of the equity method of use of masonry (Build up approach). According to the method of building, the discount rate is calculated as the sum of the following three components (Bojović, 2006., p. 137):

- The real rate of return on investment without risk;
- The risk premium of investment into the country;
- The risk premium in the investment company.

The real rate of return on investment without risk is related to the return on investment in government bonds. The premium for the risk of investment in land should be included because it can occur as investors and foreign entities. The calculation of the risk premium of investment in the country includes an assessment of specific risks related to funding, business environment risks and financial risks in the country. On the other hand the risk premium for investing in a company whose capital is estimated assess ment includes specific risks such as key man risk (Key Man), firm size, financial structure, production /geographic diversification,

diversification of buyers and predictability. Analysis and interpretation of mathematical calculations valuation companies, as well as mergers and acquisitions transactions, we will show on the basis of hypothetical examples of practical analysis of the company A and company B. Budget d projections of net cash flow after debt service company A, are shown in Table 3.

**Table 3.** Budget and projections of net cash flow after debt service company A

Description / Year	Planned projection						
	2011	2012	2013	2014	2015	2016	
1. Profit	10.000.000,00	10.100.000,00	10.500.000,00	11.000.000,00	11.900.000,00	12.950.000,00	14.000.000,00
2. Amortization	2.300.000,00	2.300.000,00	2.300.000,00	2.300.000,00	2.300.000,00	2.300.000,00	2.300.000,00
3. Changes in long-term loans	1.700.000,00	1.212.000,00	1.470.000,00	1.760.000,00	1.023.000,00	1.331.000,00	1.660.000,00
4. Changes in working capital	330.000,00	232.300,00	451.500,00	363.000,00	440.300,00	530.950,00	602.000,00

5. Investments in fixed assets	700.000,00	909.000,00	1.050.000,00	1.100.000,00	1.190.000,00	1.424.500,00	2.090.000,00
6. Repayment of long-term loans	100.000,00	150.000,00	200.000,00	170.000,00	130.000,00	180.000,00	210.000,00
7. Net cash flow after debt service company A (1+2+3-4-5-6)	12.870.000,00	12.320.700,00	12.568.500,00	13.427.000,00	13.462.700,00	14.445.550,00	15.058.000,00

**Source:** The author

The remainder of this paper we approach the analysis of the discount rate. Interest rates on bonds whose issuer is the Republika Srpska is about 3% per annum. In this regard, according to this method, the real rate of return on investment without risk in the Republika Srpska is 3% (Directorate for Privatization of Republika Srpska). Suppose that the risk premium of investment into the country, based on the assessment of specific risk is 6% (Direction for the privatization of Republika Srpska). The remainder of this paper, we will analyze the rate of risk of investing in company A. Table 4. shows the calculation of risk of investing in company A (Leko, Vlahovic, acquaintances, 1997., p.167.

**Table 4.** The calculation of risk of investing in a company

	Scale risk of investing in a company in%			
	0	1	2	3
Organizational Structure			+	
The compactness of management team			+	
Strategic planning				+
Product Range			+	
Specialized knowledge of an expert				+
Weighted	0	0	6	6
Sum	12			
Number of parameters	5			
Specific risk	2,40%			
Company Size				
Number of employees		+		
The value of business assets		+		
Rating competition		+		
Weighted	0	3	0	0
Sum	3			
Number of parameters	3			
Specific risk	1,00%			
Financial Structure				
Fixed Assets / Capital		+		
Inventories and fixed assets / long-term capital		+		
Equity / Total capital			+	
Kontribucioni profit / revenue			+	
Financial Expenses / Income		+		
Weighted	0	3	4	0
Sum	7			
Number of parameters	5			
Specific risk	1,40%			
Production / geographic diversification				
The contribution of certain product revenue		+		
Existence of long-term contracts			+	



The share of foreign investments in income				+
Access to EU market	+			
Weighted	0	1	2	3
Sum	6			
Number of parameters	4			
Specific risk	1,50%			
Customer diversification				
Concentration of buyers				+
The size and position of the dominant buyers				+
The existence of long-term contracts				+
The importance of products to customers				+
Weighted	0	0	0	12
Sum	12			
Number of parameters	4			
Specific risk	3,00%			
Ability to predict				
Age enterprises				+
The stability of business performance				+
Discontinuities in business			+	
Changing economic environment branches				+
Weighted	0	0	2	9
Sum	11			
Number of parameters	4			
Specific risk	2,70%			
Total at-risk companies in%	12,00 %			

**Source:** The author

Based on the above analysis, we calculated the rate of investment risk in company A was 12%. Adding the previous components, we get a discount rate of 21%. Since the company and after the projection period (2011 .- 2017th), carries on business, we will analyze the residual value (Residual Value). Residual value(Residual Value) represents the value of cash flows in periods after the period of prediction. To calculate the amount of residual value, we use a mathematical relationship to calculate the residual value on the basis Gordonov models.

*Relation 3. (Leko, Vlahović, Poznanić, 1997., p.171.):*

$$RV = \frac{DNNT_r}{(DS - SR_r)}$$

Where:

$RV$  – residual value;

$DNNT_r$  – discounted net cash flow in the residual;

$DS$  – discount rate;

$SR_r$  – growth rate in the residual;

The value of net cash flow in the residual value of the product as we get the cash flow projections in the last year and growth rates in the residual cash flow. Assuming that the expected constant growth rate in the residual cash flow, ie. for the period after the 2017th amounts to 3%, we will value the calculation of net cash flow in the residual. Net cash flow will be equal to the residual net cash flow realized in 2017. year, plus the amount of projected growth rates in constant residual.

The value of net cash flow in the residual (2018) = 15.058.000,00 + 15.058.000,00 \* 3% = 15.509.740,00

The following work shall effect the residual value calculation. It is noteworthy that in practice most often when evaluating the company does not perform the calculation of residual values. This practice is used in international projects that are cultivated and processed in this area. In practice, most often used depending on the business they are engaged in an enterprise, a long enough period of projection.

On the basis of the relationship 1., the residual value is:

$$RV (\text{Residual value}) = \frac{15.509.740,00}{(21\% - 3\%)} * \frac{1}{(1 + 0,21)^7}$$

$$RV (\text{Residual value}) = 22.689.996,05 \text{ KM}$$

The remainder of this paper we approach the calculation of present value of net cash flow projection period, discounting all cash flows to present value, calculated using a discount rate.

$$\begin{aligned} \text{Present value of net cash flow projection period} = & \frac{12.870.000,00}{(1 + 0,21)^1} + \frac{12.320.700,00}{(1 + 0,21)^2} + \frac{12.568.500,00}{(1 + 0,21)^3} \\ & + \frac{13.427.000,00}{(1 + 0,21)^4} + \frac{13.426.700,00}{(1 + 0,21)^5} + \frac{14.445.550,00}{(1 + 0,21)^6} + \frac{15.058.000,00}{(1 + 0,21)^7} = \end{aligned}$$

$$46.168.445,78 \text{ KM}$$

A company will get value by adding the present value of net cash flow projection period and the amount of residual value.

$$\text{Value of the company } A(V_A) = 46.168.445,78 + 22.689.996,05 = 68.858.441,82 \text{ KM}$$

Projected net cash flow after debt service company B, is shown in table 5.

**Table 5.** Projected net cash flow after debt service company B

Planned projection							
Description / Year	2011	2012	2013	2014	2015	2016	
Net cash flow after debt service company B	1.000.000,00	1.000.000,00	1.500.000,00	2.400.000,00	2.700.000,00	3.000.000,00	3.600.000,00

The remainder of this paper we approach the analysis of the discount rate for the company B. Interest rates on bonds whose issuer is the Republika Srpska is about 3% per annum. In this regard, according to this method, the real rate of return on investment without risk in the Republika Srpska is 3% (Directorate for Privatization of Republika Srpska). Suppose that the risk premium of investment into the country, based on the assessment of specific risk is 6% (Direction for the privatization of Republika Srpska). On the other hand we will assume that the rate calculated risk of investing in company B is 15%. Adding the previous components, we get a discount rate amounting to 24%. Assuming that the expected constant growth rate in the residual cash flow, ie. for the period after the 2017th amounts to 4%, we will value the calculation of net cash flow in the residual-based model Gordonov. Net cash flow will be equal to the residual net cash flow realized in 2017. year, plus the amount of projected growth rates in constant residual.

$$\text{The value of net cash flow in the residual (2018)} = 3.600.000,00 + 3.600.000,00 * 4\% = 3.744.000,00$$

The following work shall effect the residual value calculation. On the basis of the relationship first, the residual value is:

$$RV (\text{Residual value}) = \frac{3.744.000,00}{(24\% - 4\%)} * \frac{1}{(1 + 0,24)^7}$$

$$RV (\text{Residual value}) = 4.152.924,62 \text{ KM}$$

The remainder of this paper we approach the calculation of present value of net cash flow projection period, discounting all cash flows to present value, calculated using a discount rate.

$$\text{Present value of net cash flow projection period} = \frac{1.000.000,00}{(1+0,24)^1} + \frac{1.000.000,00}{(1+0,24)^2} + \frac{1.500.000,00}{(1+0,24)^3} + \frac{2.400.000,00}{(1+0,24)^4} + \frac{2.700.000,00}{(1+0,24)^5} + \frac{3.000.000,00}{(1+0,24)^6} + \frac{3.600.000,00}{(1+0,24)^7} = 5.803.574,25 \text{ KM}$$

The value of company B will get by adding the present value of netcash flow projection period and the amount of residual value.

$$\text{Value of the company B } (V_B) = 4.152.924,62 + 5.803.574,25 = 9.956.498,87 \text{ KM}$$

Based on preliminary analysis, the value of the new entity resulting from merger or acquisition by company A and company B is:

$$V_{AB} = 68.858.441,82 + 9.956.498,87 + \text{value of synergies};$$

$$V_{AB} = 78.814.940,69 + \text{value of synergies};$$

Or

$$V_{AB} > 78.814.940,69;$$

The value of synergy is measured using the parameters that we previously analyzed, which reflect the operating and financial synergies. The effects of business synergies will be reflected in the more increase in expected cash flows of the combined entity will be perceived more synergism of two independent entities. It is also important to stress that the value of total capital is the range between the lower and upper limit values of total capital (the Regulation on the methodology for the valuation of capital assets and RS).

## 5. VALUATION OF SYNERGIES IN MERGERS AND ACQUISITIONS TRANSACTIONS

In the previous chapter we analyzed the procedures for assessing company value in mergers and acquisitions transactions. However, transactions in mergers and acquisitions, the buyer company, or company that brings together, in addition to the value of other acquired companies and the value of business and financial synergies.

The remainder of this paper will present models of valuation synergies in mergers and acquisitions transactions. The effects of business synergies will be reflected in the more increase in expected cash flows of the combined entity will be perceived higher degree of synergism of two independent entities. Calculation of business synergies valuation effects is shown in Table 6.

**Table 6.** Calculation of valuation effects of business synergies

	Year projections						
	2011	2012	2013	2014	2015	2016	2017
Net cash company flow A (FCFFA)	12.870.000,00	12.320.700,00	12.568.500,00	13.427.000,00	13.462.700,00	14.445.550,00	15.058.000,00
Net cash company flow B (FCFFB)	1.000.000,00	1.000.000,00	1.500.000,00	2.400.000,00	2.700.000,00	3.000.000,00	3.600.000,00
FCFFA+B	13.870.000,00	13.320.700,00	14.068.500,00	15.827.000,00	16.162.700,00	17.445.550,00	18.658.000,00
FCFFAB	13.911.610,00	13.853.528,00	14.673.445,50	16.555.042,00	16.938.509,60	18.317.827,50	19.609.558,00
The effects of business synergy	41.610,00	532.828,00	604.945,50	728.042,00	775.809,60	872.277,50	951.558,00

**Source:** Author based on data in Table 4. and 5.

One of the aspects of financial and tax synergies are the effects of the new entity. The following work shall effect the calculation of valuation effects of financial synergies through the tax effects of the new entity. Calculation of the synergy effects of the evaluation is shown in Table 7.

**Table 7.** Calculation of valuation effects of financial synergies

Category	Company A	Company B	Company AB
	60.000.000,00	5.000.000,00	65.000.000,00
Amortization	2.300.000,00	250.000,00	2.550.000,00
Other expenses	47.700.000,00	3.750.000,00	51.450.000,00
Business profit	10.000.000,00	1.000.000,00	11.500.000,00
Tax	3.000.000,00	300.000,00	3.450.000,00
Net cash flow from business activities	9.300.000,00	950.000,00	10.600.000,00
Financial synergies (tax effect)			350.000,00

**Source:** Author based on data in Table 4. and 5.

Net cash flow from operating activities of the combined entity will be greater than the sum of 350,000.00 net cash flows of individual company A and company B.

## 6. CONCLUSION

The globalization of business, strong competitiveness and volatility environment, mergers and acquisitions, as well as external growth strategy of the company, enabling firms to adapt to new opportunities and better positioned to achieve greater value for their stakeholders. Whether the result of a new company mergers or acquisitions, it must achieve a certain synergy effects that justify the whole procedure. First, it should be achieved by increasing the volume of production which can result in the benefits that brings economies of scale. Also, the conquest of new technologies that other companies have kept and improved competitive position. In addition, mergers or acquisitions, the company win new markets and use existing distribution networks that support revenue growth. On the cost side, the reduction of staff in public sectors is achieved by significantly reducing costs. Of course, the management company which intends to merge with another company must first evaluate whether the investment is profitable for them.

In this sense, they must assess how companies target actually worth. Naturally, both sides of this work have different views about the value of the company that “target”: the seller intends to evaluate the company as expensive as possible, while the buyer will try to lower the maximum price possible. Mergers and acquisition strategy to promote the necessary process of external expansion of the company. In most cases, companies can initiate to pay a significant premium to market price of shares of the company you are buying. The justification for this procedure almost always comes down to the notion of synergy. However, the added value of the new entity is not easy to create in practice, things can often go awry. There are many ways to assess the value of “target”.

The value of targets can be evolved over the discounted net revenue in the future the company realized or, even, than replacement cost of assets targets. As we already pointed out, the value of newly created entity, the sum of the value of individual companies entering into transactions and mergers and acquisitions value of operating and financial synergies. He was taken to a large number of studies that had been the subject of factors affecting the failure of mergers of companies. Most of the results suggests that companies focus too much on reducing costs, and ultimately, revenue and profit are ignored. The management company that is the product of mergers may be too focused on integrative issues and cutting costs, while neglecting the operational activities leading to the gradual loss of customers and, ultimately, reducing the company's value.

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## COGNITIVE CAPITALISM AND CONTROL OF AN INCREASINGLY AUTONOMOUS LABOR FORCE IN ORGANIZATION

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### Abstract

Fundamental shift has been occurring today from the economy based on physical resources to the one based on knowledge. Knowledge is increasingly spilling over to others through the socialization process, and thus it is becoming even more a common good and even less a private one. Author strongly believes that incongruity between knowledge as a private or/and a common good brings out the contradiction between social production of knowledge and private appropriation of it. Author argues that this contradiction will help us to better understand that the current crisis of capitalistic system is not a cyclical crisis, but a structural one. Instead of continuous precarization of labour the author seeks to explain why a new labour-capital compromise should be based on a different understanding of the knowledge.

**Keywords:** Knowledge, Common good, Cognitive capitalism, Rent, Crisis.

### 1. INSTEAD OF INTRODUCTION

Knowledge revolution describes the fact that the emergence of wealth will be in the future mainly derived from knowledge. The main source of the creativity and value now resides in knowledge workers and not in physical capital. It is becoming apparent that ownership of the means of production in the knowledge economy is going to be less straightforward than in the past since most valuable assets resides in the brains of the workers. In this context the old antagonism between labour and capital reappears in the new form.

In the paper the author seeks to show why the key to understanding, of the today's crisis and antagonism between labour and capital, lies in understanding of the knowledge. In the second chapter the author provides arguments for understanding the true nature of knowledge. In the third chapter the author seeks to explain a contradiction between social character of knowledge production and the private character of its appropriation. In the last chapter the author argues that this contradiction can help us to better understand the current crisis of capitalism and the need for a new labour-capital compromise.

### 2. KNOWLEDGE AS A COMMON GOOD

I believe that, besides the behaviour of financial markets, the key to understanding the today's economic crisis lies in deeper understanding of knowledge and its valorisation mechanism. Hence, we first need to discover the nature of knowledge itself, in particular whether it is a private and/or a common good. Knowledge requires its carrier. Knowledge-cognitive processes are basically related to the individual, since only subjective knowledge can provide the basis of decision-making. Acquiring knowledge is an individual process since individuals can acquire knowledge only through education. The neoclassical human capital theory underlines that knowledge is basically a personalised process, an investment into an individual, who is giving up a part of his or her income during education, trading it for higher income in the future (Mincer, 1958; Becker, 1964; Schultz, 1960). Consequently, an organisation can only learn by learning of its members or by accepting new ones (Senge, 1990). Nonaka (1994) and Grant (1997) emphasise that individual knowledge is stored in physical skills and in the brain, and can therefore only be transferred with the person that possesses it. All these statements show us, that knowledge is primarily a private good, because it is embodied in individual and its acquisition pertains to individual who appropriates the majority of the benefits derived from the investment into it.

Through socialization process knowledge becomes materialized in machinery, teamwork, and in production-organizational process. The process of acquiring knowledge which is fundamentally related to the individual apparently generates positive externalities that are manifest at the organizational level. Organization should be therefore viewed as a lot more than a group of individuals. Numerous authors acknowledge the organization's capacity to create, learn, and store knowledge. Nelson and Winter (1973, 1982) stress that organization creates through its operations, learning, and experience its own

organizational knowledge. Holzner and Marx (1979) assert that organization as a 'collective agent of knowledge' has the capacity to learn. Organizational learning, organizational routines, and collective brains are notions that point to a conception of the organization as an agent of knowledge. For instance, Senge (1990) speaks of a 'learning organization', Quinn (1992) of an 'intelligent organization', and Nonaka and Takeuchi (1995) of a 'knowledge enterprise'. It means that an organization can be an important agent of knowledge, besides the individual.

Knowledge also enters the market, through the system of property rights held by individuals and organizations, where knowledge can be exchanged for other entitlements. At the same time individual subjects are, through the information function of the market prices, learning from each other (Hayek, 1945). Market becomes a way of social learning and acquiring knowledge. Relations keep emerging through market as a process of social learning. Hence, knowledge cannot be entirely understood through the prism of an individual or an organization, but only through a more profound insight into the market mechanism. Or to put differently, knowledge ceases to become a private commodity, since knowledge is increasingly spilling over to others through the market relations, and thus it is becoming even more a common good and even less a private one.

### **3. SOCIAL CHARACTER OF KNOWLEDGE PRODUCTION AND THE PRIVATE CHARACTER OF ITS APPROPRIATION**

Knowledge related processes are basically related to the individual, since it is primarily acquired through education and since only subjective knowledge can provide the basis for decision-making. However, the knowledge is diffused through the whole society. It is spilling over to other users, and thus it is becoming a common good. It means that the business competitiveness increasingly depends today on so called external "knowledge suppliers" such as public research, mass education and the rising level of general training. This is completely contrary to the traditional model of industry which is based on the central role of the technical division of labour in the organization.

Since knowledge is produced by social cooperation and through the market society it means that as such it does not belong to a single owner. Therefore, the value that springs from its use it simply can't be the reward of the investment in physical capital. Value is generated by the social cooperation; thus the expropriation is no longer confined within the individual or organization but extended to the whole society (Vercellone, 2010, 93). In other words, as long as profit comes from the exploitation and expropriation of knowledge as a common good for private purposes it can be partially understood as a rent. It means that contradiction between knowledge as a private and/or a common good brings out the contradiction between social production of knowledge and the private appropriation of it.

Therefore, the cognitive capitalism requires a different understanding of the valorisation process in a way that a single person cannot take the rent from a system based on social cooperation. In the Fordist paradigm the valorisation is based on the tangibility of production factors itself and its necessary time for production. In the cognitive capitalism the process of valorisation is not immediately computable at the time of production and the result is the crisis of the traditional measurement of the value (Fumagalli, 2010, 65). New understanding of knowledge represents a new way of valorisation, since the main source of value resides in creativity of the key workers and because of the nature of the knowledge as a common good is based largely on the factors outside the enterprise itself (e.g. public research, mass education, the rising level of general training) (Marazzi, 2008). Expropriation of knowledge as a common good is no longer confined solely within the factory but extended to the whole society as well. As knowledge becomes a common good, the measurement of valorisation tends to realize itself through socialization of knowledge.

Such an understanding undoubtedly opens dilemmas regarding the wage system (e.g. universal basic income) and intellectual property right regime (Kešeljević, Cvijanović, 2011). From perspective of knowledge the universal basic income should not be understood only as social security income, but primarily as a collective investment of society into knowledge which stems from individual's productive contribution and its spill over effects. It also means, that the existing property rights (IPR) institutional framework in which knowledge is neither freely produced, nor freely available, is in deep contrast with the nature of knowledge (as the common good) as the most important production factor in capitalism (Kešeljević, Cvijanović, 2011).

#### 4. CRISIS AND INCREASINGLY AUTONOMOUS LABOR FORCE IN COGNITIVE CAPITALISM

The current debate about the causes of today's crisis mainly deals with the responsibility of the financial system (e.g. real negative interest rates, inappropriate monetary policy, weak regulation, systemic risk, high leverage effect). At the moment it seems that the rescue packages, like large increases in public deficits and expansionary monetary policy, will not be sufficient to restore soon the previous growth rates. At the moment it does not seem that BRIC countries can sufficiently compensate for the loss of internal demand in the most developed countries (e.g. EU, USA).

Fumagalli, Lucarelli (2010) and Vercellone (2010) believe that the origin of the crisis lies in the tendency of the financial capitalism toward a rent which does not belong to them. This rent comes from the exploitation of knowledge as a common good, produced by social cooperation, which does not belong to a single owner. It means that the value cannot simply be the reward of the investment in the physical capital. Since capitalistic accumulation is reproduced in the subsumption of the common, it means that a crisis becomes a permanent process.

Knowledge capitalism requires a different understanding of the valorisation process in a way that a single person cannot take the rent from a system based on social cooperation. I strongly believe that incongruity between knowledge as a private/common good, which brings out the contradiction between social production of knowledge and private appropriation of it, is crucial in explanation of the current economic crisis. Capital-labour antagonism takes the form of antagonism between the institutions of the common as the foundations of knowledge based economy and the institutions of appropriation of the common good (Vercellone, 2010, 92). The explosion of the today's crisis is the result of this antagonism, since the financial markets have taken the rent from the social production of knowledge.

These structural reasons in combination with the exhaustion of the technological foundations of the Fordist paradigm are shown as endless attempts of companies to bring back by different means the high profit rates through reduction in labour costs, flexible labour forms, attacks on syndicates, automatization and robotization of the entire labour process, delocalization of industry in countries with low wages and strong industrial reserve army force, and in precarization of work (Marazzi, 2010; Fumagalli and Lucarelli, 2010). The current crisis of capitalistic system is therefore not a cyclical crisis, but a structural one.

Knowledge increasingly becomes with the individual's inclusion into the organization and society a common good. In this context the old dilemma between labour and capital reappears in the new form (Vercellone, 2010, 106). The knowledge embodied in key workers surpassed the knowledge embodied in material capital and becomes the principal factor of economic growth. Capital is obviously losing control since it has been increasingly dependent on the quality of cooperation among workers and on external providers of knowledge (e.g. public research, mass education). It seems that capital answers to this challenge with continuous precarization of labour instead with a new labour-capital compromise based on the nature of knowledge.

#### 5. CONCLUSION

Knowledge revolution describes the shift from the economy based on physical resources to the one based on knowledge. The wealth of nations will be in the future mainly derived from knowledge, which has become today the prime factor of the value and the principal factor of economic growth.

Knowledge-cognitive processes are basically related to the individual, since individuals can acquire knowledge only through education. However, knowledge cannot be fully understood through the prism of an individual or an organization, but only through a more profound insight into the market mechanism. Since knowledge is increasingly spilling over to others in organizations and society and through the market relations it is becoming more a common good and less a private one.

Contradiction between knowledge as a private and/or a common good brings out the contradiction between social production of knowledge and the private appropriation of it. In other words, as long as profit comes from the exploitation and expropriation of knowledge as a common good for private purposes, it can be partially understood as a rent. Since knowledge is produced by social cooperation it means that such rent does not belong to a single owner.

Author also believes that the origin of the today's crisis lies in the tendency of the financial capitalism toward a rent which does not belong to them. Since capitalistic accumulation is reproduced in the subsumption of the common, it means that a crisis becomes a permanent process. These structural reasons are shown as endless attempts of companies and a strong tendency for flexible labour forms,

precarization and reduction in labour costs and in employment security. The current crisis of capitalistic system is therefore not a cyclical crisis, but a structural one. Therefore, knowledge capitalism requires a new labour-capital compromise based on the nature of knowledge and a different understanding of the valorisation process in a way that a single person cannot take the rent from a system based on social cooperation.

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**THE PRODUCT MARK-BRAND AND ITS ASSESSMENT IN THE MACEDONIAN MARKET**


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## **Abstract**

This paper is structured in several chapters and sub-chapters, where thorough analyses were made about the real situation of brand products in our country, and uncontrolled production and the distribution of various brands on the market that in most cases make the process difficult of deciding to purchase the desired brands that are offered in the market, for meeting the objectives of individuals and organizations. Therefore, the company in order to realize the desired products from the market, it must take into account customer demand, technological capacity, its skills, and commercial and financial potentials. First of all, the product strategy does not mean only the technical characteristics of hoped by the demand, but also the psychological expectations, which appear with the choice of the form, design, brand, packaging, and other services. Finally, the marketing-mix and other marketing variables (price, communication, motivation, distribution, etc.) need to be determined by the product policy, since the choices made at these levels directly affect the image-branding of the product. Thus, the purpose of the paper is the brand of product, which has special importance for the successful penetration and product positioning in the market. In this paper, we analyze in particular, theories or brand marks, meaning the brand of the product, the functions of the brand, brand policy, factors that influence the creation of the brand, brand testing and brand positioning in the market

And finally, we present results from the survey conducted with a structured questionnaire, where a total number of 1424 respondents were surveyed, where they responded to 14 questions about the brands of products. From the obtained results we came up with some findings about confidence in brands, their admiration, how much are brand products purchased, who purchases them, the satisfaction from brands purchased, and so on. From the findings for brands on the Macedonian market, we recommend solutions on how companies should brand their products.

**Keywords:** Product brands-brands, Customers, Companies.

## **1. INTRODUCTION**

### **Product Brands**

The presence of a large number of products with the same value or for the same usage, intends to fulfill the same or similar needs of customers, adds the need for identifying all needs of use of each type of product to any manufacturer. This role in the contemporary market economy has been played by brand or product brand.

The mark or brand is a well-known name or sign of any product, an acronym, a collection of words, syllables, letters, symbols, pictograms or a logo (ex: 3 Mercedes star properties), a shape, a design (ex: Perrier Bottle) , a collection of colors (Kodak), specific graphs, ways of writing the name (Ford) or a combination of two or more elements from these, which are intended to identify manufacturer's products or services from other manufacturers, which often means the quality of products.

As can be seen the brand product uses various tools for the purpose of performing the function itself. In practice we find various ways of presenting the brand of products. In most cases, brand-name is expressed with a pronounceable name, known as product name, ex: "Pepsi-Cola." When it has a name and is registered at a legal competent authority, then it is as used as a protective sign. The protective sign beside the product name, it includes the manner of its graphic and structural expression, packaging and other associated symbols.



## 2. THE MOST IMPORTANT TERM OF PRODUCT BRAND (MARKS OR BRAND)

These two terms are very often argued within circles of marketing experts in order to find out which of the two terms is more suitable for products or companies. In marketing practice, there are two rhymes, on the one side are proponents who think that marks and brand are with different meanings that must be differentiated, and, on the other side those that support the thesis that these two terms are synonyms.

It can be found even in large vocabulary of International Marketing and Communications the concept for the expression as: brand image which is probably explained as: customer feedback about product and about which brand is registered and legally protected.

### Which meaning is right?

MARK = BRAND - the personification of the product for customer loyalty. Brands and marks are synonymous, that means they have the same meaning and significance, although there are opinions that the brand is the trend of the time and has to do with the branding of the product and is more important than the mark.

The three most important terms related with the brand are the following:

- The value of the brand - based by that limit on which the brand has the highest confidence, consumer awareness of the existence of this brand and strong cooperation in production. The brand value has also other intangible assets as: the right of invention inventor, protection sign and the spread of manufacturing channels.
- The image of the brand - understood as the set of beliefs that consumers have about specific brands. The image must be developed rightly the negative image of the brand can be hardly left aside.
- The expansion of the brand - using its real name that successfully introduced or sold in the same market. VIRGIN is a good example of how fully the expansion of the brand can be used in any market.

## 3. THE FUNCTIONS OF THE BRAND

The main function of the product brand is to identify the value of use of each product, and the brand itself appears as a product guarantee that contains those used values attributed to the use of that specific product.

Kapferer and Laurent have defined six functions of the brand, as<sub>1</sub>:

- The function of practicality;
- The function of warranty;
- The function of personalization;
- The function of satisfaction;
- The function of specification, and
- The distinctive function.

The function of “practicality” is about the practical character of the brand. Brands should help to easy memorize the results of the initial process of selection without the need to review again in order to retake the brand that is prejudged as appropriate.

The function of the “guarantee” expresses the fact that for some customers and some products a known brand is a guarantee for a better quality.

The function of “satisfaction” corresponds to customers’ satisfaction from the purchases, such as varieties, where the lack of the brand will result in disappearing of the satisfaction.

The function of “specification” arises when the brand has a configuration similar to the product quality. Trademark is inseparable from the product.

The brand has a “distinctive” feature when it is the only benchmark for product differentiation by the customer. This feature is critical when products are opaque (metal, champagne, clothing,

1 J. N. Kapferer and G. Laurent, *Ce qui va changer LES MARQUES*, Paru, 2005, pp.372

liquids, etc.) because the name and visual identity of these products resemble to each other. Choosing a brand and the elements that associate it (location, signs, colors, graphic elements, etc.) is sometimes a way of differentiation, personalization and recognition of the product.

Before you introduce a brand on the market, it must be tested for:

- Its readability;
- Its ease of expression;
- Its ease of memory;
- Its attracting ability;
- Its ability to be used without modification by foreigners
- Its availability, etc.

In order for it to be more perceptive and acceptable by consumers- the market.

#### 4. THE MAIN FACTORS FOR BRAND FORMATION

The brands are rarely held for only one product. They are most often conducted for the purposes of lines or manufacturing groups. Professor David Jobber has identified seven key factors for successful construction of brands:<sup>2</sup>

- Quality - is an important “ingredient” of a powerful brand. It should be kept in mind that “advantage goals” are items that customers have in their expectations. Statistical analysis prove that with high quality brands, a greater volume of the market and greater profitability is achieved compared to poorer competitors.
- Position - has to do with the position that brands benefits from the market. Strong brands have often the clearer position in the market. The positioning is achieved through several means: brand name, image, service standards for the product, packaging and how the product is sent to the market. The successful positioning represent the combination of activities above mentioned.
- Repositioning – happens when the brand tends to change its position on the market in order to fulfill the changed needs of consumers. This is mostly needed when the brand becomes “not as required” maybe when the market is more developed, or is destroyed.
- Communication - has also an important role in developing a successful brand. It was mentioned that brand positioning is a must for attracting consumers, with the aim of building clearly defined position in the target positions of the auditorium. In the beginning, it is very important to use all the elements of the promotion techniques in order to attract customers, and then to create positive beliefs which will increase the demand for those products.
- Being first in the market - in terms of brand development, as “the first promotor”, it is possible that the first successful brand in the market to establish a clear position on the opinions of consumers, before the competition. But being the first in the market does not mean a guarantee for long term success in the market.
- Long term perspective - long-term investments are also an important factor in the brand formation. Creating positive customer beliefs and brand trust requires a strong commitment and long-successful management with marketing orders and costs creation. This means that management must invest in brands by spending its short-term profitability.
- Internal Marketing - finally management should ensure that the brand is so well promoted within the organization and outside it. This means that businesses in general must understand the positioning and brand value. This is extremely important with service activities in the act of service, where the critical brand value is with the quality of service that customers receive.

Marketers have a broader knowledge that strong brands which ensure high sales and profits, have the potential to use the same strategy in all other products. There are two operations that are usually named as rebuild and expansion of the brand.

<sup>2</sup> M.J. Etzel, B. J. Walker, W.J. Stanton, Marketing, njimbëdhjet edition, Irwin, 1997, p. 246-250.

A successful brand helps companies to more easily enter a market with a new product line. Rebuilding a brand has several advantages:

- Consumers will associate the quality from brand expansion with the new product, and will have the opportunity to trust the new product;
- The new product will attract more quickly the customer, the awareness and will prepare him/her for usage and taste of the new product;
- Distributors may notice that there is lower risk if the new product holds in itself holds the familiar brand;

The cost for promotions are supposed to be less.

## 5. BRAND POLICY

Brands at the same time represent an element of trade policy. Choosing a brand is the primary policy, mainly in the discussion between manufacturers and distributors. The distributor pays a great importance to the brand in order to refer to the product. This concept for better understanding is presented in Figure -1.<sup>3</sup>

Fig. -1. The role and importance of the brand for the product.



Choosing a brand is a primary policy, mainly in the discussion between manufacturers and distributors.

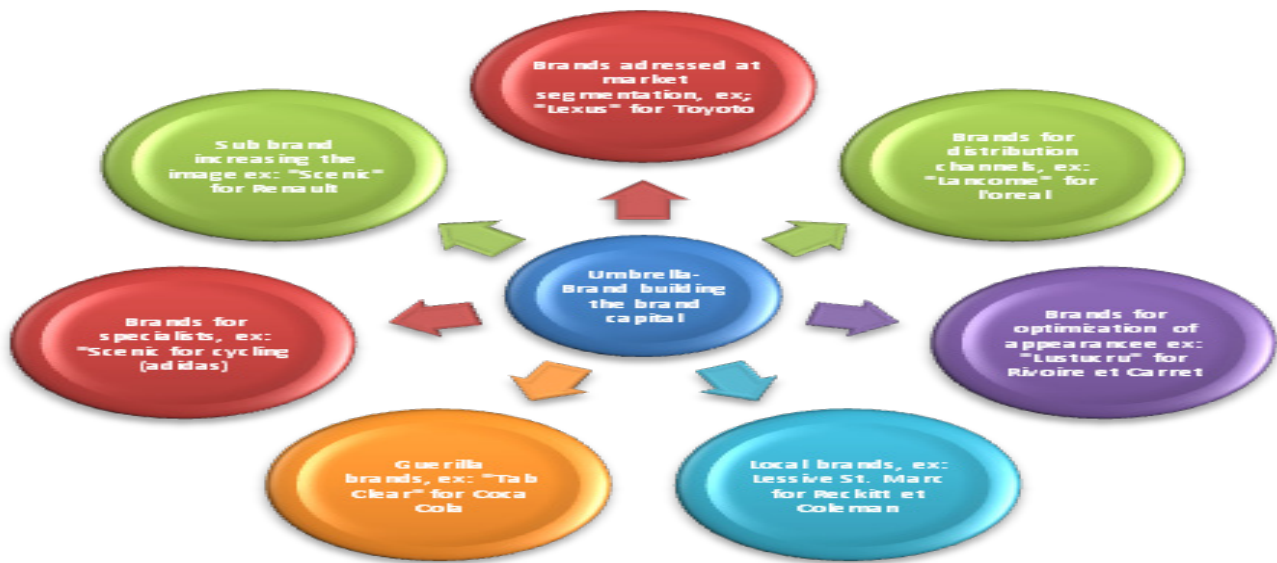
Some other important principles are:

- The choice of a unique brand for the company or product line, provides good reputation of the product, but in case of failure, threatens to damage the other products;
- Policy brand differentiation increases advertising investment, but allows a very strong segmentation;
- When a firm has many lines, it is good to differentiate its lines to avoid negative effects of the past;
- The choice of a new brand leads to a higher product differentiation;
- One of the main risks is cannibalism among brands, the last brands introduced in the market, to gain market share on behalf of other brands of the same firm. This error is often the result of inadequate or unclear positioning.

<sup>3</sup> Nexhbi Veseli, "Principles of Marketing", second edition-ALMA, Skopje, 2009.

Different policies of brands of products can be presented with Figures -2.

Figure: 2 Brand policy



## 6. TYPES OF BRANDS

There are two important types of brands:

- Manufacturing brands
- Own –label brands

**Manufacturing brands** are established and appointed by the manufacturers. Manufacturers are responsible for the brand promotion. By building the brand, manufacturers can achieve wide distribution of products and build customer confidence. **Own label brands** are mediators that are created and possessed for the network distribution - distributors. It happens in many cases that distributors are retailers, and all range of their products, to be own-labeled. Distributors often mix manufacturing brands with own-labeled brands.

Own-label marketing, if done well, offers to consumers good value of money and provides the distributor with additional skills when it comes to pricing and conditions with manufacturing brands. Often the question is why businesses are trying to build brand. There are many priority in for businesses that build up successful brands. This includes:

- Higher price;
- Higher profit;
- Better distribution;
- Consumers' confidence.

Consumers are rarely prepared to pay compensation for products or services which carry only the initial gains. Successful brands are those that besides the initial benefits that carry the product, they also bring additional values to consumers. These additional values enables brands to be distinguished from other competitive brands. When they are well built, consumers recognize the added value of the preferred product and brand information. As for example, the customer may require a guarantee for the quality, when not sure during the choice. The customer may also require a that brand has a special meaning in terms of status or life style.

Brand theory assumes that there are three main types of brand names: **Familiar brand names** - used for all products. Through building trust and loyalty to consumers about familiar brand name, all products which use the brand can benefit. The use of familiar brand name can bring up problems, if a product builds negative publicity in the market. This can destroy the reputation of all assortments of brand.

**Individual brand names** are not identified with specific companies. There are several reasons why brands must have personal identity:

- The product can be competitive in this new market segment, where a possible failure can “hurt” the main family name;
- Family brand name may not be well positioned for the entire market segment;
- Brand may already be built, or in other words to be promoted as the leading brand in the market segment. The fact that it is built from the company with a powerful brand family, does not mean it should be changed.

**Combined brand names** – links family name with individual brand name. The idea is to allow several associations for the product with a powerful name of brand family as well as maintaining some specifications that customers know what they get.

The brand name should be chosen carefully because it gives consumers more information. The following list contains ideas that should be constructed prior to final selection of brand name.

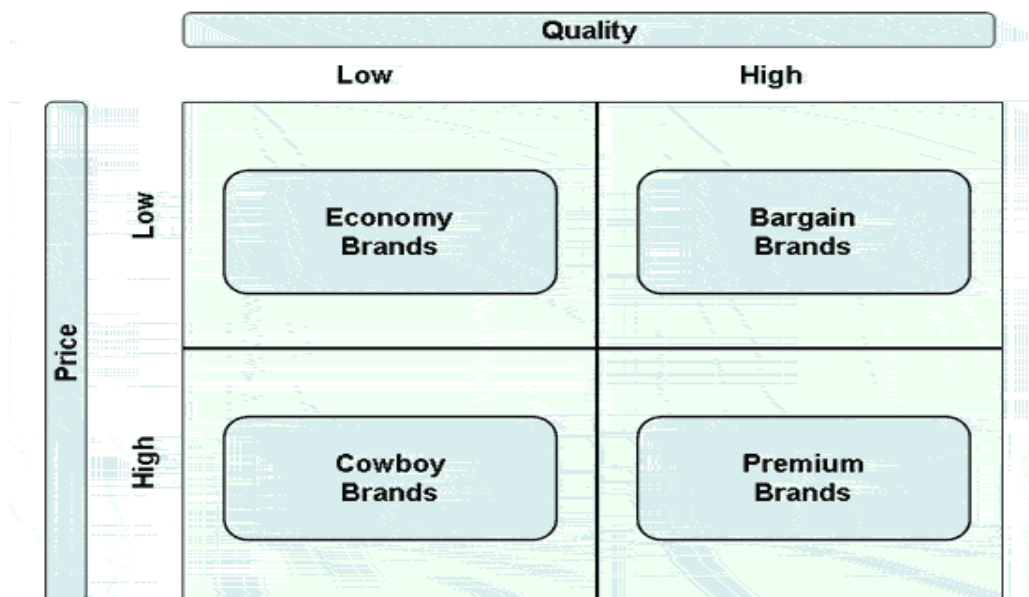
**The brand name should:**

- evoke positive associations;
- be easy for pronunciation and to be kept in mind;
- contain manufacturing benefits;
- be simple;
- use numbers when emphasizes technological properties;
- not be in conflict with the brand name that exists.

### Brand positioning

Brand positioning can be defined as: the relationship of one product with other products on the market. Brands can be positioned against competing brands in the perceptual map.<sup>4</sup> It defines the market in terms of the way that consumers perceive the key features of competing products. The initial map perception that buyers use designed products depending on their price and quality as is illustrated below:

Figure: 1 Price and quality of brands



The purpose of this paper is to show confidence and assessment in brands, and to find out how product brand affects consumer behavior. In order to achieve this, a survey sheet was carried out through a questionnaire.

<sup>4</sup> Jean-Noel Kaofferrer, Strategic Brand Management: New Approaches to creating brand equity and evaluating (London: Kogan Page, 2002).



## 7. STATISTICAL ANALYSIS OF RESULTS FROM THE CONDUCTED SURVEY

The survey was conducted with the help of students and faculty of Business and Economics in R. Macedonia. A sample of 1424 respondents were randomly chosen in the RM. Respondents answered independently and without interference of others. The age of respondents is listed in the table under the rule Sturgesit:

$$k = 1 + 3,3 \log N \quad k \text{ -number of age groups}$$

$$i = \frac{x_{\max} - x_{\min}}{k} \quad i \text{ -internal length}$$

Respondents age gropus:

48 28 70 21 21

28 17 41 35 21

34 16 41 22 23

46 20 22 20 19

49 67 29 20 21

$$\text{Solution: } k = 1 + 3,3 \log N = 1 + 3,3 \log 3 = 5,6 \approx 6$$

There would be X age groups.

$$i = \frac{x_{\max} - x_{\min}}{k} \quad \begin{matrix} x_{\max} = 9 \\ x_{\min} = 6 \end{matrix} \quad i = \frac{9 - 6}{5} = 2,8$$

the length of interval will be X years.

Age groups	Nr. of Respondents	Female	Male
16-18	212	100	112
18-22	602	283	319
22-26	246	116	130
26-30	144	68	76
Mbi 30	220	103	117
$\Sigma$	1424	674	750

From the total number of respondents 53% are male, while 47% are female. The analysis of data from 1424 respondents surveyed, 53% of respondents are males while 47% are females. 15% are aged 16 to 18 years, 42% belong to 18-22 years, 17% are aged 22-26 years, 10% are aged 26-30 years and 16% are aged over 30 years.

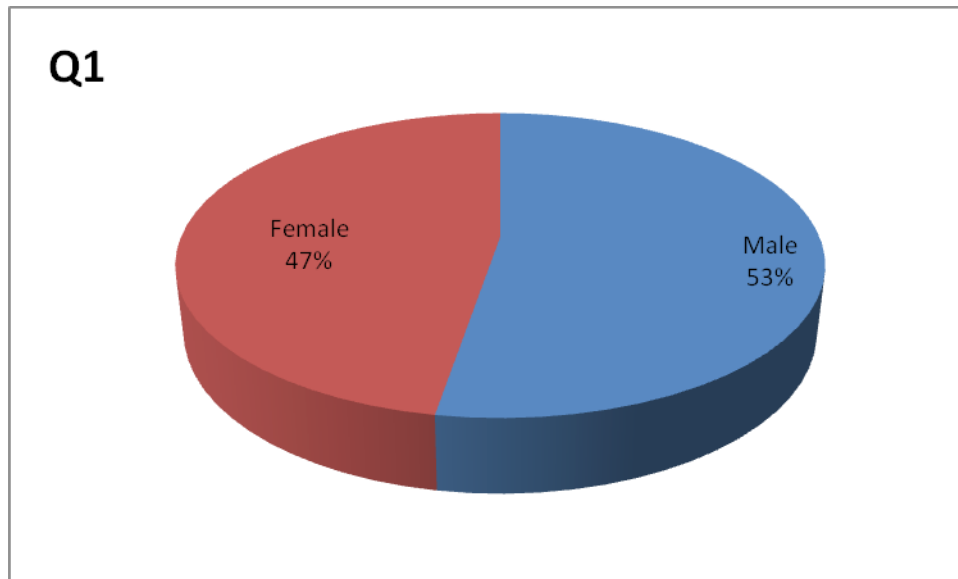
From information on monthly income, it is clear that 14% have a monthly income that reaches 6000 den, 29% have monthly incomes of 6000-15000 den, 21% have a monthly income above 15,000 den, while the rest 36% have no income.

Respondents who gave answers to survey questions is as follows:

Table: 1 Respondents based on gender

Gender	Male	Female	Total
	750	674	1424

Figure: 1 Respondents based on gender



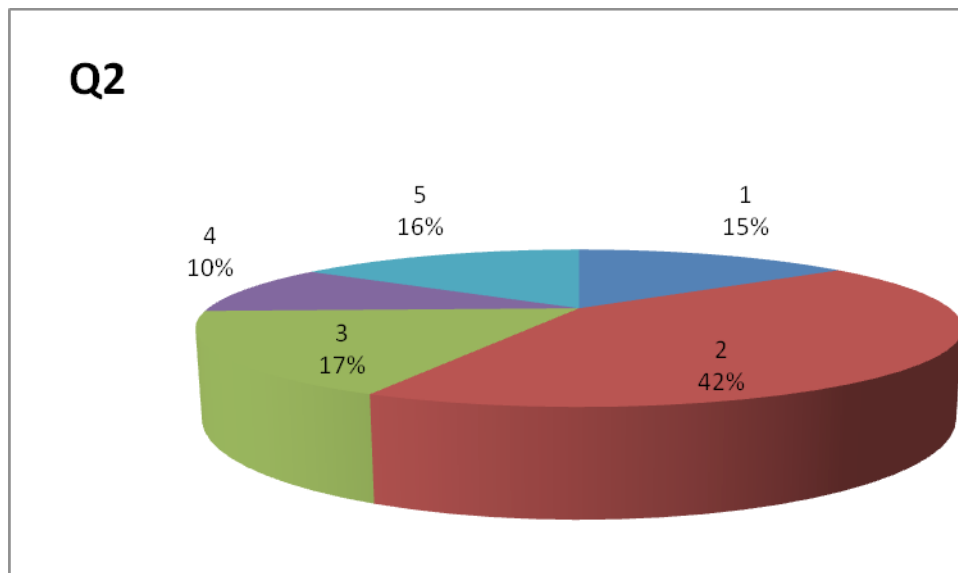
We can see from the above that 14% of respondents while choosing a product look at brands product, 46% at the quality, 11% at design, 25% at the price, while 4% choose the product with all features listed. This tells us that during the selection of product, the respondents while selecting, firstly they are influenced by the quality, secondly by price, and thirdly comes product brand.

2. According to age, 15%, or 212 respondents belong to age 16-18 years, 42% or 602 respondents belong to age 18 age-22 years, 17%, or 246 respondents are aged 22-26 years, 10%, or 144 respondents are aged 26-30, and 16%, or 220 respondents are over 30 years.

Table: 2 Respondents based on age

16-18	18-22	22-26	26-30	Over 30	Total:
212	602	246	144	220	1424

Figure: 2 Respondents based on age



Results obtained from the second question show that 50% of consumers practice buying products with known brands, 39% do not buy this type of product, 11% sometimes buy famous brand products. From this we can conclude that the majority of customers are driven buying products with famous brands.

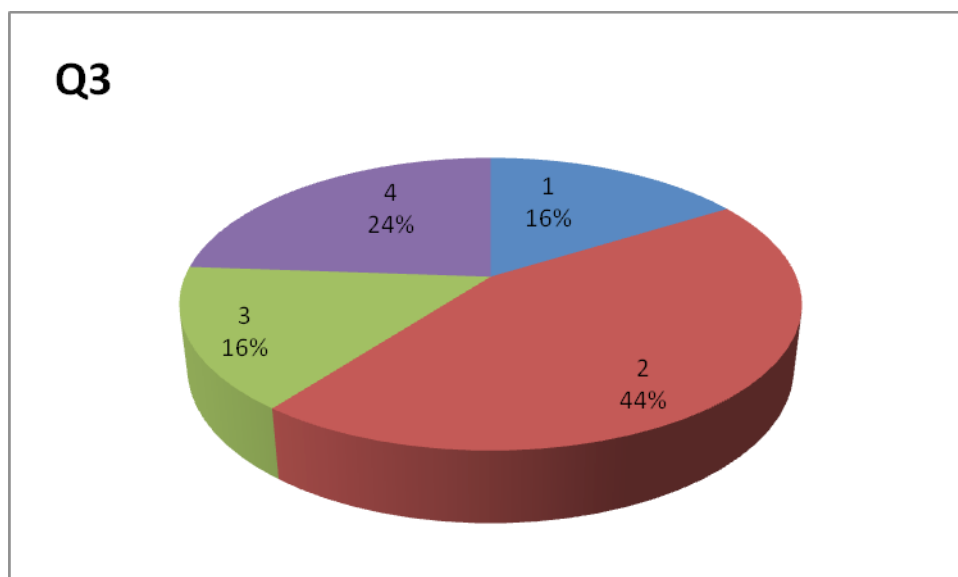
3. Regarding the percentage of respondents based on profession it is as follows: 16% are pupils or 230, 44% are students or 630 respondents, 16% are administrative employees or 224, private workers 24% or 340 respondents. So the largest percentage of respondents represent pupils and students who rarely realize income

independently.

Table: 3 Respondents based on profession

1)pupils	2)student	3)administrative employees	4)Private employees	Total
230	630	224	340	1424

Figure: 2 Respondents based on profession



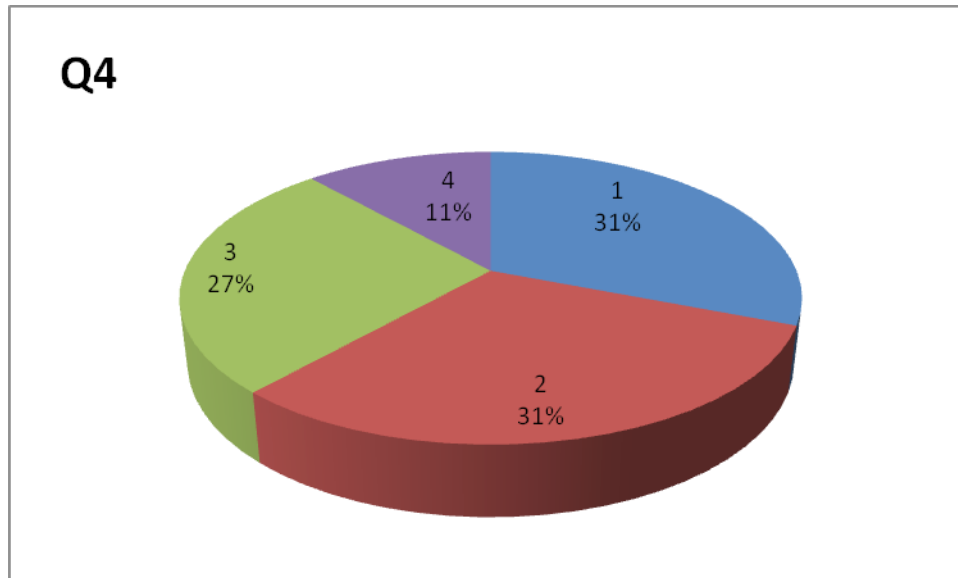
Consumers often face difficulties while deciding what brand of product to buy. From the obtained results of this survey questionnaire, 53% of customers buy products from popular international brands, 39% of them buy products from Macedonian brands, some of them buy the products of unfamiliar brands, 4% buy products without the brand, 4% of consumers do not pay attention or importance to product brands. Namely, consumers mostly buy products that are known as global brands.

4. The obtained results for monthly Income of the survey are as follows: 31% or 440 respondents have a minimum income to 6000.00 den. 31% or 438 respondents realize a monthly income of 6000.00 to 15000.00 den., 27% or 380 of respondents realize a monthly income of 15000.00 to 30000.00 den., and 11% or 166 respondents realize a monthly income over 30000.00 den.

Table: 4 Respondents based on income

a) to 6000	b) from 6000-15000	c) 15000-30000	d) over 30000	Total
440	438	380	166	1424

Figure: 4 Respondents based on income



This question is submitted in order to understand how often customers buy products from known firms, and it can be concluded that 14% of consumers always buy the products of popular brands, 82% sometimes buy products of popular brands, 4 % of consumers never buy products with famous brand.

From this we can conclude that: the number of customers who buy products with no known market is very small compared with the number of customers who buy products with known market brands.

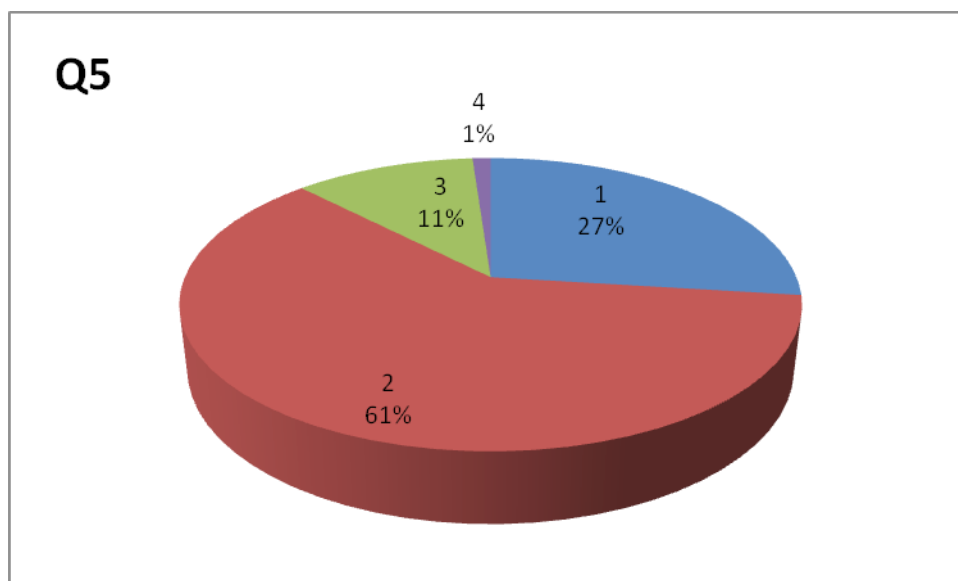
5. Concerning the question 5, how often consumers prefer to buy branded products, the results show that 27% or 384 respondents always prefer to buy products with the brand, 61% or 864 respondents answered that they sometimes buy products with the brand, while 12% or 176 of are surveyed responded that they never buy brand products

You buy branded products:

Table: 5 Respondents based on frequency

always	b) sometimes	c) never	Total
384	864	176	1424

Figure: 5 Respondents based on frequency



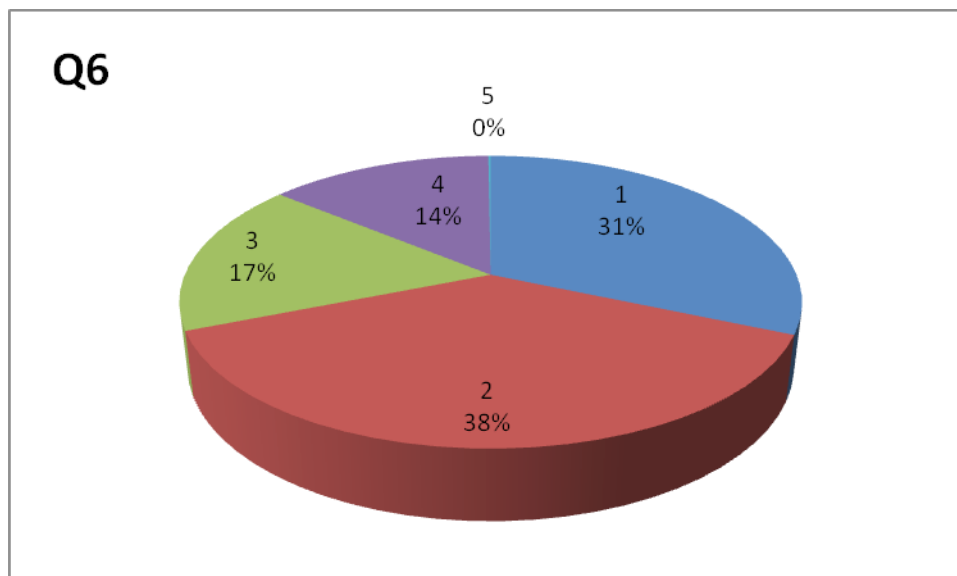
6. When asked when for the last time they bought a famous brand product, the results from this question show that: 31% or 448 respondents have purchased products with famous brands a week ago, 38%, or 534 respondents bought a month ago, 17% or 244 respondents purchased a product

with the brand a year ago, and only 14% or 198 respondents can not remember when the last time they bought a brand product or they have never bought.

Table: 6. When did you for the last time buy branded products?

1) a week ago	2) a month ago	3) a year ago	4)	Total
448	534	244	198	1424

Table: 6. When did you for the last time buy branded products?



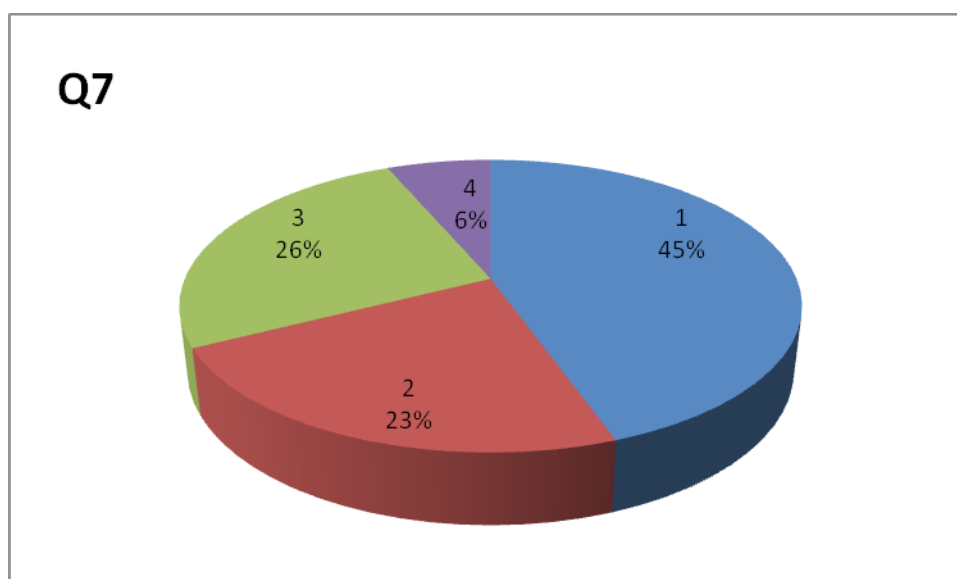
7. When asked whether they donate recognized brand products?

From the results by respondents for this question, we may conclude that: the majority of consumers, up 45% or 634 of respondents have responded positively, that donate products of famous brands to their relatives, 26% or 328 respondents donate brand products, 23% or 370 respondents do not donate brand products, while 6% or 92 respondents answered that they sometimes donate branded products.

Table: 7 Do you give branded products as gifts?

1) Yes, only to my relatives	2) Yes	3) No	4)	Total
634	328	370	92	1424

Figure: 7 Do you give branded products as gifts?



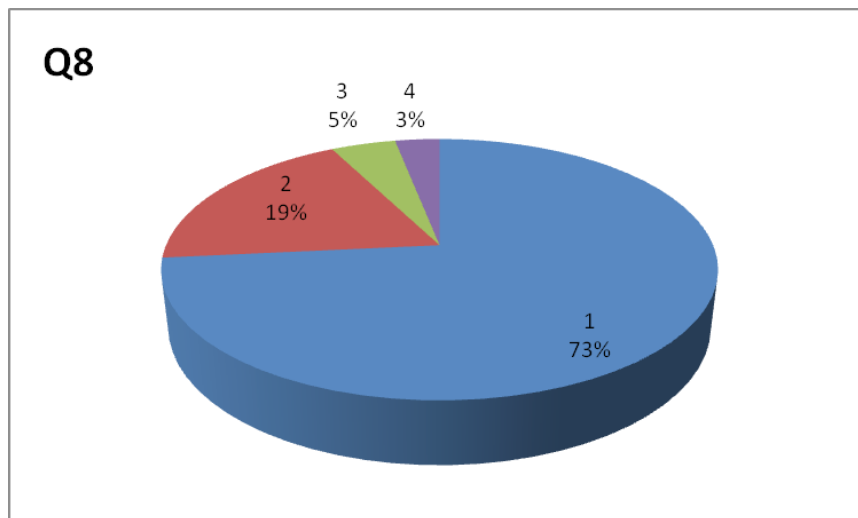


8. Regarding the evaluation of the brand, the question whether they think that products of popular brands are of different qualities from other unbranded products. Consumers often have opinions that the products of popular brands, unlike products with unfamiliar brands are with high quality and very expensive. This can be concluded from the results obtained from surveys, 73% or 1046 respondents felt that known brand products are with high quality and more expensive, 19% or 270 respondents think that they are with the same quality, no one thinks that they are with lower quality, 5% or 64 respondents think that they are with poorer quality, while 3% felt that the quality of products depends from the product itself.

Table: 8 Do you think that branded products compared to products without brands are

a) with higher quality	b) with similar quality	c) with lower quality	d)	Total
1046	270	64	44	1424

Figure: 8 Do you think that branded products compared to products without brands are

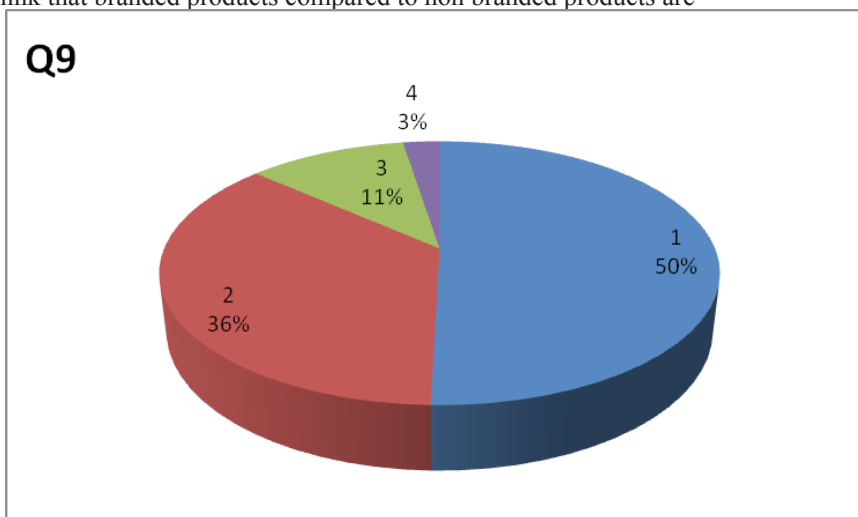


9. Concerning the question whether the price of well-known brand products are more expensive than other non brand products. 50% or 718 of respondents answered that they are more expensive, 36% or 514 respondents think they are relatively expensive, 11% or 156 respondents think that they are not very expensive, while 3% or 36 respondents felt that products of popular brands are not much more expensive products than no brand products. Therefore, we can conclude that most consumers think that products of popular brands are much more expensive than the unknown products.

Table: 9 Do you think that branded products compared to non branded products are

1) Far more expensive (718)	2) Relatively expensive ( 514)
3) Not so expensive (156)	4) not expensive (36)
Total=1424	

Figure: 9 Do you think that branded products compared to non branded products are

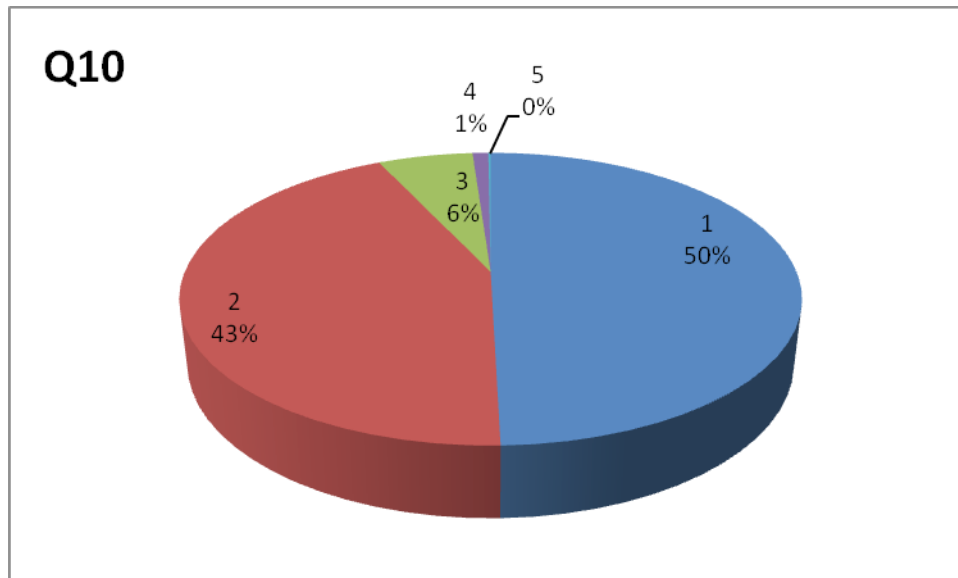


10. Concerning the question, whether the possession of a known product brand creates a higher status for the customers. The obtained results from this question show that 50% or 706 respondents having known brand products creates high status, compared to other customers in 618 respondents 43% does not create high status, while in 7% or 100 respondents sometimes creates high status, which means that brands do not create more influence in building a higher status to some customers.

Table: 10 Tell us whether the possession of a branded product creates the feeling of a higher status?

a) Yes	b) No	c) ____	Total:
706	618	100	1424

Figure: 10 Tell us whether the possession of a branded product creates the feeling of a higher status?



11. On the question of who can buy products with famous brand. This question is submitted with the aim of understanding of how consumers' income influence the increase of demand for products with popular brands. The results show that: 49% or 696 respondents felt that the famous brand products can be bought only by customers with a high income, 36% or 516 respondents felt that these types of products can be bought also by the consumers with medium-income, 4% or 64 respondents felt that these types of products consumers can be bought by the low-income as well, 11% or 148 respondents believe that all consumers can afford this type of products from known brands.

Table: 11. Products with famous brands can be afforded by:

1) high income 696	2) middle income 516	3) lower income 22	Total
4) all mentioned above 64	5) _____ 126		1424

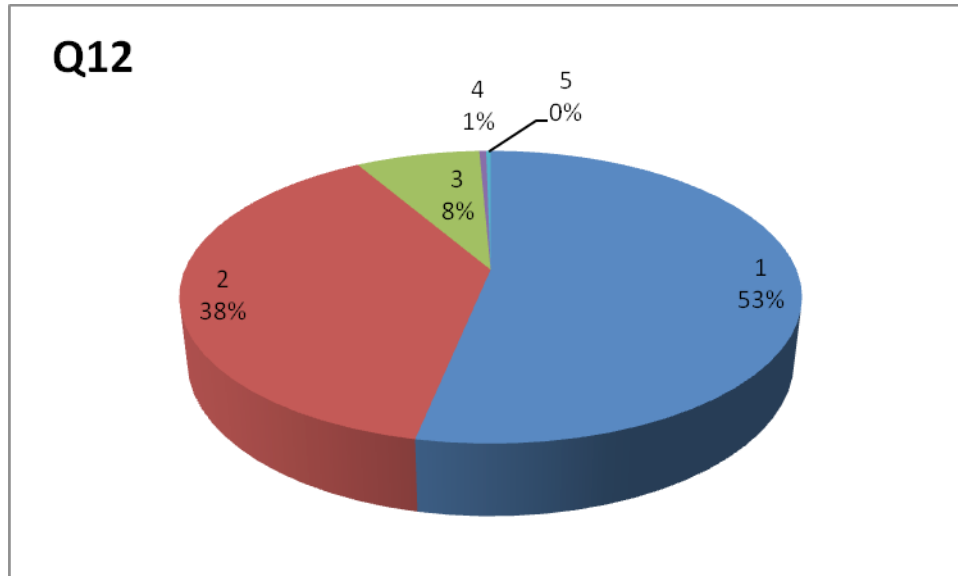
Figure: 11 Products with famous brands can be afforded by

12. Do you think that branded products facilitate the choice while buying products? We can conclude from the results concerning this question that brands facilitate the choice and the purchase of the product, because the majority of respondents answered positively about 53% or 758 respondents, 38% or 546 respondents had negative answer, while 3% or 120 of respondents are not sure whether it easy or not.

Table: 12 Brands facilitating the choice

1) Yes 758	2) No 546	3) 120	Total 1424
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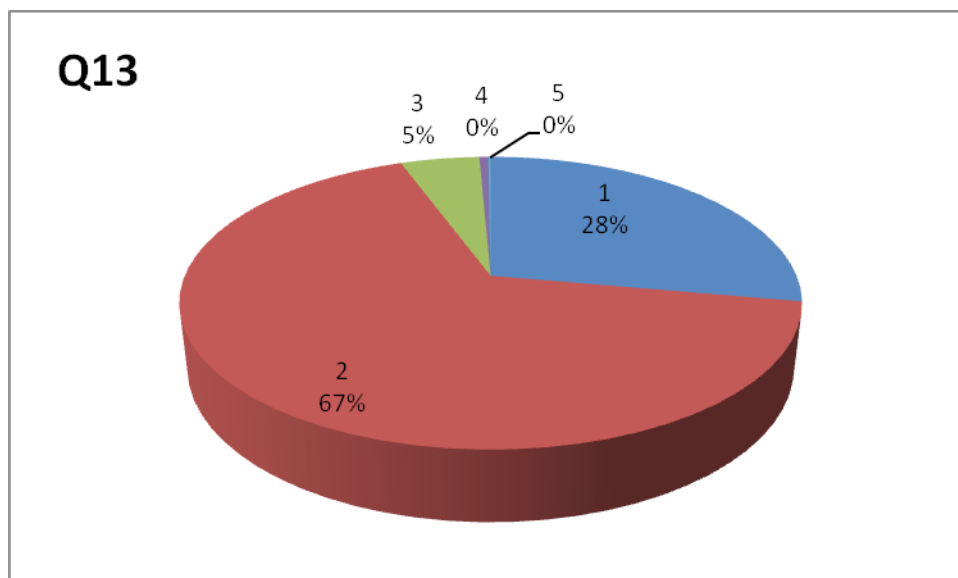
Figure: 12 Brands facilitating the choice



13. Concerning customer satisfaction with the quality of branded products, if customers were not satisfied with the quality of the product of a famous brand, would they continue to buy further just because of the brand is famous. Results, from this question are examined, because we think that while consumers are not satisfied with the quality of the product of a known brand, they do not continue to buy that brand, thinking that consumers during the buying process pay much more attention to the product rather than to the brand. But the results show something else, as 28% or 396 of respondents will continue to consume that product because of brand loyalty, 66% or 948 respondents will abandon that product, while 6% or 80 respondents are indifferent with the question.

Table: 13 If you are not satisfied with the quality of a famous brand product, would you continue to buy that famous brand?

a) Yes 396	b) No 948	c) ____ 80	Total: 1424
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**Table: 14 Are there fake of famous brands?**

1) Yes 1174	2) No 174	3) ____ 76	Total: 1424
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**Figure: 14 Are there fake of famous brands?**

14. When asked whether there are counterfeiting with branded products.

The survey results show that 83% or 1174 respondents state that there are counterfeited brands, 12% or 174 of respondents deny this phenomenon, and 5% or 76 of respondents think that maybe there counterfeited brands but they are not sure.

## 8. CONCLUSION

From the obtained results from the research carried out with 1424 respondents in Republic of Macedonia we can conclude that majority of respondents like international brands, especially younger generation who do not generate incomes, but whose desire is fulfilled by their family members. The research also revealed that many consumers buy products with brands that very often give to their relatives, because they think that the branded products are of higher quality and with higher prices. But, in the beginning they are drawn the quality, then from price, and finally from the brand of the product.

50% of respondents think that buying branded products creates a feeling of higher status in comparison with others who do not think so.

We can also conclude that the brand itself facilitates the choice between products, but if the consumer is not satisfied with the quality of the product then the brand does not influence him/her for further purchasing of the same brand. But, a great number of loyal customers would continue to buy from the same brand, when most of customers would switch to other products thinking that those are fake products, as we saw from the obtained results from the research that 83% or 1174 of respondents think that there are fake brands of famous brands. A phenomenon that is also confirmed from the media and government institutions for permanent counterfeited international brands.

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## **USING SOCIAL NETWORKS IN A SMALL BUSINESS ENTREPRENEURSHIP**

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### **Abstract**

Small Businesses give a significant impulse to economic growth and development of each country. The business environment today is changing faster than ever thanks to advanced technologies. Competition in almost every industry has become more intensive. Considering the above, companies are becoming aware of the importance of adjusting their businesses to the target market in the best possible way in order to stay competitive. We believe that social networks today are the integral part of the communication with the target market from which small businesses cannot and should not be run from. Instead of, these networks should be used as a marketing tool in order to help small business owners successfully manage the process of marketing communication. This article seeks to analyze the factors of significant influence on the entrepreneurship communication with its target market with special emphasis on the online communication. The authors will use the case study method to present the example of successful women entrepreneur in Croatia who succeeds to cope with the challenges within craft industry. Selected case study will show successful marketing communication strategies for managing small business ventures in the selected industry. It can be concluded that social networks generate significant benefits for the company through maintaining long-term contact and continuous communication with the final users of their products and services. The results of this study will give clear guidelines to small business entrepreneurs on how to use modern technologies and new ways of doing business online in order to make their brand and their organization better known. Furthermore, this work will greatly contribute those trying to establish their online communication with their clients/customers and stimulate those who still did not think about it.

**Keywords:** Small business, Social networks, Business strategy

### **1. INTRODUCTION**

Consequently, the present research aims to positively contribute to this situation, by exploring whether the social networks are a tool that should be taken seriously by SMEs in their marketing strategies, taking the stance of SMEs – how they perceive, use and see the future of social networks for their business. The objectives of this study are informed by the gaps found in the literature review: To explore how particular SME use social networks in its marketing strategy, and the benefits of them, as compared to other marketing tools and finally attitudes towards social networks – perceived advantages and disadvantages, improvements needed, and to explore their plans for improvement/future use of social networks in marketing strategies.

For the purpose of writing this paper, the authors used the method of case study. Case study research excels at bringing us to an understanding of a complex issue or object which can extend experience or add strength to what is already known through previous research. Through this case study we succeed to emphasize detailed contextual analysis of a small company and social networking and their relationships.

Through social networking sites, products/companies can have conversations and interactions with individual followers. This personal interaction can instill a feeling of loyalty into followers and potential customers. Also, by using these sites; company's products can reach a very narrow target audience.



## 2. THEORY REVIEW

### 2.1. Social networks

There are many definitions of social networks in the literature, but we will use the one which defines the term “*social network*” to represent interpersonal connections between individuals, business units, or organizations. These links are not hierarchically influenced and they include information and knowledge flows. We can extract two overarching goals of networking. The first is to *transfer knowledge* and the second is to *facilitate* it. Social networks are already a part of most Marketing Management functions these days. Marketing managers have yet to learn what makes social networks successful and how to manage and leverage them to achieve organizational value.

A social network can broadly be defined as a set of actors and the set of ties representing some relationship – or lack of relationship – amongst the actors (Brass et al., 1998). Actors in a social network (people, organizations or other social entities) are connected by a set of relationships, such as friendship, affiliation, financial exchanges, trading relations or information exchange. In the first volume of his seminal trilogy on ‘The Information Age’, Castells (1996) emphasizes the openness of networks, arguing that networks are open structures that are able to integrate new actors or nodes as long as they share the same communication codes (e.g. values or performance goals). Porter Liebeskind et al. define social networks as ‘a collectivity of individuals among whom exchanges take place that are supported only by shared norms of trustworthy behavior (1995, p. 7). According to this definition, exchanges that are conducted through social networks are supported by mechanisms of trust, whereby shared norms of trustworthy behaviors may be instilled through different processes.

Saying all of this in different language, ways of doing business traditionally have been highly contingent on ways of organizing, and major competitive breakthroughs have been achieved by firms that invented, or were quick to apply, new forms of organization and management. New organizational forms arise to cope with new environmental conditions. However, no new means of organizing or managing arrives full-blown; usually it results from a variety of experimental actions taken by innovative companies.

### 2.2. Social media marketing

The growth of social media has impacted the way organizations communicate. Using social media for marketing purposes is only a recent phenomenon. Their massive use began since 2008. Therefore, there is limited academic research into this area (Zhao and Rossen, 2009; Jansen et al., 2009) and much of it is focused on the user side, with little known from the companies’ perspective. In contrast, there is a workable amount of research into the business and marketing benefits of Word of Mouth/ e-Word of Mouth. Facebook has been recognized one of the major representative of e-WOM (Jansen et al., 2009; The Economist, 2010; Trusov et al., 2009; Brown et al., 2007). Consequently, the literature that will be reviewed will deal first with the WOM phenomenon, and will then discuss the benefits of Social network-Facebook.

Social media marketing can be defined as the use of social media to create consumer awareness about products and services of a company. Companies are using social media in an effort to sell their products or services. At the present time when the social networks influence a large presence in the life of every individual, companies should use these methods to improve their businesses. To use social media marketing effectively, companies must be perceived as members of the community media, willing to interact with other members. The main problem that is linked to social media marketing is that it requires a lot of time.

Social media marketing companies are not used for shorter periods of time. Still, social media marketing is a type of marketing that many small businesses could benefit from, if only to find out more about what their customers are thinking and saying about their brand and their products. Social networking websites allow individuals to interact with one another and build relationships. When products or companies join those sites, people can interact with the product or company. That interaction feels personal to users because of their previous experiences with social networking site interactions.

Social networking site like Facebook allow individual followers to repost comments made by the product being promoted. By repeating the message, all of the users’ connections are able to see the message, therefore reaching more people. In this way, social networking sites act as word of mouth. Because the information about the product is being put out there and is getting repeated, more traffic

1 Raymond E. Miles, Charles C. Snow, (1984), “Fit, Failure, and the Hall of Fame,” California Management Review, Vol. XXVI (Spring 1984): 10-28.

is brought to the product and/or company.

Using a social network to comment on the product and / or services of a company, interaction between individuals is created. In this way it creates and instills a sense of loyalty in followers and potential customers. Also, products can reach a very narrow target audience.

Social media marketing represents an addition to personal, small business integrated marketing communications plans. Using an integrated marketing communications organization connects with your target market. Integrated marketing communications contain elements of personal selling, advertising, public relations, direct marketing, publicity and sales promotions.

Social media has become a platform that is easily accessible to anyone with internet access

Increased communication for organizations fosters brand awareness and often, improved customer service. In addition to the prominent, social networks have proven to be extremely cost effective tool for implementing marketing campaigns.

### 3. BUSINESS EFFECTS OF USING THE SOCIAL NETWORKING

One of the positive influences of social networks is definitely stimulating Word of mouth communication. It refers to oral communication and the passing of information from person to person. Word-of-mouth marketing (WOMM), also called word of mouth advertising, is an unpaid form of promotion—oral or written,<sup>2</sup>—in which satisfied customers tell other people how much they like a business, product, service, or event. Word-of-mouth is one of the most credible forms of advertising because people who don't stand to gain personally by promoting something put their reputations on the line every time they make a recommendation.<sup>3</sup>

Ask most small entrepreneurs how they grew their business and odds are they'll tell you it was through word-of-mouth advertising. These entrepreneurs know that in a people business like retail and commercial sales, if you do a great job for someone or if someone is satisfied with your product, that person will tell a friend, who will tell someone else and so on. The same holds true for the opposite. Do a poor job and it seems that customer will tell even more people. It's one thing if these discussions take place on a one-on-one basis. But what if they are happening on the Internet in one of the many social networking groups that are attracting millions of participants? What impact could that have on a business? Do you want a disgruntled customer bad mouthing your business on a social Web site like Facebook-and you don't even know about it? Wouldn't it be better to be tapped into that "community" and resolve the issue before it grows into something bigger?

For many small entrepreneurs the Internet is still a foreign entity and the concept of marketing their business on it is something they just haven't found the need-or perhaps the time-to does. But the time is fast approaching when all entrepreneurs will have to include the Internet in their marketing plans if they want to successfully reach and keep in contact with their customer base-for example, through service reminders, "Internet-only" specials and the like. Too many people are using the Web as their primary means of communicating socially for this to be ignored. Some entrepreneurs already have begun to understand how marketing via the Internet and tapping into Facebook and other social networks like Twitter can significantly impact business. Ignoring the Internet and how people are using it comes with some peril. The ways to take advantage of the Internet are many. Entrepreneurs can get on sites like Facebook and Twitter and begin communicating with customers and potential customers. They can provide valuable content on these sites to draw attention to their products and services. The effectiveness of word-of-mouth advertising hasn't changed, but how it's done has.

Currently there are various online applications (online feedback mechanisms, viral marketing, social networking, blogging) that are a form of WOM, however, considering the speed, scale and ubiquity of the Internet, many researchers agree that the effects of e-WOM are more impactful, and even different, from those of offline WOM, favoring rapid product adoption or leading to increased sales and brand advocacy through solving product and customer problems faster and cost-effectively (Godes and Mayzlin, 2004; Dellarocas, 2003; Trusov, 2009; de Bruyn and Lilien, 2008; Jansen et al., 2009). Most researchers agree that it is still insufficient research linking social networks and WOM (Brown et al., 2007; Jansen et al., 2009; Zhao and Rossen, 2009).

2009 was the year when 800 million monthly visitors thought "life wasn't worth living unless it was documented on Facebook and Twitter" (Clark, 2009, p.6; The Economist, 2010). Easy-to-use

<sup>2</sup> <http://www.thefreedictionary.com/by+word+of+mouth>

<sup>3</sup> <http://42explore.com/story.htm>

technologies and sensible privacy control settings allowed social networks like Twitter,

Facebook or Linked-in to provide a streamlined experience to an exploding number of users and a valuable tool to marketers, with 53% of them claiming to increase their social media investments even further in 2010 (Davidson, 2009). However, out of all social media platforms in Croatia, Facebook stands out, in terms of both characteristics and growth. Launched in 2004, Facebook gained most of its popularity as a micro-blogging tool in 2009, when it reached 58.5million users world-wide, a 949% increase since September 2008 (Schonfeld, 2009). The specificity of Facebook lies in its instant messages with a default setting public, which means that the essence of events can be transmitted on a large scale across the network, instantaneously (Jansen et al., 2009). That is way some researchers define

Facebook as "an information company" (The Economist, 2010, p.5) or a form of electronic word-of-mouth (e-WOM) communication (Jansen et al., 2009; Zhao and Rossen, 2009), which is the online projection of traditional word-of-mouth (WOM). This is very important since WOM essentially represents "the process of conveying information from person to person" and it is becoming acknowledged as one of the most effective forms of marketing (Jansen et al., 2009, p.2169).

People are connected into complex interpersonal, communicable systems. Family members and friends interact on a daily basis, employees exchange vital information each single day in order to facilitate the functioning of the economic subject that lives out its existence in turbulent environment. However, there also are communication relations that are not intensive and are thus characterized by an infrequent information exchange. This means one could consider social relations in terms of "interconnectivity strength". Potential brand buyers can thus vary in a particular way they are connected to others. For instance, they may be very connected, as is the case with friendships or, consequently, be loosely connected, as is the case between acquaintances. These connections, regardless of their strength, enable the flow of information regarding brands, a key information that most certainly interests economic subjects (Šerić, 2011). The research has concluded that the concept of word-of-mouth marketing is shocking because a few research results are, at first glance, completely opposing the "common sense" (Kotler, P., Armstrong, G., 2008).

#### 4. INTRODUCTION TO THE COMPANY

Antique Company was founded by the spouses Najda Bauk and her husband during the prewar times in the late 1980s. Since they both had tendencies toward creative work, they decided to transform their love of design into a work. Noticing that the market at that time did not provide an adequate supply in the area of clothing, they decided to enter into a business world. Like most beginnings, and this one was not easy and the company has encountered many difficulties. Problems arose in the absence of high-quality local products that would complete the range of supply, so, they decided to make their own production. In the beginning it was the production of small series of clothes at home, which was promoted in his own shop in the center of Split, named Genova. Also, the offer has been completed by the purchase of some imported goods. Additional problems were compounded by the conditions of war in the country, as well as the financial collapse of the high inflation and an unrealistic exchange rate. The company has operated in different market niches, the production of working clothes, costumes for dance groups, theater, prom dresses, etc ... Today the company is focused on three business segments, sales of haberdashery, developing their own brands of clothing, "CroNavy", and producing customized products to customer specification. Cronavy presents a brand in the form of collections of casual apparel for men, women and children. Number of employees at the company's varied, depending on the volume of business, and ranged from three to forty people, as usually occurs in the season when there is increased need for more intensive labor. The company devotes considerable attention to relations with employees, and the interesting fact is that has several long-standing employees, who work at the company since the beginning, which is the result of a positive climate in the company and investment in interpersonal relationships. Through many years of business and thereby gained experience, we can say that the continued persistence in work, communication and customization with an important factor in interpersonal relations, are the critical factors for business success of this company.

#### 4.1. Marketing mix

Today, most engagement in business requires the development of brand, "Cro Navy." Inspiration for the specified product line was found in sailor-style clothing, which is based on a combination of only three colors, dark blue, white and red, with patterned stripes. Given the limitations of the product in relation to use only three colors, materials and design characteristics, it is necessary to continuously innovate in new creations and refreshing collection. The main product features are characterized by a high-quality materials, color fastness, and creative design, which are the main distinguishing factors from competitors. Logo for the collection is selected fish, which adds to the line of identity and symbolizes the marine style. Distinguishing characteristics of the collection is that the product itself presents also a Croatian wearing souvenir. This characteristic of the product is mainly influenced on the choice of distribution channels, which is based on the better-equipped souvenir shops, gift stores in the hotels, airports with an emphasis on tourist destinations on the islands and coastal areas. Considerable attention has been attributed to the formation of prices and product quality, which presents a means of achieving competitive advantage and product differentiation from similar and cheaper low quality products which are mainly sold on local markets, supermarkets and kiosks along the coast. A significant problem facing the company are imitation products in the form of cheaper versions of products from other manufacturers, which distorts the image of the company and are taking away a part of market share. Also, the business is seasonal in nature, meaning that in summer the demand considerably rises, which partly makes it difficult for the business organization. On the other hand, in the winter due to less demand, it is necessary to focus production on other market segments, usually in the form of individual orders sewing and design tailor-made products. Significant role in the marketing mix carries quality promotion. In the communication with customers, the company mostly relies on organized social events in the form of fashion shows, catalog, advertising media, Internet marketing and publicity. Lately, as the one of the most proved effective means of promotion are social networks to which are given increasingly considerable attention because of many advantages over the other forms.

#### 4.2. Social networks in the business of Antique

Free social networks have opened up many possibilities of free publicity, and many companies do business and general presence on the Internet by opening various profiles so people can more easily find subjects that are of interest to them. In the case of Antique, the idea of using social networks for business purposes, entrepreneurs came on the personal experience of using them. Currently, the activities are aimed at one of the most popular social networking site at the moment, Facebook. Once you have identified all the advantages of using social networks in private life, in the form of renewal of business and personal contacts, and the dynamics of the network that provides insight into current events, it was concluded that these advantages may also apply for business purposes. Soon after, the company profile on Facebook social network was launched in the beginning of the 2011. Time on a social network that was so far been used only for private purposes, has now become used for promoting business. Given the multiple business segments, haberdashery and Cronavy brand, it was decided to individually present each segment on a social network, every one to his account, and presented the overall product offer by placing photographs of each product, with details about him. Shortly after opening a profile on a social network, they noticed the many advantages that have contributed to the improvement of operations and access to customers. In the period of existence on the social network, the company has achieved thousands of contacts and their number, and thus the company market grows each day. In this way, it is very easy to introduce a new collection to customers. Also, through a number of users comments of individual activities can easily be assessed efficacy and acceptability of each model, and also get many ideas for future models and improving collections. Also, users are very interesting in the possibility of setting up their own files on the network, and if we add their intercommunication it is possible to create a stronger relationship and loyalty to the brand. Another big advantage is the ability to directly inform customers about a variety of news, but also providing various useful tips regarding the maintenance of clothing, choosing the most appropriate model, providing information about places of purchase, etc.

Social media have opened the possibility of communication and interaction among users and encourage them to proactively participate and generate much of the content by themselves. Of the passive role of readers the contents, users have become relevant publishers of messages, news and comments. One of the great advantages are related to the range of target groups who are crossing the Croatian border, and who are widely reporting their satisfaction with products, and publish their comments and ideas about company products.



The most important advantages of free social networks that the company realized are:

- Connecting with people from the identical area and meeting with potential clients/partners
- Free promotional tool
- Getting the immediate feedback about products or services from customers
- Generating new ideas and opportunities for business
- Building a network of loyal customers who contribute to the promotion of products or services
- Better connections with consumers and creating a community around the brand that becomes stronger with each new member
- Social networks do not have a time limit, so are constantly available to companies for promotion and consumers for the consumption
- Encouraging a word of mouth since the network provides the power of the dispersion of information and dissemination of information faster than any other communication channel
- Enabled access to traffic statistics and performance of certain actions by businesses and consumers

Social networks continuously push the boundaries of technology and tools that facilitate communication and interaction within consumers, and provide many new advanced features for the users. Based on the above, further work is planned to introduce a variety of creative activities to customers in the form of organizing lotteries, coupons and sharing other forms of sales promotion, increasing engagement of visitors by placing a variety of current events by businesses, and encourage users' activity and interaction. It also opens the possibility of starting an online store that would be associated with a social network to expand product availability and facilitate customers to select and purchase products. With the numerous benefits that social networks offer to the users, there are also several hazards that need to be careful. It is extremely important to consider what information needs to be reached to the public. A great danger is the greater access to information from competing companies, thus increases the possibility of unfair competitors facilitates the ability to copy the ideas and concepts. Taking into account all the characteristics of social media, the benefits are indisputable, and it is obvious that the future of communication with customers see the continuous interaction and investment in social media. Given this situation, in the future, company plans expansion on several other significant social networks in order to achieve greater reach of target groups and complete benefits offered by social networks. What is very important to emphasize communication in social networks is the importance of continuing to refresh the content on the network, constant communication and contact with customers, and regularly responds to their queries because otherwise it might be created an impression of carelessness on the user. It is certainly necessary to constantly keep abreast of new advances in technology, media and listen to the ways in which to achieve better communication with customers, which ultimately helps to better adaptation of products and services to them. Today it can be concluded that the existence on the social networks are increasingly becoming a necessity rather than a comparative advantage for the companies.

Social networks represent an increasingly important voice and channel of communication with target groups, customers and potential customers. Thanks to the multitude of positive effects on business, are becoming more widespread and accepted form of marketing communication with the market. As a part of web promotion and Internet marketing tool, contributes to increasing the brand's personality and helping to encourage communication and spread information by word of mouth marketing in a very simple and affordable way. Due to their accessibility, social networks are a very useful tool for small businesses with limited marketing budgets, however, their use is becoming more noticeable in the case of large, as Croatian, and global corporations such as Kraš, T-Com, Vip, Ikea, BMW and many others. It is certainly no doubt that social networks in the future represent a significant potential of Internet marketing for a number of benefits they provide, among which we can single out an interactive and personal approach to business and client where the communication is developing synergies that so much could not be accomplished solely by using the classical forms of promotion. Social networks also provide a valuable tool that can easily be combined with other forms of promotion and their characteristics greatly contribute to the creation of a holistic approach to marketing communications, and thus a greater awareness and impact of the campaign on the users and the feedback from them as well.



## 5. CONCLUSION

Analyzing this case study we came to several conclusions. By using modern marketing tools, it is possible to not only survive, but thrive in the market in this crisis despite the present recession. While other companies are distracted by the economy, the companies who cultivate relationships, look for new customers and investigate new channels will succeed in the market. By new channels, we mean primarily on the use of social networks in business purpose. An executive with proper technological support who handles all data collection and analysis, and base buying and strategic decisions on that data has an invaluable role in social networking strategy and thus in a company success. Companies who take proactive steps to grow during the current storm will not only safeguard their position, and catch up with the competition, but will defeat it in the long run as well.

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## CUSTOMER SERVICE AS A FACTOR OF COMPETITIVENESS OF RETAIL COMPANIES

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E-mail: [jelenac@cugura.rs](mailto:jelenac@cugura.rs)**Abstract**

In doing business companies use different strategies to attract and keep the customers in order to survive and achieve competitive advantage on the market. Customer service includes marketing and logistic activities in doing business and is the main mean of competitiveness. The goal of this paper is to point out the importance of customer service in retailing and its role in creating customers satisfaction and loyalty.

The paper starts from the process of managing customer service with the special emphasis on the process of creating value and managing relations with customers. In addition, attention is drawn to the use of information technology to improve logistic services and customer service.

The key determinants of logistic services quality are determined according to the results of many researches. They represent the basic assumption of customers satisfaction and loyalty and realization of the competitive advantage of retail companies. In the paper the analyses of the relationship between logistic performances and customer loyalty in e-trade is described. Special attention is given to the role the provider of logistic services has in creating customer satisfaction and loyalty.

The importance of customer service in creating customer loyalty and improving competitiveness of retailing on the domestic and foreign market is shown through the analyses of the case study.

**Keywords:** Logistic services, Customer service, Satisfaction, Loyalty, Competitiveness.

**1. INTRODUCTION**

Marketing management has an important role in doing business and its orientation towards market. Implementation of marketing strategy in doing business refers to the process of anticipation, management and meeting the customers' needs. Managing the elements of marketing mix (product, price, promotion and distribution) means providing superior value in order to attract and keep as many customers.

During the last years distribution, as one of the elements of marketing mix, became an important marketing factor in achieving competitive advantage of the company. Managing distribution activities is part of process of managing logistics and it represents process of planning and coordinating distribution activities in order to deliver wanted quality of product and service at the lowest costs (Chripstoher, 2005, p.15). Main logistic activities are: customer service, anticipating demand, communication within distribution channel, supply control, handling materials, receiving orders, choosing location for the fabrics, warehouses and shops, packaging, transport, manipulation, warehousing, etc. (Božić and Aćimović, 2010, p.11). Results of every logistic activity are reflected in achieving company's competitive advantage on the market with more efficient attraction and keeping the customers.

The goal of logistic management is achieving customer satisfaction through managing physical and informative flows from customer's location to manufacturer's location. It is an integrated process which connects all business functions (first of all production and marketing function) in unique business strategy and transforms market needs into the company's production plans.

Connection of marketing and logistic functions is implemented in order to provide maximum service to the customers while minimizing distribution costs. Marketing logistics is the process of planning infrastructure in order to satisfy demand, implement and control psychical distribution of materials, products and services. Planning the process of marketing logistics is done in few steps (Kotler and Keller, 2006, p. 523):

- Making decision on the value which company gives to its buyers (questions about timely delivery, accuracy of ordering and billing, etc.);
- Making decision on the best design of the marketing channel (should the company do business

- directly with the customers or through intermediary, choosing location of the warehouse, etc.);
- Developing expertise in anticipating sales and managing warehouse, transport and materials;
  - Implementation of solutions using best information systems, equipment, politics and procedures.

Marketing logistics starts from customers, i.e. defining market needs, and using opposite way comes to manufacturer and definition of sources of supply. In this sense marketing logistics includes output (movement of products from company to customer), input (from supplier to company) and reverse distribution (from customer to company) of products and services (Kotler, Wong, Saunders and Armstrong, 2007, p.884).

## 2. MANAGING CUSTOMERS SERVICE

Marketing logistics has an important role in achieving consumer satisfaction, specially the role of customer service as one of important areas of marketing logistics. Using customer service companies in trade differentiate their offer and create added value for their customers. Efficient management of customer service affects creation of the customer satisfaction and loyalty and thus increases profits and company's market share.

### 2.1. The Role and Importance of Customer Service

In literature different approaches to defining customer service appear (Tucker, 1994, pp.32-40). In the distributive approach customer service is a ``synonym`` for physical distribution, while in marketing approach it has wider meaning including all elements of marketing mix. Basically, customer service represents willingness of manufacturer and seller to deliver the right product, at the right time, in the required quantity and on the required place with acceptable selling price of product.

The process of customer service includes activities and services which are done before, during and after the business transactions of the company. The goal of this process is to provide the availability of products and services to the customers. The most important elements of customer service are (Christopher, 2005, p.49):

- Pretransaction elements: customer service politics, availability, introducing customer service politics to the customers, organization structure supporting customer service, credit terms, payment terms, etc.
- Transaction elements: availability of stock, time of delivery, frequency of delivery, reliability and accuracy of delivery, benefits of ordering, accessibility for taking the goods, etc.
- Posttransaction elements: accuracy in billing, guaranty, maintenance, complaints and appeals, recurrence of goods, timely replacements of products, cooperation between customers and sellers, etc.

In the process of customer service management the success of retailing companies depends on the level of delivering value to the customers. Customer value is the ratio of perceived benefits and total costs of ownership. Customer service is the primary mean of creating and increasing customer value as illustrated by the following ratio (Christopher, 2005, p.49):

$$\text{Customer value} = \text{quality} * \text{service} / \text{cost} * \text{time}$$

The ratio includes following elements:

- Quality - representing functional and technical specification of the offer,
- Service – providing availability, support and other services to customers,
- Cost – total cost of customers' transaction and
- Time - needed to respond to the customers' requests (e.g. time of goods delivery).

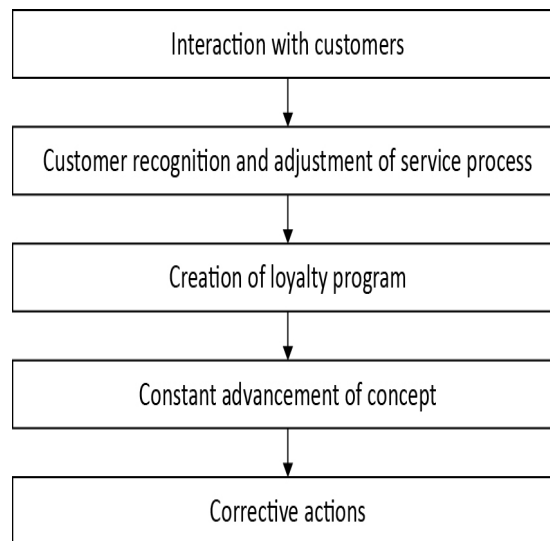
Customer value includes customers' preferences towards service elements, performances and achieved results. In the opinion of some authors (Tsai and Chang, 2010, pp.729-740), there are some differences in perception of customer value between customers and companies. In order to minimize these differences it is important for retailers to observe and assess customer value from the customer standpoint.

Hines and Zokaie (Zokai and Hines, 2007, pp.223-247) in their work have pointed out some methods and techniques for increasing customer value in supply chain and they have defined the basic elements of customers value (must-be, one-dimensional and attractive elements). The main goal of research using Kano techniques was to identify possibilities of increasing customer value and satisfaction.

In that sense, the process of managing supply chain means managing chain of delivering value to customers. The main goal in doing basic and support activities in supply chain (from providing materials to final delivery and buying goods) is satisfying consumers' needs.

Strategy of customer service is an important factor in processes of customer relationship management, increasing customer satisfaction and loyalty and achieving retailers competitive advantage. According to it the strategy of customer service is connected to the concept of customer relationship management (further CRM concept). The process of developing long-term relationship with customers has certain phases (figure 1).

Figure 1: The phases of customer relationship management (Veljković, 2009, p.19)



Development of CRM concept creates closer and deeper connection with customers based on recognition of customers' needs, wants and habits. Concept's basic assumption is that it is more important to keep the existing customer than to constantly attract new customers. By applying this concept traditional marketing mix is transformed into new relation mix, which main goal is to keep existing and potential customers and "convert" them into loyal customers or business partners (Zineldin, 2004, pp.286-301).

The process of managing customers' relationships leads to improving customer service in terms of giving accurate data about the product, fast problems identification and elimination, solving customers' complaints, providing mechanism for removal of customer service lacks, etc. Managing customer relations includes process of researching, planning and controlling mutual participants in marketing channel (Lovreta, 2007, p.177):

- Research should enable identification of right partners for developing long term marketing;
- Plan should contain financial goals of profitability through different activities;
- Realization of long term relationships means the division of labour between participants in the channel;
- Coordination of their activities and improvement of the role of customers;
- Control is based on monitoring parameters of development of long term relationships, such as profitability, cost allocation to participants in the channel, increasing customer satisfaction, etc.

Creating direct link between customers and companies is the base for successful process of development long term relationship. Satisfaction, trust, reliability and other elements which symbolize building long term relationships include direct contact and communication as well. From the standpoint of CRM concept application, suitable level of personalization with the customers is very important, whose effects are reflected in higher level of customer loyalty, brand awareness, higher number of customers, higher number of recommendations, lower service costs, etc. (Lovreta, Berman, Petković,



Veljković, Crnković and Bogetić, 2010, p.215).

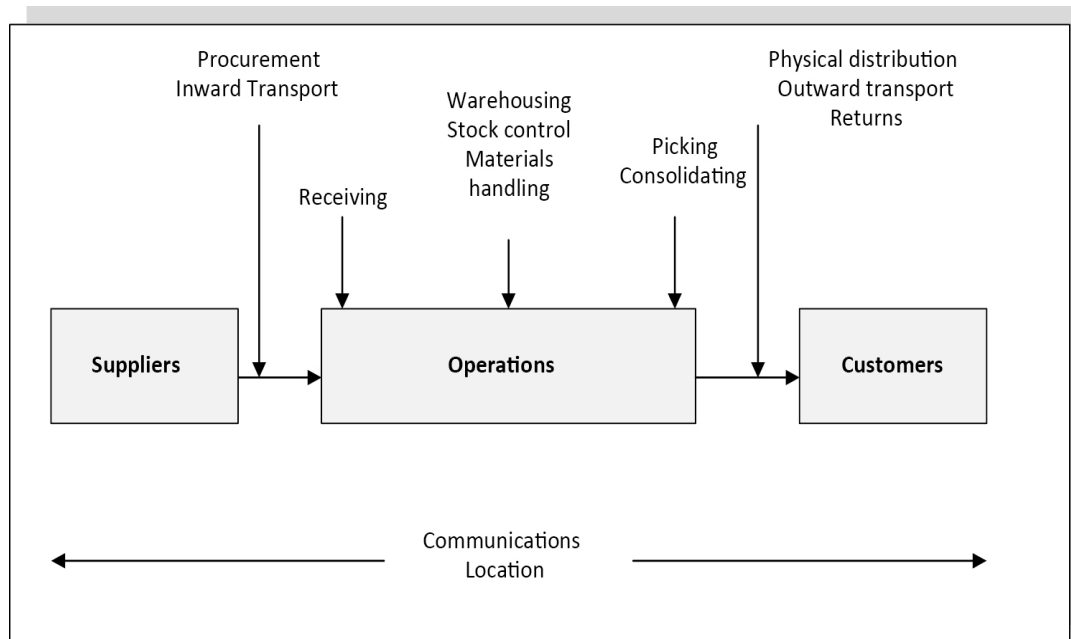
The process of managing customer relationships provides range of opportunities to retailing company, which refer to: creation and improvement of value to the customers, development of loyal customers, keeping existing customers and attracting new ones, creation of partner relations with other participants in supply chain, achieving competitive advantage, etc.

## 2.2. Application of Information Technology in Managing Customer Service

In the context of globalization and dynamic environment information and communication technology becomes significant source of competitive advantage of retail companies in the means of costs, economies of scale, companies' negotiation power, etc. The use of information technology (IT) affects the improvement of customer service and logistic activities in the company.

Traditional system of managing logistic activities (transport, distribution, communication and information, managing the inventory, handling material, etc.) requires separate managing of the activities, which brings problems in business of retailing companies (figure 2).

Figure 2: System of logistic activities (Renko and Ficko, 2010, pp.216-223)



In order to increase productivity and eliminate double business operations information technology allows the development of integrated logistic system. Integrated system of logistical activities impacts the achievement of main goal of business – reducing costs and increasing profits with customer satisfaction (Aćimović, 2003, p.48). Results of numerous researches have proven that the relationship between integrated system of logistic and customer service exists. The factor of integration has great impact on customer service unlike other factors (exp. business type and size of the company, organization of logistic functions, etc.) (Ellinger and Daugherty, 1997, pp.129-138).

Group of authors (Renko and Ficko, 2010, pp.216-223) has done the research about the level of IT use in business of retail companies in Croatia. The goal of analyze was to examine the impact of technology factors on the efficiency in doing logistical services and creating value for the customers. The use of IT in doing logistic activities means use of electronic data interchange (EDI), POS systems, barcode, etc. Integration process leads to increasing efficiency and effectiveness of logistic jobs in delivering right products on the right place at the right time. Based on the survey research done on the sample of 31 retailers it was shown that companies use IT mainly in order to optimize the level of supplies. Also, the use of internet in the processes of managing customer service and servicing customers (online interaction with the customers, virtual procurements, fast changes of orders, monitoring deliveries, use of JIT concept, on-line payments, after sales service, etc.) is increasing.

Research results have shown that internet technologies are mostly used in advertising, ordering, doing transactions with suppliers and communications with other business partners. On the other hand, retailing companies far less use electronic data exchange and video conferences in their business. About 70% of respondents (retailers) declared against the use of e-trade in the distribution process of products and services to the customers, while just 10% of them have accepted the introduction of the

information system in managing warehouse. Based on the above it can be concluded that use of IT in logistics by retailing companies is still on low level.

According to the fact that use of IT in logistics is important in providing high level of customer service companies are introducing new system of ``quick response`` - QR. This system represents a combination of information and logistic system and contributes to the faster and more efficient response to the customer needs. Development of QR system includes the use of barcodes, electronic data exchange, EPOS system (electronic point of sale) with laser scanners, etc. (Christopher, 2005, p.190).

Although the use of IT in retailing companies business impacts on improvement of managing relations with customers and ``customization`` of customer service, the impact of technology on customer service is constantly being ignored. The main reason for that is that companies pay less attention to the value of information than to the value of products and services. However with the revolutionary development of internet technology the value of information becomes very important, just as value of products and services (Bhatt and Emdad, 2001, pp.78-85).

### 3. THE ROLE OF CUSTOMER SERVICE IN CREATING COMPETITIVENESS OF RETAILING COMPANIES

Customer service is a mean used in attacking new and keeping existing customer. Providing an effective customer service means the provision of goods and services that will continually exceed customers' expectations in longer period of time. The main goal of effective customer service is creating lifetime loyal customers (Goetsch and Davis, 2004, p.2-3).

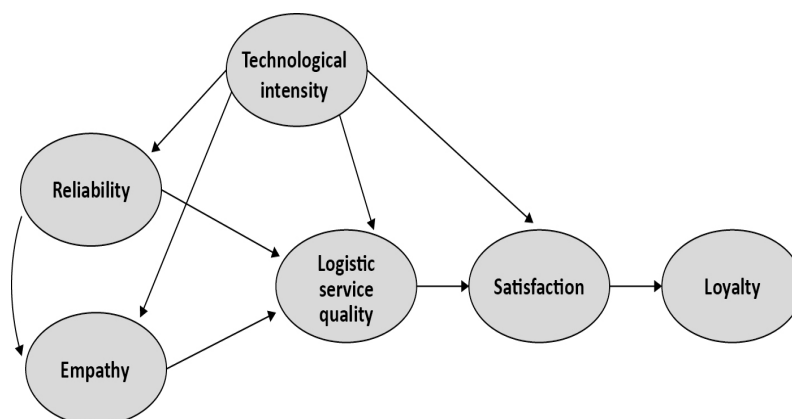
Therefore provision of high quality of logistic services is the main assumption in creating customer satisfaction and loyalty and competitiveness of retail companies as well.

#### 3.1. The Impact of Logistic Services on Customer Satisfaction and Loyalty in e-Trade

Customer satisfaction is a feeling of satisfaction resulting from the comparison of expected and received value of goods and services. Achieving satisfaction increases customer loyalty and positive word of mouth propaganda about the product. Greater customer loyalty creates more probability of repeated purchase, and greater word of mouth brings more new customers.

The research goal of many papers is identification of determinants of logistic services quality and ways of achieving business results, primarily in the means of increasing customer satisfaction. Theoretical model of 6 variables (reliability, empathy, logistic service quality, technological intensity customer satisfaction and loyalty) is shown in figure 3.

Figure 3: The impact of logistic services on customer satisfaction and loyalty (Saura, Molina and Frances, 2008, pp.495-510)



In the conducted survey based on the sample of 400 customers and 304 distributors the group of authors has proven the existence of positive impact of reliability and empathy factor on logistic services quality. Thereby empathy factor arises as a result of subjective experience and reliability factor as a result of objective valuation (Saura, Molina and Frances, 2008, pp.495-510). Therefore it can be concluded that reliability increases empathy. The quality of logistic services makes positive impact on customer satisfaction, which in return impacts on retailers' loyalty towards suppliers in the supply chain.

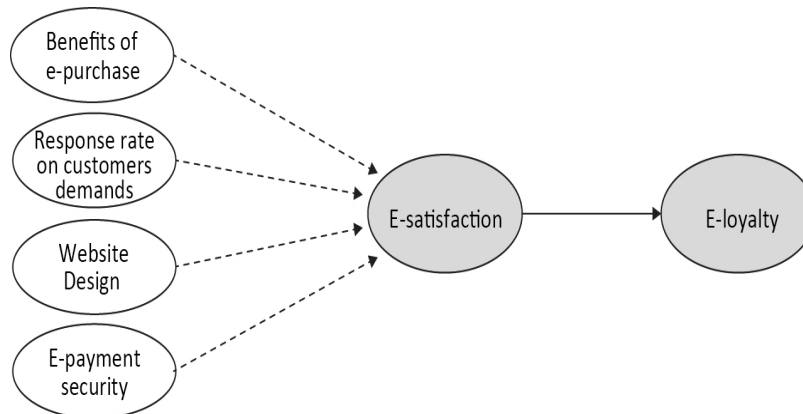
However, many researchers have proven the existence of asymmetrical relationship between customer satisfaction and loyalty. Some authors claim that satisfaction does not have to be the condition for creating loyal customers. Satisfied customer doesn't always have to be loyal, while loyal customer is always satisfied.

According to the presented model it can be concluded that logistic services have an important role in creating customer loyalty, which is the consequence of customer's positive experience in shopping. The most important logistic services, that increase loyalty, are: convenience, product availability, efficient delivery, return policy and complaints, etc. These logistic services belong to the after sales services group, which are provided to the customers after they complete their purchase.

Successful use of marketing and logistics in e-business affects the creation of customer e-satisfaction and e-loyalty. Customer e-satisfaction and e-loyalty are main indicators of successfulness of e-business. According to Turban and others (Turban, King, Lee, Liang and Turban, 2010, p.198) 80% of satisfied online customers will repeat their purchase within two months and 90% of satisfied customers will recommend others purchasing goods and services at this online seller.

A group of authors (Kim, Jin and Swinney, 2009, pp.239-247) has defined a conceptual model of services' quality impact on customer e-satisfaction and e-loyalty. The goal of research was to identify main determinants of customer e-loyalty. The authors analysed model validity and interdependence of determinants in the research based on the sample of 182 respondents (online customers). Process of customer e-loyalty development is shown in figure 4.

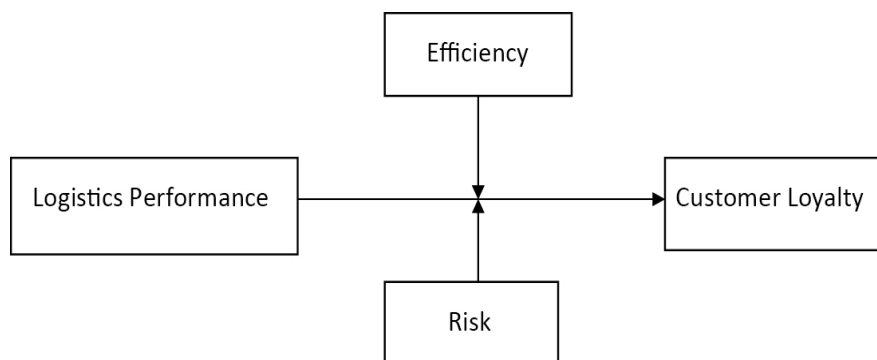
Figure 4: Process of customer e-loyalty development (Kim, Jin and Swinney, 2009, pp.239-247)



Results have shown that quality dimensions of providing online services (benefits of online purchasing, website design, security of payments, responsiveness) increase online customer satisfaction and loyalty. Direct positive impact of e-satisfaction on e-loyalty exists as well.

In his paper Ramanathan (Ramanathan, 2010, pp.950-962) analysed the impact of logistic performances on customer loyalty in e-trade. Through the research the factors, which have the greatest impact on the relationship between logistic services and online customer loyalty, were identified. Two most important factors are: production risk, referring to the price and product characteristics, and efficiency in using resources in providing customer services (figure 5).

Figure 5: The impact of logistic performances on customer loyalty in e-trade (Ramanathan, 2010, pp 950-962)



Research results have shown that the impact of risk factor on the relationship between logistic services and customer loyalty is statistically not important, while efficiency factor of website has

a great impact on online customer loyalty. According to the stated it can be concluded that efficient and integrated system of company's logistics is the basic prerequisite for providing superior services, building customer loyalty and therefore achieving competitive advantage in the market.

However retailing companies in providing superior logistic services face many problems both in online and offline environment. Customers use different ways to value performances of quality of logistic services, meaning reliability, speed, accuracy, flexibility, security, information, etc. Therefore it is very hard for companies to determine desirable level of logistic services quality which will lead to increased customer satisfaction and company's competitiveness.

Assuming that customer satisfaction is the difference between expected and received customer values, companies use the method of "listening" customers needs in order to fulfill their expectations. Retail companies can also provide extra logistic services, which will exceed the customers needs (e.g. growing concern for customers, providing additional information, etc.), and lead to creating loyal customers.

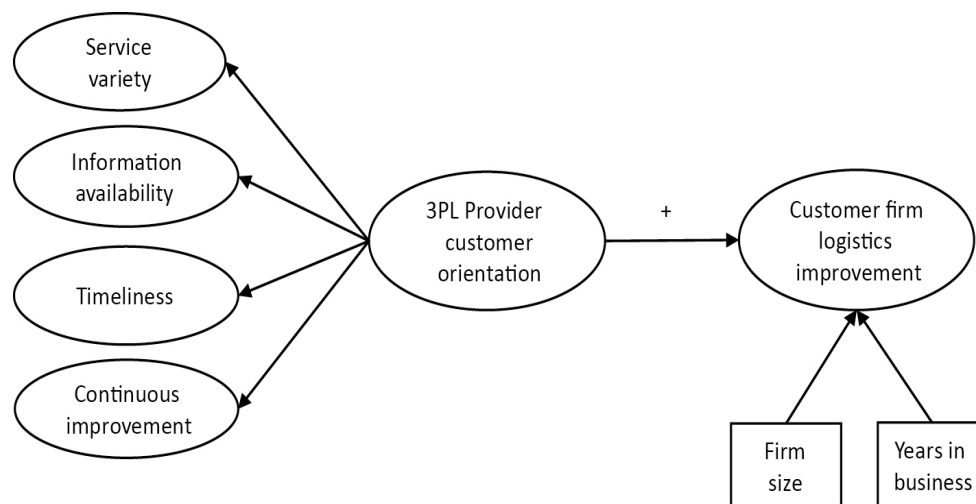
### 3.2. The Importance of Logistic Services Providers in Creating Customer Satisfaction and Loyalty

In the last 20 years significant growth in the market of outsourcing and "third part logistics" (3P logistics) has been recorded (Large, 2011). Primarily, in developed countries the number of companies (providers) providing logistic services to other companies has been increasing. 3P logistics is a complicated contract system which is made of great number of connected logistical functions.

In the process of creating customer satisfaction and loyalty it is important to point out the logistic service providers' customer orientation. Namely, providers provide "individualized" logistics services which are customized to individualized customer requirements (e.g. requirement for specific delivery locations, periodical reports on achieved performances, etc.). Thus affects the improvement of companies' logistic performances, companies which are logistic services buyers from specialized providers.

The authors (Tian, Ellinger and Chen, 2010, pp.356-376) in this paper have done the research in which they showed that customer orientated providers provide superior logistic services and participate in creation of satisfied and loyal customers. Customer orientation in business of logistic service providers, representing the basic assumption for improvement in company's logistic system, is shown in figure 6.

Figure 6: Model of customer approach for logistic services providers (Tian, Ellinger and Chen, 2010, pp.356-376)



Research results have shown that logistic service providers should satisfy customers demand by continual fulfilment and overcoming expectations when using services. Thus providers impact on improvement of the retail companies' logistic system and on providing superior value to the customers in order to achieve competitiveness in business.

According to this model it can be concluded that the use of customer orientation in providers' business has positive impact on service variety, information availability, timeliness and continuous improvement. The main purpose of providing superior logistic service is creation of customer value which will increase satisfaction and loyalty of final customers.

The use of customer approach, starting from fulfilment of customers needs, brings benefits to all participants in the supply chain. These benefits refer to achieving competitiveness by logistic service providers, achieving outstanding business results and creation of satisfied and loyal customers.

#### 4. THE ROLE OF CUSTOMER SERVICE IN RETAIL CHAIN OPERATIONS

As previously mentioned, in the early 90s the process of integration of logistic and marketing functions in companies began. Customer service, as a result of integration, increases customer loyalty and is one of the main activities in creating company's competitive advantage.

Efficient management of components of customer service in retailing is the basic assumption of successful company's business. The most important elements of customer service in retailing are: good availability, suitable store location, quality of goods package, reliability and accuracy of delivery, benefits of ordering, responsiveness to complaints, possibility of goods exchange, payment terms, quality of customer service, etc. (Božić and Aćimović, 2010, p.109).

In business literature many examples of companies using successfully customer service management can be found. The most successful companies on international markets are using informational technology and internet as their way of selling goods and services in order to provide extra value to their customers. Many companies use both classic retail forms and online shopping, while there are companies who exist only online, like Amazon.com (begun with selling books, now selling many different products) and Booking.com (online travel agency used for booking hotels).

##### 4.1. The Example of Carrefour

Numerous case studies from retailing literature show the important role of customer service in increasing sales and creation of loyal customers. One of the examples from business practice is retailing chain Carrefour Group (Božić and Aćimović, 2010, p.109). This French retail chain has six different retailing formats: Carrefour hypermarkets and supermarkets, Carrefour Express, DIA, Maxi DIA and Carrefour City. Buying chain Promodes in 1999 Carrefour became a leader in Europe and second biggest retailing chain in the world. Using the process of internationalisation the chain expands to the Asian market.

In the global supply chain management Carrefour successfully uses politics of customer service (providing right product on the right place at right time). In the process of customer service it is important for retailers to understand customers preferences and to personalise and adjust service to individual customers in order to increase number of loyal customers.

For example, Carrefour develops big distributive network in Spain in order to attract and keep great number of customers, who do their shopping "under one roof". The main assumption for providing good customer service is good knowledge of consumers. Therefore Carrefour introduces loyalty cards for identification customers' needs and expectations. The offer of loyalty card and shopping credit for certain product categories affect the customers' attraction and keeping. The use of loyalty cards can provide certain discounts to the customers, one extra shopping after certain number of purchases or customers can collect points for each shopping. So Carrefour can follow the history of relationship between retailer and each customer and the database can be formed (Lovreta, Berman, Petković, Veljković, Crnković and Bogetić, 2010, p.235).

On Chinese market Carrefour uses the strategy of lower prices and availability of goods "in one place". Unlike the European market, where hypermarkets are located outside city centre, on the Chinese market smaller retail formats are located in the centre. Chinese customers prefer to buy smaller quantities of goods several times a week. They use bicycles or busses as main way of transportation unlike European customers who mostly use cars. Thus customers are provided benefits in terms of location (place of purchase) closeness.

Carrefour implements efficient system of managing warehouse and distribution and provided reliability and accuracy of goods delivery in shops around the world. Beside that, control of all logistic costs (transport, warehousing, human resources, etc.) is done in order to minimise them in the structure of sale price. The use of e-trade and e-logistics provides benefits to customers when ordering goods and services. Online communication with other business partners (providers) in supply chain is done using online portal named CarrefourNet. In order to increase customer service quality different programs for training employees, providers and other partners in supply chain are used.

During the last past years Carrefour uses the concept of sustainable supply chain, which means providing customer service in accordance with the basic principles of sustainable development.



Carrefour is just one of many big retail chains which successfully uses the policy of customer service and thus contribute to increasing customer loyalty and achieving competitive advantage on international markets.

#### 4.2. THE EXAMPLE OF DELL COMPUTERS

Dell Computer is one of the biggest companies producing PCs. They sell their computers on the world market using different retailing chains as well as their own shops. After careful consideration they realised that selling price of their computers consists of high reseller's margins. So their founder Mr. Dell asked one simple question: ``How to make process of PC purchase easier and cheaper?`` Dell company started using internet as their shop, they started using e-trade.

The computer industry is one of the fastest changing industries in the world and the needs of customers differentiate a lot. Need for low stocks and full customisation of computers were obvious. On Dell Company's website each customer can choose one of recommended configurations or configure the computer satisfying his/her own needs, and then order and get that computer in 5 days on the home address. Using e-trade Dell can satisfy his customers' needs before producing the computer, while other computer manufacturers working through retailers first produce computer and then sell it. Their customers can only choose from final products. Therefore Dell creates loyal customers while increasing sales margins and lowering material and final products stocks. It is very important to point out that Dell's e-trade is used by company buyers as well. They have a special part on Dell's website where they can follow earlier purchases.

The con of using e-trade for Dell is higher transportation costs, because now they transport small quantities to more addresses (each customer). Before they were transporting huge quantities to just few addresses (addresses of distributors or retailers). According to the fact that computer is an expensive good and that transportation costs are just 2-3% of sales price, this increase in transportation costs does not have big impact on sales.

Finally, Dell also uses internet for being connected to his suppliers, who can follow the online orders and know how much stock to deliver. The costs of warehousing and handling materials are minimised.

Transferring part of its sales to online trade Dell made big profits and provided his customers possibility to customise its computers. They provided them extra value, which lead to creating satisfied and later loyal customers (Heizer and Render, 2011, p.502-504).

#### 5. CONCLUSION

Customer service, as part of marketing logistics, is one of the main means of attracting new and keeping existing customers. Efficient customer service management becomes one of the most important sources of retailing companies' competitive advantage.

The researches have shown that customer service has more important role in providing customer satisfaction and loyalty. The most important elements of customer service are: benefits of ordering, goods availability, efficient delivery, returning policy, etc. In order to develop integrated logistic system and provide efficient customer service the use of informational technology has the main role. Informational technology impacts the improvement of relations with customers. Customer approach of logistic service provider is important in the process of creating customer satisfaction and loyalty. Providers adjust logistic services to the individual customer needs and increase company's logistic performances in order to provide superior value to the customers.

Case studies from business practice show that efficient management of customer service increases customer satisfaction and loyalty and improve competitiveness in long terms. Examples presented in this papers show that companies must focus on logistic services as much as they focus on production. Both retailers, like Carrefour, and manufacturers, like Dell, must have efficient customer service management in order to give extra value to their customers, who are the source of their profits and competitiveness on markets.

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**THE ROLE OF BRANDING IN SMES: DIFFERENT PERSPECTIVE ON THE MARKET****Franc Vidic**

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E-mail: [jaka.vadnjal@gea-college.si](mailto:jaka.vadnjal@gea-college.si)**Abstract**

This paper examines the role of branding among Slovenian small and medium sized enterprises (SMEs) and attitude of entrepreneurs to branding strategy. The term branding is usually dominated by big global businesses which operate on world mostly consumer markets and build their competitive strategies on powerful branding. Also in academic research literature and textbook, efficient brands are frequently mentioned, particularly in connection with large global companies. However, also SME nurture their own specific approach to branding development although these processes may not be on a conscious level of thinking. Many SMEs are facing dilemmas connected with investing money, time and energy to change the established practice, and to undertake a strategic approach to brand management.

Based on extensive literature survey and researchers' own experience, a questionnaire was developed to measure the branding development attitude of SMEs. A random sample of companies with at least five employees with the purpose to eliminate micro businesses for which the issue of branding may not be that relevant enabled a level of significance which allows generalization of results. By using descriptive statistics and cluster analysis, we were able to determine the use and position of brand management within the strategic orientation context of researched companies. An important result of the study is the classification system of SMEs, with regard to their market position and future perspective. The participating companies were categorized into the following four groups (clusters): (1) ignorants, (2) users, (3) low-cost producers and (4) differentiation producers.

The ignorants are predominantly micro businesses serving only local markets with no ambition for any growth. The users are businesses of early growth which may not be entirely aware of the potential of branding which is consistent to their generic strategy which may not be refined yet. The low-cost producers and differentiation producers already utilize branding to backup their chosen core strategic orientation. While the first two groups tend to be more passive, the last two pursue more proactive strategic orientation. The main finding of the paper is therefore an empirical confirmation of the theoretical stand that branding should not be a sole-standing business function but merely embedded into the core generic strategy which a company is following.

**Keywords:** SMEs, entrepreneur, brand, core strategy, cluster analysis

**1. INTRODUCTION**

Branding in SMEs has been a relatively new subject in the business research. Although there has been a lot of contribution on this topic, both in text-books and academic research literature, most theories and case studies base on well-known global brands (i.e. Coca Cola, Nike etc.) (Krake, 2005). Thus, the main motivation of the research for this particular article was explore attitudes against branding among SMEs and the ways and styles small businesses manage their brands.

The reason that research on branding among SMEs has been so far limited to large corporations has probably been in the fact that SMEs because of their financial and human limitations of resources usually do not run a formalized process which would deal with branding. Thus, alike several other business functions in SMEs also the function of branding is designed spontaneously and simultaneously with business growth, life-cycle evolvement and organizational culture development. Start-ups which are based on powerful brands or, to put it differently, when creation, development and exploitation of a brand is actually a business idea, are extremely rare (Merrilees, 2007).

The structure of the paper goes as follows: after the theoretical framework in which a relevant overview of the research opus on the topic is given, research questions are formulated in which we suppose that in a sample of SMEs different styles of businesses would be identified according to their branding oriented behaviour against this very important if not crucial element of every company's strategy. The empirical part is conducted via a survey among SMEs in Slovenia. Finally, results are presented, answers to research questions are provided. The article is ended with some conclusions and recommendations.

## 2. LITERATURE REVIEW

Competition in the global economy has been becoming fiercer every day by day. Small and medium sized businesses (SMEs) contribute significantly to a country's gross domestic product, national job creation, and export performance (Culkin & Smith, 2000). In order to survive, grow and compete in this more and more competitive climate, entrepreneurs of SMEs need to study market conditions and implement effective strategies (Slater & Narver, 2000). SMEs tend to be more entrepreneurial, flexible, and innovative, which makes them more adaptive at serving specialist or niche markets and remaining and even increasing their responsiveness to customer needs (Goldberg et al., 2003). SMEs have more of an opportunity to get close to customers and obtain valuable feedback, which can then be utilized to provide clients with a customized and high value-added service (Gilmore et al., 1999).

Among all the competitive tools available to SMEs, we argue that branding should be close if not on the top of the list (Anarnkaporn, 2007). Brands often provide primary elements of differentiation between competitive offerings and as such, can be critical success factors of companies (Wong & Merrilees, 2005). It provides a name or symbol that gives product credibility and helps consumer to identify the product (Gillespie et al., 2007), it gives the product meaning and defines its identity in both time and space (Kapferer, 1997). But branding, especially corporate branding is often a radically new concept for people in SMEs (Inskip, 2004).

SME's organizations should develop their brands for smaller market share and higher levels of loyalty (McAlester, 2006; Kohli et al., 2005). Khan et al. (1988) noted that small segments of consumers develop needs, which differ from those of the general uses of the product class, thus providing opportunities for speciality brands. SMEs should know their customers in a time horizon offering highly customised and personally used service (Chen, 2001). Brands add value and differentiation opportunities from competitors (Grant, 2000; Ratnatunga & Ewing, 2009) and its integrity and competence resulting from the creation, development and protection of the mark (Napoli, 2006).

Among the companies with clearly defined strategy, branding, dominated to a large extent (Berhon et al., 2008). A critical question many SMEs often ask themselves is whether it is worthwhile spending a substantial amount of money, time and energy in rethinking their marketing practices, adopting a strategic marketing approach (Noble et al., 2002) and going through the branding exercise. Though tempted to reorganize their marketing practices and adopt branding strategies, SMEs very often cannot do conventional marketing, because of the limitations of resources (Uusitalo et al., 2010) and several other barriers. Such limitations can be summarised as: limited resources (such as finance (Ohnemus, 2009)), time and knowledge of marketing; lack of specialist expertise (owner-managers tend to be generalists rather than specialists); and limited impact in the marketplace (Gilmore et al., 2001).

In designing the differentiation and recognition a branding strategy is very important (Pringle & Thompson, 1999). It makes a priority in designing an effective marketing mix (Mowie & Merrilees, 2005), and builds it gradually in line with the vision and strategy for meeting the needs and desires of customers (Mats, 1999). Branding is the process of transforming functional assets into relationship assets (Kim et al., 2001). A well-crafted brand picture can guide company to develop right strategies (Davis, 2000).

Companies have to manage and protect their brands in their development (Gillespie et al., 2007). Brands represent a link with consumers (Caprara et al., 2001), consumers knowledge (Keller, 1993) and trust to ensure a quick and easy selection (Morris, 1996). Product (service) that has the credibility and helps customers to identify companies (Kumar, 2003), offer, and provide satisfaction with product (Knowles, 2001). Also co-branding with customers is becoming more common, as suppliers and customers recognize its potential advantages (Capon et al., 2001).

The main research questions of the article are therefore: (1) How is the brand managed in small or medium sized company within its different perspective on the market? And (2) What are the typical groups of companies (clusters)?



### 3. METHODOLOGY AND SAMPLING

Consistent with prior literature survey, from which research questions were generated, we focused on SMEs. An empirical survey in 2010 was conducted using mail questionnaires. This measurement instrument was developed in two phases. Firstly, a preliminary research was conducted, qualitative study based on depth interviews were conducted with entrepreneurs in 10 different organizations.

Based on preliminary research, the questionnaire was finalized after several modifications of the layout and wording of questions. It was decided to omit one-man-bands from the sample. The sample was stratified to the range between 6 and 250 employees. The direct mail questionnaire was sent out to 2500 businesses which were selected from the IPIS database using a random sampling technique.

Data were collected from entrepreneur or chief executive officer. Sixty questionnaires were returned to us unopened with 176 usable questionnaires retained for analysis. The standardized tools of statistical analysis such as cluster analysis were used for research questions exploration. Statistic analysis was done with SPSS software version 15. We measured the respondents' views on five point Likert scale. In addition, we monitored SMEs: how they see importance of branding, its strategy development and management.

### 4. RESULTS

#### 4.1. Demographics

Most of the respondents who responded to the questionnaire, belonged to our research target group of entrepreneurs/chief executive officers (82.5%). 76% of usable questionnaires were returned by male respondents, which confirms the proportion of male/female entrepreneurs in Slovenia, in fact, is rather small and lags behind the European average. The age of respondents was between 23 and 72 years, 20% of them were aged under 40 years, 70% between 40 and 60 years and 10% older than 60 years. Almost half (49%) of respondents had technical backgrounds and one third the economics or business. Level of education was different: 48% of respondents completed vocational or secondary school, while other graduated at college, university or even obtained post-graduate (9.5%) education. Three quarters of respondents were without previous work experience abroad, the other majority had experience across the border, mostly in the succession countries of former Yugoslavia. 40 % of them earned more than 1 million euros revenue in 2009 and 60% recorded less than 1 million euros. Half of the enterprises were employing up to ten employees, the largest in the sample employed 80 people. More than 60% of respondents considered their business as a family business, 80% of them are still in the hands of founding generation.

#### 4.2. Results

Before the establishment of the company, the future entrepreneur needs to develop a business idea, create a business plan and decide on the name of the company. All of these activities can be done bearing the desired brand in mind to facilitate the future corporate brand building efforts. After the establishment of the company, all of the brand building activities identified in this study need to be conducted during the inception and survival stages.

Visual stimuli are a critical part of any branding strategy. These stimuli include the logo, signage, packaging, product design, advertisements, and web sites. Hutton (1997), and some other authors argue that visual stimuli can assist in building strong brands by differentiating products, creating loyalty, allowing for premium pricing, cutting through clutter, and protecting against competition. In conjunction with this, we test whether and how Slovenian SMEs branded their company, who developed logo, type of relationships between designer and company, how much they invest to design and if they had registered and protected brand. 8.9% of the respondents said that they did not have any branding marks of their business. Other respondents use logo, signage, packaging, product design, advertisements, and web sites. 39.4% of respondents think that they had good designed firm's identity, 30.6% have developed the logo and signage. 21.1% of them stated that they have formed signage. Their image was designed by amateur designer (9.4%), a person from printing industry (8.3%), an architect (3.9) or a marketing agency (2.8). The person who created the image was in most cases not related or associated with entrepreneurs (59.4%) only 32.8 % of respondents said that they were related. Mostly, they did not pay anything for their brand design (42.8%) or they paid less than 2000 Euros (40%). Only 10.6% of them paid more than 2000 Euros for creating image. 63.9% of respondents don't legally protect their logo and only 23.9% of respondents registered and protected their logo. Other respondents did not have any sign.



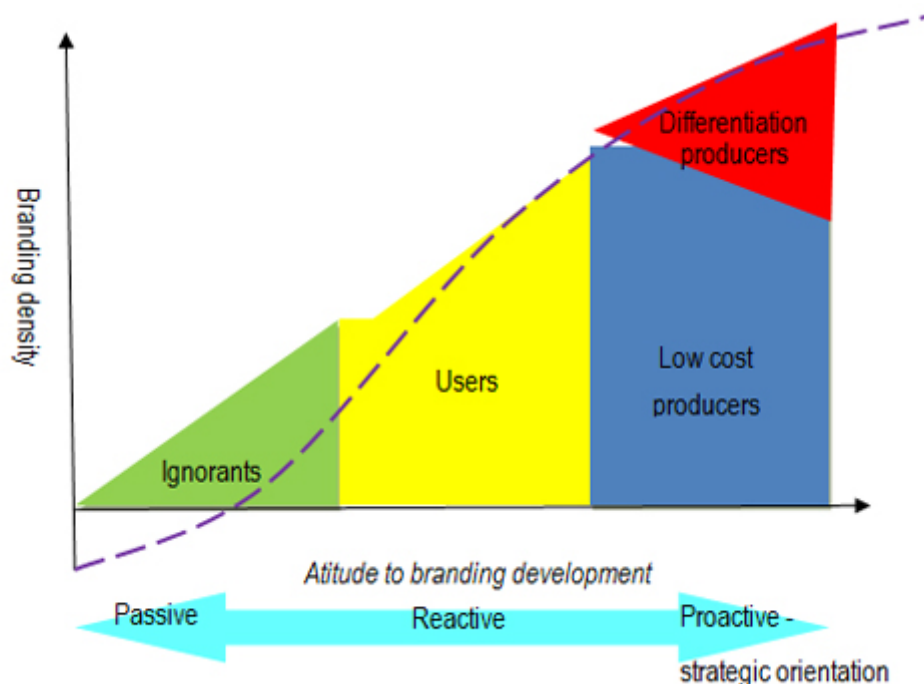
Researchers often encounter situations best resolved by defining groups of homogeneous individuals (Hair et al., 2010). Cluster analysis will always create clusters. The first task is developing some measuring instrument of similarity between each object. Next step is forming clusters on the similarity measure of each cluster. The resulting clusters should be of high internal homogeneity and high external heterogeneity. We used non-hierarchical clustering procedures also known as K-means cluster analysis which is a tool designed to assign cases to a fixed number of clusters whose characteristics are not yet known but are based on a set of specified variables. It's most useful when we want to classify a large number of cases. This procedure attempts to identify relatively homogeneous groups of cases based on selected characteristics, using an algorithm that can handle large numbers of cases. However, the algorithm requires you to specify the number of clusters. One can specify initial cluster centres if this information is known.

Preliminary results show that SMEs can be robustly classified into four different groups regarding their understanding of branding and related activities. The four groups can be partly contextualized within Porter's generic strategy framework and were identified in the study as: (1) in the start-up phase of life cycle, SMEs show almost no awareness of branding, (2) in early growth phase when they start to do some activities (logo development etc.). In the phase of the need for a strategic orientation, their branding would depend on whether (3) they aim for low-cost strategy (some formal branding activities) or (4) their strategic orientation would be differentiation which is by definition expected to be built on powerful branding.

We select one of two methods for classifying cases, either updating cluster centres iteratively or classifying only. We save cluster membership, distance information, and final cluster centres. Optionally, we specify a variable whose values are used to label case wise output. We also request analysis of variance F statistics. While these statistics are opportunistic (the procedure tries to form groups that do differ), the relative size of the statistics provides information about each variable's contribution to the separation of the groups. The analysis proceeded in a number of stages.

Distance from cluster centre creates a new variable indicating the Euclidean distance between each case and its classification centre. Cluster 1 and 4 are most different. Cluster 2 is similar to cluster 3 and different to cluster 4 and cluster 3 is similar to cluster 1 (Table 1). The ANOVA indicates which variables contribute the most to cluster solution. Variables with large F values provide the greatest separation between clusters (Table 2). The final cluster centres reflect the characteristics of the typical case for each cluster. They are computed as the mean for each variable within each final cluster. According to the findings of the cluster analysis we estimate four final cluster centers (Table: 3 and 4): ignorant (12%), users (41%), low costs producers (39%) and differentiation producers (8 %).

Figure 1: The role of branding of SMEs



**Ignorants** (cluster 4) use some elements of branding: symbols, special characters printed on the business cards and official letters, but they not confer special interest to trademarks in their business. A large number of cases were assigned to the second cluster **users** (cluster 1) which use elements of branding printed on the business cards, official letters, e-mail advertisements. The symbol of a company is a trade mark and it is designed according to the customer expectations and customers' trust to brand. Ignorant and users cluster is more passive eventually reactive than strategic oriented. Businesses are usually locally oriented.

**Low cost producers** (cluster 3). They use brand visual stimuli, such as signs on printed materials, special designed buildings and offices, signed cars, etc. Great importance in shaping the trade mark is attributed to the anticipation of customer and product functionality. Brand hasn't had a significant impact on selling success of the product or service. Low prices are most important tool for good sales.

**Differentiation producers** (cluster 2) are very conscious of the importance of branding and want to improve their operations and process. Perhaps, the fourth group is most profitable. Customers trust to company's name, great importance in shaping is attributed to the anticipation of customer and product functionality. Company brand has a significant impact on sales volume, and effect to selling price, it provides the primary points of differentiation between offers of competitive firms.

Low cost and differentiation producers are strategically oriented to branding, they operate to broader market. Branding is a strategic tool. It generally follows Porter's generic strategies of cost reduction and differentiation. Business strategy, marketing strategy or promotion strategy must support brand strategy.

## 5. CONCLUSION

The results suggest that branding is not only a large companies' issue but SMEs could benefit from it as well, and they should be more carefully taken into account with small business companies (Ahonen, 2008). As marketing of SMEs differs from marketing of large companies, similarly branding issues of SMEs differ from branding issues of large companies. However, brand building can be done with smaller resources by being innovative, using affordable means of communication and focusing the branding efforts on the right segments.

Study makes a significant contribution to the understanding of branding in the small business and entrepreneurial sectors in Slovenia. In other words, it clarified the current picture of branding, the views and attitudes of entrepreneurs in SMEs to mark the importance of branding. Findings have important implications for SME managers. Study revealed that branding does exist among SMEs and interesting evidence about the positive consequences that firms with powerful branding policy may have: the higher attitude of those companies to business performances and customer relationships were revealed. Brand adds value and differentiation from competitors. Branding is an active and continuous process fed by innovations and product differentiation.

The first set of implications would be for assisting SMEs in the field of strategic orientation and marketing. This would also include different public support programs for SMEs which are usually broadly oriented and do not take into account the phase of development and maturity of SMEs. Finding from the research will contribute to better understanding of marketing to SMEs which may be included in the design and delivery of study courses at different levels.

Properly managed brands are essential to creating good business performance. It is important to take in mind that brands have long-term value, yet what may take many years to develop can be quickly lost through inappropriate managerial decisions (Capon et al., 2001). Branding is part of the marketing and strategic orientation processes.

The value of the study would be in broader understanding of the complexity of the SMEs' marketing and strategic orientation processes. This will be shifted away from often misleading common beliefs that marketing and branding activities are "for the big ones only".

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## Appendix

Table 1: Distances between final cluster centres

Cluster		1	2	3	4
Dimension	1		5,075	3,285	4,283
	2	5,075		4,659	8,182
	3	3,285	4,659		6,886
	4	4,283	8,182	6,886	

Table 2: ANOVA

Item	Cluster		Error		F	Sig.
	Mean Square	df	Mean Square	df		
Customers trust on our products and services	2,100	3	0,601	144	3,496	0,017
Brand name does not affect to the selling price.	7,835	3	1,574	144	4,979	0,003
Attractive package is on of the most effective tools of the sales performance	10,976	3	1,282	144	8,564	0,000
Our customers trust to the name of our company.	5,557	3	0,833	144	6,675	0,000
The form of our product or. services do not significantly influence the selling	5,364	3	1,523	144	3,522	0,017
Our customers trust to the director of our company.	,284	3	1,326	144	,214	0,886
Low prices are most important for a good sale	21,854	3	1,046	144	20,893	0,000
The sales staff does not contribute significantly to our sales performance.	4,100	3	1,406	144	2,916	0,036
The brand has a significant impact on sales volume.	11,183	3	0,878	144	12,732	0,000
Our customers trust to our brand name	8,474	3	0,681	144	12,443	0,000
The brand has a strong influence on the reputation of the company as a whole	17,287	3	0,626	144	27,626	0,000
The brand represents our major competitive advantage	13,063	3	0,784	144	16,670	0,000
We use company logo on business cards, letters, e-mail, etc..	4,223	3	0,723	144	5,842	0,001
The symbol of our company is our trademark	27,405	3	0,805	144	34,030	0,000
We use company logo on product package	40,603	3	1,232	144	32,948	0,000
Our brand is signed to buildings, shops, cars, etc.	47,300	3	1,079	144	43,847	0,000
We use the symbol or brand name in advertisements.	41,480	3	0,693	144	59,881	0,000
The company name signed inside of business (offices, corridors, manufacturing facilities, warehouses, etc.).	36,636	3	1,367	144	26,808	0,000
The brand should be designed in function of the product / service	8,024	3	0,977	144	8,215	0,000
The brand should be designed so that the utmost account of the wishes of the Director.	1,372	3	1,289	144	1,064	0,366
The brand should be designed according to customer expectations.	5,177	3	1,311	144	3,949	0,010
Brands do not provide the primary points of differentiation to competitive offer.	22,541	3	1,051	144	21,446	0,000



Table 3: Final cluster centres

Item	Cluster			
	1	2	3	4
Customers trust to our products and services	4	4	5	5
Brand name does not affect to the selling price.	3	4	2	3
Attractive package is on of the most effective tools of the sales performance	2	4	3	2
Our customers trust to the name of our company.	4	4	4	3
The form of our product or. services do not significantly influence the selling	3	4	2	3
Our customers trust to the director of our company.	3	3	3	3
Low prices are most important for a good sale	3	5	2	3
The sales staff does not contribute significantly to our sales performance.	2	2	2	2
The brand has a significant impact on sales volume.	3	5	4	3
Our customers trust to our brand name	4	4	4	3
The brand has a strong influence on the reputation of the company as a whole	3	5	5	3
The brand represents our major competitive advantage	3	5	4	3
We use company logo on business cards, letters, e-mail, etc..	4	4	5	4
The symbol of our company is our trademark	4	5	5	2
We use company logo on product package	3	5	4	2
Our brand is signed on buildings, shops, cars, etc.	3	4	5	2
We use the symbol or brand name in advertisements.	4	5	5	2
The company name signed inside of business (offices, corridors, manufacturing facilities, warehouses, etc.).	3	4	4	2
The brand should be designed in function of the product / service	4	4	4	3
The brand should be designed so that the utmost account of the wishes of the Director.	3	3	2	2
The brand should be designed according to customer expectations.	4	4	4	3
Brands do not provide the primary points of differentiation between competitive offer.	2	5	2	3

Table 4: Number of cases in each cluster

Cluster	1	61	41 %
	2	11	8 %
	3	58	39 %
	4	18	12 %
Valid		148	100 %
Missing		32	

## TECHNOLOGY AND INNOVATION DYNAMICS: MODEL FOR ECONOMIC DEVELOPMENT IN TRANSITION ECONOMIES

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### Abstract

The final purpose of this paper is to show that understanding the importance of technology and innovation dynamics in developed world should be the core element of potential economic development and innovative entrepreneurship in transition economies. Namely, in the rapidly changing world of technology, constant innovation and creation of effective technology strategy derived from the world's best examples, is the only way to move forward in terms of economic development, especially innovative entrepreneurship, for developing countries.

In the light of this purpose, the focus is on understanding technological changes and cycles in general, with an accent on the most recent technology market phenomenon – the rise of cloud computing industry. The case study on Microsoft vs. Google battle for cloud computing dominance evidences not only the importance of constant technology and innovation strategy revision for achieving world tech supremacy thus influencing overall economic development, but also the need for preparing transitional countries' mindset for coming changes and challenges in the world of technology and innovation as they are directly influencing their potential economic development, especially in terms of the growth of innovative entrepreneurship sector.

Thus, this paper should serve as an introductory background for all forthcoming serious researches into the pool of innovative opportunities that are approaching developing countries through the channels of technological breakthroughs coming from developed world.

**Keywords:** Technology dynamics, Cloud computing, Technology and innovation strategy, Developing countries, Potential economic development and innovative entrepreneurship.

### 1. INTRODUCTION

In the beginning of this paper, the main theoretical concepts on technological change, technology cycle models and diffusion are introduced, in order to show the importance of understanding technology and innovation dynamics over time in the context of not only technological but also economic development.

Furthermore, the paper is focusing on the most recent technology phenomenon – cloud computing, having the main purpose to lighten where developed world is currently moving so that developing countries can better prepare for forthcoming challenges when these come to them. Therefore, the main characteristics of cloud computing industry are presented, having the main aim to show how this innovative way of computing is changing traditional one so that transitional countries can immediately picture their potential future development in terms of economic growth. In addition, this paper should be a sort of guideline for innovative entrepreneurship in developing world, based on breaking technological advances that are currently taking place in developed world.

Building on these assumptions, case study on Microsoft vs. Google battle for cloud computing dominance is used as the most appropriate research methodology, taking into consideration the fact that this great technological phenomenon is yet to be explored in depth. The case study evidences not only the importance of constant technology and innovation strategy revision for achieving tech supremacy and constant development, but also evidences the need for preparing transitional countries' mindset for coming changes and challenges in the world of technology and innovation.

Namely, advancements in information and communication technologies are rapidly becoming accepted by developing countries as an effective tool to reduce poverty, enhance human capital, enlarge the knowledge gap, bring the overall prosperity and finally, try to achieve Millennium Development Goals. Especially, the Republic of Srpska and Bosnia and Herzegovina as a whole are a lot behind almost all countries in Central and Eastern Europe, not to mention the other European countries. As a matter of fact, during the 1990s, when technological development was at its peak in almost the whole world, Bosnia and Herzegovina was struggling with inner conflicts which prevented it to experience great potentials of innovative technologies. Following this, this paper highlights some implications for developing countries so that they try to come closer to mindset and brilliant achievements of developed world, pointing that leaders and decision makers in all fields are of great importance as

they are supposed to provide solutions and drive desired changes and challenges by combining not only local and national but also international and global resources in innovative ways.

The paper is closed with final conclusions, forthcoming challenges as well as potential future development of innovative world of technology that directly shapes almost every industry sector with innovative, more efficient solutions, undeniably delivering significant economic growth. Some suggestions for the further research are introduced as well.

## 2. TECHNOLOGY DYNAMICS.

Important characteristic of many technological change theories is that they underline the evolutionary character of technological change by defining it as a change that is based on technological variation and social selection done in such a way that technological knowledge, systems and institutions are developing in interaction with each other. The changes in technology have unequivocal impact on the overall economic growth (Klein, 1984) and specifically on development of the industries (Lawrence and Dyer, 1983).

In the light of various case studies across many different industries, technological progress represents “an evolutionary system punctuated by discontinuous change” (Tushman and Anderson, 1986, pp.460-62). Major product and process innovations are unusual and are usually driven by individual genius, creating technological discontinuities that trigger a period of technological ferment. When one product or process is substituted, the number of product variations increases as alternative product forms start to compete for dominance. This period of technological experimentation and competition lasts until dominant design emerges, which is actually “synthesis of number of proven concepts”, according to Utterback and Abernathy (1975). Thus, dominant design reflects the emergence of new standard (Tushman and Anderson, 1986). In this new setting, alternative designs are put away from the market, and further technological development is focused around dominant design, as it becomes a guide for further changes.

Richard Foster (1986) argues that “industry leaders become losers because they have difficulty managing technological discontinuities”. His depiction of technological progression through series of S-curves, suggests technological change follows cyclical pattern and each of those cycles begin exactly with technological discontinuity. All those enterprises that don’t adopt innovation on time or increase their investments in obsolete technology have more chances for failure as market conditions change so rapidly after discontinuity occurs. As Dutton and Thomas (1985) explained, “While technological dominance can’t be predicted at the outset, organizations that create technological variation, or are able to adopt technological change quickly, maximize their probability of being able to move with a changing technological frontier. Organizations that do not contribute to or keep up with multiple technological bases may lose their ability to be aware of and deal with technological evolution.”

### **Technology diffusion.**

Although there is a variation in the distribution of adopters of new products and services, the most common pattern is the one presented with bell-shaped curve, the so called “normal distribution” pattern which indicates different groups of customers that are adopting new technologies at different times and for different reasons. Namely, small portion of customers (“innovators” and “early adopters”) are adopting technology early, small portion late (“laggards”), but most of them are adopting that particular technology in the middle time (“early majority” and “late majority”) (Shane, 2009, p.47-52).

Therefore, in order to achieve the widespread adoption of their new product or service, enterprises need to understand when and why different customer groups adopt these new technologies, making sure that their particular new product or service has all those attributes that are necessary to gain acceptance from each single segment of the market.

Despite the fact that new technologies are in most cases important improvements of existing technologies, most firms are not willing to shift to new technologies easily as those investments give lower returns than investments in their current technology. This unwillingness to shift to new technologies could be also explained by complexity of knowledge which comes with those technologies and need for complementary resources development. Some of the necessary knowledge might be gained through manuals and some other useful documentation, but in most cases, the real knowledge is actually gained through experience. The bottom line is that potential adopters of new technology are not willing to adopt it until the moment when this knowledge is available to them, even though they are aware of that particular technology and its advantages (Georski, 2000, p.603-

25).

There are lots of scientific statistics confirming that new technology diffusion, especially in the field of information and communication, makes a significant difference to competitive and comparative advantage of nations, organizations, communities and people. Some of them even evidence that the extent of technology adoption is a prime factor in the rapid development of countries. Taking these findings into consideration, strategic approach is needed in planning technology diffusion as both scholars and practitioners believe it is the key element for influencing global recovery.

### **Technology cycles: dominant design leading to adoption of new technological standard.**

According to Tushman and Anderson (1990, p.604-34), the S-curve model suggests that technological change is cyclical. Namely, each S-curve ushers in the very beginning, which is followed by rapid improvement, followed again by diminishing returns and finally displaced by a new technological discontinuity. This last point is actually what overturns existing competitive structure of the industry and creates new leaders as well as new losers. Exactly this process is called “creative destruction”, as Schumpeter (1942) argued, it was the main driver of progress in capitalist society.

Models that best explain technological change, its various phases and the emergence of dominant designs that lead to adopted technology standards are certainly Abernathy-Utterback (Utterback and Abernathy, 1975, p. 639-56) and Tushman-Anderson (Tushman and Anderson, 1986, p.439-465; 1990, p.604-34; 1991, p.26-31; 2004) models.

The main reason why markets become oriented around a single dominant design rather than around many different technological options is that most industries work on the principle: the more one particular technology is adopted, the more valuable it becomes (Arthur, 1994).

Especially in the case of complex technologies, such as cloud computing, the more they are used the more they are improved, as those technologies exhibit increasing returns to adoption. As time is passing by, technology is more used and thus, knowledge and understanding of that particular technology increase, which usually leads to improvements of technology as well as its applications. Wide adoption of technology directly influences the development of complementary assets, which are specialized to operate only within that particular technology. According to Schilling (2010), primary sources of these increasing returns are certainly learning effects and network externalities. Learning-curve effects explain the fact that the more technology is produced and used, it becomes better understood and thus developed, which finally leads to improved performance and reduced costs. In addition to this, network externality effects are also key factor in creating increasing returns. Namely, they arise in the case when the value of good to user increases together with the size of the installed base which can happen because of many reasons such as need for compatibility or availability of complementary goods.

## **3. STUDY CASE: MICROSOFT VS. GOOGLE BATTLE FOR CLOUD COMPUTING DOMINANCE**

### **Background: development of cloud computing industry.**

Almost all characteristics of cloud computing, the comparison to the electricity industry and the use of public, private, government and community forms was explored by Douglas Parkhill in his book “The Challenge of the Computer Utility” from 1966.

The concept of cloud computing itself dates to the 1960s, when John McCarthy said that “computation may someday be organized as a public utility”, but the actual term “cloud” is borrowed from telephony when telecommunication companies, who until the 1990s primarily offered dedicated point-to-point data circuits, started to offer Virtual Private Network (VPN) services with still good quality of service, but at a much lower cost.

Cloud is used as a metaphor for the Internet, based on the cloud drawing used in the past to represent telephone network and later to represent Internet in almost all computer network diagrams as an abstraction of infrastructure it represents. Clouds often appear as single points of access for consumer computing needs.

Amazon played a key role in cloud computing development as it modernized data centers after dot-com bubble. Later on, in 2007, Google and IBM, together with many top universities, started to work on a cloud computing research project (Miller, 2008). As a result, in early 2008, Eucalyptus became the first open source platform for deploying private clouds, and OpenNebula, developed in RESERVOIR European Commission funded project, became the first open source software for



deploying private and hybrid clouds (Rochwerger et al, 2009).

Nicholas Carr argues in his book “The Big Switch” that cloud computing paradigm shift is similar to displacement of private factory power generators by utility power plants early in the 20th century. Namely, as the electricity grid became kind of general utility so is computing power becoming with the emergence of cloud computing.

As a matter of fact, supercomputers today are used mainly by the military, government agencies, universities and research laboratories, and large companies in order to deal with complex calculations for tasks such as simulating nuclear explosions, predicting climate change, designing airplanes, analyzing body proteins, etc. Cloud computing exactly aims to apply that kind of power, measured in trillions of computations per second, to various problems such as analyzing risk in financial portfolios, delivering personalized medical information, etc. This is done by networking large groups of servers that often use low cost consumer PC technology, with specialized connections to spread data processing among them (Ricadela 2007).

It is obvious that shift towards cloud computing affects various sub-categories in computer industry like software companies, internet service providers (ISPs), hardware manufacturers, etc. Those who gain the most are certainly consulting, software and hardware services companies (IBM, HP, etc.), software producers (Microsoft, NetSuite, Salesforce.com, Taleo, etc.), internet-based companies (Amazon.com, Yahoo!, Mirosoft, Google, Cisco Systems, etc.), internet infrastructure providers (Equinix, Telecity, etc.), and consulting companies (Cloud Technology Partners, SAVVIS, etc.) whereas the greatest losers are traditional software producers (Oracle, SAP AG, Lawson Software, etc.). This is mainly due to the fact that traditional business applications are very complicated and expensive, requiring a whole team of experts to install, configure, test, run, secure and eventually update hardware and software required. With cloud computing, all these things are eliminated as the maintenance of hardware and software is the responsibility of an experienced vendor. With cloud-based applications, the only thing user is supposed to do is: open a browser, log in, customize the application and start using it.

With its great cloud-based interconnection, cloud computing might be also described as “sky computing” with many isolated clouds of services which IT customers must plug into individually. The idea of loosely coupled services that run on scalable infrastructure should eventually make every enterprise a node in the cloud. Therefore, cloud computing is seen as a long running trend.

According to Gartner report for 2010, the cloud services market grew to \$68.3 billion in 2010, which was a 16.6% increase compared to revenue of \$58.6 billion, which was reported in 2009. Further predictions are that by 2014, cloud services revenue will go to \$148.8 billion, according to Gartner.

### **Microsoft survey.**

Microsoft processed on-line survey in which 2000 IT decision makers from various industries in 10 US cities discussed the way they adopt and use cloud computing. IT decision makers in financial services, manufacturing, professional services, and retail and hospitality see cloud computing as an opportunity to grow their business, drive innovation and strategy, and efficiently collaborate across geographies, according to this survey.

From Microsoft’s perspective, cloud computing has two additional advantages: it lets small businesses act like big businesses and it lets big businesses move quickly and cheaply like small business, by quickly scaling up and down in size as their IT needs shift. Big businesses have an opportunity to innovate at lower cost with multiple options rather than having to sink everything into a single, big capital cost option. In addition, cloud computing is also profitable solution for small and medium businesses as it provides enterprises with databases, programming platforms and communications that would be out of their reach because of cost or technical expertise requirements.

### **The main characteristics of cloud computing.**

The fundamental concept of cloud computing phenomenon is that computing is “in the cloud”, meaning that the processing data is not in a specified, known or static place. Exactly this makes the technology location-independent, where data and applications are maintained via internet and central remote servers. Therefore, computing is delivered as a service via internet, from shared machines in data centers. Namely, cloud computing allows its consumers and businesses to use applications without the need for hardware or software installations, being able to access their files from any computer or device with access to internet. As cloud computing customers usually do not own physical infrastructure, they avoid the capital expenditure by renting usage from a third-party provider and consume resources as a service, paying only for what they use. Thus, shared servers



provide resources, software and data to computers and other devices on demand, as in the case with electricity grid.

Cloud computing especially comes into focus when one thinks about what IT always needs: a way to increase capacity or add capabilities without investing in new infrastructure, training new personnel or licensing new software. This is usually the form of web-based tools or applications that users access and use through web browser as if it was a program installed locally on their own computer. Web-based e-mail and documents, social networking, online games and other similar data stored online or “in the cloud” are all examples of cloud computing services, accessible through browsers from any PC, smart-phone or other “client” device which has an access to Internet.

Many cloud computing offerings use utility computing model, analogous to how traditional utility services, such as electricity, are consumed. Others bill on subscription basis. This share of intangible computing power among multiple tenants improves utilization rates, thus reducing the costs while increasing the speed of application development (Various authors, 2008).

Additional benefits of cloud computing are also low barriers to entry, shared infrastructure and costs, low management overhead, and immediate access to a broad range of applications. As users can terminate the contract at any time, they avoid return on investment risk and uncertainty.

### Layers.

**Application services or “Software-as-a-service (SaaS)”** deliver software as service, so that single application is delivered through web browser to thousands of customers using a multitenant architecture. In this way, there is no need for installing and running the application on customer’s own computer. Therefore, applications are run much more efficiently and many costs for consumers and providers are eliminated. These “on demand” software services vary depending on their price and the way software is delivered to the end users. Usually, companies charge their customers a subscription fee which licenses the application to customers. In addition, more traditional approach is the one when companies sell licenses to their users.

**Platform services or “Platform-as-a-service (PaaS)”** deliver development environments as a service, using cloud infrastructure and applications. In this way, user builds his own application that runs on provider’s infrastructure and is delivered via internet from provider’s servers. Therefore, applications are deployed so that the cost and complexity of buying and managing hardware and software is reduced (Knorr and Gruman, 2008).

**Infrastructure services or “Infrastructure-as-a-service (IaaS)”** deliver infrastructure as a service. In this way, there is no need for buying servers, software, data-center space or network equipment, as clients can buy those resources as a fully outsourced service. These services are usually billed on a utility computing basis and amount of resources consumed reflect the level of activity. IaaS actually evolved from virtual private server offerings.

### Types.

**Public cloud** describes cloud computing in traditional sense, where resources are provided via web applications on self-service basis over the Internet, from an off-site third-party provider who bills on a utility computing basis.

**Community cloud** comes into play when several organizations have similar requirements and are willing to share common infrastructure, spreading the overall cost over fewer users than in a situation of public cloud. Although this option is more expensive, it offers higher level of privacy, security and policy compliance. The example is Google’s “Gov Cloud”.

**Hybrid cloud** describes either two separate clouds joined together (public, private, internal or external) or a combination of virtualized cloud servers used together with real physical hardware in order to provide a single common service. Two clouds joined together are actually called “combined cloud”. Its environment consists of multiple internal and/or external providers. A hybrid storage cloud uses a combination of public and private storage clouds, which is useful for making backups, allowing local data to be replicated to a public cloud (Orenstein, 2010).

**Private cloud** is term representing all offers that emulate cloud computing on private networks. These networks have ability to host applications or virtual machines in company’s own set of hosts. The private clouds attracted criticism as users still have to buy, build, and manage them and thus do not benefit from lower capital costs and less management.

**The Intercloud** is an interconnected global “cloud of clouds”, an extension of the Internet “network of

networks” on which it is based. This Intercloud will have the dimensions of one machine comprising all servers and attendant cloudbooks on the planet. Namely, each single cloud does not have infinite physical resources and in case when storage resources of its infrastructure can’t satisfy further requests for service allocations from its clients, the intercloud idea comes into scene as each cloud could use storage resources of other clouds.

### **The major players in the battle for cloud computing market dominance.**

“What IBM did in the mainframe era, and Microsoft did in the PC era, one of the new challengers may succeed in doing in the cloud”, according to The Economist October 2009 research. And so, a fight for being number one high-tech company in the world starts as a great amount of money is invested in research and development by many companies.

Microsoft’s main rival Google offers its range of cloud computing services, continuously launching new ones and interlinking them closely (The Economist, 2009). Yahoo! and Apple offer cloud services for consumers whereas specialists such as Salesforce and NetSuite do it for companies. Furthermore, IBM devoted 200 researchers to cloud computing project whereas Amazon broadened access for software developers to its “Elastic Compute Cloud” service, which allows small software companies to pay for processing power taken from Amazon’s data centers. Facebook runs what is actually the most successful cloud service, providing a platform for people to communicate, share information and collaborate online. Among these cloud computing leaders, some offer large suites of cloud-based services, whereas some specialize in particular areas or provide technical support for building and running the clouds. The most important thing is that most of the companies joined the world of cloud computing and so the whole new world of innovative computing tools has been born as many “simple tools” like Google Docs, Gmail, Hotmail etc. are substituted with cloud-based Google Reader, Wikis, payment systems like PayPal, social networks like Facebook and many other interesting and useful applications that are completely changing our lifestyles.

It is obvious that this cloud computing battle is about creating “universes for consumers who are willing to live their technology lives inside” (The Economist, 2009).

In this context, Microsoft wants everyone to use its Internet Explorer browser, search through Bing, use MSN portal for the latest news, email via Hotmail or Outlook Express, and finally use Windows Mobile on their smart-phones and Xbox for kids. This Microsoft system is actually a small Microsoft universe in which family of its applications represent a “dominant platform for software developers of all types” (Singel, 2009).

Following this, Google wants everyone to use its Google Chrome browser with default homepage set to Google News, email via Gmail in which it is possible to open Word documents with Google online word processor. Most of all, Google wants everyone to travel around the web, visiting pages that run Google-served ads and Google tracking cookies. The idea behind is that Google is never giving away all this technology for free as many people think because Google has an enormous silent data collection of user profiles which are delivered to various advertisers for a premium (Singel, 2009).

## **4. MICROSOFT VS. GOOGLE**

According to Sharon Gaudin (2009), “Google, one of the great Internet success stories ever, is the name that has evolved into a verb meaning “to search”, growing rapidly so much that it became a threat to Microsoft, which has had a long and storied history of high-tech industry dominance”. Days when everybody was sure that Microsoft could never been challenged by another company are over as now Microsoft invests millions of dollars to take a small portion of Google’s search market share, trying to eliminate its major threat for industry dominance.

According to Dan Olds, an analyst with The Gabriel Consulting Group, “The reason that Microsoft is so focused on Google is because Google is chipping away at Microsoft’s crown jewels of Office and Windows with their online applications. While Microsoft plays defense on the applications/operating system front, they’re attacking Google on search and online services. Search is the key to Google’s success since Web ads account for more than 90% of its revenue. If you can steal some eyes from Google’s search engine, you cut into their ad revenue and, perhaps over time, cripple them.”

Taking into consideration that the power to affect change comes with great customer base, by shifting its current PC applications to the internet, Microsoft can influence customers’ behavior, thus benefiting from cloud computing. However, the problem is potential loss of revenue from PC based software. Despite all these facts, Microsoft’s newest slogan “The Cloud - We’re all in!” suggests that Microsoft has a great determination to conquer the cloud computing market. As Kevin Turner, COO said at

Worldwide Partner conference in Washington DC, “Lead your customers to the Cloud. They are going there anyway, so lead them”. This is exactly what Microsoft strategy is all about. Leading their users in the direction Microsoft wants.

### **New battleground: different approaches to cloud computing.**

“Google sees all happening on remote servers in faraway data centers, accessible over the Web by an array of wired and wireless devices”, thus supporting cloud computing trend in every step of its high-tech innovations. It could be even said that Google has been a cloud computing company since its birth in 1998. On the other hand, “Microsoft sees a Web future whose center of gravity remains firmly tethered to its desktop PC software”, especially its Office suite. This fundamental difference in Microsoft and Google future view was an actual starting point for their conflict. Nevertheless, “both Google and Microsoft have and still are investing heavily in data centers across the country and there is no doubt that the future will see majority of software being offered as services rather than packaged software” (Balagopalan, 2007).

In his article “Battle for the Cloud: Google vs. Microsoft”, Neil McAllister argues that “Google’s model represents a radical departure” from traditional computing model – “No disks or volumes for the user to maintain, there is no need for file system to store them in. Persistent storage is reduced to an abstract concept: “all that exist are applications and their associated documents”. Furthermore, as applications are in the cloud, there is no need for installing anything, upgrading or managing security. Thus, user is far away from “traditional desktop computing experience” as he doesn’t have to deal with daily interactions with the operating system.

Therefore, it is no surprise that this was a great threat to Microsoft, as there is no need for installing or buying an operating system in order to run Google’s applications. As a matter of fact, “Google model invites users to ignore everything that has been Microsoft’s bread and butter for the past 25 years”.

Microsoft accepted cloud computing fight, but didn’t follow “Google’s lead in minimizing the importance of desktop software” as this would mean admitting defeat. Microsoft’s Live Mesh is “new cloud computing - based data synchronization and device management platform that maintains a master copy of your data on the software giant’s own servers, enabling instant access to the latest version of files from any Internet-connected device”. In this context, Live Mesh delivers the advantages of cloud computing in Microsoft way as documents persist in the cloud, but in familiar form of files and folders. “Each object in the cloud has an “end point” on one or more devices in the Mesh, where a copy of its contents is mirrored to local storage” (McAllister, 2008).

This was a serious attack on Google as the psychological distinction for the user is significant. As described by McAllister “In contrast to Google’s ethereal documents, Microsoft’s synchronized files and folders are objects with substance. Users are able to “create, modify, manage, and organize them using traditional desktop software”.

It is evident that this model fits with “Microsoft’s view of the software universe”: even though users experience the presence of cloud computing, they are still buying traditional operating systems and applications. In contrast, “Google’s Web-based applications are impressive achievements, but they lack the polish and functionality of desktop software such as Microsoft Office”. Ultimately, customers are the ones who decide which model is better for their needs, facing dilemma: “to follow Google’s lead down the road of “pure” cloud computing, where both documents and applications exist solely in the cloud” or to take Microsoft way and “push data into the cloud, while still relying on traditional desktop applications to create and manage the data” (McAllister, 2008).

Who is the winner?

The last similar war was in the 1980s and early 1990s, when Apple, IBM and Microsoft fought for dominance in PC market. Microsoft was the winner and thanks to strong network effects, which allow winners to take almost all, Windows almost destroyed rival operating systems, securing large profits for Microsoft.

This time, it is very unlikely that the battle will have so clear ending as the economics of cloud are different from those of PC and network effects are unlikely to be so strong. Namely, cloud computing is based on open standards, making it easier to switch providers and therefore, it is very hard that one single company will be able to lock in the users in its world of technology.

## 5. IMPLICATIONS FOR COUNTRIES IN TRANSITION.

First of all, understanding the overall importance of technological change is one of the crucial elements in creating effective strategies to meet the forthcoming challenges. In this respect, cloud computing phenomenon represents a huge shift not only for computer industry but also for all those related industries, as it became irrelevant what kind of computer individual or enterprise has and what kind of software that computer is running as the amount of data and software stored online is increasing and could be accessed through ordinary web browser. For the very first time, high-tech superpowers like Microsoft and Google enabled access to enormous computing power to average user reach which represents not the end of this innovation, but the beginning of new, process revolution approach in terms of value created to the end users.

All these trends happening in developed world should be used by countries in transition as a main guideline of forthcoming challenges in order to get the most out of great technology breakthroughs.

Following this logic, there is a strong need for creating innovative mindset in enterprises so that they become willing to constantly develop their core competences and become open to invest in development of new differentiated skills and assets, trying not to fall into rigidity traps. This is actually a formula for creation of sustainable competitive advantage and is providing access to wide variety of markets, making significant contribution to the perceived customer benefits of the end product (Prahalad and Hamel, 1990, p.79-91), in this case, delivering of cloud computing services.

In addition, the key success factor for survival and potential leadership in the rapidly changing market of technology is development of, in literature called, “dynamic capabilities” which represent core competences able to respond to any kind of change, and thus not specific to any technology in particular, but rather to the whole set of abilities that would potentially enable rapid and effective change of enterprise’s structure and routines in response to market changes and discontinuities, as well as new opportunities that eventually arise. From the case study on Microsoft and Google and their battle over the years now, it is obvious that organizational creativity is actually one of the greatest examples of these dynamic capabilities which are good example for developing countries on their way towards opening enterprises’ mindsets.

I would agree here with Schilling (2010) that apart from the fact that one of the most important things for innovative enterprises is to have developed systems for capturing employee creative ideas, the system for selecting and implementing those ideas is equally, if not more, important. As in the case of Google, apart from taking the advantage of idea management system, it ensures that employees report their ideas for new products and processes to company database so that they become available to every single employee. This is actually creation of “cloud computing system of ideas” as everyone within the company can create the idea, post it in the cloud (Google database), and have the feedback on it as all the people connected to “Google inside company cloud” can have a look at that particular idea, leave their comments for its potential improvement and rate it. This is definitely one of the best ways to translate individual creativity into successful innovation not only for that particular enterprise but much wider. Exactly using these enterprises’ human potentials should become much more developed and appreciated in developing countries as it directly leads to development of innovative entrepreneurship sector and indirectly to overall economic development.

Even though innovation is considered to be a freewheeling process unconstrained by rules, the great number of case studies showed that most successful innovators actually have clearly defined innovation strategies as well as strategic management processes (Schilling and Hill, 1998, p.4). As previously discussed, the organizational structure should encourage the generation of innovative ideas and ensure efficient implementation thus creating a productive background for rapidly changing technology environment, leaving enough space for constant evaluation of technology and innovation strategy. This is the only way that innovative enterprises in developing countries can capitalize on internal strengths as they develop, exploit external opportunities as they emerge, recognize their threats, and mitigate internal weaknesses before they become detrimental.



## 6. CONCLUSION

Many literature reviews on where the world is currently standing and where it is moving in terms of technology and overall development, suggest that the rapid move from industrial to information society we are currently in, was happening through various discontinuities: from technological over organizational to the most recent societal discontinuity. This paper, with its focus on the most recent technology phenomenon cloud computing, showed evidences that we are currently in network era, where knowledge and process integration are the most important elements. From all that was presented, it could be concluded that cloud computing became not only a trend but rather a necessity in today's high-tech as well as everyday life since a great variety of different web-based services are increasing each day, evidencing that we are moving from hardware to software innovation, not the one we experienced in the past years but rather, innovative internet-based software kinds.

Although it is very hard to explore all the potential of cloud computing, some of its main advantages for the society as a whole, as well as for the individuals, could be identified. As was suggested through the analytical part on cloud computing and later in the Microsoft vs. Google case study on this issue, it is obvious that this new phenomenon opens a whole universe of great possibilities, the most important of which is the idea of cloud itself – the great virtual platform above all of us which enables each individual to have enormous amount of data that doesn't have to be stored locally and depend on a particular hardware. This is a unique mechanism that offers great flexibility in terms of processing great amounts of data as well as number of users who are the main beneficiaries of the whole system. Nevertheless, the great potential of cloud computing goes beyond simple advantage of storing and transferring data, as it leads virtual networking in direction in which there are no limits.

Thus, even though I would classify cloud computing as a major technological shift, I would also like to point out its social impact as it significantly changes the way people interact. This is exactly the field which should be explored more in depth in some future researches.

There is no doubt that clouds create something like global co-operation systems as they need to collaborate in order for the whole system to have value. This, of course, opens a question of whether absolute confidentiality and integrity between the players and their networks is possible. It is an interesting topic for further research, as for the ideal cloud computing world in terms of processing, storage and transmission of the data "in the cloud", there is a need for finding solutions to issues such as security and trust in the virtual exchange of resources, data and ideas.

In a nutshell, cloud computing opens us the doors for the world in which almost everything becomes virtual, and therefore, possible. On the other hand, it closes the doors for traditional computing features. Therefore, it is partly our individual decision whether we prefer modern or traditional way of computing and to which extent we want to use cloud's enormous potential, but partly decision of great cloud computing leaders which are involving all of us in this world so rapidly that we even don't have enough time to become aware of that fact and think about direction we are going to.

Despite unclear and inconclusive results presented by very limited number of empirical researches on cloud computing development and its socio-economic implications, it is undeniable that this new phenomenon will ensure large benefits for individual countries as well as their innovative enterprises. This new technological wave is creating a completely new world in which the main citizens, huge multinational corporations and global financial markets, are facilitated by system of technological research and development, and so developing countries don't have other choice but to try with all their efforts to follow these technology directions as fast as possible. Of course, adopting new technology is not sufficient, but rather there is a need for extremely effective decision-making with innovative mindset including new management practices and structures at all levels, governmental as well as entrepreneurial, so that the potential of new technology is exploited as much as possible.

This paper provides departure point for more detailed discussion and further research in the field of new technological revolution and its potential economic benefits in the context of any country facing transition.



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<sup>1</sup> All the following internet data sources were retrieved between December 2010 and February 2011.

**Part Five:**  
**Regional development, Government**

**IMPACT OF TRADE ON DEVELOPING COUNTRIES OF SOUTHEAST EUROPE****Pero Petrović**

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E-mail: [pera@diplomacy.bg.ac.rs](mailto:pera@diplomacy.bg.ac.rs)**Abstract**

The paper discusses the trade exchange of Southeast Europe. They emphasized the analysis of trade in the region with the world and trade exchange among members of CEFTA. The work includes a brief overview of the economic regional cooperation through agreements in the past and that the same differ according to the present. The aim is to identify trade and economic similarities between the countries of Southeast Europe. Through individual analysis of trade and economy of all countries, obtained more accurate picture of the region as a whole. Exchange of goods is rising but there is a large untapped potential for further expansion of trade in the region and with third countries.

Many economists and politicians argue that the trade between countries of the Balkan region is among the most important aspects of the development of South Eastern Europe. There are several important points to this assertion, one of which is certainly the fact that by increasing the trade among each other, Balkan countries improve their economies and employ more people. Another aspect is that the Balkan countries that are not in the EU as of yet, are aiming to improve trade among themselves by lowering tariffs. This is the case with CEFTA agreement supported by the European Commission. Moreover, CEFTA members are essentially preparing themselves for the EU accession thus continuing the tradition of the original CEFTA, whose founding members are now in the EU. There is also the fact that by having a common market, the countries can improve domestic demand but also improve exports to the EU and to third countries.

**Keywords:** Trade, Development, Trade deficit, Trade surplus, the EU, CEFTA.

**1. INTRODUCTION**

Trade exchange in the region can contribute to their faster development. Regional integration processes and regional organizations can create conditions for a harmonized exchange of goods within the region and indirectly provide great benefits in terms of ease of entry into neighboring markets that would otherwise be less accessible. The advantage of CEFTA, as a common market of 27 million consumers, is that each of the countries of the region makes it more attractive place for foreign capital. This significantly raises the interest of investors. On the other hand, the biggest problem is many kinds of non-tariff barriers (for example, complicated procedures at border crossings, plenty of paperwork, insufficient number of internationally recognized accreditation and certification bodies).

The common economic market similar countries can serve as a testing ground for the willingness to enter into open market competition that prevails in the EU market. In addition to economic free trade zone in Southeast Europe has a political significance because, to a great extent the EU project aimed at improving cooperation among countries in the region. In this respect, and receiving financial assistance as well as the speed of approaching the EU, and WTO, to a large extent depend on the mutual trade cooperation among countries of the region.

Countries with the greatest economic potential and political significance, in southeastern Europe, Serbia and Croatia. Most competitive manufacturing industry, and from there most of the exports) is Croatia. Its relative importance of the "dominant" and accordingly the company from Croatia will most easily achieve the benefits of free business in the single market. Economic cooperation of SEE countries, however, is the strategic interest of all countries in the region, and foreign trade can contribute to their faster development.

## 2. THE LEVEL OF DEVELOPMENT OF SOUTHEAST EUROPE

SEE countries with the greatest economic potential of the Croatian and Serbian, but the IMF projected that GDP will grow by Serbian Croatian. In Table 1 are given indicators GDP per capita for countries and their tendency to assess the year 2015. The crisis has affected all countries in the region but recovery (measured by GDP pc in dollar terms at current exchange rate) but significant in 2011 godini. However, if for example in Serbia rose by 1.5% in 2010 due to depreciation of real GDP per capita is still reduced and that year. By far the highest levels of pc GDP has, as expected, Croatia. Serbia is in the middle, while at the rear of Kosovo and Albania.

Table 1 GDP per capita in dollars at current exchange rate

	2010	2011	2012	2013	2014	2015
Albania	3616	3720	3932	4165	4437	4765
B i H	4158	4275	4585	4929	5263	5623
Croatia	13528	13872	14572	15381	16238	17146
Kosovo	2604	2776	2925	3058	3151	3268
Macedonia	4635	4868	5204	5532	5885	6242
Montenegro	6117	6197	6530	6883	7163	7443
Serbia	5262	5574	6421	7007	7655	8257

Source: World Economic Outlook Database, October, 2010.

On the other hand, if we look at GDP purchasing power (in billions dollars) the picture is somewhat different because it incorporates the price level in each country. Serbia in 2010 was the largest economies in the region on this indicator (the level of GDP is estimated, it will be for ten years). Poorer countries have lower prices and see if the figures in the table divided by the population, the GDP per capita, roughly, about two times higher in most SEE countries, while in Croatia the difference is smaller (Table 2 ).

Table 2 PPP GDP(at purchasing power)of the SEE countries, in billions of dollars

	2008	2009	2010	2011	2012	2013	2014	2015
Albania	21,9	22,8	23,6	24,7	25,9	27,4	29,2	31,2
B i H	30,5	29,8	30,2	31,5	33,5	35,8	38,1	40,5
Croatia	82,5	78,4	78,0	80,3	83,4	87,2	91,3	95,7
Kosovo	4,0	4,2	4,4	4,7	5,0	5,4	5,7	6,0
Macedonia	18,9	18,9	19,3	20,2	21,4	22,5	23,8	25,2
Montenegro	6,9	6,6	6,5	6,9	7,4	7,9	8,3	8,8
Serbia	79,8	78,1	79,9	83,3	88,7	95,0	101,9	109,0

Source: World Economic Outlook Database, October, 2010.

According to the IMF, in 2010, all countries, except Croatia, have had positive growth rates of GDP (3.1% Albania, Croatia - 1.5%, 0.3%, Montenegro, Macedonia 1%, 4.6 Kosovo %, B 0.5%, Serbian 1.5%). The following table IMF estimates are given for the next five years, where you can see that the highest growth rates achieved Serbia, Kosovo and Albania, while GDP growth will be slowest in Croatia, which is, again, in accordance with the rule that the economy on a higher level of development progresses slowly and has a lower growth rate.

Table 3 Estimated growth rates of GDP PPP

	2011	2012	2013	2014	2015	2015/2008
Albania	4,5	5,0	5,8	6,5	6,9	42,5
B i H	4,3	6,4	6,8	6,3	6,4	33,0
Croatia	3,0	3,9	4,5	4,7	4,8	16,0
Kosovo	7,2	6,8	5,5	5,6	6,4	52,0
Macedonia	4,4	5,9	6,6	5,7	5,9	33,5
Montenegro	5,9	6,9	6,5	6,0	5,8	27,5
Serbia	4,3	6,4	7,1	7,3	6,9	36,7

Source: World Economic Outlook Database, October, 2010.



All SEE countries had a relatively high level of current account deficit of balance of payments (for example, Serbian 18% in 2008) that he would have declined during the crisis so that in 2010, compared to GDP was: Serbian 9%, B H and 6%, 3% of Croatia, Albania 11%, 29% of Montenegro. So, Montenegro and Kosovo have a very high balance of payments deficits as a result of huge capital inflows (relative to GDP in these areas) in recent years in this country, but the export sector and underdeveloped.

Fiscal deficits, generally speaking, are not so large and significantly lower than the average for the European Union. However, given the much more difficult features of these countries to borrow in financial markets deficits in public spending is not a problem. For example, in Serbia 2010 consolidated budget deficit is 4.8% of GDP in the year 2011 is projected at 4.1% of GDP, a decline caused by encouraging the adoption of rules under the patronage sallied fiscal IMF. In Croatia, the fiscal deficit stood at 4.2% of GDP, 3% in Albania, Bosnia-Herzegovina 4.5% to 7.2% in Montenegro, Macedonia 2.5%).

Public debt is also low for the standards of the European Union, but its rapid growth (in the last two years has been to nearly 39% of GDP in Serbia, an increase of up to 14%) creates potential problems for this country. External debt is a growing problem in Croatia and Serbia, because these countries by the standards of the World Bank's Heavily Indebted or are on the verge of highly indebted countries (for example, Serbian nearly 80% of GDP in 2010).

Exchange rate movements had a negative only in Serbia, because of the crisis in September 2008 to the end of 2010 was a depreciation of the diner by 28% (about 10% in real terms), while other Southeast European countries had fixed exchange rates in effect (B & H has fixed due to the currency board regime, Montenegro and Kosovo use the euro, the Albanian, Macedonian and Croatian currency, were practically unchanged in recent years). This gave impetus to Serbia in the context of growth of price competitiveness relative to neighboring countries but also in relation to the European Union and in recent years was expressed improving trade balance. Proportion of observations in the region of the seven countries is usually around 0.16% of global exports in the period 2005-2010. When it comes to imports observed seven countries share in global imports is also low but significantly higher and usually amounts to just over 0.3% during the 2005-2010 year.

### 3. IMPACT OF ECONOMIC CRISIS ON DEVELOPING COUNTRIES OF SOUTHEAST EUROPE

Indisputably the world's financial and economic crisis has hit all countries in the region. Although there is great potential for growth in bilateral trade with most Southeast European countries and the region was badly hit by the global economic crisis, so that the recovery is very dependent on economic developments in the European Union. The global economic crisis has significantly impeded the ability of countries in the region to finance the balance of trade imbalance. Therefore, the value of exports region countries is relatively small, while the value of imports increased significantly, and these countries have large trade deficit. It was in 2008 for these countries amounted to 33.4 billion euros that in 2009 dropped to 23.8 billion dollars. In 2010 there was a further decline in the trade deficit significantly higher rate of growth of exports than imports and the foreign trade deficit amounted to 21.1 billion dollars. Before the crisis, the October 2008 trade growth was higher in the mutual exchange with regard to trade with the rest of the world. The fall was greater trade between them in relation to the rest of the world. Positive growth rate of exports began in January 2010. The trade between the positive growth rate of exports was reached in mid-2011. Bearing in mind that the countries of the region hard hit by the global economic crisis, a recovery will depend on economic developments in the European Union.

There are three exit strategies, among many options that the countries of the region could use, or already partially implemented, in order to have a speedy economic recovery:

- Improve bilateral trade;
- Attract production-oriented investments, and
- Finding a bilateral financial assistance from friendly countries in case the banks
- with their markets (which is at present an unlikely option);

The European Union is only from 2007 to 2010 invested more than a billion euros in improving regional cooperation in Southeast Europe. Cooperation between countries in the region has made significant progress, but the region still is not, and in 2011, and apparently even reach the 2012 growth rate that was before the crisis, and it is necessary to convince investors that the market rule of law.

In any case, the European Union will continue to politically and financially support by the CEFTA agreement, as well as important reforms for the accession countries in the European Union. Before the global financial and economic crisis (2007-2010) South East European countries had higher rates of growth of mutual trade (relative to the growth of trade with the rest of the world) which affected the relative growth of mutual trade interest. The crisis is much more affected by the mutual exchange, but exchanges with the rest of the world, while the post-crisis recovery of exports based on demand from the rest of the world, with stagnation or slight increase in imports.

#### 4. THE ACHIEVED LEVEL OF EXTERNAL TRADE IN THE REGION

In the region of Southeast Europe by far the largest exporter of goods is Croatia, although its relative importance decreases in favor of countries that have significantly increased their exports in the previous period, primarily Serbian, speaking in absolute numbers, because it exports almost doubled. So if we take into account the exchange or export of services, Croatia's advantage is far greater, given that the country achieved in 2010 exports of services by as much as 8.4 billion euros, while imports amounted to 2.7 billion euros. The relative importance of which is improved with Montenegro (service exports 0.7 billion, imports 0.3 billion euros in 2010). B&H exports of services was 1.9 billion euros and imports about 0.9 billion euros. Serbia and the remaining SEE countries had a relatively modest share of services exports and imports about 2.6 euro 2.6 billion in 2010.

With approximately 0.5 billion euros, Croatia is among the countries of the region, the largest investor in Serbia. In contrast Serbian investments in Croatia are only 45 million. Bosnia and Herzegovina is the most important importer of products from other countries in the region and making a huge trade deficit with Croatia and Serbia. In trade with the countries of Bosnia and Herzegovina has the same aggregate value of exports and imports with countries such as the cumulative value of trade with Germany, Italy and Slovenia. Given the large trade deficit, the economic crisis affected the B&H reduces the trade deficit with the countries of the region, a deeper decline in exports to CEFTA countries than imports, a fact that reduces the trade imbalance.

In general, foreign trade, as in much other economic performance, there are many similarities between countries in the region. This above all: very few commodity exports - absolute and relative terms (relative to GDP, imports, per capita), large trade deficits (financed by remittances, loans, foreign loans and grants). The following two tables can be seen relatively modest value of merchandise exports and, to a lesser extent, imports of the region. The cumulative growth of exports was 57% and imports 26% on average in the period 2005-2010 years. The largest exporter of goods in the region has by far, Croatia although its relative importance decreases in favor of countries that have significantly increased their exports in this period.

Table 4 Total exports of the Western Balkans (in billions of euros)

	2005	2006	2007	2008	2009	2010
Crna Gora	0,369	0,441	0,455	0,416	0,277	0,330
Hrvatska	7,044	8,260	9,017	9,599	7,510	8,809
Srbija	3,751	5,308	6,660	7,638	6,172	7,632
Makedonija	1,639	1,911	2,448	2,714	1,929	2,426
Albanija	0,529	0,631	0,786	0,920	0,780	1,252
B i H	1,918	2,729	3,029	3,413	2,817	3,629
Kosovo	0,049	0,110	0,165	0,198	0,165	0,279
Zbirn za ZB	15,298	19,391	22,561	24,899	19,652	24,098

Source: official national statistics: [www.trademap.org](http://www.trademap.org)

The advantage over other countries, Croatia is significantly higher if we take into account the exchange or export of services because it was in 2010, exports of services by as much as 8.4 billion euros, while imports amounted to 2.7 billion euros. Montenegro had exports of services by 0.7 billion euros and imports of 0.3 billion euros. BiH exports of services were 1.9 billion euros and imports slightly less than 0.9 billion euros. And Serbia has a relatively modest share of services exports and imports about 2.6 billion euros 2.6 in 2010.

Table 5 Total imports of the Western Balkans (in billions of euros)

	2005	2006	2007	2008	2009	2010
Crna Gora	1,043	1,457	2,073	2,530	1,654	1,654
Hrvatska	14,903	17,116	18,843	20,883	15,203	14,792
Srbija	8,400	10,485	13,535	16,478	11,504	12,621
Makedonija	2,592	2,995	3,813	4,681	3,472	4,333
Albanija	2,099	2,433	3,064	3,568	3,261	3,616
B i H	5,663	6,017	7,091	8,284	6,290	6,965

Source: official national statistics: [www.trademap.org](http://www.trademap.org)

Trade deficit is the rule in the trade of all countries in the region, as none of the seven countries of the Western Balkans in the 6 years of observations did not achieve a surplus in merchandise trade with foreign countries. The largest cumulative deficit in the observed 6 years, Croatia has high as 51.5 billion euros, 35.9 billion euros in Serbia, Bosnia and Herzegovina 22.7 billion euros, 13.1 billion euros in Albania, Kosovo 8.9 billion euros, Macedonia, 8, 5 billion euros and Montenegro 8.2 billion euros. Export-import ratio is extremely low, averaging only 23.3%. Serbia in the period 2005-2010 it had 50.7% coverage ratio, Croatia 49.7%, 60.7% of Macedonia, Bosnia and Herzegovina 43.4%, 26.8% of Albania. The average coverage for all seven countries surveyed in 6 years, 45.9% is low but slightly increasing export-import ratio. Merchandise exports per capita shows that Croatia is leading in the region, while Macedonia, Bosnia and Serbia can halve exports per capita. Croatia is the first position when it comes to imports per capita, and behind it was Montenegro. We should bear in mind that the more advanced transition countries have generally more than 6000 euros goods exports and imports per capita in the observed years (2005-2010) and to indicate their greater integration into the international division of labor. Countries with which we can compare Bulgaria and Romania, and they have become full members of the European Union.

Table 6 Exports and imports of Western Balkan countries per capita in euros

	Izvoz pc 2009	Izvoz pc 2010	Uvoz pc 2009	Uvoz pc 2010
Crna Gora	447	533	2668	2669
Hrvatska	1707	2002	3455	3362
Srbija	834	1031	1555	1706
Makedonija	941	1183	1764	2114
Albanija	257	417	1076	1206
B i H	854	1037	1906	1990
Kosovo	75	140	880	985
Zbirn za ZB	854	1059	1890	1998

Source: official national statistics: [www.trademap.org](http://www.trademap.org)

Collectively, or average terms, exports to other Western Balkan countries generally makes about 26% - 30% of total exports, while the relative importance of aggregate or average of imports from other Western Balkan countries much more modest (around 15%). The average growth rate of the discrete cumulative exports amounted to 9.4% (cumulative 56%), and cumulative imports ZB 5.9% (cumulative 33%) during 2005-2010 years, which is somewhat higher than the growth of total merchandise imports of the same countries. Observed in absolute numbers the largest export is Serbian and that's already ahead of Croatia in 2006. Third place belongs to Bosnia and Herzegovina, followed by Macedonia, Albania, Montenegro and Kosovo. On the imports of goods from the air base sequence is somewhat different: the Bosnia and Kosovo are unmatched, and roughly half as imports have Serbia and Croatia. Then follows Macedonia, Montenegro and Albania; in 2009 those countries have reduced the mutual exchange of surplus and deficits have reduced the deficit. In 2010 the recovery of exports of the Western Balkans is directed to the rest of the world, while the recovery of imports and a modest growth rates in trade with the world and the Western Balkans, the mutual trade, improving the trade balance were: Kosovo, Montenegro and Bosnia. It notes the slow recovery of mutual exchange, because the recovery is highly dependent on the total share of the growth in imports from Italy, Germany, Slovenia.

## 5. THE DIFFICULTIES IN RAISING FOREIGN EXCHANGE

At present there are over a hundred different types of non-tariff barriers such as:

- Complicated procedures at border crossings;
- Extensive paperwork and inconsistency of customs and inspection services;
- Insufficient number of internationally recognized accreditation and certification.

Bodies, and authorized laboratories and institutions;

- Non-recognition of quality certificates;
- Complicated visa regime;
- Corruption and smuggling;

Given these barriers it is necessary to improve the quality of infrastructure to the level when the certificates for the products of the SEE countries recognized in all EU countries.

The structure of trade of the SEE countries is still is inadequate. Commodity trade is predominantly based on the lower phase of processing products (raw materials, semi-finished) and to a lesser extent, finished products with low added value. The exchange consists mainly of food products (vegetables, fruits, confectionery, cereals), agricultural raw materials, electricity, gas, petroleum products, paper, paperboard and articles of paper pulp, basic metals (steel sheets, aluminum profiles, copper cathode), chemical and textile products. With this in mind that it is not realistic in the short term significantly improve the quality of mutual trade of the SEE countries. In the last decade of the exchange notes stagnations structures within the region. In addition, many “sensitive” industrial products not covered by CEFTA (customs duty on them to reduce the phase) as well as agriculture or services. Countries of the region are technologically obsolete industries, compete in exports to the European Union and that practically no one much to offer others. On the other hand, there are still numerous obstacles to the realization of regional economic integration, the creation of powerful regional retail companies, regional trade balances, the impact of large investors. For most countries in the potential of mutual economic cooperation is important but there are significant limitations. This is primarily related to unfavorable export structure and a small number of large exporters, while the second problem can be eliminated good strategy of export incentives by attracting investment and large exporting companies, the first problem is solvable difficult in the short term.

## 6. THE ROLE OF CEFTA

- CEFTA agreements which are covered by the SEE countries is in some way, “trial balloon” to connect these countries to the EU, where the country should prepare for the obligations that membership implies. CEFTA agreement replaced a network of as many as 32 arrangements for free trade in the region of Southeast Europe, which have applied since 2001. CEFTA has a positive effect on the intensification of mutual trade, which is indicated by reference statistics. The common economic market similar countries can serve as a testing ground for the willingness to enter into open market competition that prevails in the EU market. Most benefit from duty-free space will be companies with relatively high quality supply that will help in this way to reach new consumers, while the main losers will be companies that have survived thanks to the difficulty surrounding the performance of competitors, the domestic market. Further liberalization of trade in agricultural and food products in the region should enter into force in the future. Non-tariff barriers, particularly those relating to technical barriers and phytosanitary measures, but should be abolished. It is expected to soon adopt measures to some of the barriers, primarily mutual non-recognition of quality certificates (sanitary, phytosanitary, veterinary) agricultural products, removed. Prohibition of discrimination against the products of different Member States, free movement of goods and services across administrative boundaries and strong competition, the basic economic principles of the European Union. Achieving these criteria in a smaller, more homogenous market will help the CEFTA countries to prepare themselves better for the market economy and competition within the European Union. Benefits of CEFTA, as a not-so-small market size in the European context, are that each of the countries of the region makes it more attractive place for foreign capital, which significantly raises the interest of investors. For mutual investment should be eliminated administrative and other obstacles, and the ultimate goal is establishing a joint investment market with the agreed investment policies. CEFTA has nine annexes including the list of industrial



and agricultural products, which are not fully, liberalized the entry into force. The most important new CEFTA agreement in relation to the previous bilateral agreements, which are of particular interest to industry are:

- Possibility of using diagonal communication origin of goods;
- The introduction of gradual liberalization of trade in services;
- Obligation of equalization of conditions for investment by reference to the WTO,
- Ensuring equal treatment of domestic and investors from the region;
- Gradual opening of supply markets and equal treatment of domestic and suppliers from countries in the region;
- Ensuring the protection of intellectual property rights in accordance with international standards;
- Improved mechanisms for resolving disputes that arise during the implementation of the Agreement;
- The obligation to respect the WTO rules, regardless of whether a country is its member. In addition, the CEFTA agreement is determined to eliminate all quantitative restrictions, customs duties and other duties among the countries of the region, and to not introduce new barriers. There are certain restrictions on the list of products that can be exported duty-free, or lists of products that do not apply to preferential trade rules. However, the biggest problem is probably more than one hundred kinds of non-tariff barriers (procedures at border crossings, extensive paperwork, insufficient number of internationally recognized certification bodies and accreditation) based on the theoretical and empirical research as well as data on the relative importance of countries region, the greatest benefit from the implementation of CEFTA is Croatia, and Serbia. The relative importance of Croatia's economy is "dominant" (the proportion is generally greater than 40% in relative economic indicators), and accordingly the company from Croatia will most easily achieve the benefits of free business at the regional common market.

## 7. PROSPECTS OF REGIONAL INTEGRATION OF SOUTHEAST EUROPE

Due to the relatively small industrial base, with high import restrictions from the effects of insufficient integration of the developed countries in the region are not appropriate. These effects are, usually, determined empirically, because due to the effects of economic geography (economies of scale) industrial production tends to concentrate in the largest and most developed country in the integration, with negative consequences for other countries in the integration. This is probably the main reason why most of the regional economic integration among developing countries has failed, and lasted a very short time. The experience of many free trade agreements between developing countries, points to some examples in which integration promotes divergence and trade diversion. Gravity model (which measures the difference between potential and actual trade) shows that Serbia has a scope for increasing trade with Croatia and Albania, while trade with Bosnia, Macedonia and Montenegro, well above potential.

Regional economic integration of countries with low GDP, most likely, will lead to divergence in the development of the countries involved in at least two reasons: (1) is usually the country in the free trade agreement that has a comparative advantage furthest from the world average is most at risk of serious and divert trade flows (if a group of low-income countries formed a free trade zone there will be a tendency for states with the lowest incomes have a real loss of income due to diversion of trade);

(2) agglomeration gravity to bring about the spatial cauterizations activities of this force tends to lead to large concentrations of economic activity will be expressed in free trade zones that form the poor countries, in relation to the integration of developed countries (that's extra power divergence in levels of development, the free trade of developing countries, with relatively rich countries have used to the detriment of the poor.

Undeniably, the regional economic integration is a particularly good choice for the countries small and medium-sized those are highly dependent on international trade. The overall effects of integration are more important than the quantifiable economic size and can be understood as an extension of opportunities and development potential. When it comes to the future of EU integration will depend on the momentum to enhance efficiency and international competitiveness of European economies,



convergence in productivity and income across countries, the political unity between countries, and harmonize conflicting interests. The goal of development policy is to help poor countries, especially those historically associated with the EU member states that economic growth, but not at the risk of exposure to politically sensitive sectors of European higher competition. For all countries in the region faster EU accession requires regional economic cooperation and market reform, and change the economic structure in order to create opportunities for accelerated economic development.

## 8. CONCLUSION

The accelerated development of the SEE countries can greatly affect the quality and increase the volume of foreign trade. The greatest barriers to trade are the numerous non-tariff barriers. In addition, many “sensitive” industrial products not covered by CEFTA (customs duties on them to reduce the phase) as well as agriculture or services. Gravity model that measures the difference between potential and actual trade, shows that all countries have scope for increasing trade. Regional economic integration is a particularly good choice for the country’s small and medium-sized, such as the Southeast European countries, which are highly dependent on international trade. Short-term, medium term and to a lesser extent, the costs can be greater than the benefits, but the benefits arrive in the small “meals”. In the long run, the overall benefits of economic integration are greater than costs. The overall effects of integration are more important than the quantifiable economic size and can be understood as the expansion and development opportunities potential. CEFTA creates conditions for a harmonized exchange of goods within the region and indirectly brings huge benefits, which are primarily related to the possibility of easier entry into neighboring markets that were less accessible and increase participation in other markets of this agreement.

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## GLOBALIZATION PROCESS AND THE IMPACT ON INVESTMENT IN ALBANIA

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E-mail: [irmitash@yahoo.com](mailto:irmitash@yahoo.com)**Abstract**

The globalization is the philosophy that supports all over the world the establishment of private companies (business) without boundaries. It is an irreversible process. The ideology of globalization explains that the world is a big market where each company, undistinguished the country, has the access (the right) to compete without national or local boundary with other companies. The footfalls of changes for some countries are fast. During the human history in the all the world, the human beings has been connected. But now the process of relationship is so different. The airplane, the mobile, email, computer, the highs speed transfer of money are making the world more complicated. The multinational corporates produce in many countries and sell all over the world. The money, the technology, and the stock have moved fast between the countries. Together with products and the finances also the ideas and the cultures are moved freely. The FDI is the most important factor for the development of a country and Albania has a lot to do in order to stimulate the foreign investments. How the process of globalization will be for Albania? Why many multinational corporates are addressed to invest in Albania? How can the fast economic growth of Albania be explained? Which are the factors that influence the low levels of FDI?

**Keywords:** Globalization, FDI, Risk, Development

**1. THE CONSEQUENCES OF GLOBALIZATION UNDER ALBANIAN ECONOMY**

Globalization is a predictable and irreversible process. Globalization refers to the process of the intensification of economic, political, social and cultural relations across international boundaries. It is principally aimed at the transcendental homogenization of political and socio-economic theory across the globe. It is equally aimed at “making global being present worldwide at the world stage or global arena”. It deals with the “increasing breakdown of trade barriers and the increasing integration of World market. (Fafowora, O.O. 1998).

Albania lately has reached an adoption with the international institutions as BB, MNF, etc., making a step further into the global trade. Yet Albania needs an economical and political strategy, which will be able to drive the country on an active position to the global economy. Home-brew business is set upon globalization elements, which through a long-term strategy must exploit opportunities discovered by this new area of globalization. Globalization is a continues phenomena and never seized.

Firstly globalization it is seen under economical and financial terms. On this concept it can be conceived as a large and deep connection with the national economy under world trade goods, services and especially capital assets. The revolution in telecommunication and informational technology on the last 15 years was a huge progress on the trade connection and in the international exchange of the capitals.

Participation in the euro area, which has the second world currency and is second-largest economic area in the world, should bring some advantage to its members. (HM Treasury, 2005)

The positive consequences are:

**Economical growth.** It is theoretical argued that it will bring an efficient delivery of a country resources towards the sectors and fields where they have a competitive advantage. Focusing on the Albanian conditions, this means to high coefficient industries under working utilization force because of the low cost it has and this helps in the increase of the national economy. The poor layer will profit from this increase by getting employed from these industries. On the other hand it is essential to be invested on the human resources (education and training) to increase their working efficiency. There were made many researches by the World Bank and others, and they show that generally the rapidly increase of the economy is accompanied by reduce of the poorness. This is the reason that the

World Bank adds the pressure on different states (including Albania) to be driven towards free trade and WTO. In fact, there is no lack of the facts of both success and failures. For the last mentioned, generally the fault remains to the performance of the national institutions.

**Productivity's Improvement.** One of the most positive effects (approved by all) is the improvement of the productivity. This for the reason of the simplicity it brings on the investments and technology transfer through different countries. In order to reach this state, a transit period is necessary through which are needed to be developed and consolidated the country's structures, to guarantee a law functioning state, with the terminus to empower the trade's economy.

**Increasing companies competition.** Today, more than ever, companies are obliged to oversee the continuance of the quality of their products, to keep prizes on accepted levels and to present new products from time to time, and for this is required the constant improvement of the technology and the scientific researches.

**Improvement of the relationships between different countries,** through inclining the rate of the conflicts and through raising the rate of cooperation between them.

As a conclusion, the increase of the chances for survival and success in the era of globalization needs an immediate role of the government and of other important principals for the Albanian economy reconstruction through specific programs which would drive the Albanian economy towards the sectors which have higher possibilities of development. Such are: industries with high coefficient of the usage of manpower, the organic agriculture, tourism, the medical and aromatic planting industry, the confections industry, etc.

Beside the positive effects, on the other hand globalization could increase the risk for the financial crisis in the developed countries. According to Stiglitz, *"Small countries in development are like small boats. Quick liberalization of the capital trade which IMF aspires, is like sending the boat in a strong sea before closing the holes, or before training the captain, before taking safe tires. Even on best conditions it stands the possibility that the boats will drown when hit by an open wave"* (Stiglitz, 2002)

**Civilization's Confrontation.** The disappearance of the economical boundaries between countries, brings about the mixture of the different traditions and mentality and this could cause unexpected conflicts.

**The bankrupting of small companies,** which will be obliged to accept the loss before giant companies, or to be their allies, under conditions established of course by the strong.

**Increase of unemployment in western countries,** which have high living-cost, because the companies of course will employ people from poor countries to apply a lower salary.

**Difficulty of control** which means that each phenomena enlarging to global sizes, represents a danger, because every moment it can come out of hand and have unpredictable consequences.

While the most known view of the globalization on the last decade is the rapid integrity of the stock and financial trades; trade and investments are the main power standing under the curtains of globalization.

The discussions coming from the field of FDI are important part of the whole globalization process. FDI can play an important role raising the capacity of the host country in order to respond the chances offered from the world economy integration, a purpose known as the main one for the strategic development.

FDI in the last two decades were part of the main elements of globalization and world economy. Companies from different countries are spreading more than ever taking part in many industries through direct investments. Economy competes virtually together to get rid of multinational companies. As a result, world investment fluxes have reached higher levels.

## 2. FDI AND AFFECTS ON THE HOST PLACES

Affects of FDI on the host places are visible. They are shown on the profits and costs.

### Profits

**Technology.** According to the economists, multinational companies through FDI help to fill up the gaps between developed countries and those under development process (hosts) and they ensure smaller possibilities of increase in the host trades. According to this point of view, producers on developed countries have full access on productive knowledge not present on host counties. This productive knowledge could take the role of the technological survey, manger and marketing abilities, export contracts, coordinated connections between suppliers and customers and the good name. According to economists, the technological transfer could stimulate the economical growth of the countries under development. Besides technology, there is also the transfer of capital and manager abilities. So the host country can, through FDI and through multinational companies have access to the finances which are unavailable for the home-brew companies.

**Manpower.** The transfer of productivity and technology solves the problem that the intrusions from outside are good or bad for the workers in terms of salary. When the foreign company has untouchable product knowledge, then the technological transfer and other trainings will be seen in the human capital of the foreign company in the host country. This expansion of the human capital is seen in the higher productivity of the people which are paid with higher salaries.

**The macro economical growth.** The FDI connection as a macro economical growth and the stability of this connection is very important because the host countries evaluate pro and contra according to the foreign intrusions.

The largest evidences are found in the studies made to the countries under development. For example: introductory investments analyzes in Greece, Taiwan, Indonesia and Mexico show positive contribution on the growth of these countries. The raise and enlargement seem to be stronger when foreign branches and home-brew firms compete directly with each other as in the case with the protected industries (Markusen, 1995, he is an advocate of this idea). Borensztein, De Gregorio and Lee (1998) find almost positive effects between FDI and the growth with the accumulation of the human capital in the host countries, admitting that they must be abundantly big so that the places can profit from the positive effects of the foreign fluxes growth.

**Business circles.** FDI can affect business circle model in the host countries, the transmission of the circles from outside trades and the crisis escort through trades. When countries under development are separated into two big groups: well integrated financial economies and non integrated, they both have connections to the macro economic world aggregates, with this connection not higher last decades compared with that of 1960-1970 (Kose, Prasad, Terrones 2003). The interdependence role of FDI and specifically multinational firms under the integration of business circle, is not yet explored totally. The specific contribution of the FDI under the business circle still remains an issue to be solved.

### Cost

**Bad effects in the national competition.** It happens that the multinational companies take over all the funds generated somewhere else to fill their cost. This can bring about the monopolization of the trade and bankrupting of the home-brew companies.

**Negative effect on the balance fee.** We have decrease of balance fee where the daughter company brings back into the mother country parts of the income. Also if the stock is imported from outside to the host countries of FDI then we have decrease of account of the balance fee of host country.

**National sovereignty.** Many of the times, the decisions for the host countries economy have to be taken from these multinational companies which show not so much interest for the host countries and most of the time the government of this countries has no control over them.



## 2.1. FDI growing in the future

The FDI flux is rapidly growing the last days. The highest fluxes of FDI in the world shows an economical environment always improving, this on the presence of reforms and political orientation towards investments. The growth of FDI has reached record levels. This was brought by/stimulated also by the extinction and international purchases of the companies. The higher the fluxes of FDI in a country the more occupation that country could have. FDI create more occupation in productive sectors than in any other sectors. Throughout the years many countries have created a welcoming environment on their places with the clear purpose to gain more funds to be invested in the country.

### *Structural and short-term conditions in favor of the growth of FDI*

Growth of FDI until 2009 is explained in 3 main factors:

- continuance of the long-term inclination which are engrossing for the multi nationalization of the companies
- long-term and short-term economical view characterized by stable growth and financial sources available
- necessity of new resources and opportunities for investments

Governments of the countries under development perceive the FDI as a source for economical growth, this is also shown by the rivalry growing of the places interested for this investments. FDI play positive role in the economical development through intrusion of capital, contemporary technology, on the marketing and management field, on rebuilding the economy, speeding up the denationalize rate, entry of new job opportunities, raise of exports, improvement of the salary balance, etc. for all these reasons they hold a special importance, especially for the countries under development and it is necessary the creation of suitable strategies to attract these investments. Taking a glance at the value that foreign directly investment hold (FDI) for the economy of a country and the interest that Albania has shown towards it, I thought it was of a great value making a study of this kind.

## 3. FDI DISPERSION IN ALBANIA

We can say that FDI are settled on main towns like Tirana and Durres. Tirana as the capital of Albania is more exposed from investors, becoming the most important economical centre of the country and of human potentials. Tirana holds 80% of foreign or common capital investments and also branches, departments or representative offices of many multinational known companies which have invested in Albania over than 231 million euro. While Durres has the largest Albanian port holding 85% of the import-export services of the county.

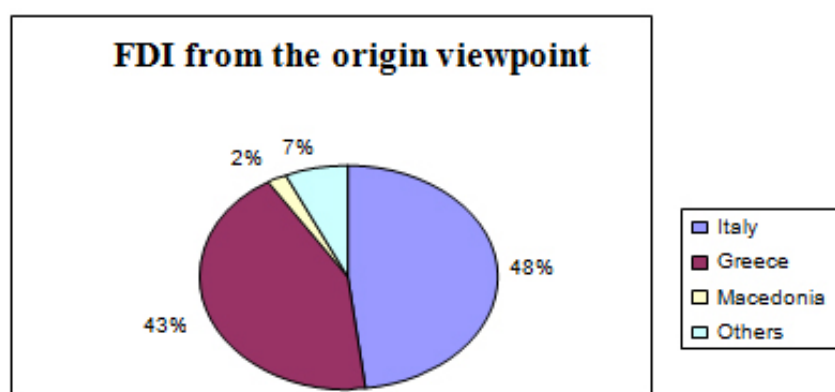
As it might be seen, the areas where FDI are centered are places with higher income rate and more developed infrastructure. The internal central part and the north-east part of Albania, are the least preferred areas from foreign investors. Beside the non-developed infrastructure of these areas and the missing marketing, it might have played a serious role also the internal and external migration, which makes it even harder the possibility of qualified manpower. However, a high percentage rate was find in terminal cities of Albania and Greece like Korca and Gjirokastra. Investments in industry have intended sectors of high manpower percentage and not those of capital and technology percentage leaving small window to the foreign investments role under technology transfer and on the growth of technological capacity production in Albania, through minimizing positive side-effects of these investments on other productive sectors.

### 3.1. FDI origin in Albania

From the origin viewpoint, Italy and Greece hold the leading position on foreign investments in Albania. FDI origin is 48% from Italy, 43% from Greece, 2% from Macedonia and Turkey and the remaining part belongs to Germany, Austria, Bulgaria, UK, USA, etc. On the contrary of other center and east European countries, Albanian FDI is connected to near-by countries.

On this foreign capital stock viewpoint, at the end of 2004, almost 82% of this stock was hold by the EU nations, with Greece as the main investor (with 48% of foreign capital stock in the end of 2004) and Italy (with 30%). Greece and Italy have raised meaningfully their presence on the foreign capital stock in Albania. The geographic connection of Albania and also the economical powerful cooperation with EU, are some of main reasons that these places host foreign investors. (INSTAT, 2006)

Fig.1. FDI from the origin (Source: Albanian Bank)



Italian investments are utilized on the western part of Albania, near Adriatic sea. The largest parts are held by small and medium industries, which handle construction works (35%), textile and shoes production (21%), trade and services (16%) and also with the agro-nutritive industry (8%) mostly coming from the south Italy. Italian firms profit from the rivalry advantage of working quality with low cost in Albania. Salaries are ten times lower than those in Italy. Italian investors profit from Italian Government grants focused to stimulate Italian investments in Albania. Greek investors are centered on south and south-east part of Albania. They follow trade more and only 2% are held with other different branches of industry, like textile, clothing, production of leather products and tobacco. Over than 60% of Greek FDI come from grants offered by Greek Government for these firms, with the intention to invest in Albania.

Tab.1. Flux of the FDI by activity (Source: INSTAT)

Activity	Flux %
1. Trade	67%
2. Industry	17%
3. Agriculture	1.3%
4. Service	6%
5. Building	5%
6. Transport	3.7%

**FDI in agriculture** are on low rates, as a result of small and fragmented parcels of ground, limitations to take assets on rural areas, bad roadway infrastructure and difficult transport with the biggest trades of the region and area. Sectors which attract more investments in agriculture and other common industries are fishing, rehashing and conservation of the fish, food rehashing, olive oil refining, production of beverage and the production of wood.

**On the service sector**, FDI are focused on the bank service, retails and construction. Construction FDI are raising referring to the number of the companies and their activities. Many investors in construction come from Turkey, Italy and Greece. FDI will necessarily be lied on these fields as investments in infrastructure and habitation (business centers and living houses), based on the source fluxes from donation countries and also as a response of urban migration.

**On the production sector**, the largest part of the foreign companies take part on the final re-exportation and half-final products, most of which are textile, different articles of leather and shoes. They consist of around 60% of our exports and only in 2006 have reached a raise of 20%.

### 3.2. Factors affecting low level of FDI in Albania

Low levels of IDH in Albania could be attributed partially:

- Slow process of the states medium and big companies denationalization under the industrial sectors which have high capital intensity and of the strategic sector like energy and telecommunication.
- Low interest of foreign investors as a result of a political percept risk of the country connected with social violence on the past and on the other hand the political changes in Albania and the lack of stability in Balkan and Kosovo.
- Image problem that Albania has created to the foreign countries.
- Problems and conflicts connected with land ownership, bureaucratic procedures for the register of ownership rights, for the approval and construction license authorization create barriers to the foreign investments.
- Informality levels of economy, which is a fact that brings about a wrong competition of trade.
- Lack of efficiency and high cost of infrastructure (transport, energy, water) and the missing of industrial places for the FDI oriented towards export and tourism.
- Lack of abundance in financial services, benches or not (low level of credits, low quality of financial services for the international trade, high rate of interest, high request for collateral, etc.
- Low function of public institutions and low application of law.

### 3.3. Elements of a strategy to stimulate investments

FDI role could change from place to place, depending on the governmental and economy nature. There exists no ideal development of FDI that can be natural to all nations at all times.

This way Albania could attract three types of investors:

**Investors based on the sources research**, which could be interested in mineral reserves, forests, petrol, gas. First investment companies could be international companies of refinery or mine. Then it could be the aim towards production of the minerals.

**Investors based on trade research**, which could be companies interested to enter the Albanian consumption trade and the creation of a presence growing with the growth of the trade. On this category it is important the stimulation politics of FDI on strategic sectors (telecommunication, energy, bank sector, transport, water) as well as other private investments in infrastructure.

**Investors based on the efficiency assumptions**, (or FDI oriented towards export). These would be more outside of strategic sectors and infrastructure, for production of products in export and re-export

### 3.4. Stimulation and attraction of FDI

The stimulation and attraction of FDI is a high rivalry and a specialized activity, on a growing number of the countries looking to attract active foreign investors and also from many systematic sponsored campaigns.

Now a considerable experience is present on the strategies and techniques used for the attraction of FDI and in the part of which could function and which can not.

Attraction Investment Agencies from all over the world use many techniques to attract FDI through:

**Creation of image** – is the most suitable when investors image over a place as a destination for investment is less favorable in reality, and where fore-requests to attract investments are present.

**Investments generation** – represents the identity of potential investors, which are more interested for a place, development of a strategy to contact and cooperate with them, with the intension to make them be involved in investing. Specific used techniques to generate investments include: campaigns through telephone and post, seminars for the investments, missions run inside and outside boundaries and the direct marketing.

**Service towards investors** – could split into two components: fore and after approval services.

**Fore approval services** – is focused on the investors approach referring to the requirements over which

the decision to invest has already been taken and the project has been approved (if it is necessary)

**Service after the approval** – or after taking the decision if no approval is requested, is considered a necessary activity, including here bank field and industry operations on some fields like: assistance in having a indispensable infrastructure like telecommunication, energy, water and canalization: ensuring the main contacts with the government, business and community:

- Satisfied investors are the best stimulation for a continuance of investments in the future;
- Service towards investors is the element containing the most efficient cost, manageable in all stimulation activities for investment;
- Maximization of the potential investors number which become actual investors enforce the reputation and image of a country;
- Services towards investors are more indispensable in an investment place, where not all the elements are favorable and could face obstacles to realize investments from the interested firms.
- Many of the countries have established success in attracting investments through the usage of these Agencies for the Investments stimulation (AIS). AIS have many important functions, including fulfillment of investment needs, maintenance of friendly politics towards business, and the cultivation and projection of the favorable image of a country as the destination of the investments.

#### 4. CONCLUSION

- The level of FDI in Albania remains on low rates, even though from 1999 it has been drastically grown in projects and flowing fluxes from investments.
- The main causes for these low rates of investments are: the most important is the image of Albania into the international arena, this acquired from the political instability, economical one, perceptive risk, the slowing process of the denationalization mostly on strategic sectors, lack of responsibility and institutional ability, low application of law, lack of efficiency and low cost of infrastructure, lack of composition in comprehensive strategies of the social and economical development, impotence and overcharge of administrative taxes, etc.
- Low intensity of foreign investors is due to the perception of a high risk connected with the social violence existing before and the political changes in Albania and also due to the lack of stability in Balkan and Kosovo.
- Albania has some potential sectors and very good possibilities for the attraction of IDH, mainly in tourism (sector with much of the perspective also for the reason of favored natural conditions), services, transport, etc.
- Agriculture in Albania had much possibility of development starting from the geographic positioning, its sources, quality and quantity of manpower. The country could become an important exporter of agricultural products with organic basis pointing at European and world trades.
- Albania has no developed an effective strategy for the investment attraction. It is very important to mention here the lack of marketing territory. The territory marketing plays a very important role, especially to create the image of a country, its communication, approaching of investments.
- The territorial promotion and attraction of investment agencies play a very small role according to their original function, this maybe also from the lack of connection with the investors, or low approach from state authorities, etc.
- Foreign investments must help Albania through chances of food elaboration to ensure foreign trades. The strategy for investment attraction in the agriculture field of Albania must decide the main perfumers and retailers in Europe and USA.

## 5. RECOMMENDATIONS

- Albania must work to improve the environment where FDI are active, in order to acquire attract on higher and diverse levels.
- Albania must attract FDI for products that the country is considered to have high international advantages at (actual or potential ones). It's important mainly that part of production which identifies the export products, for which the country have made possible a response to the growth of world trade (cotton trousers, shirts and cotton suits, rough tobacco, etc.). Also it must utilize its potential on the field of tourism, agriculture, etc.
- Albania must focus its energies on the service of actual and possible investors. The investor's gratification is the best advertisement for the country and is considered as the most faithful source for other investors. The actual investors can stay longer and could raise their investments.
- It is very important that Albania develops the territory marketing. Several efforts must be made through this marketing to improve its image.
- The government must stimulate such politics to attract investors it must speed up and finish the program for the return of the land. The land must be registered as soon as possible, mainly the urban land and attractive areas which serve to the trade development. To improve the efficiency of s solution to the disagreement of land and also to raise its administrative efficiency.
- The government must utilize a strategic vision, which would decide for a number of long-term, medium-term and short-term efforts which give priority to the acceleration and finalization of program for the return of the land to finalize the registration of urban land and trade development areas.
- Main agent which could pay the role of a contact, sustainer and promoter of the territory for the foreign investors are the territorial development agents.

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## SOCIAL ENTREPRENEURSHIP IN POLAND'S CENTRAL AND REGIONAL POLICY IN THE ASPECT OF FINANCIAL EFFECTIVENESS

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### Abstract

Social co-operatives are on one hand regarded as small, private enterprises, on the other hand are a good example of social entrepreneurship and development department of economics, called the social economy. Both the social economy and social entrepreneurship lies in the direct interest of the central and regional policy in most European Union countries. The development of social economy enterprises, such as social co-operatives can contribute to the economic potential of local communities, which also has a long-term effects on the regional level.

The co-operative form of management is and will be used as an essential element of the social economy sector in order to implement the principles of active labour market policies and social inclusion. In most EU countries, social co-operatives shall be considered as an autonomous association of people united voluntarily to meet their common aspirations and needs of economic, social and cultural rights through a jointly-owned and democratically controlled enterprise. Social co-operative is a form of legal entity combining characteristics of companies and non-governmental organization, so as to enable its members, which are often those at risk of social exclusion, a return to orderly social and labour market activity.

Also in the policy of supporting social entrepreneurship, one of the most important factors is the problem of efficiency of different kinds of support. The funds used on supporting social organizations (for example social co-operatives) should not only bring profits to the people running this kind of business but also it should also be efficient from the public point of view (central or local government in this case is a specific investor interested in efficiency). The key point is to establish appropriate measures which allow local government to check and to estimate this specific type of investment.

The main objective of the research was to assess the effectiveness of financial aid, granted social co-operatives. The subject of the study was 20 social co-operatives, created in 2005-2010 in the Polish region (Warmia and Mazury). On the basis of source materials and research tools estimated revenues to the state budget and the costs associated with assistance in setting up co-operatives. 54% of money invested by the state to help in the formation and functioning of co-operatives is returned to the budget. This means that the co-operatives issued 1800 000 PLN, returned to the state budget of over 967 000 PLN. Financial aid is not high, and bears very harsh rigors. Note, however, that the effectiveness of public financial resources is not the only factor in an active combat unemployment. The task of the social economy is the choice of such instruments in the allocation of funds from the budget that they have been issued as the most sense, it means that in addition to financial effects, they also fulfill social functions. The study shows that there is some level of support that allows the development of a specific type of enterprise that is social co-operative and increases the chances of development of social co-operatives in a competitive market.

**Keywords:** Social co-operative, Social entrepreneurship, Effectiveness

### 1. INTRODUCTION

The co-operative movement is a social movement, which arose in the nineteenth century to combat poverty. (Zakrzewski, 2011). The problem is very important, because in some countries, mainly middle- and low-income ones (like for example Poland or even Spain), the implementation of severe adjustment processes ended, in general terms, with remarkable improvements in the economic growth rate, but with very different poverty outcomes. This is confirmed by the number of cases in which mean income growth was compatible with significant poverty reduction and some cases where poverty increased (Ayala, Jurado, 2011, p. 104). A key factor in these differences is the positive effect of redistributive policies on poverty reduction. Most egalitarian societies ensure a more efficient transformation of growth into poverty reductions (Jantti, Danziger, 2000, p. 309). One very useful tool to combat poverty can be social co-operative. Social co-operative as the first in Poland, the legal form of the new law, was explicitly defined as a social enterprise (Act of 20 April 2004 on promotion of employment and labour market institutions (Journal of Laws of 2004 No. 99, pos. 1001)). The current legal basis for the functioning of cooperatives is the Law of 27 April 2006 on social co-operatives (Journal of Laws of 2006 No. 94, pos. 651), which came into power on July 6, 2006. Social co-operative is a form of legal entity combining characteristics of companies and non-governmental organization, so as to enable its members, which (according to Polish law) must be in 50% of those at risk of social exclusion, a return to orderly social and labour market activity. Social co-operative,

as a kind of co-operative work, based on the personal performance of work by its members. Such co-operative activities combines in its social and economic functions, but, as a result of profit-making business activities is not an end in itself, but merely a means to achieve social goals. The object of the social co-operative is to carry out a joint venture based on the personal work of members and the promotion of social and vocational integration of its members. According to the social co-operatives act, these institutions should work towards:

- social reintegration of its members, what is meant by action to restore and maintain the skills for participation in community and social roles in the workplace, residence or domicile,
- professional reintegration of its members, what is meant by action to restore and maintain the ability to self perform work on the labour market - and these actions are not executed in the course of a social co-operative business.

The social aspect of social co-operatives mainly due to the definition of co-operative movement, because the co-operative is an association of people, not capital. For this reason, co-operatives, despite the fact that there are companies belong to the social economy sector. Profit in these companies is not an end in itself, is an instrument that is designed to achieve a social goals. The diversity of cultures and legal regulations in different countries of the world makes the development of co-operative movement takes various forms and structures. In some countries there are separate laws for co-operatives (as in Italy or in Poland), in others the law on co-operatives are included in other laws, and in some there are no such regulations in general. It is important however, that for the whole of the international co-operative movement are common values and principles. They are defined in the Declaration of Co-operative Identity adopted by the XXXI Congress of the Jubilee International Co-operative Alliance in Manchester on 20-22 September 1995. The International Co-operative Alliance is an independent, non-governmental organization that unites, represents and serves co-operatives worldwide. Founded in 1895 and currently has 222 member organizations from 91 countries worldwide that are active in all economic sectors ([www.krs.org.pl](http://www.krs.org.pl)).

Proponents of the most limited forms of support such entities as social cooperatives from public funds, emphasize the high risk of failure of such initiatives, and thus wastes public funds. Answering for such charges clearly Mike Alken (Alken, 2005, p. 67), dealing with issues of so-called. "third sector", claiming that through the development of social economy enterprises may increase the economic potential of not only individual organizations but entire communities, which also has a long-term effects on the regional level. In such a sense of social economy enterprises transfer of funds "for a good start," to apply to them the principle of priority in contracting services, or equip them with fixed assets, can be regarded as a local strategy of "investing" in human capital and community infrastructure, and not simple bearing certain "costs".

## 2. RESEARCH SOURCES AND METHODS

In Poland at the moment there are 333 social cooperatives (according to the National Court Register - 23 May 2011). The subject presented in this study was to evaluate the effectiveness of state money spent on co-operatives. The analysis included source materials such as:

- survey used as a research tool,
- data archived by the special Co-operatives Social Support Center in Olsztyn (the capital of the Warmia and Mazury region),
- professional literature on the subject of research,
- legislation (mainly the act on social co-operatives),
- websites,
- data of Central Statistical Office in Poland.

The subject of the study was 20 social co-operatives, created in the period from 2005 to 18 January 2010 in the Warmia and Mazury region. The study was conducted in August and September 2010. More than 57% of surveyed co-operative members were women. The scope of activities undertaken was diverse, but most often repeated activities were road works (8 co-operatives), although often they do not constitute the main activities of the co-operative. Quite often a recurrent seizure was also an artistic activity. This may mean that among the unemployed who are active but can't find work, there are many artists. Such persons acknowledged that earlier exercise their talents outside the business, often without social security. Those surveyed are often

educated, experienced, artistically talented people, but they had labour market problems, so under a co-operative attempt to pursue their passions and interests. Such activities mainly related to: arts embroidery, handicrafts, musical presentations, artistic, design and artistic prints and advertising, organization of performances. Among the respondents, 20 co-operatives up in 6 main scope of activity was the work of renovation - construction. Often, most people setting up such co-operatives had been trained in the construction industry, as well as powers to use specialized construction equipment. Those surveyed admitted that they are much easier to acquire orders. In 9 subjects co-operatives was five members, the remaining 11 cooperatives, this number ranged from 6 to 10 members. Can be concluded that the unemployed rather willingly crossed the minimum size members, imposed by law on social co-operatives. Tools that were used in the study were the questionnaire addressed to the presidents or members of co-operatives and direct standardized interview conducted with members of the co-operatives surveyed, with the director of Cooperatives Social Support Center in Olsztyn and the person responsible for contacts with the unemployed people who start own business financed by special Labour Fund in the Municipal Labour Office in Olsztyn.

### 3. ECONOMIC EFFICIENCY IN THE MANAGEMENT SCIENCES

Efficiency is a concept used both in everyday language and science (especially in the field of economic sciences). While the use of colloquial does not require strict operationalization of this concept, but in economic sciences (including the sciences of management) not only requires a precise definition of the concept of efficiency, but also the construction methods and tools of measurement of that efficiency. The very essence and way of understanding the efficiency with which we deal in the sciences of management, are a simple consequence of a unique characteristic of this discipline. The point here about its relationship with business practice and pragmatics of modern enterprises (What, 2011, p.3). Therefore, economic theories of efficiency issues, relate it directly to the economy prosperity, and consider the same efficiency in V. Pareto way of thinking. (the Italian economist and sociologist Vilfredo Pareto). Pareto believed to be effective, such forms of resource allocation, in case anyone's situation, which can't be improved without worsening the situation of someone else (Stiglitz, 2004, p. 69). A. Smith also drew attention to the direct relationship between the wealth of the country, and the effectiveness of applied economic resources (Smith, 2007, p. 3). Interestingly, A. Smith, pointing to the causes of the wealth of a nation sets out two main factors:

- firstly, it depends on the wealth of skills, efficiency and penetrated with which a man performs his work (and thus the broader efficiency),
- secondly, the ratio of the number of those who work usefully and the number of those who do not.

While A. Smith observes that the abundance or scarcity of supply (and hence wealth) is more dependent on the first than the second factor. Like many of the later relationship management practitioners emphasized the efficiency of work (often through the prism of her performance) with the wealth of the nation and the wealth of individuals. Though K. Adamiecki (Frank, 1997, p. 167) to improve the efficiency of the team treated almost as a social mission, leading to improved living conditions of staff at the time, as evidenced by at least below its lecture program in which the audience does not recommend the reduction of costs, by lowering workers' wages:

- the principle of high wages but low-cost products,
- compatibility of high earnings with high profit businesses and social well-being,
- alignment of business with profits from growing labour costs by increasing production rates.

Furthermore, the management sciences, a large emphasis on linking the concept of economic efficiency with the principles of rational action and economy. As noted by B. Haus, the economic principle is relevant to each operator. This entity may seek to achieve a given objective at minimum consumption of resources, or may seek to maximize the purpose of the predefined measures. It may also choose the way between maximizing and minimizing the resources - in any case we are dealing with the implementation of the principles of economy (Haus, 1999, p. 16-17). With links to the economic principle of economic efficiency due to two main reasons. First close connection (especially evident on the basis of management sciences), the efficiency of the problems of defining and implementing the organization's objectives. Second consideration in the process of achieving these objectives two main categories, namely, the effects and costs. Therefore, most definitions of economic efficiency as the relationship specifies a particular effect to a given factor of production or assembly factors of production (Matwiejczuk, 2000, p.27; New Universal Encyclopedia, 1996, p. 484). If we add these

two quantities that everything must be done and be evaluated at a specified time, it can be concluded that the economic efficiency of development processes determined by three components: inputs, effects and time (Wesołowski, 1996, p. 133). It is in this perspective has been studied the problem of economic efficiency of Warmia and Mazury social co-operatives. Bearing in mind the fact that companies of this type are in the direct interest of social economy, which is next to such a narrow conception of economic efficiency (i.e., taking into account only the relation of effects to inputs) take into account also the so-called “social efficiency”, which is directly related to the implementation of social objectives, the pursuit of social mission and the concept of corporate social responsibility. This does not mean that the areas to implement the social mission should be excluded from the principles of rational management. Rather pursue social goals should be achieved at the best possible indicators of economic efficiency. The more that as the notes P. Drucker, people with high efficiency can best be seen in management positions when they are missing there. (Drucker, 2010, p. 11).

#### 4. EMPIRICAL RESULTS

In the calculations presented in this article, benefits to state budget included:

- Value Added Tax and other taxes paid by co-operatives,
- income taxes paid by co-operatives members (workers),
- paid social insurance (retirement fund) to the Social Insurance Institution,
- unpaid allowances from social security – money paid by the state to those in need (members of social co-operatives don't receive it),
- unpaid health insurances (these insurances are paid by the state in the case of unemployed people),

State budget costs included:

- grants from Labour Fund given to social co-operatives,
- social insurance paid to the Social Insurance Institution by local governments.

Based on the above financial efficiency was estimated as:

$$Efficiency = \frac{Benefits}{Costs} = \frac{Benefits}{Costs}$$

Table 1. Financial efficiency of social co-operatives support

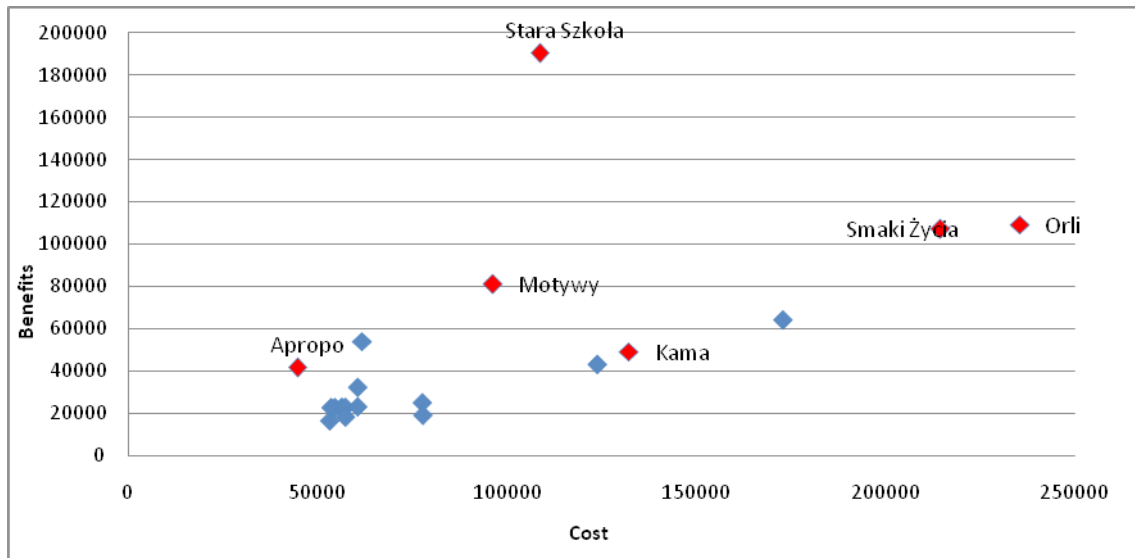
Co-operative name	Costs (PLN)	Benefits (PLN)	Efficiency (%)
APROPO	44760	41590	92,9
PRZYSZŁOŚĆ	53107	16584	31,2
AGROZUL	53481	22881	42,8
RÓŻA	54503	22881	42,0
RĘKODZIEŁO LUDOWE I ARTYSTYCZNE	56319	23022	40,9
BLASK	57279	23022	40,2
BUDOWNICTWO	57279	18438	32,2
SZANSA	60514	23270	38,5
KLAR	60514	32438	53,6
SANLAB	61729	53877	87,3
POMOCNA DŁOŃ	77617	25173	32,4
UNITY	77758	19270	24,8
MOTYWY	96416	81153	84,2
STARA SZKOŁA	108747	190350	175,0
JAME ROMA	123902	43314	35,0
KAMA	132318	49249	37,2
PASBUD	173015	64302	37,2
SMAKI ŻYCIA	214664	107170	49,9
ORLI	235606	109290	46,4
Total	1799528	967274	53,8

Source: own work based on studies



Financial effectiveness of individual co-operatives is at a different level. Starting with a payback of 25% in the co-operative “Unity”, until the return of 175% in the longest running co-operative (since 2007) “Stara Szkoła”. The effectiveness of the financial operations of all co-operatives surveyed stands at 54%. This means that more than half of the invested funds returned to the state budget (as mentioned before state budget benefits). It means that public authorities expended on social co-operatives almost 1 800 000 PLN, but recovered more than 967 000 PLN (i.e. the net cost of creating cooperatives amounted to 832 thousand PLN). Financial performance also shown in the figure 1 to better illustrate it.

Fig. 1. Relations between benefits and costs of social co-operative to the state budget



Source: own work based on studies

Red signs are in the case of co-operatives which still operating in the market. Other activities completed, unfortunately. You can see clearly that at higher expenditure incurred by the state, the efficiency increases. However, this situation is fairly obvious. It should be noted, however, that the figure appeared in a spending limit (oscillating around 100 000 PLN), which gives a much better chance of survival in the market. Above this limit the costs incurred by the state to establish cooperatives have survived more than 70% of enterprises. You may be tempted to assume that only a certain level of support allows the development of a specific type of enterprise that is social co-operative. And below, operates on the market only a social co-operative Apropos, whose members are primarily people with disabilities. It receives, therefore, much more assistance in the form of refunds even if the remuneration and reimbursement of PFRON (State Fund Rehabilitation of the Disabled) paid insurance premiums. The costs of its ongoing activities are therefore not comparable with other co-operatives.

## 5. CONCLUSION

The co-operative form of management is and will be used as an essential element of the social economy sector in order to implement the principles of active labour market policies and social inclusion. Reimbursed at 54% is perhaps not too high, but remember that there are also non-financial performance, which refers to social objectives, activities, assistance and activation of the least resourceful in life, who are victims of systemic change in Poland. The state budget does not count solely on financial gain by providing financial support in setting up co-operatives. Besides the financial efficiency of public funds spent is not the most important factor in active combat unemployment. The task of the social economy is the choice of such instruments in the allocation of funds from the budget that they have been issued as the most sense, it means that in addition to financial effects, they also fulfill social functions. Poor financial performance should therefore be explained by the existence of pursuing the objectives of social economy and state support in facilitating the unemployed into the labor market. Activation of the excluded population, often with major life problems is also a great benefit to the state and local society. Financial assistance for the appropriate level can help to create and increase opportunities for the development of social co-operatives in a competitive market.

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## COMPARATIVE ANALYSIS OF FACTORS FROM MARKETING AND LEGAL PERSPECTIVE AND POLICIES THAT AFFECT SMES IN MACEDONIA AND EU

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### Abstract

This paper examines the current factors that affect the competition of SMEs in Macedonia as a representative country of the transitional economy from marketing and legal perspective, as well as the state policies that are being implemented in Macedonia on one side and the developed countries on the other. The development of SMEs depends on the mutual collaboration and engagement of the enterprises and the national institutions, because SMEs are one of the greatest sources of strength of world economy, quality way of creating new jobs and competitive economy. In transitional economies this fact gets even greater significance in light of the gradual integration of the countries in the European Union. Having in mind that the European Union (the Lisbon Strategy) has set a very high goal - to become the leading economic force by the end of 2010, and SMEs are identified as the most significant factor, Macedonia, as a contender to join the EU should have the same goal.

In Macedonia, SMEs are usually organized as Ltd., as a hybrid form of company which contains elements of personnel and elements of a capital company. Supporting the development and long-term survival of SMEs in the market is achieved among other things, with a good formulation of the legal and administrative framework of the company itself. This is particularly reflected in the use of the opportunity offered by the Macedonian Company Act for independent and autonomous regulation of a number of issues that are of particular interest to the company's founding act of the company, in this case-the contract of the company. By using this opportunity that the law offers and the self regulation of number of issues within the founding act, SMEs become more competitive in the market, can successfully built their reputation and avoid problems that can occur with the operation of the company at the very beginning, and thus would avoid costly and lengthy court procedures. In order to discern the current situation of SMEs in Macedonia in terms of how they work, we have conducted two studies (research technique: questionnaires; purposive sample of 1st - 40/ 2nd – 50 entrepreneurs in service and production industry; June – September, 2009/February 2011; tool of analysis: SPSS software). The first research was done to determinate the degree to which SMEs in Macedonia use marketing activities and provide an answer to the following:

- Do the owners/managers of enterprises carry out research before beginning or during the work of the enterprise in the domestic or on foreign markets?
- What data sources and research methods do they most often use?
- Whether they need more information of the markets where they are performing?
- The second research had an aim to provide information about:
- *Whether the founders of the companies in establishing their agreement despite the mandatory regulations have provided optional regulations that would have been helpful for further work?*
- *Whether they know the meaning of the founding act?*
- *How detailed is the contents of the Founding Act?*

**Keywords:** SMEs, Marketing, Legal factors, State policies.

## 1. INTRODUCTION

Entrepreneurship has become a major movable coupling of economic and social development worldwide. The role of SMEs is significantly amended by the transition from the model of the so-called managed economy to a so-called entrepreneurial economy. The impact of SMEs is manifested through the growth on the level of enterprises, local and national level. In contemporary economic theory and practice major attention is drawn to the analysis of the behavior of states in the screening and implementation of national policy for support and development of small and medium enterprises, and implementation of market orientation and marketing strategy and planning in the operations of small and medium enterprises as one of the key factors for the development of national economy and greater competitiveness of the economy. It is shown that proportional to their size, small firms create more jobs than large firms do (DG Enterprise & Industry, 2009). Small and new enterprises have an important role in innovation, which has replaced price as the most central competitive weapon in key parts of the economy (Baumol, 2002). The many experiments by these enterprises, even if not successful, facilitate implementation by larger firms (Nooteboom, 2000). New enterprises create a higher degree of competition, leading to a positive effect on aggregate employment growth five to eight years later (Fritsch, 2008). In industries where the SME sector is bigger, large firms are often more efficient because they can outsource activities to smaller firms. These positive structural contributions of SMEs to macro-economic performance outweigh the fact that on average, large enterprises outperform SMEs with respect to labour productivity and profitability. During much of the past decade SMEs have seen an impressive growth, but since the onset of the financial crisis this trend seems to have been interrupted, even though there are indications that, at least in the early stages of the crisis, EU SMEs have proven to be comparatively resilient (DG Enterprise & Industry, 2009). An increasing body of literature like: Carree and Thurik (2010), Parker (2009) and Van Praag and Versloot (2007) for surveys, indicates that small and medium size enterprises (SMEs) are of major importance for macro-economic growth (DG Enterprise & Industry, 2009). On the other side, it is also clear that for SMEs is impossible to exist on the market if they are not market orientated, don't have closely defined marketing strategy, and do not obey the legal regulations.

## 2. THE ROLE OF SMES IN A NATIONAL ECONOMY

The first and most obvious question when starting up your own business is what form of entrepreneurship to choose. In the Republic of Macedonia, the Company Act that regulates this matter provides for the following five forms of companies: Public business partnership; Limited partnership; Limited partnership with shares; Company with limited liability; Joint Stock Company. In FYROM, the Company Act, Article 470 gives several classifications of traders, i.e. companies (Table 1).

Table 1. Terms of company's classification in Macedonia, FYR

Classification of the trader/ company	Average number of employees (hours of work)	Gross income (in MKD equivalence)	Average value of total assets	Other criteria
Micro	< 10	< € 50.000	-	- At most 80% of the gross income is derived from a customer by a person associated with this customer. - All rights of participation are owned by at most two individuals.
Small	< 50	< €2,000,000	< € 2,000,000	-
Medium	< 250	< € 10,000,000	< € 11,000,000	-
Large	-	-	-	Traders who are not classified into micro, small and medium, acquire the status of large traders.

Under the provision of the Company Act, in case of inability to classify traders according to the criteria provided for micro, small and medium traders, they can be classified according to the first criterion, which is the number of employees. In Macedonia, the SMEs which were the focus of our research are usually organized as DOO (Limited liability company) or DOOEL (Limited liability company – single person) as a hybrid form of companies containing elements of personal and elements of capital company. The frequent use of this form of organization of SMEs in our country is because of the

possibility offered by this form of autonomous regulation of a number of issues and relationships that are of particular importance for the development of the enterprise. According to the statistics of the Central Registry of the Republic of Macedonia, of all companies that are registered including inactive companies, only 1566 are formed as A.D. (Joint Stock Company), while the remaining 137,349 are Limited liability companies (DOO or DOOEL).

In comparison to EU, the SMEs sector in Macedonia has a small - scale structure: the percentage of small enterprises is slightly higher than the European average. The contribution of small firms to employment in Macedonia is significantly higher than the European average while the contribution of the medium-sized enterprises is lower. As a consequence, the contribution of the total SME sector to employment (71%) surpasses the EU average (67%) (Table 2).

Table 2. Comparison of Enterprises, Employment and Value added in Macedonia vs. EU-27 for non-financial business economy (NACE C-I, K)

	Enterprises			Employment			Value added		
	FYROM		EU-27	FYROM		EU-27	FYROM		EU-27
	Number	Share (%)	Share (%)	Number	Share (%)	Share (%)	Billion €	Share (%)	Share (%)
Micro	40890	90.6	91.08	79563	29.5	29.7	n/a (not available)	n/a	21.0
Small	3792	8.4	6.9	74095	27.5	20.7	n/a	n/a	18.9
Medium-sized	376	0.8	1.1	38133	14.2	17.0	n/a	n/a	18.0
SMEs	45058	99.8	99.8	191791	71.2	67.4	n/a	n/a	57.9
Large	88	0.2	0.2	77644	28.8	32.6	n/a	n/a	42.1
Total	45146	100	100	269435	100	100	n/a	n/a	100

Some of the main findings about SMEs role in the national economy in the European Commissions Directorate – General for Enterprise and Industry annual report on EU SMEs 2009, “European SMEs under pressure” are the following:<sup>1</sup>

- Between 2002 and 2008, SMEs in the EU-27 grew strongly and turned out to be the job engine for much of the European Economy. The number of SMEs increased by 2.4 million (or 13 %), where as the number of large enterprise increased by only 2 000 (or 5 %);
- Between 2002 and 2008, the number of jobs in SMEs increased by 1.9 % annually, while the number of jobs in large enterprises increased by only 0.8 % annually. In absolute numbers, 9.4 million jobs were created in the SME-sector between 2002 and 2008;
- There are areas where SMEs out perform LSEs: the propensity to invest which is – for the EU non-financial business economy as a whole – highest for micro firms. For micro enterprises, gross investment in tangible goods amounts to 24 % of value added, compared to 19 % for all firms. While for a large part, this is due to particular service industries (real estate, leasing, etc), the fact remains that the propensity to invest in micro enterprises overall is still higher than could be expected on the basis of their profitability underlining their importance for the EU-economy;
- Over the long run, underlying structural determinants of the earlier growth trend in the number of enterprises in the EU, including the Internet revolution, the growth of the services sector and institutional developments favouring self-employment, are, expected to remain relevant in the coming years. When economic growth seriously picks up again, the number of SMEs is expected to resume its upward development.

<sup>1</sup> For more information, see [http://ec.europa.eu/enterprise/policies/sme/small-business-act/index\\_en.htm](http://ec.europa.eu/enterprise/policies/sme/small-business-act/index_en.htm)



### 3. STATE POLICIES FOR SMES DEVELOPMENT IN MACEDONIA VS. EU

Regulations that apply to an economy's businesses during their life cycles, can include start-up and operations, trading across borders, paying taxes, security, macroeconomic stability, corruption, skill level, the strength of financial systems, closing a business, etc. Macedonia made significant strides in seven out of ten reform areas, (Doing Business report, 2011) (Table 3):

- Starting a Business,
- Construction Permit,
- Employing Workers,
- Registering Property,
- Getting Credit,
- Protecting Investors,
- Paying Taxes.

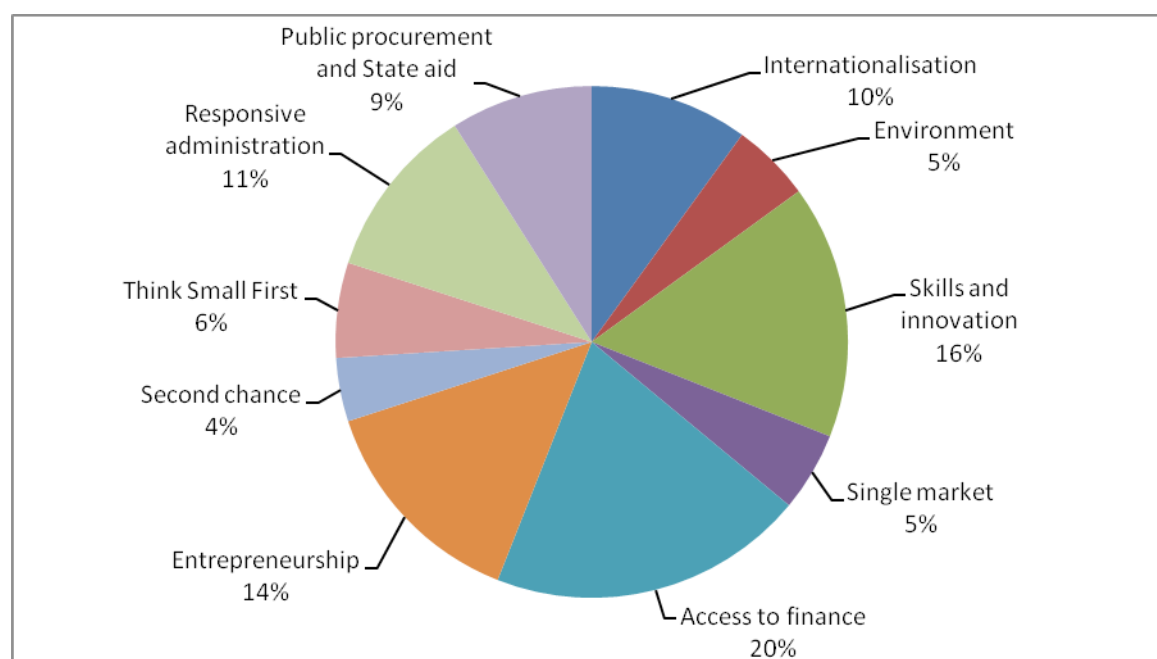
Table 3. Summary of policy reforms in doing business - Macedonia, FYR

Doing Business 2011	Rank	Policy reforms	
Starting a Business	5	Procedures (number)	3
		Time (days)	3
		Cost (% of income per capita)	2.5
		Paid - in Min.Capital (% of income per capita)	0.0
Dealing with Construction Permits	136	Procedures (number)	21
		Time (days)	146
		Cost (% of income per capita)	1601.4
Registering Property	69	Procedures (number)	5
		Time (days)	58
		Cost (% of income per capita)	3.2
Getting Credit	46	Strength of legal rights index (0-10)	7
		Depth of credit information index (0-6)	4
		Public registry coverage (% of adults)	39.4
		Private bureau coverage (% of adults)	0.0
Protecting Investors	20	Extent of disclosure index (0-10)	9
		Extent of director liability index (0-10)	7
		Ease of shareholder suits index (0-10)	4
		Strength of investor protection index (0-10)	6.7
Paying Taxes	33	Payments (number per year)	40
		Time (hours per year)	119
		Profit tax (%)	6.2
		Labor tax and contributions (%)	0.6
		Other taxes (%)	3.8
		Total tax rate (% profit)	10.6
Trading Across Borders	66	Documents to export (number)	6
		Time to export (days)	12
		Cost to export (US\$ per container)	1376
		Documents to import (number)	6
		Time to import (days)	11
		Cost to import (US\$ per container)	1380

Enforcing Contracts	65	Procedures (number)	37
		Time (days)	370
		Cost (% of claim)	33.1
Closing a Business	116	Recovery rate (cents on the dollar)	20.7
		Time (years)	2.9
		Cost (% of estate)	28

Regarding the information on the situation of SMEs and SME policy in Macedonia and the EU, we follow the logic of the Small Business Act for Europe (SBAs 2008) 10 principles – 1. Entrepreneurship, 2. Second Chance, 3. Think Small First, 4. Responsive Administration, 5. Finance, 6. Public Procurement and State Aid, 7. Single Market, 8. Skills and Innovation, 9. Environment and 10. Internationalisation – which were developed to guide the conception and implementation of policies.

Figure 1. Distribution of policy measures by SBA principle: EU 27



In 2007 - 2009, in Macedonia were initiated actions in several areas regarding the policies that regulate the SME sector (SBA Fact Sheet FYROM, 2009): **Entrepreneurship** - A course on business and entrepreneurship is compulsory in gymnasiums, in the four - year secondary vocational schools and in the new curriculum for primary education. The government organises SMEs promotional events, the celebration of the EU Day of the Entrepreneur, organisation of the European SME Week and selection of the Entrepreneur of the Year. **Second chance** - In 2006 a new law on Bankruptcy has been adopted that is in line with the international trade standards (UNCITRAL), paying special attention to compatibility with the Trade Company Law. **Think small first** - In 2002, the government presented the first National Development Strategy for SMEs 2002 – 2012. The SME support is implemented by the Agency for Promotion of Entrepreneurship (APPRM). The main tasks of APPRM are: realisation of the SME Programme, preparation of progress reports on the implementation of the European Charter for Small Enterprises, as well as implementation of other programmes adopted by the Government related to entrepreneurship and small enterprises. Consultation with SMEs takes place via the SMEs Forum. The feedback obtained was incorporated into the revised SMEs Programme. **Responsive administration** - In 2008, an IT system for electronic submission of annual balance sheets was introduced. During 2007 and 2008, the Public Revenue Office achieved significant improvement in the development of filing and reporting procedures for SMEs through the preparation of an ease of access strategy for SMEs in their communications with the tax institutions and the way in which they make their tax returns. **Public procurement and state aid** - In 2008, the Public Procurement Bureau has implemented an Information System for Electronic Filing (ISEF) through which all physical or legal persons may access calls for tenders and advertisements. This web-based system enables implementation of public procurement in electronic form. **Finance** - In 2009, the Government opened an operational credit line with a total budget of € 100.000.000 based on European Investment Bank

funds. The credit line is intended to support SME and start ups. The mechanism of its distribution involves the Macedonian Bank for Development and Promotion (MBDP) and commercial banks as intermediaries for the final beneficiaries. The credit line is implemented through 4 programs: 1) Co-financing and guarantees for long term investment credits and subsidized interest rates (€ 35 million); 2) Co-financing and guarantees of working capital credits and subsidized interest rates (€ 45 million); 3) Short term working capital credits with subsidized interest rates (€ 5 million); 4) Program for guarantees (€ 15 million). **Single market** - During 2007 and 2008, the Economic Chamber of Macedonia organised five training sessions for the implementation of international standards. **Skills and innovation** - In 2008, APPRM introduced a new Innovation Voucher Programme with maximum amount approved as a subvention by the state under this new scheme of € 1,500 that can be used for introduction of new product or service, investment in RD, JIT Management, TQM, protection of Intellectual Property Rights. In 2009, the Ministry of Economy adopted the Programme for Support and Development of Clusters with activities such as: Preparation of a catalogue and a web page for the existing clusters; Training to improve clusters management; Improving of networking between regional clusters associations; Support for the establishment of new clusters; Organisation of cluster conferences. In 2009, APPRM together with Human Resource Development Fund implemented a Training Needs Analysis for SMEs. In November 2009, the Project "Technical assistance for Implementation of European Innovation Scoreboard for Macedonia was implemented, which will increase the level of awareness among SMEs for more innovations in the future in their activities. **Environment** - Examples of services provided to SMEs are: issuing green certificates, carrying out project valuation for banks and investors, preparation of projects for Energy Efficiency (EE) and Renewable Energy Resources (RER) and professional training for EE and RER. **Internationalisation** - During 2007 - 2009, the Macedonian Government adopted an annual Programme for Improving the Competitiveness and Export of Macedonian Products and Services, which included: subsidies for private enterprises such as: costs of quality system certification (ISO) and product certification, HACCP system, costs of industrial design of product, costs of ICT related training of staff and cost for international application for patent and promotional activities: financial support for the organisation and participation on business forums and workshops in Macedonia and abroad, participation of Macedonian companies in International fairs, campaigns, publication of promotional materials, support and promotion of cluster development.

#### 4. METHODS

The first research was done to determinate the degree to which SMEs in Macedonia use market orientation and marketing activities. The second research had an aim to provide information about the effect of legal factors on the work and success of SMEs. The research technique that was used in both of the researches was questionnaires. The statistical samples were purposive samples of 40 entrepreneurs in service and production industry for the first and 50 entrepreneurs in the second research. The time table was June – September 2009 – 1<sup>st</sup> and February 2011 – 2<sup>nd</sup> research. Used tool of analysis: Statistical Package for Social Sciences (SPSS) software to determine the statistical correlation between the SMEs and their market orientation on one side, and SMEs and the implementation of legal acts on the other.

## 5.RESULTS

The acquired results with the first research are shown hereinafter:

Figure 2. Share of enterprises that have conducted market research before starting the business

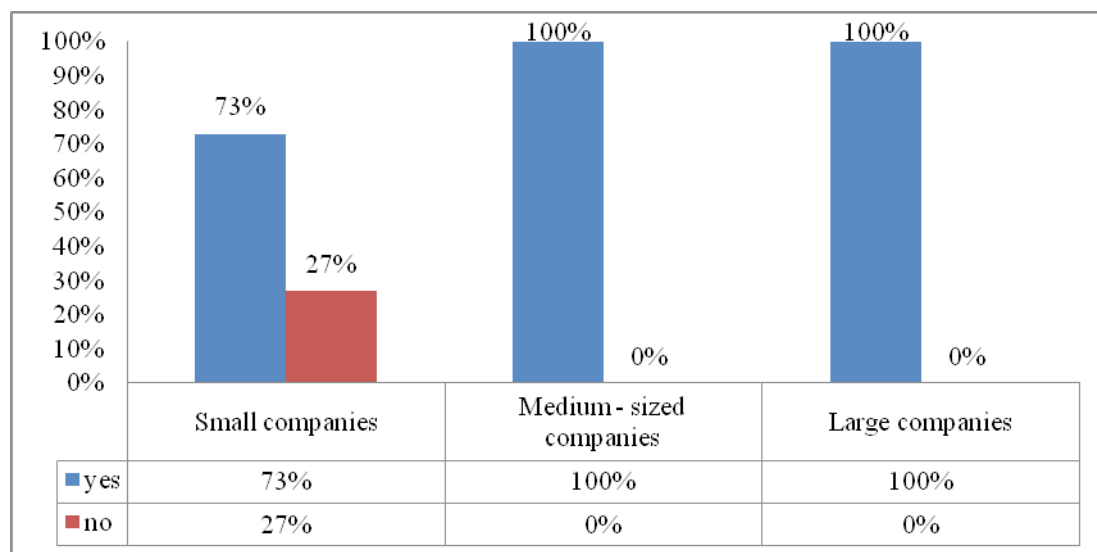


Figure 3. The type of knowledge that the owners had before starting the business

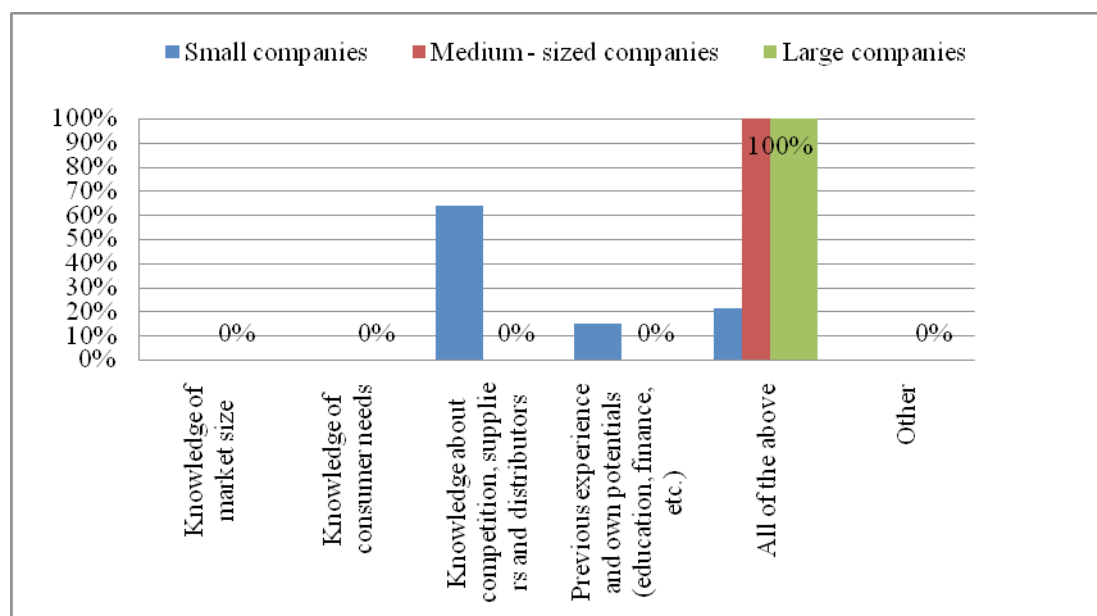


Figure 4. Share of enterprises that carry out market research through out the work

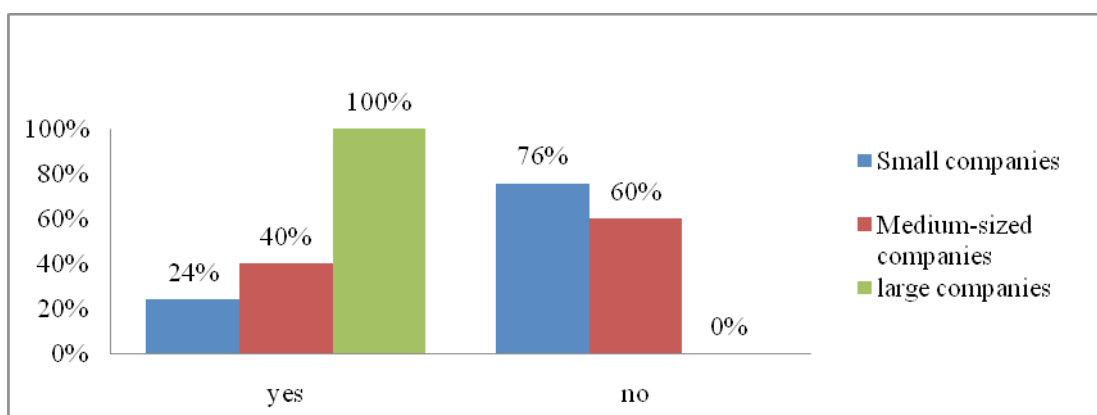


Figure 5. Main reasons for not conducting a market research

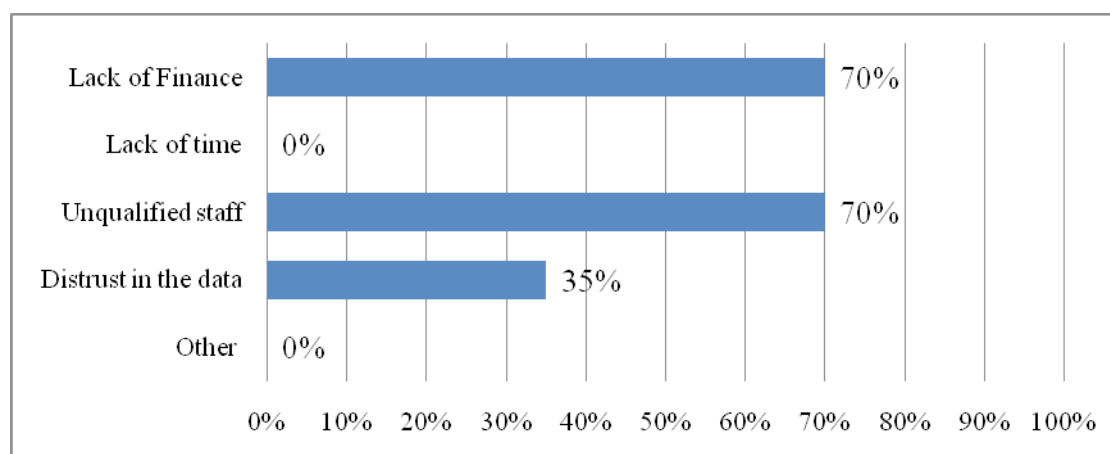


Figure 6. Ways of conducting the market research?

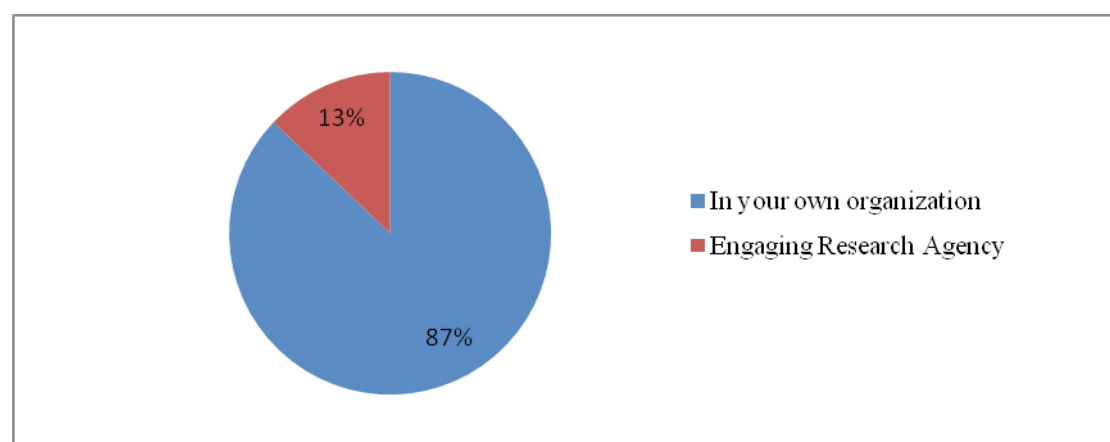


Figure 7. Type of secondary data sources that are commonly used in the market research

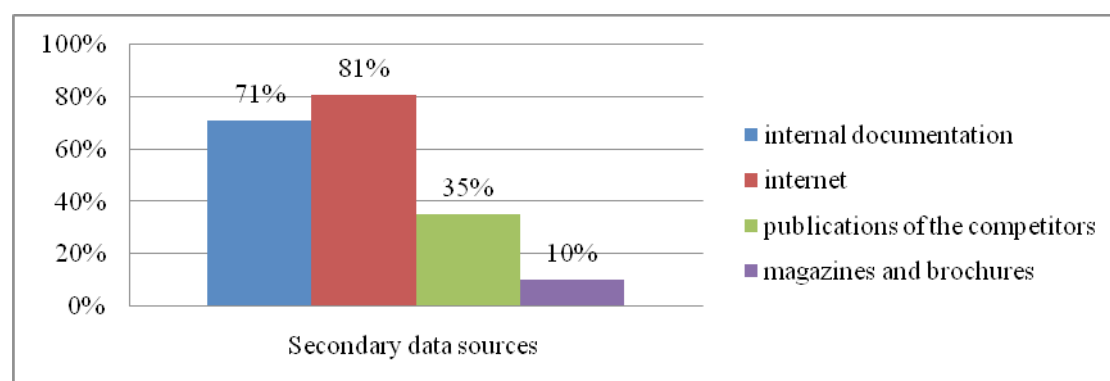


Figure 8. Type of primary data sources that are commonly used in the market research

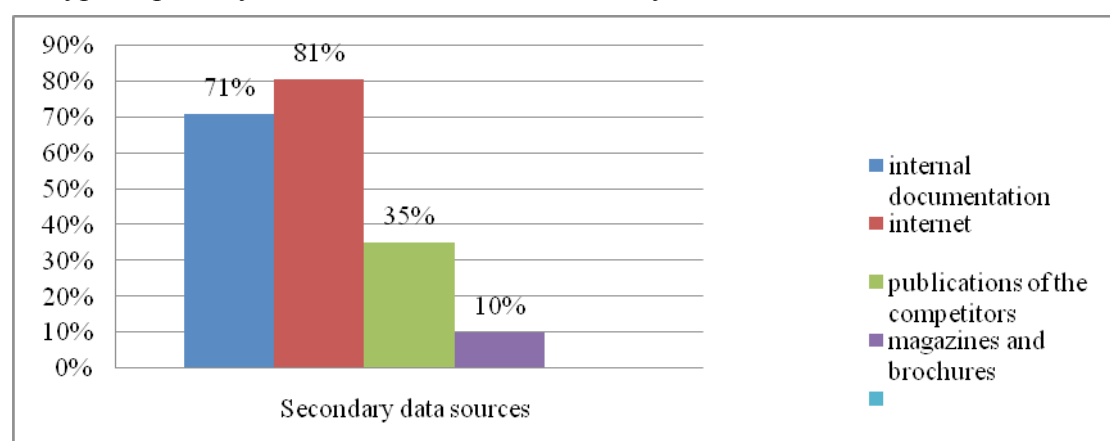




Figure 9. Share of enterprises that feel the need for more information featuring the market

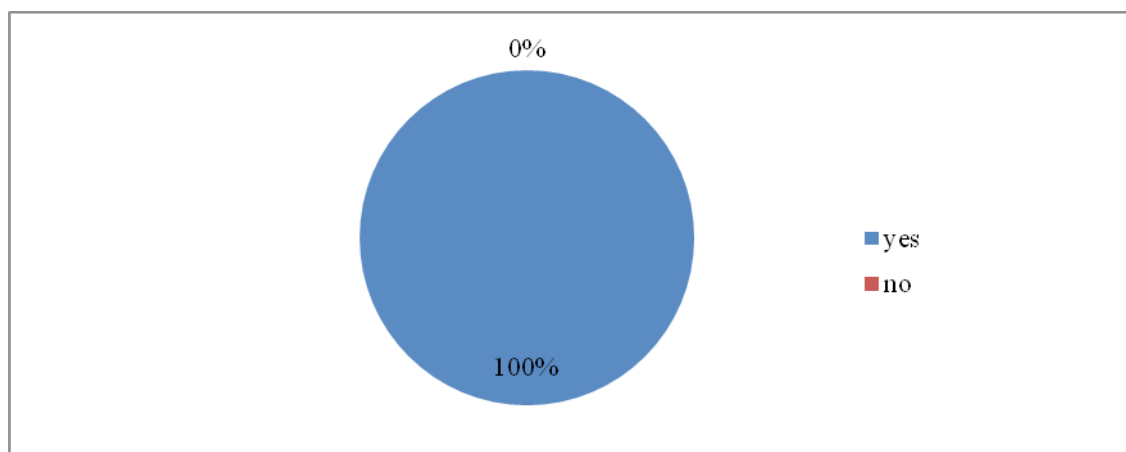
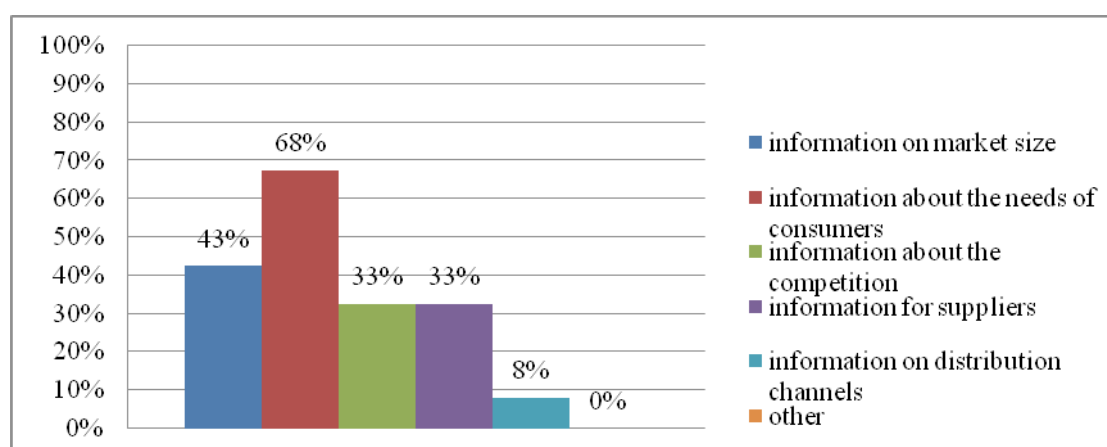


Figure 10. Type of data that enterprises have most shortage of and want to get with market research



This research shows that the SMEs in Macedonia don't have enough information about the market they compete on, don't take the needs and wants of customers seriously enough, they look upon marketing activities as a cost instead as an investment and rarely include them into the business plans. The owners of SMEs don't have enough knowledge about running a business, and do not understand the marketing process and its meaning for the success of a company in a market economy. All of these facts lead to losing the battle with competition from abroad because of the unclear or incorrectly defined business strategies.

The results of the second research are in addition:

Figure 11. The percentage by which the founding act of the company determinates the advantages that the founders retain

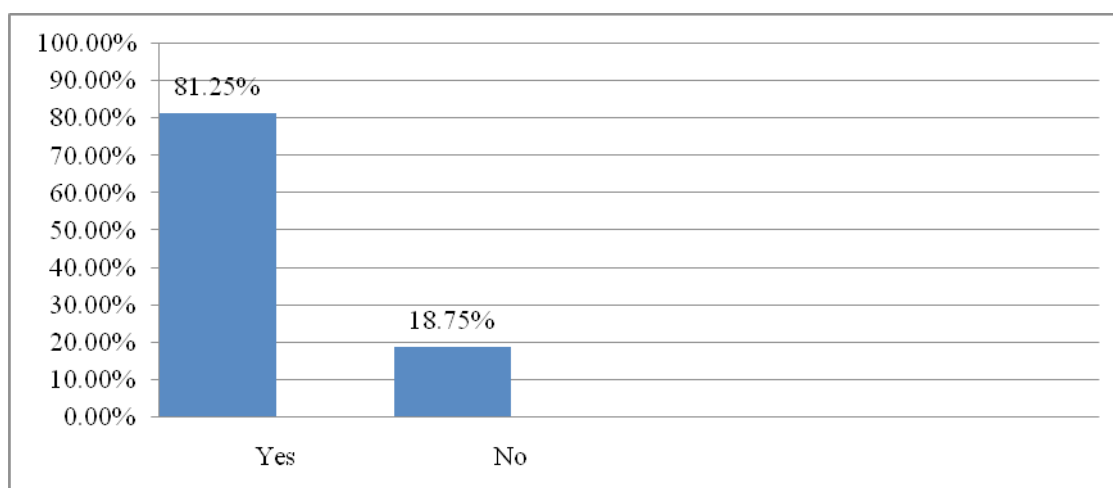


Figure 12. The share of detailed contents of the general act of the company

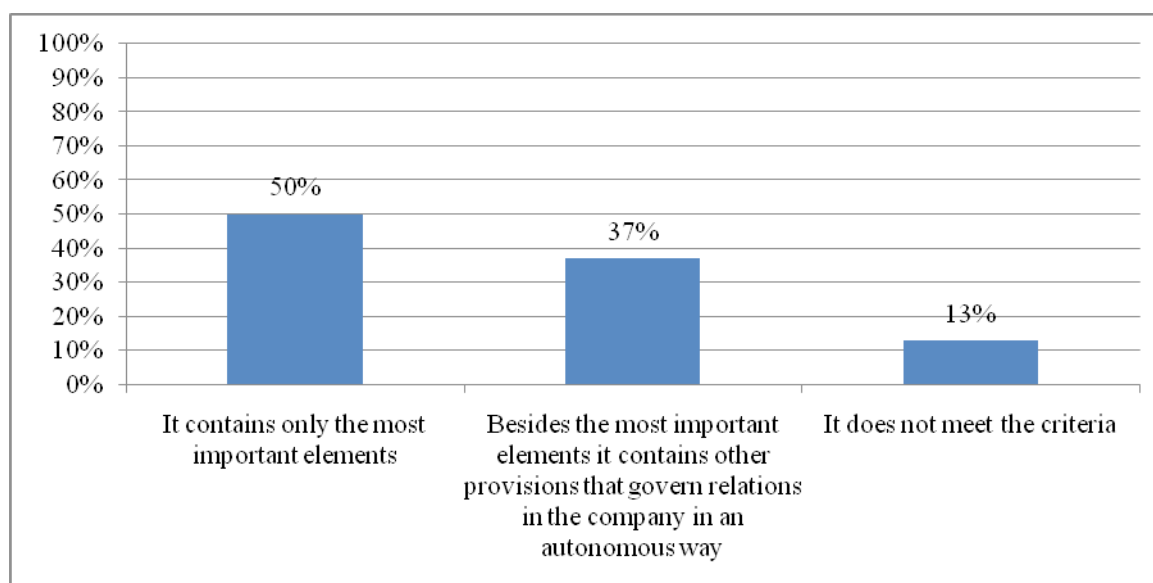
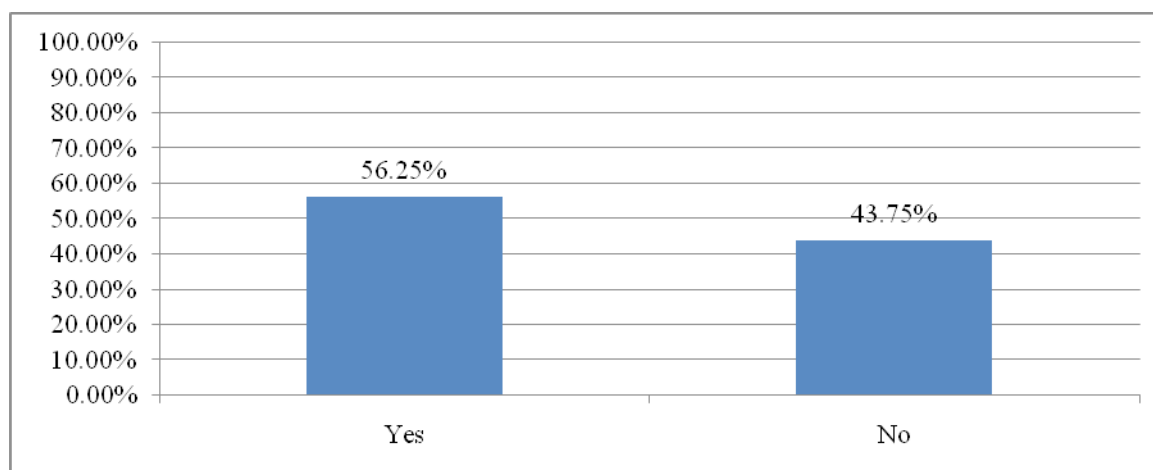


Figure 13. The percentage of allowance of free access to the statute – the founding act to interested persons



The second research results shows that SMEs in FYROM have very little knowledge of the legal possibilities and constraints of running their own business. They usually use short and pattern – like agreements that contain only obligatory legal provisions, and do not envision an autonomous regulation of internal relations in the manner that would be most suitable for them. As a result, very often the company operates only for a short period because when there is a misunderstanding between the partners, due to unregulated internal relationships, important decisions for the company cannot be made. This leads to expensive and lengthy court procedures, violation of honor and reputation of the enterprise, and thus loss of the market position. Issues related to the founding acts of capital companies in Macedonia are very important because they regulate issues and relationships that occur between the investors, and between the company and the wider community in which it operates and exists, issues of particular importance for the company's existence. Well - structured founding acts of the capital companies provide conditions for reduction of conflicts that can arise at a minimum, i.e. the lowest possible level, and thus at the very onset of operations of the company provide greater legal certainty for the investors, shareholders and partners and for all persons entering in any business relationship with the newly founded company, and all the "stakeholders". The name of the general founding act indicates that the provisions in it, except for those strictly required by the law and which must be contained in any agreement of the company, are of dispositive and binding nature. With the contract of the company, in some way the shareholders determine its shape and make the company more or less closed. It plays the normative-legal role of an organizational act of the company, so we can freely say that the contract of the company is an integral agreement that governs the legal, property and administrative infrastructure of the company. In addition to the mandatory provisions which must be contained in any agreement, our Company Act provides the opportunity for optional regulation of a number of issues. The current situation in our companies in relation to

the legal possibility of autonomous regulation of certain issues in the contract of the company is in a phase where investors or founders still do not know the Company Act enough or do not use enough professional legal assistance in preparing the general founding general acts and are not sufficiently aware of the benefits of the legal opportunity for autonomous regulation of certain issues with the general act of the company. In order to access the acts of the other half of the surveyed companies, interested parties have to go through lengthy and complicated procedures. This is the result of the fear of the shareholders that if free access to the acts and documents of the company is allowed, the business secrets of the company will be disclosed and perhaps abused by the competition.

## 6. CONCLUSION

The independent business and entrepreneurial SMEs represent the most valuable part of the economy of countries in transition, and hence the Macedonian economy. They are generators of social growth, new jobs, reducing poverty and a key factor in maintaining the stability of a country. The success of a company, a part of its size, depends from the synergistic effect of the mutual simultaneously actions both of the government and the company. As mentioned above, on national level, in Macedonia various steps towards higher level of competition of the SMEs are being made, but on other side, the cost to close a business and the number of years it takes to close a business remained constant over much of the period 2005-2009, without catching-up to the EU-averages. While there has been a progress as regards start-up conditions, in the other subsegments, i.e. labour regulation rigidities and other administrative processes (tax payments, property registration, costs of enforcing contracts), progress has been much more limited. Sadly but true, the effort of the companies on other side is not the strongest link in the chain and leads to regression in the process of strengthening the national economy.

The results of the study generate a general picture of a invidious position of our domestic SMEs, especially in the area of insufficient information, poor marketing activities mostly consisting of TV advertising, neglecting the other elements of the marketing mix. Opposite of the situation in Macedonia, marketing research and activities are taken seriously everywhere in the world. Many authors have asserted that a market - oriented approach to business will result in better corporate performance (Kotler, 1991) and many studies have found a positive association between market orientation and performance. The industry of market research is constantly rising, with exception in 2009 in line with expectations given the economic downturn (ESOMAR Industry Report, 2010), especially in the manufacturing sector where the Fast Moving Consumer Goods, pharmaceutical and health-care sectors account for the lion's share of sales in research services (ESOMAR Industry Report, 2008). Consumer researches generated 83% of the research industry turnover (ESOMAR Industry Report, 2008). Most dynamical markets which invest in market research (in billions) on a year basis are Europe (\$13,299) and North America (\$9,188), with rise in the Middle East and the Pacific (\$0,442) (ESOMAR Industry Report, 2010). It is necessary for the owners of the businesses to acquire more knowledge and skills about the business they are in, about the usefulness of the internationally adopted rules of doing business and the national and international laws that refer to this issue.

The development of SMEs also depends on the business - oriented legal and regulatory framework in the country. The current practice of business environment shows several weaknesses. From a macro perspective the legal issues are problems associated with the operation of the judicial system, which is slow in resolving disputes. Intermediate problems include lengthy procedures for obtaining construction and use permits because of lack of regulations on Urban Planning. At the micro level - lack of business information on local, regional and national level. Ideally, companies should adopt their own rules and standards of conduct, based on best practices. Competitiveness and success, in fact, are based on flexible legal mechanisms. What is missing in the Macedonia is the lack of assessment of the effects of regulations on the business environment, which is useful because it would lead to results in the decision-making process by the companies themselves. The development and long-term survival of SMEs in the market are also achieved by a well - formulated legal and administrative framework of the company. The structure of the company and its management is vital for its further development and success. This is particularly reflected in the use of the opportunity offered by the Company Act in Macedonia for independent and autonomous regulation of a number of issues that are of particular interest for the company, in this case - the contract of the company. By using this opportunity offered by the law and the self-regulation of a number of issues, the SMEs become more competitive in the market, successfully build its reputation and success, avoid possible problems caused by the operation of the company at the very beginning, and thus avoid costly and lengthy court procedures. The general constitutive acts, comparatively speaking, are the foundations for building a

permanent, solid and reliable structure that will be able to survive major shocks that may occur in the life of the company. In the countries of the Common Law system, the contract as a general act of Ltd companies may be longer and complex or shorter and simple depending on the will of the shareholders themselves. The laws of capital companies of these countries are based primarily on dispositive legal rules (enabling model). This means that the law offers the partners the possibility, when preparing the contract of the company as a general act, to decide on a large number of legal rules that will apply in their company, which would enable them to avoid the pattern-like contracts and to shape it according to the needs of their business. A good example for comparison is the legislation in Germany. The functioning of Ltd there is regulated by a small number of legal provisions and its development is based more on practice. The Law on Ltd is much smaller compared with the Law on JSC as another form of capital companies. With the law reforms in Germany in 2008, 87 articles of the law allow free regulation of relations in the company with the contract of the company. This shows that German law is quite liberal in relation to this hybrid form of capital companies. We can conclude that the national strategy for the development of SMEs in Macedonia has already been largely implemented, but what is lacking is the use of legal assistance by investors who take a dip in entrepreneurial waters by founding the company. They think that legal matters are the least important for starting and running a successful business venture, which is quite wrong and leads to larger and more painful problems. The benefit of a well - regulated general act of the company as one of the factors for the development of entrepreneurship may be of internal and external nature. Internal benefits of the company are: creating an ethical, motivated and stable working environment, legal certainty for both founders and future investors, and thus better positioning in the market, improvement of competitiveness, establishing fair relations in the company, solves the problems of the agency and provides greater accountability and transparency. External benefits are: increasing the value of the company and attracting investors. This results in avoiding lengthy and expensive court procedures, which according to our research may last up to 7 years, and if such actions occur, the precise regulation of relations in the general founding act would facilitate the work of judges. Predicting future situations and their regulation in the general founding acts will contribute to establishing a balance between the obligations or duties granted to the governing bodies and their rights.

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## STRATEGIC APPROACH TO PERIPHERAL AREAS DEVELOPMENT THROUGH SMALL BUSINESS ENTREPRENEURSHIP

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### **Abstract**

For many transitional countries, the consequences of transitional process in perripheral areas have resulted in unemployment, outmigration, and general perripheral areas decline. Under such conditions low-income residents, limited-resource farmers, and other economically disadvantaged groups are particularly vulnerable. The proliferation of policies and programs on entrepreneurship and small business development in these countries is widely viewed as a homegrown, local initiative that focuses attention on small firms and local entrepreneurs rather than on traditional branch plant attraction models. Increasingly, the literature on perripheral areas and economic development suggests that the implementation of more entrepreneurship-led development policies could enable economically disadvantaged perripheral areas to reverse stagnant economic conditions by creating wealth and jobs through locally owned businesses. The notion that entrepreneurship-led development can spur economic growth is complemented by a growing chorus of development scholars that has begun to suggest that social relations and a strong local social structure may positively affect such development. The prospect that social relations may enhance entrepreneurship-led development bodes well for small perripheral areas, especially those characterized by limited factors of production and few economic opportunities.

This rural development policy initiative need to be designed to promote the growth among new start-ups and enhance the competitiveness among existing small and medium sized businesses. In its effort to improve local socioeconomic conditions, the initiative employs the Theory of Change framework. This framework is aimed at boosting the performance of small- to medium-sized rural enterprises as to ultimately improve the socioeconomic conditions of the rural people they serve. The initiative involves funding from different sources and to support entrepreneurship development training that seeks to develop and assist businesses and future entrepreneurs in underserved, targeted perripheral areas. Since rural areas often lack the requisite economic factors to stimulate growth and development, the initiative includes a strategy that strengthens and builds upon the rural area structure. To this end, the initiative involves building entrepreneurial capacity, developing perripheral areas and business networks, and developing effective public policy.

Such entrepreneurial approach strategy that seeks to enhance economic opportunities for underserved perripheral areas through entrepreneurship and small business development must done results. Each component is directed toward developing entrepreneurial capabilities and leadership to facilitate economic growth. The Initiative's call for the expansion of private and public support of programs that invest in human capital development, particularly in those perripheral areas where resources are limited, suggests that the rural policy is beginning to change, with rural economic development gaining more prominence on the national policy agenda to encourage and enhance business capacity across an even wider segment of perripherl areas, including the transitional poor, disadvantaged youth, and women, among others. To this end, rural development policies must continually adapt as economic organization and public policy environments change, thereby creating a viable policy framework for setting rural economic goals, developing strategies to accomplish those goals, and transforming institutions to address critical issues facing specific features of perripheral areas in the R. of Macedonia.

**Keywords:** perripheral, entrepreneurship, development, small business

## 1. INTRODUCTION

Development theories of economic growth have largely ignored the existence of entrepreneurship, but pressures resulting from global competition and corporate restructuring have prompted development scholars and professionals alike to focus more attention on entrepreneurship as an area of policy and practice. Entrepreneurship is “the process of uncovering or developing an opportunity to create value through innovation and seizing that opportunity without regard to either resources (human and capital) or the location of the entrepreneur-in a new or existing company” (Slaughter 1996:7). Entrepreneurship is critical to the maintenance of a healthy economy and if economic development is to be effective, new businesses in low income areas must be started through local initiatives (Acs and Malecki 2003, Lichtenstein and Lyons 2001, Smilor 1997, Winders 1997).

Rural development is more than ever before linked to entrepreneurship. Institutions and individuals promoting rural development now see entrepreneurship as a strategic development intervention that could accelerate the rural development process. Furthermore, institutions and individuals seem to agree on the urgent need to promote rural enterprises: development agencies see rural entrepreneurship as an enormous employment potential; politicians see it as the key strategy to prevent rural unrest; farmers see it as an instrument for improving farm earnings; and women see it as an employment possibility near their homes which provides autonomy, independence and a reduced need for social support. To all these groups, however, entrepreneurship stands as a vehicle to improve the quality of life for individuals, families and communities and to sustain a healthy economy and environment.

Due to the multiplier effects that accompany enhanced small enterprise development, the most apparent contribution of entrepreneurship to increased community welfare is the creation of new jobs and the generation of additional income as new firms start and existing ones grow.

The entrepreneurial orientation to peripheral areas development accepts entrepreneurship as the central force of economic growth and development, without it other factors of development will be wasted or frittered away. However, the acceptance of entrepreneurship as a central development force by itself will not lead to rural peripheral areas development and the advancement of rural enterprises. What is needed in addition is an environment enabling entrepreneurship in rural peripheral areas. The existence of such an environment largely depends on policies promoting rural peripheral areas entrepreneurship. The effectiveness of such policies in turn depends on a conceptual framework about entrepreneurship, i.e., what it is and where it comes from.

To examine entrepreneurship and small business development as a rural development strategy, this paper explores the links between entrepreneurship and rural development. The goal of the paper is to expand our understanding of entrepreneurship and its conceptual underpinnings as well as its potential as a rural development strategy for economically disadvantaged regions

## 2. RURAL ENTREPRENEURSHIP AND DEVELOPMENT OF DISADVANTAGED REGIONS

Defining entrepreneurship is not an easy task. There are almost as many definitions of entrepreneurship as there are scholar books on the subjects (Byrd W.A., 1987, p. 3). To some, entrepreneurship means primarily innovation, to others it means risk-taking to others a market stabilising force and to others still it means starting, owning and managing a small business. Accordingly, the entrepreneur is then viewed as a person who either creates new combinations of production factors such as new methods of production, new products, new markets, finds new sources of supply and new organizational forms; or as a person who is willing to take risks; or a person who, by exploiting market opportunities, eliminates disequilibrium between aggregate supply and aggregate demand, or as one who owns and operates a business (Tyson, Petrin, Rogers, 1994, p. 2-3).

To choose the definition of entrepreneurship most appropriate for the disadvantaged regions context, it is important to bear in mind the entrepreneurial skills that will be needed to improve the quality of life for individuals, families and communities and to sustain a healthy economy and environment. Taking this into consideration, we will find that each of the traditional definitions has its own weakness (Tyson, Petrin, Rogers, 1994, p. 4). The first definition leaves little room for innovations that are not on the technological or organizational cutting edge, such as, adaptation of older technologies to a developing-country context, or entering into export markets already tapped by other firms. Defining entrepreneurship as risk-taking neglects other major elements of what we usually think of as entrepreneurship, such as a well-developed ability to recognise unexploited market opportunities. Entrepreneurship as a stabilising force limits entrepreneurship to reading markets disequilibria, while entrepreneurship defined as owning and operating a business, denies the possibility of entrepreneurial behaviour by non-owners, employees and managers who have no equity stake in the business.

In his work on creating wealth within disadvantaged communities, Porter (1995:62) asserts that sustainable economic growth strategies require “improving the environment for business.” To create such an environment, Porter contends that government must use public funds in ways that do not distort business incentives, but rather focus on providing infrastructure to support “genuinely profitable businesses” (Porter 1995: 67). Porter’s model is not aimed to redistribute wealth but “to identify and exploit the competitive advantages of inner cities that will translate into truly profitable business” (Porter 1995:56). In so doing, the focus is on the private sector, as opposed to government and social service organizations. Another important factor in Porter’s model is the engagement of skilled and experienced minorities in building business versus engaging them solely in the social service sector. What is essential to the proper functioning of such a model is that:

Government assume[s] a more effective role by supporting the private sector in new economic initiatives. It must shift its focus from direct involvement and intervention to creating a favorable environment for business. This is not to say that public funds will not be necessary. But subsidies must be spent in ways that do not distort business incentives, focusing instead on providing the infrastructure to support genuinely profitable business (Porter 1995:67).

Drawing from Porter, fundamental principles underlying an entrepreneurship-led rural development policy are:

- An economic versus a social focus, emphasizing the creation rather than the redistribution of wealth within economically disadvantaged rural communities.
- An emphasis on the private sector as opposed to the government and social service sector; but highlights the supportive role of government and social services.
- An emphasis on having skilled and experienced individuals engaged in entrepreneurial activities.

### 3. RURAL ENTREPRENEURSHIP AND RURAL POLICY

Behind each of the success stories of rural entrepreneurship there is usually some sort of institutional support. Besides individual or group entrepreneurial initiative the enabling environment supporting these initiatives is of utmost importance.

The creation of such an environment starts already at the national level with the foundation policies for macro-economic stability and for well-defined property rights as well as international orientation. Protection of the domestic economy hinders instead of fosters entrepreneurship. National rural policies such as price subsidies to guarantee minimum small business enterprises (SBE) incomes and the keeping of land in production when over-production already exists are definitely counter-productive to entrepreneurship. The long run solution for sustainable rural development is only one, i.e. ‘competitive rural economies. While prices can set the direction, entrepreneurs who will meet the challenge of increasingly demanding international markets and who will find profitable alternative uses of land, alternative business opportunities and so on are needed. Therefore, policies and programmes targeted more specifically at the development and channelling of entrepreneurial talent, are needed. Policies to increase the supply of entrepreneurs, policies developing the market for other inputs into successful entrepreneurship, policies for increasing the effectiveness of entrepreneurs and policies for increasing demand for entrepreneurship can significantly speed up entrepreneurial activities at national, regional and community levels.

The policies and programmes targeted specifically to the development of entrepreneurship do not differ much with respect to location. From the perspective of the process of entrepreneurship, whether the location is urban, semi-rural or rural, is not important in itself. For example, the needs of a would be entrepreneur or an existing small business do not differ much from those in an urban area. To realise their entrepreneurial ideas or to grow and sustain in business, they all need access to capital, labour, markets and good management skills. What differs is the availability of markets for other inputs.

The inputs into an entrepreneurial process, capital, management, technology, buildings, communications and transportation infrastructure, distribution channels and skilled labour, tend to be easier to find in urban areas. Professional advice is also hard to come by. Consequently, entrepreneurial behaviour, the ability to spot unconventional market opportunities, is most lacking in those rural areas where it is most needed i.e., where the scarcity of ‘these other inputs’ is the highest.

These are the reasons why rural entrepreneurship is more likely to flourish in those rural areas where

the two approaches to rural development, the 'bottom up' and the 'top down', complement each other. Developing entrepreneurs requires a much more complex approach to rural development than is many times the case in practice. It requires not only the development of local entrepreneurial capabilities but also a coherent regional/local strategy. Evidence shows that where this is the case, individual and social entrepreneurship play an important role in rural economic, social and community development. The top down approach gains effectiveness when it is tailored to the local environment that it intends to support. The second prerequisite for its success is that ownership of the initiative remains in the hands of members of the local community. The regional development agencies that fit both criteria can contribute much to rural development through entrepreneurship.

Other institutions that can make a difference to rural development based on entrepreneurship are rural extension services. However, to be able to act in this direction, they too must be entrepreneurially minded. They must see rural activities as one of many possible activities that contribute to rural development. They must seek new entrepreneurial uses of land and support local initiative in this respect. While tradition is important it is nevertheless dangerous to be over-occupied with the past, otherwise the rural community may turn into a nostalgia-driven society. Networking between different agencies involved in the promotion of rural development through entrepreneurship, by pooling together different sources and skills, by reaching a greater number of would be entrepreneurs and by assisting a greater number of local entrepreneurial initiatives, can have a much more positive effect on rural development than when each agency is working on its own.

Entrepreneurship in rural areas can benefit a lot from the so called strategic development alliances, i.e., partnership among governments or nonprofit seeking organizations, universities and the private sector.

To summarise, policy implications for rural entrepreneurship development are:

- sound national economic policy with respect to agriculture, including recognition of the vital contribution of entrepreneurship to rural economic development;
- policies and special programmes for the development and channelling of entrepreneurial talent;
- entrepreneurial thinking about rural development, not only by farmers but also by everyone and every rural development organization; and
- institutions supporting the development of rural entrepreneurship as well as strategic development alliances.

In response to today's global economy, community activists and rural policy makers are beginning to call for development strategies that focus attention on small firms, regional trade associations, industrial districts, and local entrepreneurs. They maintain that such institutions are potentially important, though often neglected agents of development. Others argue that if policy makers and program planners expect to foster economic development in underserved, low-income communities, a policy of endogenous selfdevelopment for sustainable economic growth is needed. This notion is backed by a growing body of theory and research that reexamines the "bigger is better" model, and emphasizes the organizational embeddedness of small-scale, locally-controlled economic enterprises (Robinson, Lyson and Christy 2002). Moreover, it suggests that the establishment of more entrepreneurship-centered economic development could enable economically disadvantaged communities to reverse stagnant economic conditions by creating wealth and jobs through locally-owned businesses.



#### 4. MACEDONIA: A RURAL DEVELOPMENT CASE STADY

List of rural areas in the Republic of Macedonia in accordance of the Law on Agriculture and Rural Development, to be submitted for adoption to the Government of Republic of Macedonia at the end of 2007 (prior to implementation of this Programme). In addition, the Law for Agriculture and Rural Development envisages definition of the Less-Favoured Areas (LFA) in the Republic of Macedonia in compliance with the provisions of the Council Regulation (EC) No 1698/2005 and according to the approximation of the national policies towards CAP related policies.

For administrative purposes, the differentiation between rural and urban areas in Macedonia is based on the local territorial divisions according to the Law on Territorial Organization of the Local Self-Government (OG 55/2004) i.e. Article 6: The Definition of the Populated Areas (settlements) of the Territory of the Republic of Macedonia providing definitions of towns and villages as presented below:

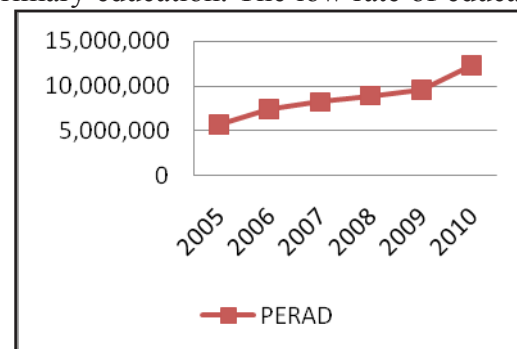
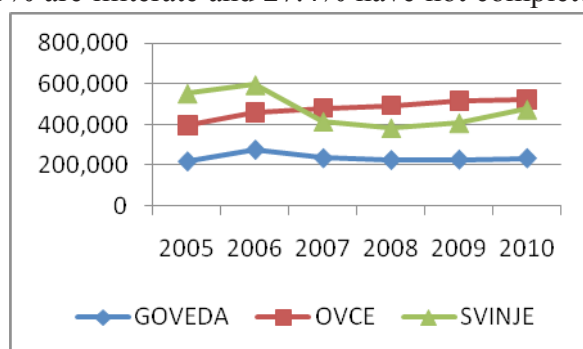
- The towns are compactly built up residential areas with a population exceeding 3000, has a developed structure of various economic activities, above 51% of the employees are working in the secondary and tertiary sector, has an urban physiognomy of zones for residence, recreation and green area (parks), town square, street infrastructure, communal services and acts as a functional centre for the surrounding populated places.
- Villages are defined as mono-functional populated areas, in which one business activity is prevalent and whereas the area has rural physiognomy and function.

According to the Law all Municipalities being with headquarters settled in villages (41) as “rural”, and those, with headquarters in “towns” (43) including 10 municipalities in the city of Skopje as “urban” areas.

Based on this administrative differentiation criterion, out of the total population according to census data 2002, 43% of the inhabitants were classified as rural and 57% as urban population.

Total number of villages is 1,715 out of which only 1,570 are inhabited and 145 are abandoned. Total number of towns in Republic of Macedonia is 34 towns including city of Skopje.

Exact boundaries of towns are defined in accordance with a General Urban Plan and the boundaries of the villages are outlined in Urban Plan of a populated area. Difference between urban and rural areas in the educational structure. According to the 1994 census, a sizeable share (37.9%) of village and farming population above the age of 15 have insufficient or total lack of primary education: 10.5% are illiterate and 27.4% have not completed primary education. The low rate of education in



the rural areas is due to the: moving out of young and capable population for work, ... the lack or small number of education facilities, not sufficient care for improvement of the school education of the young population, isolation of the undeveloped villages, etc.

#### 5. NATIONAL SUBSIDY AND AID PROGRAMME IN THE ECONOMICALLY UNDER-DEVELOPED REGIONS

The total area of the less developed regions covers 64 per cent of the total area of the country, and is a living place for 21 per cent of the total population.

The most important aspects of the rural development policy in less-favoured areas in Macedonia is enclosed in the Law on Stimulation of the Development of Less Developed Areas (OG 2/94 and 39/99), as well as in the Law on Self-government and the Law on Spatial and Urban Planning. However, The Law on Stimulation of the Development of Less Developed Areas basically regulates



the development issues of those areas which, under the criteria set by the Law, have a status of less developed, which are mostly rural centres, mountainous areas and areas close to borders.

The wider objective of the policy is aimed towards reverting of the process of rural urban migration and promoting balanced regional economic development. The policy areas targeted are diversification of the economic activities improvement of irrigation and water management, forestation and management of forests, building transport infrastructure in terms of better access to urban centres, accessibility to quality health care and education, public utilities in terms of promoting rural tourism.

The measures of the LFA policy are implemented through the Bureau for less developed areas, under the Ministry of Local Self Government while the eligible areas are set by a Government decision. In this respect, the Decision of eligibility for the 2004 - 2007 periods encompasses a total number of 1,092 settlements, out of which 500 in mountainous areas, 319 in mostly deprived areas and 116 settlements established as rural centres.

According to the Law the eligible measures and areas of development support include:

- Implementation of the economic infrastructure projects
  - Construction, modernization and reconstruction of local roads;
  - Construction and reconstruction of local water pipelines;
  - Construction and reconstruction of electrification network;
  - Construction of sewage network system (excluding user by user network). This measure allows functional completion of the already constructed local water pipelines, thus enabling full utilisation of the installations.
  - Construction of water holes;
  - Construction of micro-accumulations;
  - Construction of anti-hail stations, which will provide more security and safety regarding the impact of hail damage on the rural production;

Building and adaptation of roads, electrification, water and water holes supply for sheep farms, goat farms, cow farms and fish ponds.

- Implementation of non-economic infrastructure projects
  - Construction and reconstruction of elementary schools premises and facilities;
  - Construction of new and modernization of the existing health and veterinary stations;
  - Construction and reconstruction of the cultural objects (libraries, cinemas, cultural facilities in the rural centres);
  - Construction of TV transceivers necessary for following the public broadcasting companies programmes, which will improve quality of life of the rural population, especially in cultural and educational sense.
  - Transportation of schoolchildren, to the nearest inhabited place with elementary school.
- Partial interest refund on the granted domestic and foreign loans, intended for investments in small and medium size production facilities, engaged in industrial, rural, production artisanship, and agricultural machinery repairing activities.
- Granting funds for premiums for newly created production-related employments for small industrial facilities (currently not operational –due to lack of funds)
- Funding the preparation of scientific researches, related to economically underdeveloped areas.
- Participation in staff training for particular projects. The priority would be given to retraining for agricultural and livestock breeding professions, and for professions related to agricultural and mixed farming products processing.
- Guarantee on loan, granted for livestock supply on the basis of the insurance premium payments.
- Covering the pension-disablement and health insurance payments for individuals living in specific areas (hilly and mountainous, border areas and particularly underdeveloped) with

high migration level, as well as for persons with a status of returnee.

The Law stipulates that the funds for development support of less developed areas are generated from the central budget, in the amount of 1 per cent of the GDP p.a. At its peak in 2002, the Bureau operated with annual budget of approximately € 9 million while in 2006 the budget was down to €3.3 million. In the last two years the activities of the Bureau were limited to construction and reconstruction of local water pipelines, partial interest refund on the granted loans and reconstruction of electrification network

Table I- 7 Work Program of the Bureau for economically under-developed regions (2005-06)

Name of the measure/ Year	2005		2006	
	Amount Approved (MKD)	Amount Paid (MKD)	Amount Approved (MKD)	Amount Paid (MKD)
Construction and reconstruction of local water pipelines	14.592.556	10.681.314	14.115.071	14.088.177
Partial interest refund on the granted loans	581.295	581.295	268.669	268.669
Reconstruction of electrification network	1.518.277	1.518.277	0	0
Total	16.692.128	12.777.886	14.383.740	14.356.846

Source: Bureau for economically under-developed regions, Ministry of Local Self-Governance

However, mentioned program of the Bureau, stipulated by the Law on Stimulation of the Development of economically under-developed areas, will be phased out by the end of this year. Starting from 01.01.2008 the new Law on Balanced Regional Development defines new functions of the institution. In accordance with this, the current forementioned Bureau will be transformed into Bureau for Balanced Regional Development and will be enhanced with new personnel. The new law should define a legal and institutional frame for establishment of a system for policy management related to balanced regional development and coordinated direction of the activities and funds of the state bodies towards achievement of synergetic effects from the investments in the development of the areas with special status. Improvement of rural support policies will be achieved through the establishment of a new regime of subsidies which will be traceable, carefully targeted and monitored as currently the payment mechanism for farm subsidies (per ha or per head of animal) does not allow adequate verification, mainly due to the absence of registers. The new regime of subsidies should be gradually shifted to an income support mechanism (decoupled payments) in accordance with Common Agricultural Policy EU (CAP), and shall comply with the commitments of the WTO that relate to the restrictions in the part of the market access, the amount of the summary measures for support and support to export. Also, the following challenges the rural and agricultural sector have been identified during the preparation of the programme that needs to be seriously addressed in the soon future;

- Improvement of the low competitiveness of key rural sectors, including agriculture, food processing, etc;
- Strengthening horizontal institutional linkages and between ministries and other public bodies;
- Overcome the lack of coordination between different authorities concerning policy and strategy development and enforcement as well as the implementation of activities in the agricultural and rural sector;
- Enhanced development of rural infrastructure;
- Improved access of rural population to public goods and natural resources including rural credits;
- Improving the level of education of rural population, organization of rural population in professional associations, and strengthening their linkages with rural support services;

## 6. CONCLUSION

Entrepreneurship most appropriate for the disadvantaged regions context, it is important to bear in mind the entrepreneurial skills that will be needed to improve the quality of life for individuals, families and communities and to sustain a healthy economy and environment. Therefore, policies and programmes targeted more specifically at the development and channelling of entrepreneurial talent, are needed. Policies to increase the supply of entrepreneurs, policies developing the market for other inputs into successful entrepreneurship, policies for increasing the effectiveness of entrepreneurs and policies for increasing demand for entrepreneurship can significantly speed up entrepreneurial activities at national, regional and community levels.

These are the reasons why rural entrepreneurship is more likely to flourish in those rural areas where the two approaches to rural development, the 'bottom up' and the 'top down', complement each other. Developing entrepreneurs requires a much more complex approach to rural development than is many times the case in practice. It requires not only the development of local entrepreneurial capabilities but also a coherent regional/local strategy. Evidence shows that where this is the case, individual and social entrepreneurship play an important role in rural economic, social and community development. The top down approach gains effectiveness when it is tailored to the local environment that it intends to support. The second prerequisite for its success is that ownership of the initiative remains in the hands of members of the local community. The regional development agencies that fit both criteria can contribute much to rural development through entrepreneurship.

The wider objective of the rural policy in Macedonia is aimed towards reverting of the process of rural urban migration and promoting balanced regional economic development. The policy areas targeted are diversification of the economic activities improvement of irrigation and water management, forestation and management of forests, building transport infrastructure in terms of better access to rural centres, accessibility to quality health care and education, public utilities in terms of promoting rural tourism.

In the future is need to establish legal and institutional frame of a system for policy management related to balanced regional development and coordinated direction of the activities and funds of the state bodies towards achievement of synergetic effects from the investments in the development of the underdevelopment areas mainly trough SBE.

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## TRENDS IN PRODUCTION AND PROCESSING OF MEAT IN THE REPUBLIC OF SRPSKA

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### Abstract

One of the strategic objectives of economic policy of each country is to improve food production, in order to attain the higher level of self-sufficiency in food needs. On this basis, it follows that meat production is a very important resource for food production, so that production is given adequate attention both legal and institutional. In the RS, livestock, especially cattle and sheep, have a long tradition. The potential for the development of animal husbandry is a major, taking into account the available land capacity. Research in this paper includes the analysis of meat and meat products in the RS for the period 2006-2010. Also, the collection of livestock has been monitored, the installed annual capacities for meat processing, their degree of utilization, as well as import and export of meat and meat products.

**Keywords:** Livestock production, Meat industry, Trends

### 1. INTRODUCTION

In the RS there are climatic, geographic, and socio-economic conditions for the development of agriculture, especially livestock. The rapid development of the organized commercial agriculture is disturbed by small and fragmented land (small plots of land), technical knowledge of producers (modern methods and the latest developments in agriculture), availability of raw materials (seeds, breeding materials, plant protection, fertilizer) as well as lack of funds and reducing the purchasing power of most of the population. On the other hand, consumption of proteins of animal origin grows proportionally with the increase in living standards. Thus, the consumption of these types of proteins in the EU is twice the world average and the trend is increasing because of growth in living standards, due to EU enlargement and increase of population. EU countries cannot meet the needs of the proteins of animal origin from its own resources. EU countries are also moving away from the strategy of further intensification of production of animal products because it would have meant even greater pressure on land resources, biodiversity, and quality and safety of products, and this is not what European producers now want. This situation creates room for producers from RS to create supply for the European market. The aim of this paper is to demonstrate the capabilities and trends in meat production in the Republic of Srpska, and the willingness of this part of the RS economy to compete in the European market.

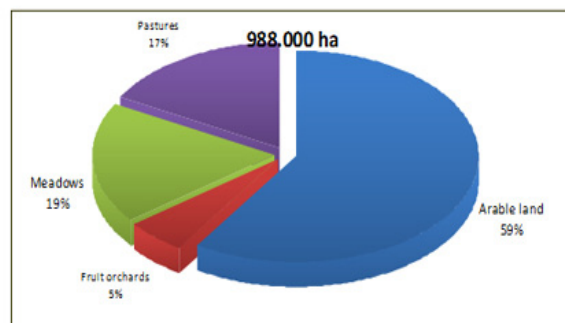


## 2. THE RESULTS OF RESEARCH

- The situation of livestock production in the RS

The available arable land is very important for the development of agricultural production, notably livestock production. There is available, in average, around 988.000 ha In the Republic of Srpska.

Graph 1: Structure of sown area in RS for 2009.<sup>1</sup>



- At 70-80 000 ha - forage crops are cultivated annually,
- On average 147 000 hectares annually produces about 550 000 tons of maize,
- At average of 3.5 thousand ha - about 6.5 thousand tons of soybeans are produced annually,
- The area of sown arable land (in 2009 - 368 000 ha), about ½ is in use for production of production of fodder.

In the RS agriculture, livestock production has great economic importance. Status and development of livestock production is the most reliable indicator of the development of agrarian sector of any country, including the RS. The significance of the development of livestock production is reflected in the fact that the ruminants exploit surface under natural grasslands (meadows and pastures), which in the structure of agricultural land covers about 36%. Graph 2 shows the types and categories of livestock in the Republic of Srpska for the period 2005-2006.

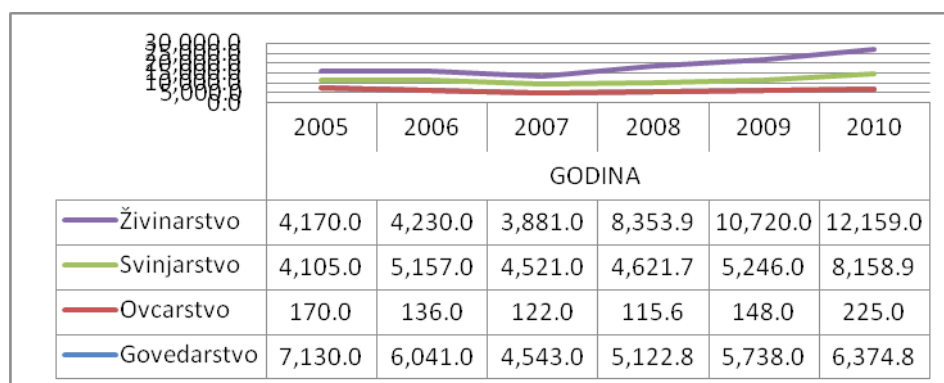
Graph 2: The number of livestock in the RS<sub>2</sub>

In terms of number of the individual types of livestock it can be seen that the number of poultry and sheep in the five-year period had an increasing trend, while in cattle and pigs, although the first three years, recorded a slight increase, the number of cattle in the last two years has declined. Regardless of fluctuations in the number of certain types of livestock, the total volume of livestock production in the six-year period showed an increase. The largest volume of production was recorded in poultry production, followed by pigs and sheep, Graph 3

1 Statistical Annual Bulletin ISSN 2232-7312, Banja Luka, December, 2010. p.149

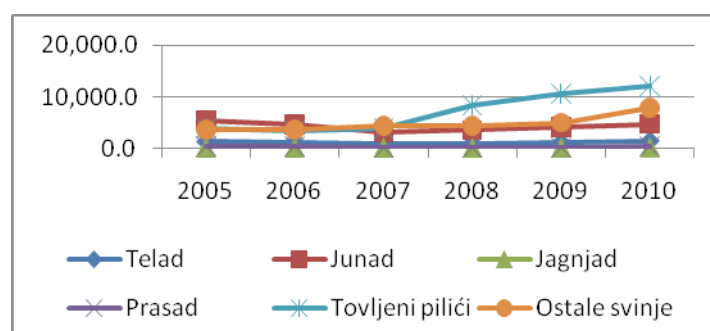
2 Statistical Annual Bulletin ISSN 2232-7312, Banja Luka, December, 2010. p.162

Graph 3: The RS livestock production (2005-2010)



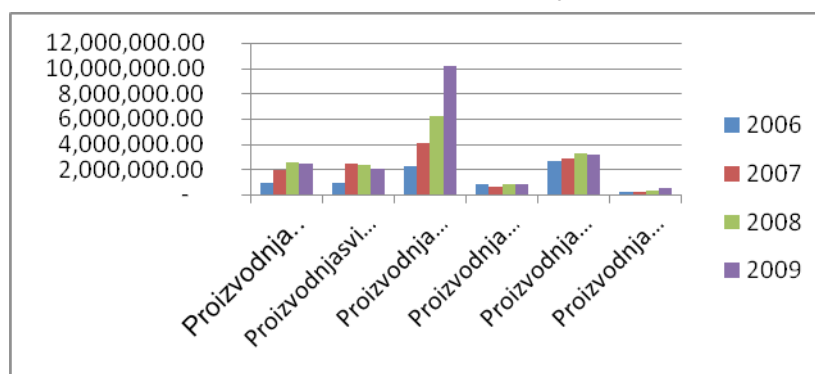
**Cattle** as one of the most important branches of livestock production in the RS are very widespread and are present in most farms. During the monitoring period, the average number of cattle stood at 236 973. For the same period, average production of beef was 5824.9 tons. **Pig** production, in addition to cattle breeding and poultry production, is a very important branch of animal production. According to statistics, the total fund at the level of many years has averaged about 472,517 pigs. Total production of (pork) meat for the monitoring period ranged, on average, around 5301.6 tons (Graph 3). For the monitoring period, on average, pork production per capita was about 3 kg, which is very low production, especially if you consider the possibilities of this production in RS. **Sheep** production in the RS for the period 2005-2010, based on average, is about 478,292 heads of sheep. This form of livestock production is most prevalent in the hilly mountainous areas, which are rich in large parts of the natural pastures. The RS is prevalent mainly with the extensive production of sheep, with a mixed production of meat, milk and wool. Production of sheep meat recorded a significant decline by 2009, but with a slight increase in 2010, Graph 4.

Graph 4: Meat production in the RS



Processed meat, especially dry and smoked meat, is a tradition in the RS, which lasts for centuries. What started as just one of many activities that are performed in a household, and then turned into a cottage industry, today represents a significant portion of the food sector. RS with its own present production is unable to close the balance of meat and therefore larger quantities of meat are imported, especially for processing. Those are primarily economic reasons, i.e. the global market offers a large quantity of frozen meat, much cheaper than domestic production, but poor quality. Low prices of imported meat have disincentive effect on domestic production of meat.

During the monitoring period in the RS, the amount of purchased livestock for slaughter has increased, and increase in the total quantity of meat originating from local slaughterhouses, especially in poultry (Graph 5).

Graph 5: The amount of meat and meat products in the period 2006-2009<sup>3</sup>.

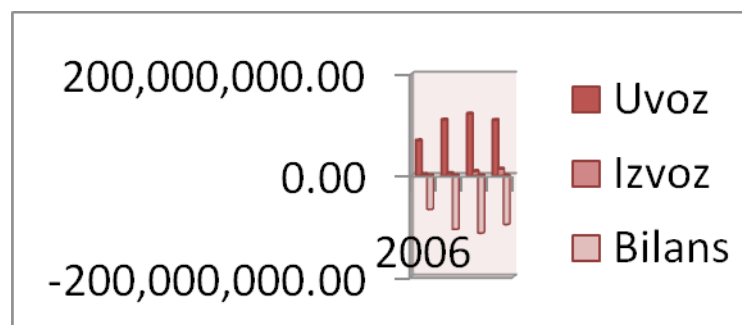
According to the relevant ministry<sup>4</sup> in 2008, RS processed 2.506 tons of beef, 2.329 tons of pork and 6.616 tons of chicken meat. In the processing of beef and chicken meat a significant increase was noted, while in the production of pork, slight decrease was noted in comparison with the previous year. With respect to meat processing, production of sausages and canned products increased. According to the same source, the capacity of meat processing industry in the RS use only 20-25% capacity, which indicates their low level of usage. In addition, many do not meet the required standards, which is one of the reasons for their poor competitiveness in international markets.

According to MoA total number of processing capacities is 262, of which only 35 industrial buildings and 226 craft, out of 35 industrial facilities, 12 are into bankruptcy or ceased operations.

- Foreign trade

Foreign trade of agricultural products and foodstuffs of BiH, and RS within it, showed chronic deficits in all the years of the existence, Graph 6.

Graph 6: Balance of exports and imports of meat and meat products on the BiH level



The opportunities of placement of meat in foreign markets are evident, but this placement is limited to a certain number of countries. In most cases, the exports of meat are due to incompatibility of veterinary-sanitary regulations with regulations in the environment. In addition, there is insufficient motivation of primary production to enter into commercial production.

Then, failure of basic safety standards, improper organization of purchasing, quality inconsistency, lack of knowledge of foreign markets, are just some of the reasons why the potential for exports, which exists in this sector, is not used.

Table 1: Bosnia and Herzegovina and the EU trade of agricultural products

EU import from BiH (in mil. €)	2008	2009	2010	EU export to BiH (in mil. €)	2008	2009	2010
Sugar	7,5	6,5	7,0	Cereals	79,2	28,4	39,5
Fruits	6,2	7,1	10,6	Dairy products, eggs, honey	27,9	26,2	36,6
Vegetable	3,6	5,4	8,9	Sugar	8,9	8,5	8,2

<sup>3</sup> Statistical Annual Bulletin ISSN 2232-7312, Banja Luka, December, 2010.god. Industrija, p.191

<sup>4</sup> Information on status and conditions in food industry in RS in 2008. MAFWM RS, 2009, p.5.

Leather and fur	26,8	16,6	36,3	Meat and meat products	20,1	24,8	29,5
Oils	5,5	10,4	10,8	Oils	18,6	23,5	21,6

Based on the above review (Table 1) it is clear that BiH and the RS do not use the comparative advantages in the production of meat, but on the contrary, they appear as a net importer of meat from the European Union.

- The market chain in meat production and processing

The market chain in meat production is largely unorganized and short, because a large part of production ends within the household or in local markets (official and unofficial). One part of the production, however, is collected/purchased through the slaughterhouses, directly or through intermediaries, making it possible to extend the chain of production thus generating additional value of the product. Small amounts of meat products are exported to neighbouring countries (Albania, Serbia, Croatia), Graph 7.

Graph 7: The ratio of imports and exports of meat products in neighbouring countries and EU



One of the main reasons for short market chain is that a significant portion of production is in the hands of small producers, mainly with extensive production. The largest portion of meat is produced by family farms that are commodity producers with ten bullocks, a hundred pigs and sheep and in recent years, there is a tendency to increase Poultry production with 10 000 chickens for fattening. There are also organized producers (relatively large producers for the conditions of production in the RS) who fatten cows on their own farms or in the organized fattening on member farms. This situation indicates that production can be distinguished in three groups of producers of meat, that are determined by different production and sales market chains,<sup>5</sup> Table 2

Table 2: Market chains in the production of processed meat in RS

Small producers	Commercial producers	Relatively large producers
Not participants in the official meat sales channels meat produced for their needs small quantities of live animals or meat sold in own household they are important for food security poor standards of production, storage and food security, taking into account all standards and demanding users, in order to keep control of production, it is necessary to be engaged in official channels that guarantee health safety.	Product Group with largest part of production usually sell their products to registered slaughterhouses, either directly or through intermediaries mainly produce feed and are engaged in both farming and cattle production they are the most important group, thereby a priority of agricultural policy to allow them further growth in the future.	Companies engaged in the production of animal feed, processing or selling of meat trying to establish a vertical connection, which would reduce the market or price fluctuations that are characteristic for meat production In addition to them, there are companies that saw their opportunity for profit in meat producing and through the privatization process came to productive resources

Medium-sized producers are most important from the perspective of agricultural policy, because the biggest production is done by them in all areas of meat (beef, pork, lamb and poultry).

<sup>5</sup> National Program of rural development of Serbia 2011-2013, Belgrade, 2011.

- Reform of the CAP as a chance for producers of meat in RS

Livestock sector of the EU had a steady growth in recent decades. The old EU12 Member States had the strongest growth in the period 1961-1985, when milk production increased by 70%, pigs by 120% and poultry by 300%. Production of beef and milk stagnated after 1985, mainly as a result of changes in the CAP. Production of pig and poultry continued to grow by around 4% per annum. Today the EU is a net importer of beef and mutton, and a net exporter of pork and dairy products.

Livestock production in the EU is heavily influenced by the Common Agricultural Policy - CAP. Although the CAP in the last few decades has experienced significant reforms and further characterized by direct subsidies and export taxes that exist for most livestock products. Long-time negotiations within the World Trade Organization - WTO on the reduction of export subsidies for EU products can cause a rise in prices of livestock products from the EU, taking into account production costs suffered by EU producers. Therefore, the sharp sanitary regulations that the EU imposes on imported products of animal origin, are the how the EU protects the domestic market.

Apart from market measures next important factor that can affect change CAP in terms of support for livestock production is the impact of this kind of production on the environment and ecological factors. Feed production requires large amounts of land, water and other inputs, and produces large amounts of nitrogen and leads to the greenhouse effect. Livestock production accounts for about 10% of total greenhouse gas emissions at the EU level. About 75% protein livestock feed needed in the EU production are covered from imports, mainly soybeans from countries of South America, allowing the EU to indirectly affect the environmental factors of production outside its territory.

Directly related to livestock production were also questions about the conditions of keeping animals and animal health care. The last 10-15 years the EU market was disturbed by the great crises ranging from mad cow disease and foot-and-mouth disease, bird flu, swine fever, etc.

All these factors influence the policy to support livestock production from the EU budget, and on the other side on the preferences of EU consumers. No EU tax payers want to set aside money for the production of products of suspicious quality, which is, in addition, disrupt the balance of the environment, neither the EU consumers want to consume such products. Awareness of EU consumers therefore moves in the direction of consuming products that are produced in an environmentally healthy area, which meet their quality and hygiene standards.

### 3. CONCLUSION

In the Republic of Srpska a relatively small amount of meat is produced, with respect to the available natural resources. Therefore, this is a limiting factor in supply in the domestic and foreign markets. On the other hand, coming closer to the EU market and the characteristics of demand in this market provide an opportunity for domestic producers to increase production for export. Therefore, there is a need to increase livestock production through:

- better organization of fattening cattle in terms of compliance capacity of primary and secondary production, and development of strategic orientation in the production and processing of meat, in this sense to harmonize the institutional, political and economic support systems prevailing in the country with the strategic orientation of sectoral policies;
- improving the quality of production especially in terms of ensuring continuity and quality level, in this sense, the introduction of quality grades of carcasses at slaughter, especially in pigs, go to the system of buying meat per unit and not kilo, hence producers would be stimulated and rewarded for better quality meat in its production;
- improve the situation in the meat production and processing by economic measures, which occurs as a necessary precondition for export, but also use pre-accession funds, including making available soft lending to investment in livestock production, and systematic support measures that would be compatible with economic and organizational rules in livestock;
- encourage efficient forms of cooperation between producers, feed industry for poultry and processing industries and in that sense, support the establishment of agricultural chambers, which would bring together representatives of all sectors in the chain and allow the establishment of rules and agreements in the field of production and market agricultural products;
- Establishing laboratories for testing the quality of meat, and accrediting them, in order to adequately monitor the quality and provide support of local institutions to the export of products of animal origin;



- an increase of work on prevention and combating of infectious diseases in order for BiH to obtain a license for the export of products of animal origin;

Taking into account the resources available and the needs of European consumers for high quality protein of animal origin, one of the strategic orientations of Srpska in the period before accessing the European Union could be the production of animal products, i.e. primarily meat for the European market.

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## INSTITUTIONAL SUPPORT FOR ENTREPRENEURSHIP AND SMEs DEVELOPMENT: AN EMPIRICAL STUDY ON REPUBLIC OF SRPSKA (BOSNIA AND HERZEGOVINA)

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### Abstract

The global financial crisis has been increasingly destructive for transitional economies further weakening its fragile manufacturing sector. Bosnia & Herzegovina (B&H) including one of its entities Republic of Srpska (RS) is not an exception. Although, as the official statistics suggest, the economy of Bosnia and Herzegovina is not in recession, evidence of its growth is still discouraging. In this country where an irregular transition and economic reform wiped out most of the manufacturing sector dominated by large firms, entrepreneurship and SMEs development is seen as one of the key avenues for the economic recovery. This paper examines the range of influences in the institutional environment that affect the development of entrepreneurship and SMEs in RS. These include the role of government agencies, policy infrastructure, and other factors critical for the SMEs support. More specifically in this study we analyzed the programs, policies and strategies for SME support in RS. In so doing a survey was conducted in early 2010 in one of the most developed regions as well as the largest concentrations of new businesses in RS, Banja Luka. With 47.3 SMEs per 1000 inhabitants, Banja Luka has exceeded the European average. However, the RS marks the uneven development in its regions with weak entrepreneurial infrastructure. Specifically, respondents in the sample of 87 enterprises evaluated the availability of funding sources as a major problem to the development of SMEs in the Republic of Srpska. Entrepreneurs expect help from development programs through soft loans, grant and through guarantee funds. On the order to ensure the balanced and systematic development of the RS, based on the results of the research and analysis of the models of support for the growth and development of SMEs in the countries of Southeast and Central Europe, we will present a new Model of Structural Support to SMEs and Entrepreneurship in the Republic of Srpska.

**Keywords:** Transition, SMEs development, entrepreneurship infrastructure, institutional support

### 1. INTRODUCTION

The economy of Bosnia and Herzegovina and the Republic of Srpska, in the last decade, from 2001 to 2010, according to official statistics, has recorded a significant economic growth. Between 2001 and 2010 GDP in the RS has almost doubled, from 1,478.000 € to 4,250.000 €, respectively (Republic of Srpska Institute of Statistics, 2011). This growth is due to the growth of the sector of small and medium-sized enterprises, that, in the period between 2006 and 2008, has recorded a growth of SMEs of 8.41%. *“The largest share in the overall increase in the number of SMEs had micro enterprises with 86.18% and small enterprises with 8.93% and medium-sized enterprises with 4.89%”* (Petkovic, 2010, p. 65). The growth has continued in 2009. Out of 14,321 companies, only 55 or 0.38% were large enterprises. However, in 2010, according to APIF<sup>3</sup> data, 9,472 companies have submitted their required financial reports for the year 2009. Comparing this number with the data from 2009, the question is what happened with other companies? Have they ceased to do business or simply have not fulfilled their legal obligation?

At the beginning of 2009 the first negative effects of the global financial crisis spilled over in the real sector of the RS, which were felt in the decline of the number of companies, job cuts, in the reduction the effective demand, problems of liquidity expressed in low levels of debt collection and the inability to pay short-term obligations, difficulties in accessing external financing sources outside the company, as well as problems with solvency. Economies of developed countries have also felt the negative effects of the recession, but did not give up on further and increased institutional support to SME sector. Small enterprises in the European Union are in fact the true giants of the European economy. Micro enterprises (with fewer than 10 employees) are dominant in employment in the countries such as Italy (47%), Poland (41%), while the share of large enterprises in employment in the Great Britain is only 46% (Glavanits, 2007).

Modern capitalist economies are experiencing a change in the nature of production, organization of work processes and the economic structure (Parker, 2001). Traditional, production-oriented industries

1 Republic of Srpska (hereinafter RS, one of the entities in BiH, A/N.)

2 Hereinafter the SME sector.

3 Intermediary Agency for IT and financial services (abbreviated APIF), <http://www.apif.net/index.php/en>

continue their decline, while service-oriented industry grows and changes (Solymossy, 2009). During the economic crisis major companies have released a large number of workers. Mass unemployment and growing poverty have forced governments to revise their interest in big business. Until then, business historians have neglected the SMEs in their research, and very little research in this area has actually been done (Scranton, 1984; Benson, 1983; Blackford, 2003). At the same time, scientific studies have confirmed the importance of small and medium-sized enterprises to the economy and this has triggered changes in government policies. According to the highly influential study of David Birch from 1979 as stated by Landström (2005) in his paper, SMEs are largely responsible for creating new jobs, and additional studies have emphasized the high level of innovativeness of SMEs. These figures have shocked many, particularly economists, because it was contradictory to their earlier theories of economies of scale. Further studies have shown that the growth of national income is unambiguously connected with high levels of the foundation of new companies and especially the new so-called start-up companies (Stam et al. 2007; Wong et al. 2005). While big business was still struggling to survive, and the number of workers was still being reduced, governments wanted and needed to stimulate employment growth. SME has been branded as a creator of jobs and the entrepreneur has become a new hero of economic policies. For many this has become the era of entrepreneurship. There is a link between self-employment, entrepreneurship and small and medium-sized enterprises, and these are inseparable categories between which there is a strong correlation in the same direction (Goey, 2004). *"Small enterprises are the backbone of the Western Balkans economies, according to a report on the implementation of the European Charter in the Western Balkans"* (Report on the Implementation of the European Charter for Small Enterprises in the Western Balkans, 2007, p 3).

The starting research problem in this paper can be briefly represented with the question whether the existing institutional support for entrepreneurship development and SME sector in the Republic of Srpska is efficient and enough built? Entrepreneurship is considered to be an important mechanism for economic development through employment, innovation and welfare effects (Schumpeter 1934; Acs and Audretsch 1988; Wennekers and Thurik 1999). The dynamics of entrepreneurship can be vastly different depending on institutional context and level of economic development (Acs et al., 2008).

Analyzing institutional arrangements in the Republic of Srpska, Bosnia and Herzegovina and surrounding countries and European Union, and reviewing the literature of positive European practices, the starting hypothesis of this paper can be defined as follows: *Improvement of entrepreneurial environment and building of entrepreneurial infrastructure through rounding up the process of building of institutions for financial and non-financial support to SMEs, adopting and implementing policies, programs and strategies, will give an additional contribution to the establishment of efficient doing business and economic structure of the Republic of Srpska in which SMEs have a dominant role and alongside big giants, will be an engine out of the crisis.*

Particular emphasis in this paper is placed on the search for answers to questions: which are the key external and internal factors of efficient and effective business of SMEs in the Republic of Srpska. We analyzed the answers of entrepreneurs and managers from 87 SMEs in Banja Luka in the comprehensive research conducted in late 2009 and early 2010. As a result of the research, we constructed a new *Model of Structural Support to SMEs and Entrepreneurship in the Republic of Srpska*, whose establishment, in the long term, would lead to a systematic and efficient development of entrepreneurship, as well as significant economic growth and employment growth.

## 2. SMALL AND MEDIUM-SIZED ENTERPRISES IN THE REPUBLIC OF SRPSKA

*Since the SME sector represents the most important and most dynamic part of the Republic of Srpska economy, which employs half of the total number of employees in the Republic of Srpska and makes 99.56% of the total number of enterprises, growing importance is given to the development of SMEs in the Republic of Srpska over the last few years* (Analysis of the situation in the field of SMEs for 2008, 2009, p. 8). According to official statistics, in 2009 the number of companies increased. *According to data from the Tax Administration 14,321 companies operated in the Republic of Srpska in 2009, of which 14,266 or 99.62% were SMEs. Micro enterprises make up the majority SMEs with 12,049 or 84.14%, followed by small enterprises with 1,805 or 12.60%, while the number of medium-sized enterprises is 412 or 2.88%. According to the industry structure most SMEs are still in the field of wholesale and retail sector with 42.18% and 20.31% in the sector of processing industry. According to the regional representation the largest number of SMEs is located in the economic areas of Banja Luka and Bijeljina with 46.96% and 16.56% respectively.* (Analysis of the situation in the field of SMEs for 2009, 2010, p. 7).

TABLE 1. RS enterprises structure by size in 2009

Enterprise	Number of enterprises	The share in total (%)
Micro (up to 9 employees)	12.049	84,14%
Small (10-49 employees)	1.805	12,60%
Medium (50-249 employees)	412	2,88%
Total number of SMEs	14.266	99,62%
Large (over 250 employees)	55	0,38%
TOTAL	14.321	100%

(Source: Tax Administration of RS)

In the period since 2004 the Republic of Srpska has done a lot of work on creating a legal framework to encourage the development of SMEs. Agency for Development of Small and Medium-Sized Enterprises and Investment-Development Bank of the Republic of Srpska were established, 16 local agencies for the development of SMEs and entrepreneurship were established, SME Development Strategy for the period 2006-2010 was adopted, and the new Strategy for the period 2011-2015 is being developed. Significant resources have been invested to encourage the development of SMEs from the Development Programme of the Republic of Srpska for the period 2007-2010, new legal initiatives have been started on the guillotine of regulations to eliminate unnecessary administrative procedures in business registration and obtaining various permits, the Guarantee Fund of the RS has been formed, a series of strategies<sup>4</sup> have been developed. All these are good preconditions for systematic and strategically defined economic development of the Republic of Srpska, where entrepreneurs and SME sector occupy a key position.

Agency for Development of Small and Medium-Sized Enterprises of the Republic of Srpska (hereinafter RARS, A/N) has created a descriptive comparative analysis of SME sector in the Republic of Srpska in 2010 in the form of report to the Government of the Republic of Srpska. The main disadvantage of the analysis itself which is highlighted in the report is the lack of the Republic of Srpska institutions for statistical monitoring of the data on SMEs and the lack of use of the European methodology by EUROSTAT. The data from multiple sources have been used, mostly data from the Fund for Pension and Disability Insurance of the Republic of Srpska (Fund PIO RS), Intermediary Agency for IT and Financial Services (APIF) and the Republic of Srpska Institute of Statistics, which were often in conflict with each other.

Unfortunately, official statistics data on the situation in the SME sector in 2010 and the first two quarters of the 2011 in the form of report of the RARS to the Republic of Srpska National Assembly (hereinafter RSNA) are not yet done and published.

However, in 2010, according to APIF data (Intermediary Agency for IT and Financial Services), 9,472 companies have submitted their required financial reports for the year 2009. Comparing this number with 14,321 companies registered in 2010, the question is what happened with 4,849 companies, the largest number of which were micro, small and medium-sized enterprises?

Have they ceased to do business or simply have not fulfilled their legal obligation? It is about reducing the number of companies that exist in the real sector by 33.44%.

Negative effects of the financial crisis and crisis of the real sector have inflicted a heavy blow to SME sector in the RS in 2010. If we looked at the pre-crisis period between 2006 and 2008, there was a noticeable upward trend in the number of SMEs until 2009, but in 2010 it became the downward trend.

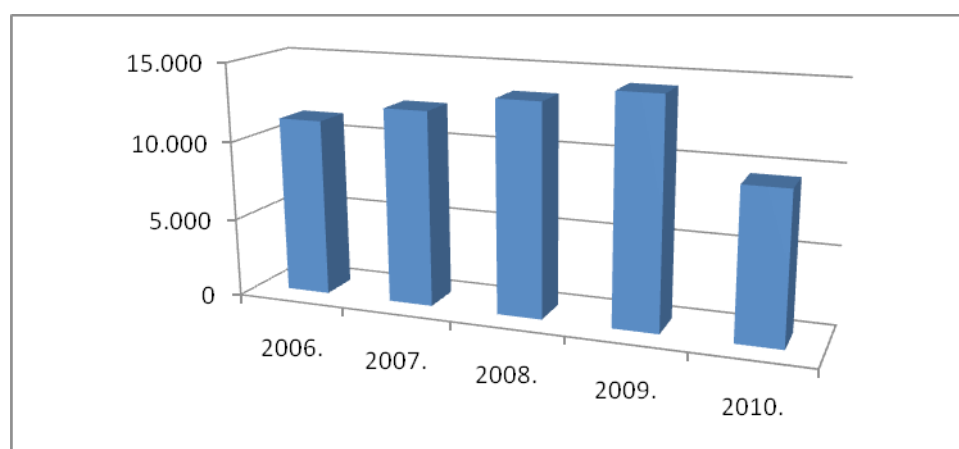
<sup>4</sup> Strategies of the Republic of Srpska (SME Development Strategy in the RS for the period 2006-2010; Action Plan for the Support to Establishing and Developing Business Zones in the RS 2009-2013; Program of Reconstruction of the Crafts and Entrepreneurial Chamber of the RS, 2009; Sector strategy of Industrial Development in the RS 2009-2013; RS Development Programme 2007-2010; Strategy of the RS Investment-Development Bank 2007-2013; Strategy for Encouraging and Developing Foreign Investments in the RS 2009-2012; Strategy for Encouraging RS Exports 2009-2012; RS Education Strategy; Strategy for Local Self-Government of the RS 2009-2015; RS Employment Strategy 2010-2014; Trade Development Strategy of the RS 2010-2015; Strategic Plan for the Rural Development of RS until 2015). **Strategies of Bosnia and Herzegovina** (SME Development Strategy in Bosnia and Herzegovina, 2009 – 2011; Strategic plan of Development of Local Self-Government in Bosnia and Herzegovina, 2006; BiH Development Strategy (draft); Employment Strategy BiH, 2010-2014 (draft).



TABLE 2. SMEs in RS in the period 2006-2010 (Sources: Pension Fund of RS, APIF)

Year	2006	2007	2008	2009	2010
Number of SMEs in RS	11,282	12,391	13,433	14,321	9,472

FIGURE 1. SMEs in RS in the period 2006-2010 (Sources: Pension Fund of RS, APIF)



The year 2009 saw a real decline in economic activity in the Republic of Srpska of 3.0%, in developed countries 3.2%, Euro zone 4.1%, Germany 4.7%, while the decline in gross domestic product in Serbia and Croatia amounted to 3.0% and 5.8% respectively (Economic Policy of the Republic of Srpska in 2011, p. 4). However, the year 2010 saw a slight increase in GDP. The RS government also helped the recovery with its economic policy measures. Of the funds placed on a credit basis, the development of enterprise and entrepreneurship in the RS is supported with 316 million KM, and the funds were used to finance the modernization, improvement and expansion of business activities and liquidity of the existing enterprises and for the establishment of new enterprises. At the same time, 65 million KM was placed in the development of domestic agricultural production. It is important to remember that these are the cheapest loans, with the repayment period of 20 years; interest rates are in the range from 4.0% to 6.0%, and with a grace period in specific credit lines up to 36 months (Ibid, p. 13).

In 2009, there were 99,430 workers employed in the SME sector in the Republic of Srpska.

TABLE 3. Enterprise structure by size in 2009

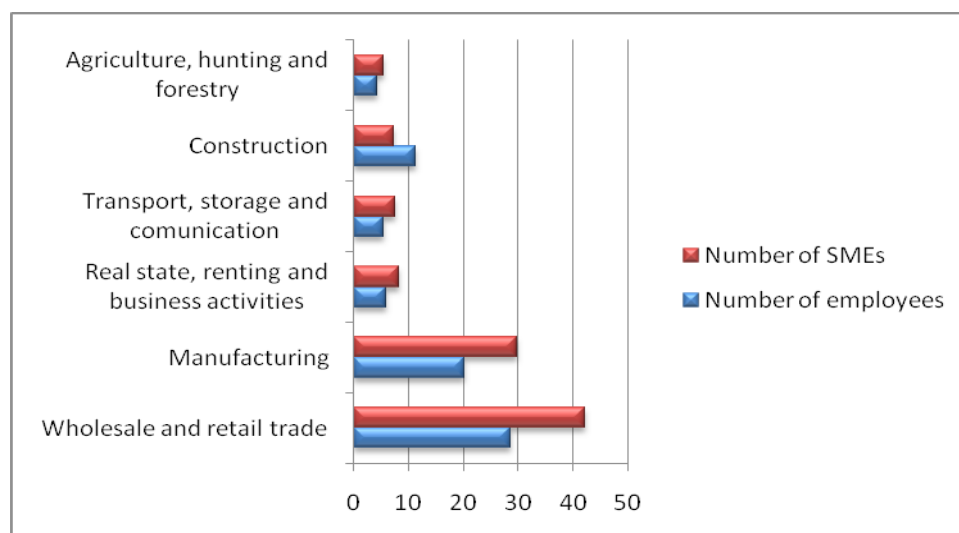
Enterprise	SMEs	Number of employed in SMEs	The employees share in SMEs (%)	Average number of employees per enterprise
Micro (up to 9 employees)	12,049	21,687	21.81	2
Small (10-49 employees)	1,805	36,413	36.62	20
Medium (50-249 employees)	412	41,330	41.57	100
Total number of SMEs	14,266	99,430	100.00	7

(Source: Tax Administration of RS)

Data on the economic structure shows a relatively unfavorable industry structure of the SME sector in the Republic of Srpska, in relation to the industry structure of the SME sector in the EU countries. This disadvantage is reflected in the majority participation of SMEs in three to four industries, with the dominant share of retail and wholesale industry, repair of motor vehicles and items for personal use, while in EU countries there is proportionate representation of SMEs in all industry sectors. The largest number of SMEs in the Republic of Srpska is concentrated in the sector of wholesale and retail trade, repair of motor vehicles and items for personal use – 6,018 companies, or 42.18%, manufacturing industry – 2,898 or 20.31%, real estate and renting – 1,168 or 8.19%, and transport, storage and communications – 1,091 or 7.65%. Large enterprises are mostly concentrated in the sectors of manufacturing industry and the production and supply with electricity, gas and water.



FIGURE 2. The structure of SMEs and employees in SMEs by sectors in %



(Source: Tax Administration of RS)

*Indicators of business performance of SMEs in the Republic of Srpska in 2009 are presented on the basis of data contained in the annual tax return for income taxes. According to data from the RS Tax Administration, the total income reported by companies that are the subject of observation in this Report, for 2009, by filing an annual tax declaration for income taxes amounted to 14,792,120,605 KM. Of this amount, 78.64% refers to SMEs and 21.36% to large enterprises. 75.28% of the total reported profit refers to SMEs, while 72.63% of the total tax paid on profits came from the SME sector (Ibid., p. 25).*

TABLE 4. Data from Annual tax returns for income tax

Enterprise	Total revenue	(%)	Profit/Loss	(%)	Income tax	(%)
Micro (up to 9 employees)	2,796,527,916	18.91	101,545,479	20.70	21,576,836	22.24
Small (10-49 employees)	4,056,738,054	27.42	196,146,132	39.98	26,240,968	27.05
Medium (50-249 employees)	4,779,303,045	32.31	71,652,509	14.60	22,641,839	23.34
Total number of SMEs	11,632,569,015	78.64	369,344,119	75.28	70,459,643	72.63
Large (over 250 employees)	3,159,551,590	21.36	121,294,208	24.72	26,548,488	27.37
TOTAL	14,792,120,605	100.00	490,638,328	100.00	97,008,131	100.00

(Source: Tax Administration of RS)

Detailed statistics on SMEs in the RS can be found in the document called Analysis of the situation in the field of SMEs for 2009, available on the RARS<sub>s</sub> web site.

### 3.LEGAL ASPECTS OF THE ENTREPRENEURIAL INFRASTRUCTURE IN THE REPUBLIC OF SRPSKA

For growth and development of enterprises in general, and particularly SMEs, in addition to the effects of the entire set of internal factors, such as vocational training of the owners, managers, employees, technology choices, shapes, looks, size, quality and other tangible characteristics of products, standardization of provided products and services and, of course, a sufficient level of demand for the offered products and services as one of the main external factors, it is essential that SMEs operate in an motivating environment from the aspect of business security and the development of institutions for the support to SMEs and the business sector in general. Problems of SMEs in the Republic of Srpska, and specifically in Banja Luka, have relatively recently come into the focus of the political and business community, especially in the last quarter of 2008 and the first two quarters

of 2009, when the first negative effects of the global financial crisis began to be felt in the real sector in the RS and BiH. Finally, in the Republic of Srpska, the awareness of the role and importance of small and medium-sized enterprises was raised to a higher level, so that there was an institutional arrangement of the legal framework for the operation of SMEs. Business operations of enterprises and entrepreneurs in the Republic of Srpska are defined by the Law on Business Companies and the Law on Craft and Entrepreneurial Activities. SMEs in the RS are defined under the Law on the Encouragement of the Development of SMEs.

Until then, SMEs were not treated individually, nor were the subject of a special interest in the legislature. Unfortunately, SMEs are treated differently both in the Republic of Srpska (for example, there are two laws that are contradictory because they define companies by size in a different way, and those are the Law on the Encouragement of the Development of the SMEs and the Accounting and Auditing Law) and in the Federation of BiH, and we are in a situation where on the level of the common state we do not have harmonized legislation that treats SMEs, nor this regulation is harmonized with the European legal practice. In the next table view, we shall see the basic similarities and differences between certain legislation in the Republic of Srpska, the Federation of BiH and the EU.

TABLE 5. SMEs definition in EU27, RS and FBiH.

	GDP per capita (in EUR)	Definition of SMEs
EU 27 average GDP per capita in 2007	EUR 24,900	For policy purposes, SMEs in the EU are defined as enterprises with fewer than 250 employees, provided that they are independent (of other enterprises) and do not have sales that exceed EUR 50 million or an annual balance sheet that exceeds EUR 43 million. For statistical purposes, structural business statistics (SBS) may be broken down by enterprise size class according to employment thresholds – to present information on: large (250 or more persons employed); medium-sized (50 to 249); small (10 to 49); and micro enterprises (less than 10). Micro, small and medium-sized enterprises are collectively referred to as SMEs.
Republic of Srpska average GDP per capita in 2010	EUR 2,963 (BiH)	Medium-sized enterprises are legal bodies with following features: - 50 to 249 employees per year; - do not have sales that exceed EUR 25 million or an annual balance sheet that exceeds EUR 21.5 million. Small enterprises are legal bodies with following features: - 10 to 49 employees per year; - do not have sales that exceed EUR 5 million or an annual balance sheet that exceeds EUR 5 million. Micro enterprises (less than 10). Micro, small and medium-sized enterprises are collectively referred to as SMEs.
Federation of Bosnia and Herzegovina		Medium-sized enterprises are legal bodies with following features: - up to 250 employees per year; - do not have sales that exceed EUR 20 million or an annual balance sheet that exceeds EUR 15 million. Small enterprises are legal bodies with following features: - up to 50 employees per year; - do not have sales that exceed EUR 2 million or an annual balance sheet that exceeds EUR 2 million. Micro enterprises are legal bodies with following features: up to 50 employees per year; - do not have sales that exceed EUR 0.1 million or an annual balance sheet that exceeds EUR 0.1 million.

(Source: The Republic of Srpska Investment-Development Bank (IRBRS), Eurostat)

Legislation in the Republic of Srpska and Bosnia and Herzegovina that defines SMEs must be harmonized with European legislation. According to the European Commission Recommendation of 6 May 2003 (2003/361/EC), SME is any entity, regardless of legal form, which is involved in economic activity, including in particular those involved in craft activities, and other activities of

the independent or family basis, partnerships or associations that have regular economic activities. The recommendation is published in the EU Official Journal L 124, page 36 of 20 May 2003 and represents the only authentic basis for determining qualification requirements of SMEs.

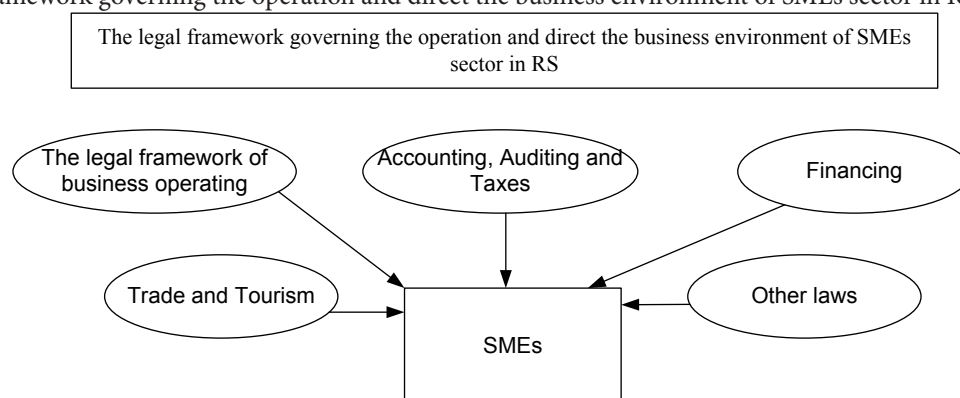
*Bosnia and Herzegovina needs better laws and regulations and another problem is the lack of Analysis of the Impact of Regulations and lack of state Strategy and the Agency for SMEs. Agency for SMEs has been established in almost every country of the Western Balkans except Bosnia and Herzegovina (SME Development Strategy in BiH 2009-2011, 2009, p. 25).*

The situation in RS is different than in the FBiH and BiH in general, i.e. it is considerably better in terms of institutional arrangement to support the development of the SME sector, but is far from ideal. *Developing entrepreneurial infrastructure is somewhat slower in the Republic of Srpska and Bosnia and Herzegovina with respect to the financial opportunities for the incentives, situation in the business environment, legislative framework and other factors. We should also say that there is insufficient sensitivity in the society and the business environment for the development of entrepreneurial infrastructure. Currently in the Republic of Srpska there are 5 business incubators, in Banja Luka, Prijedor, Trebinje, Samac and Modrica (Analysis of the situation in the field of SMEs for 2009, 2010, p. 9).*

Legislation in the Republic of Srpska and BiH as a whole, in its basis and from the point of application is a complex area. Although a significant number of laws have been adopted until now, they are poorly implemented in practice at various levels, especially where they should apply for the benefit of business enterprises. On the other hand, implementation of new legislation represents a strong cost burden for small business enterprises, as if they were large enterprises. Serious analysis of the impact of regulations is done in the Strategy for the development of SMEs and entrepreneurship in the City of Banja Luka, whose coauthor is the author of this work, but only analysis of those laws that hinder the business operations of potential and existing SMEs on the local level. There are many legal obstacles to the development of SMEs, which not only slow down the development of the City as a local community, but also indirectly reflect on the development of SMEs in its territory. Without wishing to analyze the impact of each individual legal solution in the Republic of Srpska, we will give a unique overview of legislation that currently shapes the business environment of SMEs in the Republic of Srpska and Banja Luka, defines the legal basis for the work and activities of enterprises and institutions for the support to SME sector. Legislation that affects or could affect the work and performance of SMEs in the Republic of Srpska is divided into:

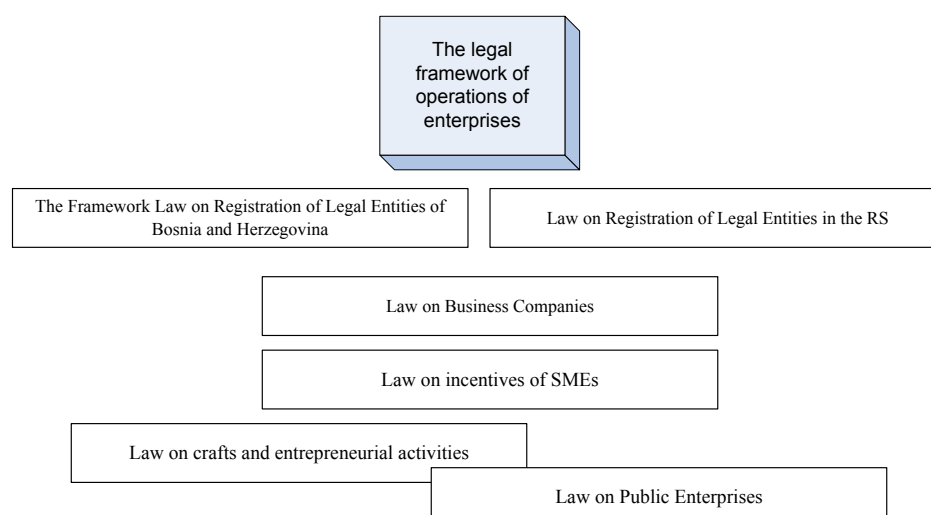
- Legislation that defines the general framework of business enterprises at the Entity and State level, and
- Legislation that indirectly regulates the development of SME sector at the local level.

### 3. The legal framework governing the operation and direct the business environment of SMEs sector in RS and BiH



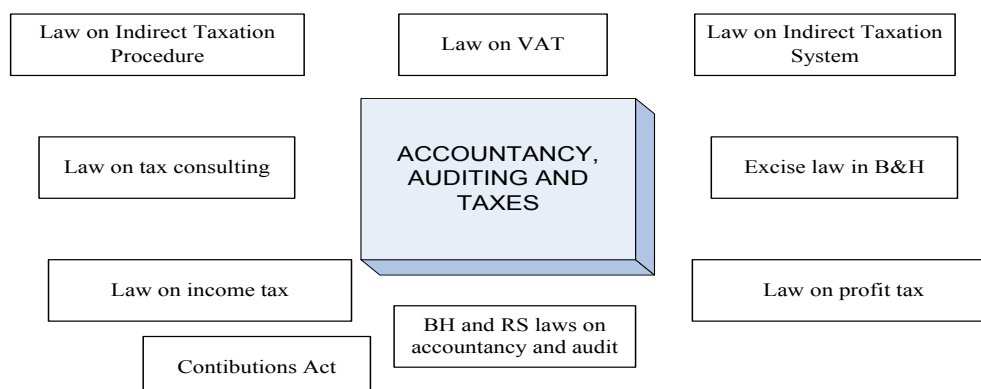
At the level of the Republic of Srpska and Bosnia and Herzegovina, the following schematic presents the laws that define the general legal framework for the establishment and operation of enterprises, tax liabilities, finance, trade, tourism, and institutions for the support to the development of SME sector.

FIGURE 4. The laws governing the registration and legal framework of SME sector in RS and BiH



According to the Law on Registration of Legal Entities in the Republic of Srpska, the procedure of registration in the Register of Companies is defined in accordance with the Framework Law on Registration of Legal Entities of Bosnia and Herzegovina. Unfortunately, this law is still not fully implemented, nor the Register has been established. The Law on Business Companies came into force on 01 January 2010, replacing the Law on Enterprises, and it is expected from this law to facilitate the establishment of enterprises and provide greater protection for small shareholders. The maximum number of members for limited liability companies increased from 30 to 50, for closed joint stock companies to 100, while those with more than 100 members must operate as open joint stock companies.

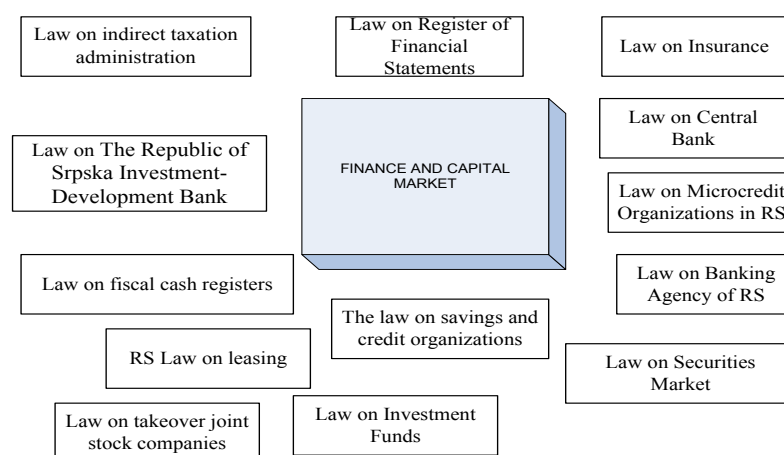
FIGURE 5. The laws governing tax liability, accounting and auditing in enterprises in RS and B&amp;H



Indirect taxes are the responsibility of BiH, while direct taxes are the responsibility of entities. Without wishing to comment on the tax system and the Accounting and Auditing Law in the Republic of Srpska, Figure 9 presents the main laws that regulate this very important area for business growth and development of the SME sector. In BiH, and therefore in the Republic of Srpska, all companies that generate annual revenue of 50,000 BAM or more annually, are VAT tax payers and pay the single tax rate of 17%, and in the Republic of Srpska income tax is payable in the amount of 10%.

From the aspect of financing the SME sector and banking and micro-credit institutions, the laws in force are those on the level of BiH and the Republic of Srpska, regulating this highly sensitive area necessary for normal functioning and development of SME sector and the economy in general. In fact, in many studies conducted in the world and in our country, entrepreneurs reported that the complicated and expensive procedures to obtain the loan, as well as the price of borrowed capital, especially for start up businesses, represents one of the main obstacles to growth and development of enterprises. Figure 6 presents laws governing the financing of SMEs and finance in general.

FIGURE 6. The laws governing SMEs financing in RS and BiH



Legal barriers affecting the development of SMEs indirectly from the local level can be grouped into the following groups (Strategy for the development of SMEs and entrepreneurship in the City of Banja Luka, 2010-2015, 2010, p. 99-101):

- legal barriers arising from the legislation that regulates the field of local government
- legal barriers arising from the legislation that regulates the field of construction land, spatial planning and agricultural land
- legal barriers arising from the legislation that regulates the field of utilities, the Law on Communal Activities
- legal barriers arising from the legislation that regulates the field of concessions and fees for the use of natural resources
- legal barriers arising from the legislation that regulates the division of assets, legislation on transfer of rights of property of the local government and the legislation that regulates the field of privatization of buildings, offices and garages.

Legislation in the Republic of Srpska and BiH still needs to be harmonized with the European Charter for Small Enterprises and the European practice, taking into account that when creating legal regulations that directly, but also indirectly influence the entrepreneurial environment it is based on the principle of “Think Small First”.

#### 4. INSTITUTIONAL INFRASTRUCTURE FOR THE DEVELOPMENT OF SMALL AND MEDIUM-SIZED ENTERPRISES AND ENTREPRENEURSHIP IN THE REPUBLIC OF SRPSKA

In the previous section, we presented the main laws that regulate the operations of the business sector in the Republic of Srpska and BiH. The necessary condition for the generation and establishment of policies in the field of SME development, and then for its implementation, is adequate institutional infrastructure.

*The institutional framework appropriate for the entrepreneurship consists of “fundamental political, social and legal-based rules that reinforce the basis for production, exchange and distribution. The existing institutional framework for the support to the SME sector is very complex, with numerous institutions that operate at the state level and at the City level (Strategy for the development of SMEs and entrepreneurship in the City of Banja Luka, 2010-2015, 2010, p. 91).*

Seen from the aspect of SME development in Banja Luka and RS, the institutional framework for developing and supporting the SME sector is still weak and underdeveloped in comparison with the positive international practices, as well as the institutional framework developed by other countries of Southeast Europe. However, many institutions for direct and indirect support to entrepreneurship and SME sector are established.

According to current institutional organigrams, at the level of RS, the development of entrepreneurship and SME sector is affected by the following institutions:

- Committee for Economy and Finance of the RSNA
- Ministry of Economy, Energy and Development through the work of the Department for SME



## Development

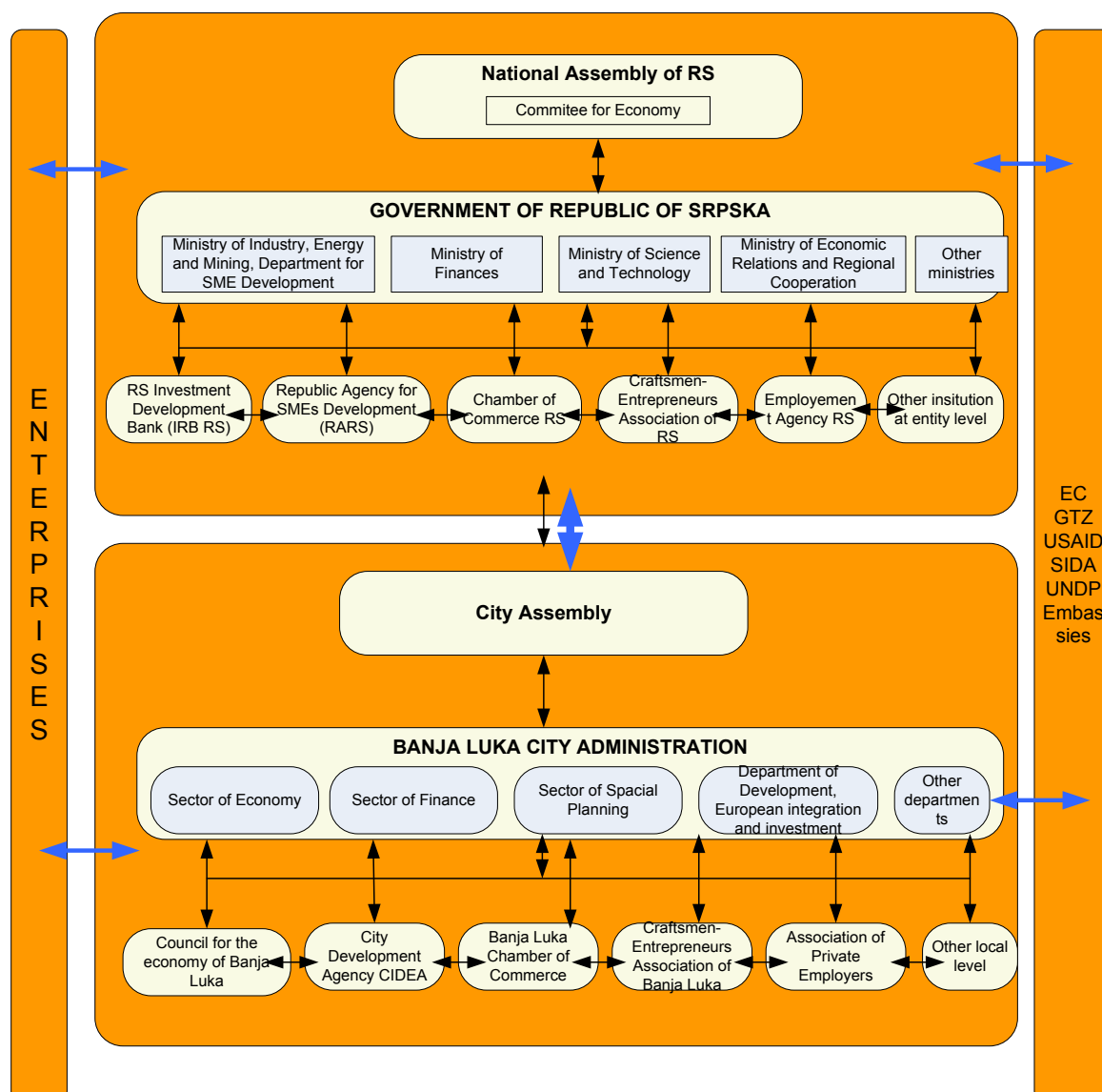
- RARS
- Investment-Development Bank of the RS through the RS Development and Employment Fund
- RS Employment Bureau
- RS Chamber of Commerce
- Craftsmen-Entrepreneurs Chamber of RS

At the level of local communities, taking the City of Banja Luka as an example, it is the following institutions:

- Council for the Economic Development
- Sector of Economy of the City of Banja Luka
- City Development Agency Banja Luka (CIDEA)
- Regional Chamber of Commerce Banja Luka
- Craftsmen-Entrepreneurs Chamber of the Banja Luka Region
- Association of Private Employers Banja Luka.

Total institutional organigram for SME support of the City is shown in Figure 7

FIGURE 7. The organizational structure of institutions for SME support in Banja Luka



For the further development of the SME sector and entrepreneurship, we lack the key institutions, which neighboring countries have, especially Croatia and Serbia, and these are the ministries that are primarily and not incidentally engaged in entrepreneurship and SME sector. In Serbia, it is the Ministry of Economy and Regional Development and in Croatia it is the Ministry of Economy, Labor and Entrepreneurship. In the Republic of Srpska we have a Department for SMEs at the Ministry of Economy, Energy and Development, as well as the Ministry of Economic Affairs and Coordination. Unfortunately, we have no ministry that would be solely concerned with the creation of policies, strategies and measures for the development of entrepreneurship and SME sector. For the purpose of rounding up “cycle” of institutional support for SME development, it would be desirable, in addition to the Guarantee Fund of the RS, which was formed in October 2010 with the equity of 15 million €, to work on the formation of credit and guarantee funds, business incubators and technology parks at the level of local communities, and create a Career Center, which would primarily provide the services of training, additional training, and retraining.

In Banja Luka, in terms of policy and program development of the SME sector a lot has been done. City Development Strategy for the period 2007-2015, Strategy for the Development of SMEs and Entrepreneurship for the period 2010-2015 as well as the Rural Development Strategy of the City has been adopted. The results of this strategic action are already visible. In the Strategy for the Development of SMEs and Entrepreneurship in Banja Luka 2010-2015 it is stated (ibid, p. 153):

Through incentive policies and programs, in the next five year period we aim to increase the number of newly registered and active micro, small and medium-sized enterprises above the EU average in 2006 (40 enterprises per 1,000 inhabitants), and it is from the current 47.3 to 56.76 of SMEs per thousand people (an increase of 20%), change the qualitative structure of the economy in favor of the traditional manufacturing businesses, the resource-based industries and businesses in the area of information-communication technologies, pharmaceutical industry, electro-mechanical industry, and increase the number of employees in the private sector by 30%.

Objectives are measurable and, we believe, with such a systematic approach – achievable. In order for goals to be met, it is necessary to further develop the institutions of support to the entrepreneurship in the RS and BiH, but also to adapt the legislation to the needs of smaller players in the market and harmonize it with the positive legal regulations of the European Union.

## **5. ANALYSIS OF PROGRAMS, POLICIES AND STRATEGIES FOR SUPPORT TO SMALL AND MEDIUM-SIZED ENTERPRISES IN THE REPUBLIC OF SRPSKA AND BOSNIA AND HERZEGOVINA**

There are common institutions and legal frameworks that are adopted at the level of Bosnia and Herzegovina, which are binding for the entities and Brcko District. The authors of the Strategy for SMEs in BiH 2009-2011 (2009) believe that Bosnia and Herzegovina needs better laws and regulations, and another problem is the lack of analysis of the impact of regulations and lack of the state Strategy and the Agency for SMEs. Agency for SMEs has been established in almost every country of the Western Balkans except Bosnia and Herzegovina. Agency for Development of Small and Medium-Sized Enterprises of the Republic of Srpska was established and commenced its operations in September 2004. In FBiH and Brcko District, there is no similar umbrella agency. In the Republic of Srpska the current strategy of SMEs development is still the one for the period 2006-2010, and many cities, like Banja Luka, Trebinje, Prijedor, and Mrkonjic Grad have adopted their own development strategies and strategies for the development of entrepreneurship and SMEs.

The Report on the fulfillment of the Charter for SMEs in the Western Balkans emphasized that before any further progress, an agreement between the governments on the Strategy for SMEs in BiH must be made at all levels (2007). The structure of Bosnia and Herzegovina is very complex and complicated. It consists of four levels of government (state level, entities and the District, cantons and municipalities), and at every level there are fairly autonomous legal-institutional arrangements that influence the creation of entrepreneurial environment and economic milieu in general. A key factor for growth and development of entrepreneurial activity is certainly entrepreneurial environment (BiH GEM National Report, 2008). The obstacles faced by entrepreneurs can largely hinder the growth of existing and creation of new businesses.

In June of 2008, the author of this paper facilitated a panel discussion on the main obstacles to growth and development of SMEs in the Republic of Srpska with 26 representatives of SME sector, RS Chamber of Commerce, Ministry of Finance, Ministry of Economy, Energy and Development of the RS, the Banja Luka Stock Exchange, the Agency for SMEs of the RS, City Development Agency,

ARDA, EU TAC, IRBRS, etc.

In the time before the global financial crisis, when the level of demand for products and services was considerably higher than in 2011, the main obstacles to growth and development of SMEs in the Republic of Srpska that were identified by the participants of the panel discussion were the following:

- The long, costly and complicated procedures of business registration.
  - Unfavorable financing conditions for start up and existing SMEs.
- 2.1. Lack of private and state seed capital institutions for the support to the establishment of start up companies.
    - 2.2. High interest rates for working capital and fixed assets as well as the high indebtedness of SMEs.
    - 1.3. Problems in the collection of current receivables.
    - 1.4. Complicated procedures for the implementation of the loan.
    - 1.5. The absence of the guarantee fund.
  3. Inadequate education system.
    - 3.1. The mismatch of the education system with the Lisbon Charter.
    - 3.2. Admissions policy in secondary and higher education is not aligned with the needs of labor market.
    - 3.3. Underdeveloped sector of informal education and training.
    - 3.4. The lack of basic managerial and technical knowledge and skills of entrepreneurs and managers.
  4. Lack of awareness and financial conditions of entrepreneurs about the necessity of introducing quality systems in manufacturing and service processes.
  5. Insufficient use of information technology in SMEs.
  6. Non-incentive fiscal policy (heavy burdens of taxes and excise duties for SMEs).
  7. Lack of awareness of consumers about the quality of domestic brands and insufficient investment in building national brands.
  8. Insufficient and non-adequate protection of domestic producers from substandard goods from abroad as well as goods with dumping prices.
  9. Equating the business conditions for foreign and domestic investors.

Further, the State Strategy (2009) argues that the unfavorable tax policy and finance are not coordinated between entities. It is also necessary to improve the banking policy of high interest rates and unfavorable requests for guarantees.

*In the European Union, SMEs face obstacles when participating in public procurement markets, which constitute 16% of EU GDP, often for the simple reason, because small firms are not familiar with the possibilities that exist and/or are discouraged by the procedures and because the government prefers to entrust some of the contracts to larger companies with experience, rather than to young innovative companies. Nevertheless, 42% of the value of public procurement across the EU limit was assigned to SMEs in 2005. However, additional significant efforts are necessary to reduce the remaining obstacles for SMEs to access the procurement market, especially by mitigation of requirements, which contractors put in tenders (Small Business Act for Europe, 2008, p. 10).*

Public procurement in the Republic of Srpska could certainly be an excellent source of financing for business projects for SME sector. In terms of facilitating access to sources of finance for daily operations and growth and business development, creation of credit and guarantee funds will contribute to facilitating access to loans, especially to start up enterprises. We believe that the effect of guarantee funds at the level of the Republic of Srpska and local guarantee funds will not only facilitate access to

loans, but will also influence the reduction of cost of capital, which will have direct consequences on the development of SME sector.

In the literature, the available research in the EU and the region (BiH National GEM Report, 2008; Unlocking Business Potential, especially of SMEs, 2009), we note that the lack of highly trained personnel is the main obstacle to growth and development of SMEs. The situation is identical in BiH and in the Republic of Srpska. Although we can often hear the opinions of the public that the educational system of the former Yugoslavia produced a highly skilled and trained personnel, in addition to being cheaper than most employees in Europe, their training and knowledge are often not practically applicable.

Education, training and retraining are important prerequisites for the development of human resources for the development needs of the SME sector. Although BiH has no legal obstacles to export its products to EU countries, non-tariff and other “invisible” barriers disrupt the work of companies in BiH and the Republic of Srpska. Even cooperation with neighboring countries, members of CEFTA<sub>6</sub>, is not great, because they often do not recognize national certificates of quality standards or laboratory findings of the technical conditions and safety of products. Therefore, at the level of the Republic of Srpska, it is necessary to systematically address the issue of training, additional retraining and retraining of the workforce by opening the RS Career Centre, and implement the reform of the formal educational system from basic education to higher education by introducing entrepreneurial education in accordance with the recommendations of the Lisbon strategy. However, some developments in BiH, namely in the RS, were made, which was recognized by the European Commission in its report on implementing the European Charter for Small Enterprises 2008. Regarding education the Report notes that the attention is given to entrepreneurial knowledge by introducing the subject Entrepreneurship in the curricula of 75% of secondary schools in the Republic of Srpska. Specialized training for entrepreneurs and SMEs which export their products in CEFTA countries and EU, and Internet access to information about all directives and requirements, would certainly make it easier for our entrepreneurs in effort to improve the quality of their products and services and thus general economic competitiveness of the Republic of Srpska.

If we analyze the laws in the field of direct and indirect taxes, we can notice that in the Republic of Srpska start up enterprises, and SMEs in general, have no privileges in paying taxes. The system of indirect taxes is embodied in a single VAT rate of 17% which burdens proportionally all businesses, regardless of size, strength, industry, or life cycle of the company.

Policy of direct taxes is not harmonized at the level of Bosnia and Herzegovina. Law on Value Added Tax with a single rate of 17% was adopted in 2004 and currently in force. The Indirect Taxation Authority at the state level is responsible for collecting VAT, all indirect taxes and payments in connection with the international trade. In BiH, the corporate income tax is 10%.

Other tax liabilities, which are currently defined in the entities have different tax rates (e.g. income tax, property tax), which is a problem. If the company headquarters is in Brcko District and the same company has a business unit in entities, corporate income tax for a business unit is paid in the entity where the business unit is registered, and for the part of profit made in the Brcko District the tax is paid in the District. The same applies to the situation where the company headquarters is in one of the entities, and a business unit is in the Brcko District. Finally, one can consider the implementation of various tax incentives to support local SMEs, particularly those who invest in demanding sectors.

Entrepreneurship climate in Bosnia and Herzegovina was rated lower than in many other countries. Ratings given by experts from all areas of entrepreneurial activity have characteristics typical of countries with a low index of entrepreneurial activity.

*Inadequate funding support, low interest of the most responsible government institutions to build a favorable environment for entrepreneurship development, inconsistent support programs to entrepreneurship by all levels of government, lack of representation, or lack of non-institutional forms of education in the field of entrepreneurship, the inadequate representation of entrepreneurship in formal education, low investment in research and development, fragmented and insufficient professional infrastructure for providing consultancy and other intellectual services, market tightness, insufficient physical infrastructure for the development of entrepreneurship, and the lack of entrepreneurial culture are some of characteristics of entrepreneurial activity in Bosnia and Herzegovina in 2008. (GEM BiH 2008, p. 12).*

Development Strategy of the Republic of Srpska 2010-2015 is at an early stage of development. At



the level of BiH the strategy of small and medium-sized enterprises in Bosnia and Herzegovina 2009-2011 was adopted. Development Strategy for SMEs in the RS expires this year and it is expected that the new strategy for the next five year period will be developed. Agency for Development of SMEs in the RS, city development agencies in Banja Luka, Prijedor, Trebinje, Doboj and other smaller towns of the Republic of Srpska, adopted development strategies, as well as strategies for the development of entrepreneurship and SMEs in a number of towns in the Republic of Srpska confirm the strategic commitment of the Republic of Srpska for further institutional building of entrepreneurial environment and connecting to the European tendencies of development of the SME sector. Instead of a conclusion that confirms this claim, we will state the following information: *“Investment-Development Bank of the Republic of Srpska in 2009 placed 181.17 million KM (92.63 million €) for 626 companies. Of the total amount of loans 91.11% were loans to SMEs.”* (Analysis of the situation in the field of SMEs for 2009, 2010, p. 8).

As for BiH in general, its competitive position in 2010 at the regional and global level has worsened. According to the data from the Report “Doing Business 2010”, it is clear that Bosnia and Herzegovina is ranked worst in the area of starting business considering the time required (4.6 times higher than the OECD economies and the neighboring countries), cost (3 times the cost of compared OECD countries and 90% more than the neighboring countries), and the number of procedures and minimum capital (Doing Business 2010, 2010). Comparative presentation of BiH and the Western Balkan countries is presented in Table 6.

TABLE 6. Comparative review of BiH and neighboring countries on the ease of doing business in accordance with Report of the World Bank’s Doing Business 2010

	FYR Macedo- nia	Slovenia	Montenegro	Serbia	Croatia	BiH
Ease of Doing Business	32	53	71	88	103	116
Starting a Business	6	26	85	73	101	160
Dealing with Construction Permits	138	59	160	174	144	136
Employing workers	58	162	46	94	163	111
Registering Property	63	108	131	105	109	139
Getting Credit	43	87	43	4	61	61
Protecting Investors	20	20	27	73	132	93
Paying Taxes	26	84	47	69	96	63
Trading Accross Borders	62	84	47	69	96	63
Enforcing Contracts	64	60	133	97	45	124
Closing a business (enterprise)	115	40	44	102	82	63

(Source: [www.doingbusiness.org](http://www.doingbusiness.org))

If we look at the situation in 2011, out of 183 countries covered in the World Bank’s report Doing Business 2011, BiH holds 110 place, which represents a slight improvement compared with 2010 (Doing Business 2011).

## 6. METHOD, SAMPLE, INSTRUMENTS AND RESEARCH RESULTS

Between November 2009 and January 2010, two-stage research was conducted for the purpose of drafting a strategy of small and medium-sized enterprises and entrepreneurship in the city of Banja Luka 2010-2015. The goal of this research was determining influential, stimulating and limiting factors, their direction and intensity on the efficient and effective operations of micro, small and medium-sized enterprises in the City of Banja Luka. City Development Agency with a team of experts in the field of entrepreneurship and small business from the Association of Economists “SWOT” was working on drafting the Strategy for the development of small and medium-sized enterprises and entrepreneurship in the City of Banja Luka, 2010-2015.

The research was conducted using the questionnaire with questions that were designed in a way that they reviewed facts and opinions, and the research had characteristics of both quantitative and qualitative research. The questionnaire consisted of a total of 32 questions, and those were closed questions, questions with several possible answers, questions in the form of answers on the Likert scales, with a descriptive assessment of the attitudes of respondents, and several open questions.



The general goal of this research was to enable the authors of the project of drafting the Strategy, whose project team leader was the author of this paper, on the basis of analyzed influential factors, to define the strategic goals of strategic determination of the City to build a supportive entrepreneurial environment in the next five years, as well as the proposal of specific measures of financial and non-financial support to SMEs in Banja Luka. The research was conducted in two stages.

The first stage was so-called pretesting of the questionnaire stage where, using a method of purposely selected sample of SMEs in the sample of 10 companies, we tested the clarity of the questionnaire and the quality of received responses. Of the original 47 questions, after the test stage, the questionnaire was reduced to 32 questions, and in November 2009 the implementation of the research began. The process of data collection was done by a team of the RS Association of Economists "SWOT" solely by electronic means, using their own database of business enterprises in the territory of the City of Banja Luka, using a method of random sample. During the period from 10 November 2009 to 15 January 2010 collection of the questionnaires was conducted directly by sending the questionnaires electronically using a method of random sample, with the degree of response of 24.85%. The sample included 87 companies from Banja Luka. Questionnaires were sent to about 350 addresses. Interviewers managed to collect 87 questionnaires by double sending questionnaires to the same addresses, with the aim of reminding the respondents. Generally, interest of our businessmen for any type of research is really at a very low level, which certainly makes the job of the academic community more difficult.

In this way, representation is provided, and a sample of 87 SMEs (N=87) compared to the statistical weight is 3.75% (if we take into account the fact that according to the APIF Report, in 2009, only 2,320 enterprises from Banja Luka submitted their financial statements). In the sample, 32% of enterprises are "older" than 15 years, 29% were from 10-15 years of age, and only 2% were established in 2009. From the standpoint of the industry structure, the dominant enterprises in the sample were the ones in the field of retail and wholesale, followed by manufacturing, construction and other industries. Economic structure of the city of Banja Luka, corresponds more to the economic structure of EU average, which is a good indicator of growth and development of the SME sector. Number of SMEs per 1,000 inhabitants in non-financial business sector of the Republic of Srpska in 2008 amounted to 26.1 SMEs per 1,000 inhabitants,<sup>7</sup> in the region of Banja Luka 30.45 SMEs per 1,000 inhabitants (Analysis of the situation in the field of SMEs for 2008, 2009), and in the City of Banja Luka 47.3 SMEs per 1,000 inhabitants, where the European average of 40 SMEs per 1,000 inhabitants was surpassed. The leading EU countries by number of registered SMEs are Czech Republic (83.4 SMEs per 1,000 inhabitants), followed by Portugal (81.43 SMEs per 1,000 inhabitants), Greece (74.46 SMEs per 1,000 inhabitants), Italy (65.43 SMEs per 1,000 inhabitants) and Spain (60.07 SMEs per 1,000 inhabitants) (Strategy for the Development of SMEs in Banja Luka, 2010-2015, 2010).

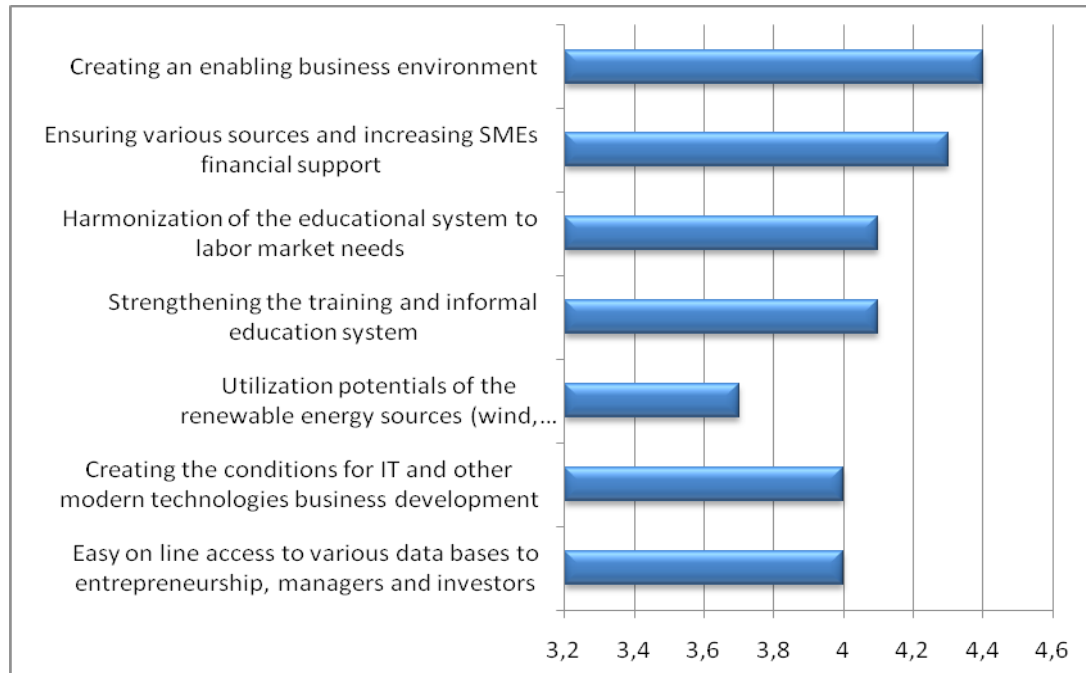
Given the goal of this research, more attention has been devoted to examining the attitudes of entrepreneurs and managers, rather than on finding cause-effect relationships between the factors of business and total income, and total net profit of the surveyed companies.

Let us return to the goal of this research, which was determining influential, stimulating and limiting factors, their direction and intensity on the efficient and effective operations of micro, small and medium-sized enterprises (SMEs) in the City of Banja Luka. What else have we discovered?

To the question: *In your opinion what should be the priority directions in the strategic plan of the development of SMEs in Banja Luka? On the scale from 1 to 5, where 5 marks priority and 1 irrelevant, we got the following responses:*

<sup>7</sup> The number of enterprises per 1,000 inhabitants was calculated according to the European Commission Recommendation of 6 May 2003 (2003/361/EC)

FIGURE 8. Attitudes of entrepreneurs from Banja Luka on the priority directions of the development of SMEs in Banja Luka



Entrepreneurs would primarily like to create a business environment favorable for economic growth and development (weight 4.4), then ensuring and increasing financial support to SMEs (weight 4.3), harmonization of the educational system to labor market needs and strengthening the training and informal education system (both with weights 4.1).

What is significant is the fact that the need for support, both financial and non-financial is evident, and particularly interesting is the interest of entrepreneurs and managers to harmonize the educational system to the needs of enterprises and strengthening the training and informal education system.

A key part of the research that will partly answer the research problem is related to the research question about obstacles to the development of SMEs. Frequency of the response is summarized in Table 7.

TABLE 7. Limiting factors of SMEs development in Banja Luka

What limits developmental activity in your enterprise? (1 – unimportant, 5 – priority)		
	Responded	Average
The high rate of VAT	67	3.0896
Problems of claims collection	79	4.0759
High rates of taxes and contribution for salaries	74	3.7297
Administrative burdens and complexity of procedures	73	3.6986
The instability and lack of clarity of legislation	70	3.8571
High interest rates of loans	78	4.0513
The costs of energy sources	70	3.5429
Raw materials costs	63	3.2857
Availability of financing sources	70	3.6571
Loss of markets in former Yugoslavia	61	2.6885
Unfair competition	70	3.6857
Foreign competition	63	2.8571
Domestic competition	63	2.8254
Outdated technology	61	2.5246
The quality of products	60	2.9333
Price	63	3.0952
Labor costs	59	3.0000
Outdated products	56	2.9107
Lack of funds for research and development	60	3.2833
Valid N (listwise)	51	

The first problems by priority, with an average score 4.07 and 4.05 were problems of claims collection and high interest rates of loans. These two problems, the problem of claims collection and the problem of reaching the necessary external funds is very important factor that strongly affects the liquidity and solvency of the SMEs in Banja Luka and the Republic of Srpska. Besides the negative effects of the global financial crisis which is evident from the beginning of 2009, inefficient and very expensive judiciary contributed significantly to the first problem. Through the introduction of mediation and the establishment of commercial courts in the Republic of Srpska (the first commercial courts began operating in May 2010) this problem should be less frequent. Further, the instability and lack of clarity of legislation as a very big obstacle for further development of SMEs were assessed with the weight of 3.85. If we compare results across certain studies (Petkovic, 2010) and these factors, enterprises do not practice planning (strategic, operational, financial, marketing) in their business operations, so that the uncertainty continues to increase disorientation of the owners and managers of SMEs. Knowledge to work in conditions of crisis and uncertainty in addition to the natural resourcefulness and intuition must be based on the use of certain forms of strategic management, which is not applied in our country. High rates of taxes and contributions for salaries (3.72), the administrative burdens and complexity of procedures (3.69) and unfair competition (3.68) are highly ranked barriers to further business development. We would also like to emphasize that the weight of 3.65 evaluated the availability of financing sources as a big problem for SME development in the Republic of Srpska. Finally, with the weight of 3.2 as the limiting factors were assessed the lack of funds for the research and development activities. Thus, the entrepreneurs themselves have noted what they need to improve the competitive position, and which are now the limiting factors in the Republic of Srpska, comparing them with SMEs from the EU. All the factors are external in character. Factors of the external support and internal character, i.e. “inside” the company, according to the respondents, which may affect the further growth and development of SMEs were ranked as follows, as in Table 8.

TABLE 8. Factors of increased competitiveness of SMEs

What needs to be improved in your enterprise in order to be more competitive on the market? (1 – unimportant, 5 – priority)		
	Responded	Average
To improve quality of product/services	70	3.3857
To improve promotion activities	80	3.6250
Get the necessary certificates of the quality	66	2.8788
Professional consultancy assistance in the areas of business and production, e.g. training on specific machine and similar	62	2.6613
Training and education in entrepreneurship	67	3.4925
Training and education in IT	62	3.0484
Training and education in management	69	3.6957
Training and education in project management	64	3.1562
Training and education in finance	65	3.1846
Training and education in sales	70	3.7571
Training and education in marketing	67	3.5970
Training and education in foreign languages	66	3.1970
Associating with companies from my area in order of common market participation	68	3.1912
Assistance from development programmes through grants	78	4.3077
Assistance from development programmes through favorable loans	75	4.3200
Assistance from development programmes through guarantee funds	71	4.2113
Valid N (listwise)	1	

Entrepreneurs expect assistance from development programs by using favorable loans (4.32), grants (4.30) and guarantee funds (4.21). Thus, there are high expectations in terms of support from government representatives. Few entrepreneurs talked about the need to improve the quality of their products/services (3.38), the need to introduce quality systems (2.87), or the need for professional consultancy assistance (2.66). Therefore, factors of the internal character were rated relatively low. The question for further research is whether the private companies in transition countries should unrealistically expect the full external help and support from the state for their own development or should they turn to themselves, i.e. to the development of market wanted quality products, innovativity of products or processes, transfer of knowledge, branding, meeting the needs of customers. With respect to the education needs, the greatest need for additional education the entrepreneurs see in the field of sales (3.8), management (3.7) and marketing and promotion activities (3.6).

Absence of statistical significance between the certain variables indirectly confirms the research hypothesis. SMEs do not have an effective system of institutional support to entrepreneurship and SMEs, in the opinion of most respondents:

- Entrepreneurs in Banja Luka do not have available high-quality external resources of financial and non-financial support;
- They are not associated with universities so we cannot talk about the transfer of knowledge and new technologies;
- Most enterprises are not interested in participating in the clusters;
- Entrepreneurs expect assistance from development programs by using favorable loans, grants and guarantee funds.
- Although some entrepreneurs talk about the need to improve the quality of their products/services, the need for the introduction of quality systems and the need for professional consultancy assistance, it is evident the need for education and training in the field of quality and management of SMEs.

Based on analysis of existing legislation, strategies, policies and programs of the support to the development of SMEs and entrepreneurship in the Republic of Srpska, and on an the analysis of the conclusions of the panel discussion on the focus group held in June 2008 and the results of the quantitative research conducted in 2010, we believe that the existing model of institutional support to SMEs in the Republic of Srpska is not adequate, and that the Model of Structural Support to SMEs and Entrepreneurship in the Republic of Srpska, on the example by the cities of the City of Banja Luka, which we suggest can answer to the needs of growth and development of SME sector and changes in qualitative economic structures in Banja Luka and the Republic of Srpska.

In the proposed *Model of Structural Support to SMEs and Entrepreneurship in the Republic of Srpska*, we propose the reconstruction of ministries in the Government of the Republic of Srpska in accordance with the Constitution of the Republic of Srpska and BiH, taking into account the complexity of the country and political complexity, and territorial compatibility of the Republic of Srpska, geographic area, population, number of regions and relatively simple political arrangement with two levels of government: local and entity. The proposed model of restructuring of ministries was created by the analysis of the model of ministries in Slovenia, Croatia, Serbia and the Czech Republic, where the exceptional institutional attention was given to SMEs. The results are most visible in the Czech Republic, which is the European leader in the number of SMEs per 1,000 inhabitants, a total of 83.4 SMEs per thousand inhabitants (Analysis of the situation in the field of SMEs in the Republic of Srpska, 2008, p. 31).

All of the new institutions that should be established are marked in red in the model itself, i.e. they are bold and underlined for easy identification in relation to existing institutions. With this regard, in the proposed model, the following ministries would provide direct and indirect support to the development of entrepreneurial environment and SME sectors, namely:

- Ministry of Industry, Trade and Entrepreneurship.
- Ministry of Education, Science and Technology.
- Ministry of Finance.
- Ministry of Agriculture and Rural Development.
- Ministry of Economy, Regional Development and European Integration.

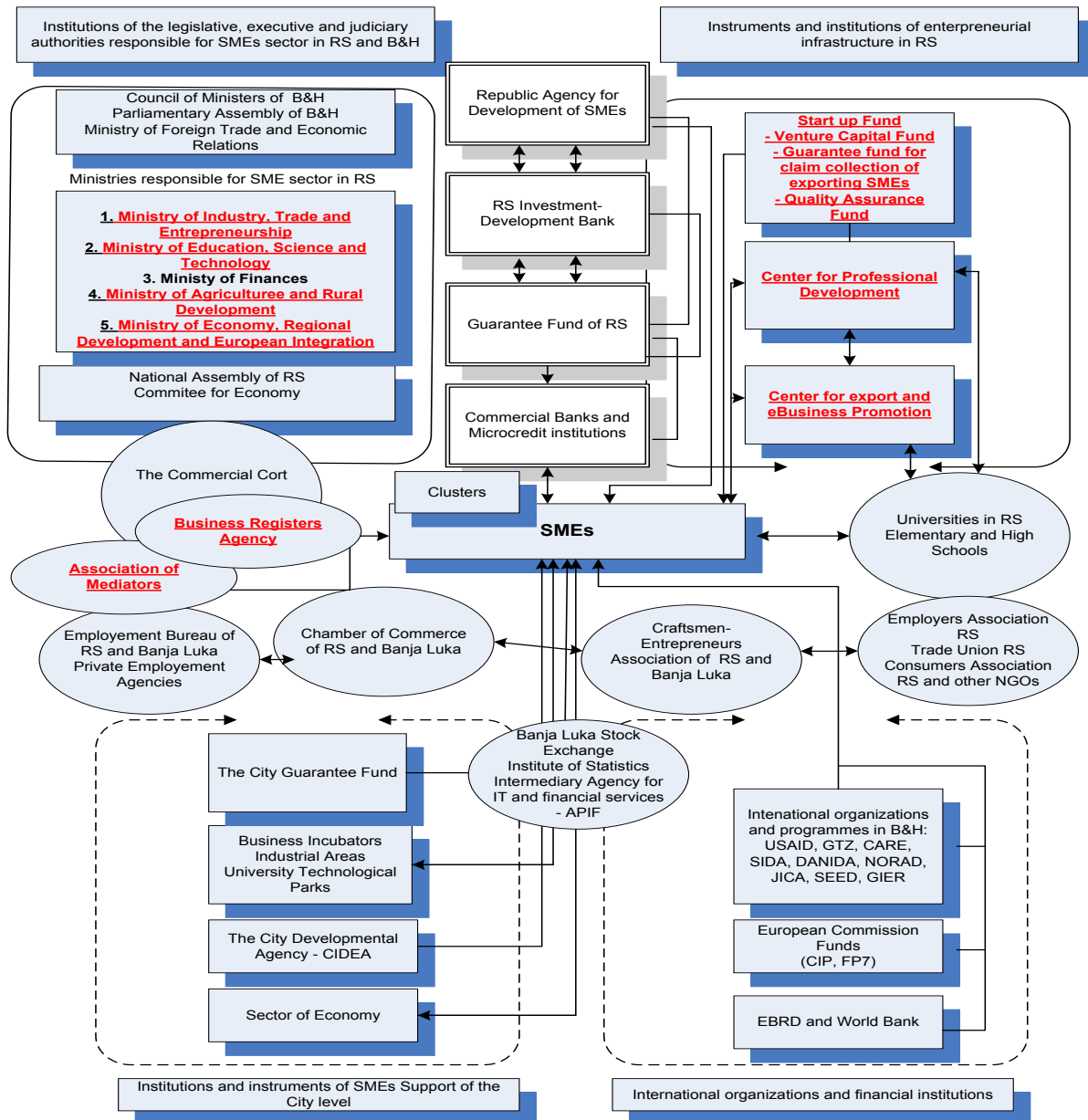
Particular emphasis should be placed on strengthening the capacity of the Ministry of Industry, Trade and Entrepreneurship, in case of restructuring the RS Government in the above proposed way. Within the newly established ministry, one part of the ministry that would deal with the entrepreneurship should build its own capacities in a way that in the future it coordinates networking of SME sector and the sector of formal and informal education, local and regional development agencies and entrepreneurs, encourage and assist in the construction of clusters of SMEs, university and technological parks, business incubators and innovation centers, lobby in the legislature in order to adopt legislation friendly to the development of entrepreneurship and small businesses, involve entrepreneurs in the process of creating new laws and institutional arrangements, help entrepreneurs and clusters in applying for access to European pre-accession funds.

In addition to the RS Guarantee Fund, as the first guarantee pillar of access to loans for newly formed



and existing small and medium-sized enterprises, which issued the first guarantees for loans on 08 July 2011, all cities and municipalities need to establish city or municipal guarantee funds, which would constitute the second guarantee pillar for micro and small businesses. Some cities and municipalities already have them, mainly in the northwestern part of the RS, such as Banja Luka, Prijedor, Kozarska Dubica. However, most municipalities have still not established them. The third guarantee pillar should be networks or clusters of small private businesses that would, on the principles of mutual solidarity, guarantee the return of loans from commercial or specialized banks for small and medium-sized enterprises.

FIGURE 9. Model of Structural Support to SMEs and Entrepreneurship in the RS



The model provides structural support for the establishment of the *Business Registers Agency of the Republic of Srpska* with the aim of quick, cheap and easy business registration. The Agency should provide opening of the web portal for free access to the registry and for online registration of business entities, the electronic cadastre and land registry, documents and forms for public procurement, in the form of “One stop shop”. In accordance with best European practices, business registration process can take up to 7 days, and preferably 48 hours. Numerous statistical data on all enterprises would be available at one place, which would be of particular use to the creators of policies, programs and strategies, and scientific workers.

The model proposes the formation of *Start up Fund of the Republic of Srpska* which would consist of



the following funds:

- Venture Capital Fund
- Factoring Fund for the purchase of receivables of export enterprises
- Quality Fund

This Fund can be formed within the Investment-Development Bank of the RS, or as an independent legal entity whose founder would be the Republic of Srpska Government.

The purpose of a Venture Capital Fund is to attract “angel” investors and to provide start up capital for promising new companies through the funds of IRB RS. Factoring Fund would participate in co-financing debt collection from the export-oriented enterprises in the Republic of Srpska, which would directly influence the increase in liquidity of SMEs. The objective of the Quality Fund would be to promote the quality culture and assistance in the introduction of various quality systems such as ISO, HACCP, CE mark, etc.

Further encouraging of the establishment of entrepreneurial business incubators, university and technology parks where the future entrepreneurs can get free advice about registration, legal and accounting services and related consulting services, and at relatively low cost start their own business. It is necessary to utilize existing capacities of the non-privatized industrial enterprises, which do not have the potential for revitalization and ownership transformation and use them to create the above mentioned incubators and parks.

*Career Center of the Republic of Srpska* would play a role of central training institution for training, additional training and retraining, but also the role of coordinator for the analysis of needs for human resources and labor.

*Center for Promotion of Exports and eBusiness* would provide support services and subsidies to export-oriented enterprises, and promote the best European practice in eBusiness.

All proposed new institutions for the support to the development of this new structural model should contribute to increasing efficiency and effectiveness of the existing SMEs, accelerate and simplify the creation of new enterprises, enable easy access to information on SMEs and in respect of SMEs to the newly established ministries and institutions, with the aim of systematic surveillance (monitoring) and evaluation of programs, policies and support measures for SMEs.

## 7. CONCLUSION

Developed countries, in addition to facing with the global financial crisis, do not give up a systematic search for solutions out of the crisis. In this struggle out of recession, a significant role is played by self-employment and micro, small and medium-sized enterprises. With regard to their basic characteristics, SMEs as flexible, adaptable, relatively inexpensive to establish and close, adjustable to specific market demands, and particularly suited to capture a market niche, with major giants as pillars of the economy should be the generators of economic development. Left on its own without special attention of the state and its institutions, no systematic financial and non-financial support from all sectors, SMEs do not have great chances in the local markets, and especially not in the global market. It is particularly important in transition countries, such as BiH, to continue the positive trend in building institutions that are supporting entrepreneurship and the SME sector. As this research has shown, despite all the positive trends of building entrepreneurial infrastructure in the Republic of Srpska, in the opinion of entrepreneurs and academic community, entrepreneurial infrastructure is still not enough built.

The institutions supporting entrepreneurship and development of the SME sector in the Republic of Srpska do not meet the requirements of entrepreneurs and managers in SMEs. Legislation does not follow the needs of small and in the case of the Republic of Srpska, laws dealing with micro, small and medium-sized enterprises are not harmonized with EU legislation. Larger problem than this discrepancy lies in the internal inconsistency of laws and regulations dealing with SMEs. This is the case with the Law on the Encouragement of the Development of SMEs and the Accounting and Auditing Law, which define SMEs in RS in the diametrically opposite way.

At the RS level, there is no ministry that deals exclusively with entrepreneurs, although in the structure of the RS economy, SMEs dominate with a share of 99.62% according to data from 2009. Data from the real sector suggest the need for a more serious approach to SMEs. Other ministries in the existing model of the RS Government do not play active role in supporting entrepreneurship. Rather, the SME

sector is treated sporadically, and there is a lack of coordinating role of strong ministry that would be solely concerned with SMEs from the real sector.

Given that there is no time to lose, and the negative effects of the global financial crisis are visible, it is necessary in the next five years period to get the answers the following questions:

- How to provide the entrepreneurs in the Republic of Srpska with quality external financial and non-financial support?
- How to connect effectively the SME sector with universities so that we can talk about the transfer of knowledge, innovation and new technologies?
- How to interest SMEs to join existing or new clusters?
- Entrepreneurs expect assistance from development programs through favorable loans, grants and guarantee funds. How to continue facilitating access to favorable loans?
- Although some entrepreneurs talk about the need to improve the quality of their products/services, the need for the introduction of quality systems and the need for professional consultancy assistance in the research, it is evident the need for education and training in the field of quality and management of SMEs. How to build an effective system of formal and informal education of entrepreneurs and managers in SMEs?

Answers to the above questions, arising from the research conducted on a sample of 87 SMEs from Banja Luka, as well as other problems faced by entrepreneurs in the Republic of Srpska due to insufficient development of entrepreneurial infrastructure, in the long-term we can try to solve by implementing the proposed Model of Structural Support to SMEs and Entrepreneurship in the Republic of Srpska. The initial hypothesis of this paper we could check in the future, if the Model is implemented in the Republic of Srpska.

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## THE CORRESPONDENCE OF PUBLIC POLICIES IN THE REPUBLIC OF MOLDOVA TO THE DEVELOPMENTAL NEEDS AND PROBLEMS OF SMEs

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### Abstract

The goal of this article is to discuss the principal dimensions of the public policies in the Republic of Moldova supporting small and medium-sized enterprises (here and after SME) and to evaluate the correspondence of such policies to the actual needs and problems experienced by businesses.

Based on statistical findings, the article presents a brief overview of the current state of the SME sector in Moldova and the major trends in its recent development, including the period of the economic crisis.

Main issues experienced by Moldovan SMEs will be identified and classified into categories, such as problems resulted from the SMEs' limited access to resources, from certain actions of the governmental business regulating agencies, and from business environment-related factors. The article relies on the findings of the polls and interviews as its main method of identifying problems experienced by Moldovan SMEs. The polls and interviews employed in the article were conducted with an active participation of the author during the last five years by the Academy of Sciences of Moldova and within the context of international research projects bringing together research teams from the EU and NIS states.

The article identifies and discusses the principal carriers and agents of the public policies supporting SMEs in Moldova, such as business-regulating legislation, public programs implementing strategic policies, and agencies involved in SMEs support. Furthermore, the attention is given to the policies targeting specific categories of entrepreneurs.

The business-support policies suggested and executed by Moldovan government will be juxtaposed to the actual problems and needs experienced by entrepreneurs as identified by the authors during polls and interviews. This juxtaposition will allow for the evaluation of the degree to which the public policies succeed in addressing the problems and needs of SMEs and for the identification of the ways in which these policies fall short of the entrepreneurs' expectations. Certain improvements with regard to the SMEs-supporting policies in Moldova will be offered, in particular concerning the redistribution of the tasks and responsibilities between the national and local business-regulating institutions, the improvement of the allocation of a differentiated support to specific categories of entrepreneurs, and the advancement of the dialogue between private business and government regulating agencies.

**Keywords:** SMEs; Business support policies; Business problems; Public policy's adequacy to problems and needs of businesses.

### 1. INTRODUCTION

The Republic of Moldova became an independent state in 1991 as a result of the breakdown of the USSR. Since that time Moldova has undertaken economic reforms, in the foundation of which has lied the development of the country's private business sector. At the present time small and medium-sized enterprises (here and after SME) in Moldova are significantly contributing to its social and economic development. They are saturating the country's internal market and are providing its citizens with work places and income. The Moldovan Government recognizes the significant role played by SMEs as well as a positive effect of the governmental policies supporting this sector in many other countries, including those in the EU. That recognition has resulted in a particular attention which Moldovan Government directs to the country's SMEs.

The goal of this article is to present the major dimensions of governmental policies regarding the SMEs sector in the Republic of Moldova. Furthermore, these policies will be evaluated with regard to their efficiency in addressing actual problems and needs of enterprises.

The article will offer a brief analysis of the major trends in the recent development of the SMEs sector in Moldova, including the period of the economic crisis. The key figures characterizing the contribution of SMEs into Moldova's national economy and the dynamics of the sector will be calculated on the basis of statistical findings.

The emphasis of our research is to identify the main issues encountered by Moldovan SMEs. Such issues will be analyzed and classified into categories, such as problems resulted from the SMEs' limited access to resources, from certain actions of the governmental business regulating agencies, and from business environment-related factors.



The principal carriers and agents of the public policies supporting SMEs in Moldova will be identified as legislative in form of business-regulating legislature; as public programs implementing strategic policies; and as institutional in form of agencies involved in SMEs support. Furthermore, the policies targeting specific categories of entrepreneurs will be given special attention.

The business-support policies suggested and executed by Moldovan Government will be juxtaposed to the actual problems and needs experienced by entrepreneurs as identified by the author during polls and interviews. This juxtaposition will allow for the evaluation of the degree to which the public policies succeed in addressing the problems and needs of SMEs and for the identification of the ways in which these policies fall short of the entrepreneurs' expectations. Certain improvements with regard to the SMEs-supporting policies in Moldova will be offered, in particular concerning the redistribution of the tasks and responsibilities between the national and local business-regulating institutions, the improvement of the allocation of a differentiated support to specific categories of entrepreneurs, and the advancement of the dialogue between private business and public regulating agencies.

## 2. METHODOLOGY

In order to identify the business-related problems and needs experienced by entrepreneurs, methodologically this research primarily relies on the findings of the polls in forms of fill-in questionnaires and in-depth semi-structured interviews with entrepreneurs. The polls and interviews have been conducted with an active participation of the author within the last 5 years by the Academy of Sciences of Moldova (here and after ASM) and as part of international research projects between the countries of the EU and CIS. The article has primarily employed the results of the following research projects (the detailed references are cited in the bibliography):

- The institutional project “Elaboration of Programme for Economic Growth” (2006-2007) undertaken by the Institute on Economics, Finance and Statistics of the ASM and the Ministry of the Economy of the Republic of Moldova. The polls were conducted in three regions of Moldova – Briceni, Orhei and Leova - geographically located respectively in the Central, Northern and Southern parts of the country. Over 500 of economic agents were interviewed, which constituted 48% of all enterprises registered in the above-mentioned geographic regions. (IEFS, 2007);
- International research project “Cross-border Cooperation and Partnership in Selected NIS Countries and the Consequences of EU-Enlargement: Fostering Entrepreneurship in the Ukraine, Belarus and Moldova.” (INTAS, 2005-2007). 20 representatives of business support institutions alongside with 40 business owners participating in cross border cooperation were interviewed. The interviewed SMEs were geographically based in Cahul and Edinet - two Moldovan districts located in a close proximity to Romanian border. (Welter and others, 2007);
- The research project “Conditions for Enterprise Creation and Development: Gender Analysis,” executed by The National Bureau on Statistics of the Republic of Moldova with support offered by the United Nations Development Fund for Women and the United Nations Development Program. 15.500 entrepreneurs were interviewed in every geographical region of Moldova. (Aculai, 2009);
- The institutional project “The Identification of Primary Problems of Moldovan SMEs and the Elaboration of Methodology on Creation and Development of Clusters” conducted in 2010. 126 entrepreneurs were interviewed from all geographical regions of the country. (IEFS, 2010).



### 3. THE ROLE OF SMES IN MOLDOVAN ECONOMY

According to Moldovan statistical data, by the end of 2010 there were 45.600 enterprises registered in Moldova. The absolute majority of those - 98% - belong to the SMEs sector. 59% of all workers are employed by SMEs, which earn 37% of the total sales income in Moldova's economy and account for 41% of the profits and losses of all Moldovan enterprises. Among Moldovan SMEs the vast majority – almost 75% - are constituted by micro-enterprises. Small enterprises constitute 20%, and medium-sized enterprises - slightly over 3% (see Table 1).

Table 1. Principal indicators of SMEs sector in 2010

Principal indicators	SMEs, %
Number of enterprises, % of the total	97.7
Including, %:	
medium-sized enterprises	3.4
small enterprises	19.6
micro-enterprises	74.8
Average number of employees, % of the total	58.8
Sales income, % of the total	36.8
Profit (+)/ loss (-) before taxation, % of the total	41.4
GDP, % of the total (2009)*	28.9
Average number of employees per 1 SME/ enterprise, persons	6.8/ 11.3

Source: calculated by the author on the basis of statistical findings

The total number of SMEs continued to grow even in 2009, at the time when all major macroeconomic indicators of the national economy considerably decreased. The growth in the number of SMEs occurred primarily due to the growth in the numbers of micro- and small enterprises (with the exception of 2009). These groups of enterprises are characterized by a relatively large share and high annual growth rates (see Table 2).

Table 2. Growth/ reduction rates of the number of Moldovan enterprises, compared with the previous year, %

Indicators	2006	2007	2008	2009	2010
Total enterprises, including:	109.1	110.6	105.3	106.0	104.6
SME sector, including:	109.6	110.6	104.6	106.2	104.4
Medium-sized	104.0	102.9	95.0	94.3	100.7
Small	101.6	109.9	115.8	99.2	110.1
Micro	112.0	111.3	102.5	108.7	103.2

Source: Statistics databank of Moldova

The general number of the employed in Moldovan economy had been decreasing annually between 2005 and 2009. However, in the SMEs sector the dynamic of employment was different (see Table 3). Whereas in 2006-2007 there was a growth in the total number of the employed, in 2008-2009 it was decreasing.

However, different categories of the SMEs displayed various dynamics. Thus, small enterprises showed a more stable growth in the number of employees (with the exception of 2009).

Table 3. The growth rates of the number of employees compared to preceding year, %

Indicators	2006	2007	2008	2009	2010
Total enterprises, including:	99.5	99.9	100.0	94.2	97,6
SME sector, including:	104.9	103.3	95.5	96.4	97,8
Medium-sized	98.6	98.2	89.1	91.7	94,6
Small	101.9	104.2	107.7	97.4	103,3
Micro	123.4	110.8	90.4	102.1	94,8

Source: calculated on the basis of the data provided by The National Bureau of Statistics of the Republic of Moldova (2011).

The indicator of the share of SMEs within the Moldovan GDP is characterized by an especially long period of decline. Although the share of SMEs in Moldovan GDP increased in 2005-2006 from 22.4% to 35.0 %, afterwards it had been steadily decreasing until it reached 28.9 % in 2009 (see Table 4)

Table 4. The Dynamics of SMEs Contribution to GDP in 2005-2009

Years	Contribution of SMEs to GDP, %
2005	22.4
2006	35.0
2007	34.4
2008	31.9
2009	28.9

Source: Statistics databank of Moldova

#### 4. MAJOR PROBLEMS EXPERIENCED BY BUSINESSES

In this article the problems experienced by SMEs have been analyzed from 3 different perspectives:

- Through the evaluation of the access to various kinds of resources available to SMEs (such as financial, labor and other resources);
- Through the evaluation of the business-related procedures implemented by business-regulating governmental institutions and their impact upon SMEs (such as registration, licensing and other procedures);
- Through the identification of other barriers less dependent upon the governmental regulations and linked to business environment.

##### A. The problems experienced by SMEs with regard to their limited access to resources

The main problem as identified by entrepreneurs is their high and unmet need to have access to the sources of financing. Throughout all the polls offering a multiple-choice response option conducted within our research projects the issues concerning financing were stably marked as the most significant ones by 75% to 85% of the respondents (IEFS, 2007; Aculai, 2009). Among certain groups of entrepreneurs, such as those based in rural areas, the problem was indicated as significant by up to 95% of respondents (Aculai, 2009). According to the respondents, the issues related to financing are caused primarily by the unaffordability of the loan-granting conditions stipulated by commercial banks, such as too high interest rates and collaterals, for businesses.

The second largest problem identified by Moldovan SMEs is the lack of qualified workforce. During the recent years that problem has become more acute in Moldovan economy. This trend reflects, on the one hand, the negative processes occurring on Moldovan labor market and the decrease of highly-qualified labor force. On the other hand, it shows the increasing role of qualified labor in a more highly technological production. Primarily, the entrepreneurs experience difficulties finding and hiring relatively more highly qualified workers and professionals. It may be supposed that a primary reason for that phenomenon is the labor migration of qualified workers and professionals. Both temporary labor migration and immigration are wide spread, especially among younger adults, many of whom are dissatisfied with the level of income they would be earning in Moldova.

The list of main issues identified by SMEs with regard to the limited access to resources is presented in Table 5:

Table 5. Problems SMEs Experience regarding Access to Various Resources

Main Problems	Respondents who experienced problems (2008), % *
Absence/lack of funds and financing/loan opportunities	86.1
Absence/lack of qualified workforce	11.8
Absence/lack of cutting-edge technologies and equipment	6.0
Absence/lack of raw materials	3.7

\* Respondents were offered a multiple-choice response option

Source: Aculai, 2009

## B. The problems experienced by SMEs with regard to the governmental regulation of private business

As they strive to abide the laws regulating business activities, the vast majority of entrepreneurs (94.4%) indicated that they have experienced problems (IEFS, 2010). Most respondents identified the state inspections and audits of enterprises and business taxation as creating major issues for enterprises.

The state-initiated inspections and audits of private businesses were identified as problematic by 57.1% of the interviewed entrepreneurs. In order to make the procedure more “business-friendly,” 47.8% of the respondents suggested that more detailed instructions regarding the undertaking of inspections and audits be stipulated in the legislature. 20.6% of the respondents suggested that the quality of work of the inspectors be more professional. 16.7% believe that the inspections should be less demanding on the entrepreneurs in terms of labor and time investments and 15.7% - in terms of financial investments. Some respondents openly stated in the questionnaires that corruption and bribing commonly accompanying such inspections and audits should be addressed.

56.3% of the respondents consider business taxation laws to be an obstacle for the business development. As a possible solution, the entrepreneurs suggested that first the financial burden of taxes should be decreased, in particular that value added tax, social security tax and mandatory medical insurance tax be reduced. Furthermore, 29.0% of the entrepreneurs suggested more detailed regulations concerning taxations, 13.7% - to make taxation procedures less labor and time-consuming and 12.9% - to increase the quality of the services of state tax agencies available to entrepreneurs.

The list of main government-regulated procedures identified by SMEs as “creating obstacles” is presented in Table 6 below:

Table 6. Major Regulating Procedures “Creating Obstacles” for SMEs

Regulating Procedures	Respondents, who experienced problems, %*
Inspections and Audits	57.1
Taxation	56.3
Accounting and accounting reports	33.0
Procedures involving cooperation with jurisdictional agencies/courts	32.5
Authorization	28.6
Regulations of imports and exports	27.0
Certain actions of public safety institutions (e.g. police)	24.6
Liquidation of enterprise	24.6
Certification	24.6
Licensure	21.4
Registration of enterprises	15.1

\* Respondents were offered a multiple-choice response option

Source: IEFS, 2010

## C. The problems experienced by SMEs with regard to business environment

As the respondents were asked to identify other obstacles encountered by their businesses that are not related to state regulations, the entrepreneurs identified as primary the political instability in the Republic of Moldova and the limited demand in the country’s internal market.

The list of main obstacles identified by SMEs with regard to business environment is presented in Table 7 below:

Table 7. The Problems SMEs Experience Regarding Business Environment

Main Problems	Respondents who experienced problems, %*
Political instability 58.7	58.7
Internal market demand	57.9
Competition	42.9
Work of monopolies	41.3

\* Respondents were offered a multiple-choice response option

Source: IEFS, 2010

## 5. POLICIES SUPPORTING MOLDOVAN SMES: LEGISLATION AND PRIORITIES

The business activities of SMEs in Moldova are regulated first and foremost by The Law On Support of Small And Medium-sized Enterprises Sector approved in 2006. Since then the law has undergone changes regarding the category of “small” enterprises. A definition of a “medium” enterprise was introduced, thus to a greater extent adapting Moldovan classification of the enterprises within the sector to the EU standards.

Practically-oriented policies concerning Moldovan SMEs are implemented by means of state programs. The State Program for Supporting Small and Medium Enterprises Development during 2009-2011 is currently being implemented. The Program stipulates the following 5 strategic areas in which the SMEs support needs to be directed:

- The formation of a normative-judicial and legislative base which would contribute to the establishment and development of SMEs;
- The improvement of financial climate for SMEs;
- The advancement of business culture and cutting-edge management strategies for SMEs;
- The raise of competitiveness and the internationalization of SMEs;
- The promotion of a dialogue between the government and private businesses.

In accordance with these strategic areas, the government has been implementing various support-providing measures. Thus, with the support of the World Bank a regulatory reform is being undertaken. The state registration of the enterprises and the customs offices have now introduced a “one-window” principle (which allows a customer to be served by one as opposed to multiple clerks). An informational portal for the SMEs has been created and annual forums for Moldovan SMEs have been held.

During the last 3 years, targeted programs have emerged aimed at providing support for specific groups of entrepreneurs. For example, since 2008 the National Program for the Economic Support of the Youth has been implemented. The Program’s goals are to facilitate the acquisition of entrepreneurial skills by young men and women, presenting many of whom a real opportunity to start their own businesses.

In 2011 the Program on the Attraction of Money Transfers into Economy was started. The need for such a program had been stipulated by the fact that over a million of Moldovan citizens are working abroad. Annually the value of the monies transferred by these migrant workers via commercial banks to their families in Moldova exceeds one billion of the U.S. dollars.

## 6. THE CORRESPONDENCE OF THE STATE POLICIES TO THE NEEDS AND PROBLEMS OF SMES

Although throughout the recent years both policy makers and executives have been seeking to be more responsive to actual problems and needs experienced by entrepreneurs, in general many of these problems remain extremely challenging for businesses.

Throughout the recent years the access to the sources of financing has become even more grave of an issue for SMEs. As a result of the world’s financial crisis, the risks of loan defaults on part of entrepreneurs has raised. Therefore the general opportunities for SMEs to receive loans from commercial banks have decreased. Furthermore, the presence and role of non-banking financial institutions oriented specifically towards working with SMEs, including but not limited to credit unions or venture funds, is rather insignificant in Moldova. Among state-owned institutions, the Fund of Guaranteed Loans is a single agency existing specifically to provide financial support to SMEs. Structurally the Fund is part of OSMED and operates a modest budget. The main source of the state-funded support of SMEs are national programs and international projects which offer certain categories of SMEs better conditions of financing. Such categories include first of all young adult entrepreneurs located in rural areas. Nevertheless the funds available for such financial supports are quite limited. Therefore the above mentioned measures alone have thus far not been able to make a significant impact upon the financial support of SMEs in Moldova.

Moreover, recently the problem of finding and hiring skilled workers and professionals has become more acute. The business managers have been finding it more difficult to hire employees of both certain (higher) level of qualification as well as with a particular set of skills. The businesses at times were successful at training and raising the qualifications of their employees within the context of

a company. Nevertheless, it has proven extremely complicated for SMEs to train their employees to perform a completely new set of skills or profession. One of the reasons behind this problem is a dissonance existing between supply and demand on Moldovan labor market. With time such a dissonance may be predicted to grow even deeper. The spectrum of specializations offered by professional schools, colleges and universities in Moldova often seems divorced from the real-life needs of working businesses in the country.

Another negative influence upon the labor problem faced by Moldovan SMEs is the lack of institutions specifically serving the job market. The few existing institutions serve primarily the needs of large enterprises, branches of international companies and projects based in Moldova, since these are able to offer bigger wages for their services. At the same time, SMEs often choose to ignore the services otherwise potentially available via such institutions. Instead they rely on the informal sources of personnel seeking, such as via the networks of families, friends and former colleagues.

Business inspections and audits conducted by the governmental agencies pose enormous difficulties for healthy development of Moldovan SMEs. This problem has been hardly addressed by the policy makers yet. It may be suggested that within the framework of the currently conducted regulating reform, it would be of crucial significance to introduce a working system reasonably limiting the power of the state officials and the employees of business-regulating agencies to “permit” (and prohibit) numerous aspects of business practice as well as limit their control over private business activities in other ways. In particular, the following strategy may be deployed: (i) first, to reduce the necessity of frequent personal visits of entrepreneurs to government offices and personal interactions with state officials. Instead modern technologies, including Internet, should be used more actively to simplify these processes, such as introducing options of making appointments online, submitting of required documentation over e-mail alongside with the improvement of the “One-window” services; (ii) second, we suggest restoring a former procedure which regulated the inspections and required that all inspections and audits were registered in the Registry of Inspections of Enterprises. That procedure had been active for several years before it was suddenly cancelled by the government without prior consultations with the representative of the business community.

Certain problems experienced by Moldovan SMEs may appear to not be completely resolvable by means of national policy making. Nevertheless their negative impact may definitely be reduced. For instance, the reality of the “narrowness” of Moldova’s internal market may be partially overcome if the exporting opportunities were to be expanded.

Throughout the economic crisis, Moldovan government succeeded to maintain and even increase its employees’ salaries and retirement pensions. However it failed to maintain, let alone stimulate, the demand on Moldovan internal market. Moreover, monies transferred to Moldova by its migrant workers abroad also decreased which had an additional negative effect on the country’s internal market. The world economic crisis led to the decrease in demand in many countries, which respectively led to the decrease in the exports of the goods produced in Moldova. When Romania became an EU member in 2007, it resulted in new complications for cross-border travellers between Romania and Moldova as well as in new restrictions on the exports of the Moldovan-produced goods (Welter and others, 2007). This phenomenon also negatively affected many of Moldovan SMEs.

The Moldovan government took certain successful measures to boost Moldova’s exports to the EU countries. It succeeded to ensure a number of quotas to export certain goods to the EU market, which primarily one-sidedly benefited Moldova. Such a support on part of the EU had a positive impact on Moldovan business. However our research has shown that the principal beneficiaries of such policies in Moldova were primarily its large and medium-sized enterprises. At the same time, Moldova’s relations with Russia, which presents a significant external market for Moldovan businesses, have been destabilized. Although economically Moldova would have benefited from the advancement of the economic cooperation with Russia, the Moldovan government failed to address the issue of maintaining and promoting the favorable conditions of exporting Moldovan goods onto the gigantic Russian market.



## 7. GENERAL DEFICIENCIES OF BUSINESS SUPPORT POLICIES AND SUGGESTION FOR THEIR IMPROVEMENT

The state-sponsored business support policies in Moldova reveal certain characteristics which impede their potentially significant positive impact on business development.

One of the major problems hampering business development in Moldova is that the regulation of SMEs still occurs primarily on the national level. Despite being well aware of the actual needs and problems existing in their regions, the employees of the state regulating agencies on the local level often view their jobs as serving merely as implementers of the policy decisions made on the national levels. With a rare exception, in Moldova state agencies working on the regional and local levels are not yet involved in developing SMEs support programs and do not offer entrepreneurs recommendations on business development specific for a particular geographic region. It is advisable to organize seminars for the employees of local state regulating agencies in order to communicate to them the necessity and goals of the support of SMEs and to offer them instruction in the cutting-edge strategies for advancing the development of SMEs.

SMEs-supporting policies in Moldova do not normally include differentiated support aimed at specific categories of businesses and entrepreneurs. The only exception within the last 2-3 years has been support directed at young adult entrepreneurs, a much needed measure, since an average age of entrepreneurs in Moldova is currently 45 years (Aculai, 2009). Nevertheless, there is a remarkable lack of targeted attention to the needs of the smallest-size businesses which could especially benefit from support, which include individual enterprises, family-owned enterprises, self-employed and household enterprises. These are not currently viewed by state regulating agencies as an important part of the business sector. However these enterprises perform important functions in Moldovan society: they create jobs, many of which allow for more flexible work conditions; they provide income (albeit modest) for their owning families; and they serve as a way for professional self-realization of their owners.

Business support policies in Moldova lack specific measures specifically designated for the businesses now working in the geographic region of Transnistria. Transnistria is a part of Moldova which attempted to break away from the country in 1990. Although the government support measures as stipulated in the state programs apply to the entirety of Moldovan territory, their advancement and implementation should take into account the particularities of Transnistria region. This became especially evident as a result of a round-table discussion on SMEs held in Tiraspol in August 2011. The discussion was organized by the Center for Strategic Studies and Reforms within the context of the project "Support for Building Trust" and was attended by entrepreneurs and governmental officials from both Transnistria and the "mainland" Moldova. The representatives from all parties demonstrated interest in building mutually beneficial collaboration. It is advisable to facilitate the processes of communicating new opportunities for collaboration to the entrepreneurs in Transnistria and the rest of Moldova and present the explanations of the application procedures to receive support in a more purposeful, clear and customer-friendly way.

In addition to the two specific categories of businesses discussed above, we recommend allocating targeted attention and support to the following four specific categories of businesses: based in rural areas, senior entrepreneurs, female entrepreneurs and innovative enterprises.

Partially the problems experienced by SMEs stem from the lack of purposefully-maintained stable dialogue between businesses and governmental regulating agencies. The dialogue taking place now in many respects is not mediated by normative documentation. Rather it is driven to a great extent by several individuals from business and governmental regulating sectors, and is defined by their particular personalities, beliefs and interests. We recommend designing and putting into practice a formal working structure ensuring the stability of the dialogue between business and the government regardless of individual wills and desires of certain persons.

Furthermore, the lack of a strong representative position on part of SMEs in their dialogue with the government is rooted in an extremely weak association ties between SMEs. This reality results in the inability of the various categories of SMEs represent their interests in their dialogue with the government. There should be regional and national associations of enterprises representing the interests of large groups of entrepreneurs. Currently some business associations in Moldova are de facto political forces, rather than true representatives of the economic needs of business, with their leaders being closely affiliated with the government, thus serving the government rather than business interests.

In order to strengthen the resource base of enterprises of different sizes, it is advisable to promote

the associations of SMEs in form of clusters and holdings including those with international partners (Veverita etc, 2010; Bajura, 2011). The associations formed between Moldovan SMEs would facilitate the integration of Moldova's national economy into European and world economy. A significant stimulus not currently available for Moldovan enterprises would be an opportunity to participate in the operational programs in the EU.

Finally, the resolution of the obstacles impeding the development of Moldovan SMEs is not limited to the necessary improvements in business regulating policies. Political instability in the Republic of Moldova is another significant factor which has been negatively affecting SMEs sector. Thus, during the last 2 years Moldova has been undergoing a political crisis, with the Parliament failing to reach consensus to elect President and consequent re-elections of the Parliament. Another factor is corruption which is currently affecting all major sectors of Moldovan society, including business. This problem as well has grown worse within recent years and the governmental response has so far failed to yield any significant results.

In conclusion, in order to assist the Moldovan SMEs with enhancing their competitiveness, the state policies of business support should take into account the actual needs and problems experienced by business as demonstrated in this article.

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## COMMERCIAL DIPLOMACY IN PRACTICE: EXPERIENCES OF INTERNATIONAL BUSINESS EXECUTIVES AND REPRESENTATIVES

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### Abstract

Commercial diplomacy aims at creating and expanding business opportunities abroad. Empirical research on commercial diplomacy from a business perspective is hardly available. This paper presents the results of a study on the experiences of an embassy's commercial diplomacy activities by home country business executives and representatives abroad. The findings show that companies familiar with the foreign business environment apply less for diplomatic business support, but that support towards newcomers is assessed as valuable. Businesses experience the commercial diplomatic services as reactive, though willing to help. Matchmaking facilities are valued, especially by companies that are not familiar with the foreign business environment.

### 1. INTRODUCTION

Governments and businesses from developed and emerging economies alike face competitive challenges in today's global economy. Governments realize that their businesses need to expand internationally as it creates opportunities to grow. Expanding beyond the domestic market can be beneficial for companies and governments of home as well as host countries. Companies can gain easier access abroad through a sustainable relationship with governments, and governments are interested in job creation, tax revenue increase and economic integration. This provides an explanation why governments support commercial internationalization by means of diplomatic relations abroad.

The consensus view is that diplomacy has a constitutive function; it is a means of ordering the relations between states, an ordering principle that can create balances of power (Lee and Hudson, 2004). Ambassadors have traditionally been their countries' chief trade promotion officers. Today, with the forces of globalization ensuring greater and greater economic integration, the government's role in responding to and managing this process bears greater scrutiny (Potter, 2004).

Far less attention has been devoted to the topic of commercial diplomacy, defined as the application of the tools of diplomacy to help bring about specific commercial gains through promoting exports, attracting inward investment and preserving outward investment opportunities, and encouraging the benefits of technology transfer (Potter, 2004). The spectrum of actors in commercial diplomacy ranges from the high-policy level (head of state or prime minister to ambassador) and the lower level of specialized diplomatic envoys like trade representative, commercial attaché or commercial diplomat.

Commercial diplomacy has an "invisible" status within diplomatic studies (Lee and Hudson, 2004), since it is often confused with economic diplomacy, and there is overlap in several activities. Governments benefit from commercial diplomacy services because 'image impact' extends in both directions: successful companies may improve the country's reputation, and 'successful' governments might have a positive impact on a business firm's image (Naray, 2008).

Commercial diplomacy is a significant factor in the on-going process of globalization, yet there is a shortage of empirical research on this activity (Kostecki and Naray, 2007; Naray, 2008). A reason for a shortage of research articles relates to the newness of the field. There is widespread evidence of prioritization of commercial diplomacy in the international objectives of an increasing number of states (Lee and Hudson, 2004) and increased government spending in business support. Governments are reorganizing their diplomatic systems (Lee and Hudson, 2004; Potter, 2004; Naray, 2008) so that commercial activities are far more centralized. The commercial activities of diplomats are extended, whereby branding of the nation plays a more central role.

1 Cambridge Dictionary: Diplomacy refers to the management of relationships between countries

Governments are recognizing the importance of commercial diplomacy as a new area of activity. Most of the literature views commercial diplomacy from a diplomacy and policy perspective. However, not much empirical research has been published on how commercial diplomacy activities are working out in practice. This paper aims to contribute to our understanding of commercial diplomacy in action and how it is assessed by a core target group and stakeholders, namely international business executives and representatives. We present the results of a single case study, the Netherlands embassy in Malaysia. Dutch business executives and representatives doing business in Malaysia were interviewed on how they experience commercial diplomacy facilities and activities as deployed and on their usefulness and effectiveness.

## 2. LITERATURE REVIEW

### Defining commercial diplomacy

Commercial diplomacy was introduced relatively late in the whole range of diplomatic activities led by state representatives. Better known activity fields are economic, military or political diplomacy. There are several different angles regarding the content and purpose of commercial diplomacy. For example, Potter (2004) argues that commercial diplomacy is a value-creating activity due to its usefulness in dealing with both managerial and government concerns, each disaggregated into strategically relevant activities. Two types of activities are distinguished: *primary activities* (relating to trade and FDI, research and technology, tourism and business advocacy) and *support activities* which provide the inputs needed for the primary activities to take place (intelligence, networking, involvement in the 'made-in' image campaign, support for business negotiations, contract implementation and problem solving). According to Lee (2004) commercial diplomacy involves the promotion of inward and outward investment and of exports in trade and can be classified into three broad categories of activity. One is gathering and disseminating commercial information and market research, which is information on existing and potential markets on both a geographical and sectional basis. Secondly, developing business and government contacts in the host countries and introducing the home private sector to these contacts. Finally, there is the promotion of goods and new products in the host market through the organization of seminars, trade fairs, and direct lobbying.

Kostecki and Naray (2007) identified the following rationale for commercial diplomacy by way of an interdisciplinary literature search:

- the need for access to reliable and neutral business information,
- support for the newcomer's weak credibility and image in foreign markets,
- partner search: encouragement of national firms (mainly SMEs) to internationalize,
- conflict handling,
- support of home country delegations: ministers often are accompanied on state visits by business people, and
- strategic concerns, such as the government's desire to engage in strategic trade policies, support for R&D activities or improved access to supplies.

Naray (2008) identified that commercial diplomatic activities abroad can be divided into a range of activities. They can undertake business-facilitating activities and services in the field of trade, investments, tourism, country image and promotion of science and technology.

In summary, the major support activity of commercial diplomacy is gathering intelligence, which includes an information search and dealing with business enquiries from the home country and host country firms. A commercial diplomat's public relations activities essentially aim at maintaining good contacts with business leaders and authorities and cover advocacy efforts aimed at protection of the home country's business interests in public hearings or consultations in the host country's legislative process. Many of these kinds of issues are discussed during periodic bilateral consultations between the government and host country (Kostecki and Naray, 2007). Anglo-Saxon commercial diplomats (Lee and Hudson, 2004) state that they assist both SMEs and MNEs.<sup>2</sup> In the case of the MNEs, the emphasis is on public relations involving the host country government and private sector personalities. Support for MNEs involved in negotiations with authorities or corporations from the host country are also an important form of support offered by commercial diplomacy services.

There is a critical need for the government and companies to act together and realize mutual benefits.

2 SME: Small and Medium Enterprises, MNE: Multinational Enterprises



Due to globalization and the need to approach the world as one market, countries can no longer generate enough growth, jobs profits and savings from domestic sources (Garten, 1997). Government objectives in business promotion (commercial diplomacy) are ultimately to create jobs, increase tax revenue and stimulate economic growth (Kotabe and Czinkota, 1992). Business needs government help to liberalize trade, protect intellectual property, remove regulatory barriers, and encourage continued economic integration. For example, by reforming the Foreign Service Organization in the UK, government–business partnerships have become a key organizing principle in contemporary UK diplomacy, so much that public interest is increasingly conceptualized as a collective of private business interests (Lee, 2004).

### **Effects and impact on host and home country**

Countries' efforts and impacts in commercial diplomatic activities depend on many factors in the home and host country. The host country's market size and market potential are the most significant determinants of the investment in commercial diplomacy, even more important than the current business flow (Rose, 2005). Countries with a lot of growth potential are able to attract more commercial diplomatic activities. That seems to be a logical step for strategic governmental decisions because the objectives of government are to increase jobs, increase tax revenues and stimulate economic integration. The most crucial markets are those where not only the opportunities but also the commercial and political risks are the greatest.

### **Issues in commercial diplomacy**

Commercial diplomacy, being a government service, is accused of certain shortcomings. There is an ongoing debate in the literature (Potter, 2004) and at research institutes, about whether the service and activities of diplomats are adequate in the current setting of globalization. In some cases, the criticism may reflect certain stereotypes about government agencies (Potter, 2004; Kostecki, 2008; Naray, 2008). Some of the criticisms are listed below:

- There is 'no need for commercial diplomats: they only take advantage of diplomatic privileges; one cannot measure their performance in export promotion at all' (confidential source).
- Diplomats are generalists most of the time and do not understand business concerns.
- Commercial attachés are bureaucratic and ineffective (an Australian businessman).
- Commercial diplomats will only help their private friends and will therefore only encourage corruption within the diplomatic services.
- Diplomats are overloaded most of the time with issues other than trade and investment so they do not have time to do their work correctly as trade representative and do not have the sense of priority to assist business people.
- There is no need for commercial diplomat activities in a free market economy. Buyers and sellers can meet without assistance.
- Performance – being intangible – is difficult to measure. The quality of the relationship between commercial diplomats and their beneficiaries is highly dependent on the skills and motivation of the individual/team.

Although there are several critiques on the effectiveness and favoritism of commercial diplomatic activities, one of the very few studies done on the results on commercial diplomacy by Rose (2005) found that the presence of foreign missions is positively correlated with exports. He found, by keeping other factors constant, that each additional consulate is associated with slightly higher exports; his point estimate is around 6-10%<sup>3</sup>. It varies by exporter, and also seems to be non-linear; the first foreign mission has a larger effect on exports than successive missions. Still, the commercial diplomatic activities do indeed seem to enhance exports at the margin (Rose, 2005).

Commercial diplomacy is tailor-made to the needs of different countries, and there is no one-size-fits-all concept. The diplomatic service is always adapted to the local circumstances and preoccupations first of all (Melissen, 2006). Secondly, commercial diplomacy that deals with foreign target groups should be a two-way street. It is as much about listening and receiving as it is about speaking and sending. The intention is to work more outwards. In other words, diplomatic activities serve as a window into a society and as a window out.

3 This conclusion was derived from an interview with the Clingendael research institute (International diplomatic relations).

4 This result is statistically significant, and economically plausible in magnitude.



As mentioned earlier, little empirical research has been done into the field of commercial diplomatic activities. Most research that has been conducted is conceptual and hardly includes a business perspective. This paper aims to fill in this gap and presents result of a study on the experiences and evaluation of commercial diplomacy activities by a core target group, namely business executives and representatives from the home country that are doing business in the host country. Overall, this study's contribution is that it provides one of the very few available insights in commercial diplomacy in action by an embassy.

### 3. METHOD

We decided to do an exploratory study, since there is no solid literature base yet regarding commercial diplomacy and commercial diplomacy from a business perspective. In this context we also thought it was most relevant to adopt a case study design, meaning that one specific context was selected for our study. The context chosen was an embassy of the Netherlands in Malaysia. Dutch business executives and representatives are the embassy's main target group for its commercial diplomatic activities (the other target group are host country businesses for example to support them in investing in the embassy's home country).

By adopting a single case study design we were able to 'control' the phenomenon (commercial diplomatic facilities provided by an embassy), namely one and the same set of facilities where business executives and representatives are referring to. Obviously, a single case study limits us in generalizing the findings empirically; to a considerable extent this is outweighed by the fact that our approach provides an in-depth view on commercial diplomacy 'in action' as experienced by business executives and representatives.

We used semi-structured interviews as the research technique, which means that we designed an interview protocol based on definitions of the dimensions of commercial diplomacy as put forward by Naray (2008). The activities are depicted in table 1.

Table 1: Selected dimensions of commercial diplomacy and their definitions (based on Naray, 2008).

Support newcomers	How does the embassy support Dutch newcomers and mediate in conflicts?
Information provision	How does the embassy participate in the process in the need for access to reliable and neutral business information?
Network of the embassy	Partner search: encouragement of national firms (mainly SMEs) to internationalize.
Delegations and events	Credibility and image in foreign markets.

However, during the interview there is space to probe the answers, when it is useful for the respondent to explain, justify or clarify the given answer. The interviews were conducted face-to-face, individually with each interviewee.

The selection of interviewees, the business executives and representatives was done via the non-probability sampling method. We aimed for diversity among the interviewees in order to get 'rich' data, rather than aiming for a representative sample. The latter would also be hard to achieve as it is not fully clear how many and in what type of industries entrepreneurs and businesses from the home country were doing business in Malaysia. Based on data available through the Netherlands embassy we compiled a list of potential entrepreneurs and businesses. We found 21 companies willing to participate. The majority of the respondents were already engaged in business projects in Malaysia, most of them had business ties extending back for more than 1.5 years. In addition, more than 70% of the companies are actually based in Malaysia, with an own subsidiary, manufacturing plant(s) and/or sales office(s).

Interviews were done individually, face-to-face and lasted from one hour to two hours. The setting was always the interviewee's office environment or an agreed on location, but never the embassy was chosen as the place to meet.

The interviews were recorded and literally transcribed. We developed an analysis matrix with the dimensions of commercial diplomacy as the one side and the definitions, indicators and key words on the other side. This matrix was used to code the interview transcripts.

#### 4. RESULTS

The embassy of the Netherlands in Malaysia, and especially the commercial diplomat, is the contact person for the home country government, home country companies, and institutions interested in trade, development, technology or joint ventures. The commercial diplomat is expected to connect home country companies with Malaysian counterparts to encourage opportunities between local and foreign players. It is important to have an in-depth knowledge of the local markets in order to understand them and make an adequate contribution. To serve the target group as good as possible, it is important for the embassy to communicate to several stakeholders about what they might expect from it. The embassy needs to follow current developments closely to remain prepared to respond at any time to requests from the Malaysian niche markets. The embassy's home country maintains close business ties with Malaysia as the 9<sup>th</sup> largest importer and 4<sup>th</sup> largest investor in Malaysia. Between the embassy's home country and Malaysia the potential for cooperation is increasing between several industries, like 'green technology' and R&D. Its special knowledge position in the field of agricultural technology and water management from an environmental perspective distinguishes the embassy's home country from the competition and can be used to its advantage.

The assistance of commercial diplomats is considered a primary service, which means eliminating trade barriers, providing information, assistance, promotion of the home country and supporting missions. It is prohibited by law of the embassy's home country to interfere with market research for individual companies, consultancy and transaction help.

Findings derived from the interviews are presented in this section as follows. The interview results are displayed by category. In the first subsection we summarized the gathered data regarding the subject *support of newcomers*, followed by *information provision*, *network of the embassy*, and finally *delegations and events*.

##### Support of newcomers

The embassy's support towards newcomers has been experienced as moderately valuable by the target group. Companies who are unfamiliar with the Malaysian business environment and/or have no business ties with Malaysia judged the assistance of the commercial diplomat as very fruitful. One of the respondents said:

*"I was quite unfamiliar with the Malaysian market and contacted the embassy for the possibilities to export my product to Malaysia. They informed me about the opportunities in the country, and after an official request from my side, they arranged 4 meetings with potential agencies for my company. Due to embassy efforts I found my way in Malaysia."*

Another respondent however said:

*"The relationship is very reactive on their side, sometimes I put some effort into making it more interactive. The request from my side is a trigger for the embassy to take action. I would like to see them being more active in sharing information and mentioning challenges."*

But yet other respondents having the opposite experience:

*"The relationship with the embassy is very good and close. I consider it an interactive relationship with passion on both sides."*

In addition, it was found that companies with current business ties to the Malaysian market invoke the embassy less frequently on issues related to newcomer problems, like market information, concessions, and customer contacts, as they gather their own knowledge and have market experience. According to one of the respondents:

*"The information of the embassy contains little information that is new to me. I consider this as not interesting."*

Another respondents stated:

*"The embassy can provide a prepared list of customers, which I can do better by myself."*

It is acknowledged by business executives and representatives that the first request for help or information has to come from the company, but subsequently the embassy was very willing to help. SMEs<sub>5</sub> are found to make use of the information and matchmaking facilities of the embassy, whereas MNEs<sub>6</sub> do not.

5 SME: Small and Medium Enterprises

6 MNE: Multinational Enterprises

Or as one respondent put it:

*“I gather all necessary and interesting information myself, also I was not aware that an embassy could offer such assistance.”*

Another respondent was positively surprised by the mixed program of the matchmaking day. In the morning he was informed about the market structure, challenges and opportunities, and in the afternoon he was introduced to potential clients.

*“If I had known of this service before, I would have contacted the embassy much earlier.”*

And yet another respondent expressed:

*“I received a list with Malaysian partners in the same industry, and it should be interesting to cooperate with them in the future.”*

In cases where the embassy was present during ceremonies, e.g. signing contracts, or arranged meetings, both MNE and SME appreciate the embassy's presence and awareness of the business situation the company is involved in.

A respondent said:

*“The commercial diplomat introduced me to a potential client. After the introduction, we put our efforts into a good business relation, but the initial contact was based on the embassy's network.”*

But also a respondent with an established business expressed:

*“The existing network is already so well developed that the embassy could add little value”.*

#### Information provision

It was found that most requests for information are related to general topics, and the embassy will not usually receive requests for more in-depth information.

One of the respondents said:

*“The commercial diplomat keeps me informed about new opportunities. However, while she put great effort into making it accessible for me, I have to put effort into getting the contract signed.”*

Respondents acknowledge that players in specific industries have better access to market information than the embassy. Further findings in this research are that the longer a company is part of the Malaysian business environment, the less its need for information from the embassy. The information provided to clients during matchmaking programs is considered of high quality and informative. Participants of this program can be considered as unfamiliar with the Malaysian market which they are interested to enter. Respondents who had participated in industry-specific missions/matchmaking programs were highly satisfied with the information received.

Or as one of them put it:

*“During the matchmaking day, the first appointment was with a representative of the government, who elaborated extensively about the market opportunities. This quick scan was really helpful to get an overview of the market.”*

Especially in selected high-tech countries Dutch embassies employ a science & technology specialist. The Netherlands embassy in Malaysia does not have such a specialist, and this lack is considered a shortcoming by two of the 21 interviewed companies. These two small company representatives from the technical industry said:

*“The embassy initiates and stimulates some key industries in Malaysia politically, but is not focused on technical assistance on an individual level”.*

Critical notes regarding the information provided by the embassy where that the embassy is not sufficiently focusing on business issues. One respondent put it as follows:

*“The embassy is out of the touch with reality, a ‘clean saloon’ but the output of information is marginal. The economic department is overshadowed by the consular affairs.”*

#### Network of the embassy

It is acknowledged that the embassy has a very extensive network in the private and public sectors, but some respondents mentioned that the embassy's network is just one of many, assumed to be “one

of the players” and not the hub in the system.

To cite a respondent:

*“Each company creates its own network, as it happened to me. I don’t need the embassy’s support for any contacts or matchmaking events. I already had contacts in Malaysia before I established the company here.”*

Another respondent said:

*The embassy might be a hub in someone else’s network, but not for the companies which have been doing business for a longer period of time ... Especially for new entrepreneurs with fewer contacts and experience, the embassy is able to facilitate a good network that could serve as a good stepping stone.”*

Especially companies that have been operating in Malaysia for quite some time, or that have close business ties, have built up their own network and business contacts. It is noted that the embassy is willing to use its network and even search beyond its network for appropriate partners. Companies interacting more closely with the embassy experience a more active attitude of the commercial diplomat than companies with less contact.

The “round-table” events organized by the embassy are evaluated as successful and positive by all participating SMEs, and the interaction between SMEs and the embassy is recognized as fruitful.

One respondent said:

*“Because we have no local representative in this area, it is important to us to have a tight relation with the embassy. In the Asian business environment, it is largely a matter of people-network, carefully built up over a long period of time. Therefore, the embassy, with all its contacts and seniority, is our hub.”*

Although the embassy maintains an extensive network in certain ministries and government-linked agencies, the influence of the embassy in the policy-making process is slight, the Malaysian government sets its own agenda. The embassy can create the opportunity to improve the business environment by having an open dialogue on specific issues or raise certain points in conjunction with the EU<sub>7</sub> ambassador.

A CEO of a MNE said:

*“Foolish to think that the [home country] embassy has any influence on the legislation in Malaysia, but the embassy creates an opportunity to have an open dialogue on difficult issues, whether or not in cooperation with other embassies. You can’t change them if they do not want to change.”*

Another respondent added:

*“The influence of the [home country] embassy can only be exploited when it is accompanied by money and major investments in Malaysia. As long as the [home country] is one of the largest investors in Malaysia, they have some influence.”*

There is a small group of respondents who actually think that the embassy has some influence on political affairs.

Or as one respondent put it: *“The influence of the embassy is considerable.”*

### Delegations and events

Based on the interview findings it can be concluded that the majority of the trading missions are initiated by organizations established in the embassy’s home country. When the embassy is involved in the preparations, efforts are mainly focused on matchmaking (due to its extensive network in the private and public sector) or logistic facilities. SMEs taking part in trade missions mention the high level of the negotiations and that participation in these missions was invaluable. They experienced limited room for individual meetings and business negotiations, while a lot of attention is paid to signing MoUs and agreements. This opinion is shared by a respondent of another home country company:

*“We receive invitations for trade missions frequently. However, the composition of the delegations is not interesting for our company and thus has little added value.”*

MNEs judged these missions as valuable, because more attention is paid to multinationals. One



respondent, CEO of a multinational, appreciated the invitations to participate in trade missions. He considered the trade mission valuable for his company, because *“attention is focused on the services our company delivers”*. He judges this as *“mutual advantage”*.

The companies involved in matchmaking programs, meant to serve as an introduction to the Malaysian market, evaluated the embassy's efforts in arranging the meeting as useful and thought it very important to have an overview of the main issues/challenges in the market.

When interesting and knowledgeable persons from the home country visit Malaysia, the embassy puts on an event (e.g. seminar) and invites all relevant parties, to share their knowledge and bring together home country solutions for Malaysian challenges.

None of the interviewed companies mentioned being dissatisfied about not being invited.

*“As a newcomer, I am not aware of the important players, rules and regulations. We were grateful for the help from the embassy, and it was of great assistance to us to decide to enter the Malaysian market.”*

## 5. DISCUSSION AND CONCLUSIONS

In this section we will discuss the findings of the data. Expanding the domestic markets can have mutual beneficial effects for companies and government (Kostecki & Naray, 2007), as mentioned earlier. Companies gain easier access abroad through a sustainable relationship with the government, and the government is interested in job creation, increased tax revenue and economic integration.

Regarding the support of newcomers, not all new home country players on the Malaysian market are being supported by the commercial diplomat. In those situations in which the embassy was not involved in a supportive or advisory role, it is very common for companies to have conducted market scans in their home country before deciding to expand abroad. This market research process is already accomplished when companies enter a new market and/or come into contact with one of the diplomats.

Kostecki and Naray (2007) mentioned that the commercial diplomatic activities should focus on assisting a large range of companies rather than supporting individual companies. Given the perspective of entanglement of interests or nepotism, it might be more transparent to offer a large range of companies the same service, instead of individual help. This criticism is also mentioned in a review of Kostecki and Naray (2008), *“Commercial diplomats will only help their private friends and will therefore only encourage corruption within the diplomatic services”*.

However, the embassy is accessible for all companies, which means that every company has the opportunity to apply for the same services. In addition, there is a policy guideline from the home country that indicates what services can be delivered, and finally, an integrity code is implemented in every embassy. Nepotism cannot be excluded completely (in all industries). Based on our findings, we can doubt whether the argument in the paper of Kostecki and Naray is solid.

The individual support experienced by newcomers, especially the matchmaking programs based on company-specific needs, were very attractive. After an extensive intake, the local employees of the embassy contact and arrange appointments with local companies. The strength and benefits of local employees, with their experience and knowledge of the local market, are very obvious in these matchmaking programs. The markets in Malaysia are increasingly transparent, but still difficult for inexperienced players. The important positive effect that knowledgeable employees can have for the local markets is in line with the theoretical findings of Kostecki and Naray (2007). Without this commercial diplomatic support, SMEs were less able to scan the market for business opportunities and meet appropriate counterparts. This individual help is considered as fruitful and helpful, based on the findings. One of the reasons why SMEs do not invoke the embassy's help was that they were unaware of the support on offer.

According to Lee (2004), one of the commercial diplomatic activities is gathering and disseminating commercial information and market research, which is information on existing and potential markets on both a geographical and sectional basis. Although the discussion within the embassy's home country ministries of Economic and of Foreign Affairs is directed towards a more result-oriented system of organization, information gathering and sharing activities are based on the commercial diplomat's judgment. There are some industries that are relevant for the Netherlands in most countries and that should be included in an annual report, like oil and gas or water management; there are also some specific needs for each individual country, depending on the level of development, geographical



location and natural resources.

When investigating the reorganization in Canada's Foreign Service, Potter (2004) stated that the trade commissioners are Canada's eyes and ears in foreign markets. We assume that this statement can be generalized to every commercial diplomatic department. Requests for industry-specific related issues are rare. Both MNEs and SMEs that are familiar with the local business environment do not complain about the lack of in-depth information of explicit sectors, which is quite understandable. It would be remarkable to ask a commercial diplomat with less in-depth knowledge about a specific industry for advice or information. The supportive task of an embassy regarding providing information is based on primary services, regarding general information of the market, but the spotlight is on the needs of an individual company. These findings are in line with Naray (2008) who stated that the development of the Internet as a source of information has shifted the service of the commercial diplomat towards more value-added and tailor-made intelligence based on personal contacts. The longer companies are established in a country (thus more experienced), the less their demand for information. The highest added value is delivered to newcomers and concerns information provision.

Ambassadors, commercial attachés, and other members of the diplomatic corps are said to play a key role in developing and maintaining export markets, and creating an image of the home country (Naray, 2008). An embassy provides a so-called primary service to anybody who requests assistance, which is in line with the state-aid legislation for interference in the free market economy. In the Ministry of Foreign Affairs there is an ongoing discussion about reorganizing the task-oriented system towards a result-oriented system, whereby assistance could be extended to more in-depth market information or tailor-made advice. The second question that arises is the free availability of the service. Is an embassy an appropriate institution to extend the service into tailor-made options, subject to a fee?

If it is decided to reorganize the embassy into a result-oriented organization, there are several implications and consequences. Industry-specific specialists should be hired to deliver the correct information/advice, which increases the cost of labor. As a consequence, the embassy might be seen as a competitor of other consultancy firms, 'customers' will expect high-quality work, the accessibility of the embassy may be diminished and/or objectivity may be compromised.

### ***The future of commercial diplomacy***

Commercial diplomacy is undergoing a gradual process of privatization (Sherman and Eliasson, 2006). These institutional developments consider a move toward influence of the government's foreign policy by the private sector.

Reorganizations, increasing the yield, and improving efficiency are recurring items of the discussion about the future of commercial diplomatic activities. The economic crisis has also affected the budget of the Ministry of Foreign Affairs, which may result in a cut for embassies and consulates, and thus also for the commercial diplomatic activities.

Critics or opponents of these commercial diplomatic activities might argue that information gathering and disseminating activities and matchmaking events could be realized by private companies. Aside from this "informal" task, the presence of the commercial diplomat also serves "formal" purposes, such as a backing facility and maintaining a network in private and governmental institutions, which are more difficult for private companies.

In the interest of making the embassy visible to its target group, it is quite important for the embassy to communicate repeatedly what services it can offer and stay connected with the target group.

### ***Suggestions for future research***

The findings of this research are based on information gathered in Malaysia, and the results are limited to the circumstances faced there. It would be interesting to see if these findings could be generalized to other embassies. Future research in different embassies is needed to validate the outcomes of this research, and find out whether these outcomes are applicable in all cases.

Another suggestion for future research is the influence of the personal traits of the commercial diplomat on the image of embassy. The three work styles mentioned by Naray (2008) are significantly different. From bureaucratic report writer towards a hands-on approach, it can create a completely different image of an embassy. Is the Ministry of Foreign Affairs aware of these influences, and how can these personal traits aspects be implemented in their HRM system?

An interesting topic for future research is whether the effect of a mission accompanied by captains of industry or political leaders has more added value/leads to a significant positive effect than one without them. For example, a Norwegian delegation seems to be very impressive due to the presence

of important and influential leaders from industry and politics. These missions are extensively announced and get massive attention when they visit a country. In addition, it would be interesting to discover whether matchmaking programs/trading missions in cooperation with an industrial branch organization are more effective in industry promotion than ones without this cooperation.

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## SHAPING THE PATH? LEARNING EFFECTS ON ENTERPRISE POLICY DEVELOPMENT IN POST-COMMUNIST ALBANIA

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### Abstract

Post-communist countries have taken diverse paths of development, partly shaped by their pre-communist histories and experiences of communism, as well as the decisions of political elites after 1989. This diversity of post-communist experiences has given prominence to path dependency arguments that through their institutional determinism account little for a process of learning that takes place in these contexts and its power in shaping and /or generating new pathways of development. I study learning both as subject to individual policy actors' efforts to interpret their worlds and make sense of the changing context they operate in, but also as subject to internal and external influences in the process such as from domestic social actors or powerful stakeholders like EU or other international organisations. The latter influence learning through their powerful discourses, benchmarking practices, as well as material or symbolic incentives related to EU membership. Drawing on qualitative data from government policy documents and interviews with domestic and international stakeholders in 2004 and 2009, and utilising theoretical concepts from the path dependency approach and policy learning literature I explore the historical development of enterprise policy in post-communist Albania emphasising both stability and change.

I find that enterprise policy development has been characterised by multiple junctures and shaped by many internal and external pressures for change over the past 20 years which have altered enterprise-related institutional configurations. Communist legacies and early transition legacies continue to influence enterprise policy development through authoritarian policy making practices or weak state capacities and resources. Nevertheless, external pressures from EU and lesson drawing processes have generated diverse processes of institutionalisation of enterprise policy through learning from past problems or / and the experience of other countries.

The paper concludes that the transnationalisation of enterprise discourses and policies, as well as Europeanization processes have brought the need to adapt path dependency approaches to account for continuous pressures for change rather than just for stability. New learning, whether instrumental or social and independently of the conditions under which it occurs provides pressures to alter institutional configurations. Consequently, path dependency approaches should account for the effect of existing policy structures / institutional legacies on individual and collective behaviour but also for the inclination of policy makers to shape these paths through their new interpretations of the past and new policy solutions in interaction and dialogue with other domestic and international social actors.

**Keywords:** Path dependency, Policy learning, Albania, Enterprise policy, EU

### 1. INTRODUCTION

A common feature of many recent studies of enterprise development in post-communist contexts is their emphasis on the institutional characteristics of these countries (Boettke and Coyne, 2003) and the social structures in which entrepreneurship is embedded (Davidsson, 2003; Baker et al., 2005). Post-communist countries have gone through a deep process of institutional and social transformation with implications for the extent of entrepreneurship development and the forms of entrepreneurial behaviour evidenced in them (Kolodko, 2000; Smallbone and Welter, 2009). Many countries have struggled to establish and develop institutional frameworks conducive to business development. The quest for establishing these institutional frameworks continues and it often occurs within the framework of EU membership incentives, dominating discourses on enterprise policies or lesson drawing as evidenced also by an unprecedented extent of policy transfer in these contexts. Post-communist countries responded to the challenges arising from the political events of 1989-91 by extensively borrowing policies from the West (Schimmelfennig and Sedelmeier, 2004) facilitated also by the increasingly global links in communications, trade and politics that have enabled policy-makers to discover, and implement, policies introduced elsewhere (Evans, 2009).

Some commentators stress the role of political elites as active policy-making agents (Petrovic 2008) whereas others emphasise the initial structural conditions shaping elites' policy choices in the transition from communism to democracy (Alexander 2008). Those emphasising the role of context have argued that sophisticated formal institutions are not the answer to institutional development;

their consistency with a country's history, culture and traditions is. With the collapse of communism, the formal institutions of communism were dismantled, but the old social institutions such as ways of behaving, norms and practices were still available and people adapted their behaviours to the new environment not *on the ruins of communism but with the ruins of communism* (Stark, 1996; see also Pejovich, 1999; 2003). This emphasis on institutions has also heightened the awareness of history and path dependence as explanatory concepts for the persistence of inefficient institutional arrangements and resistance to change, administrative heritage, absorptive incapacity and different meaning-making processes (Soulsby and Clark, 2007). Although past dependency is an attractive concept to explain post-communist institutional development, by focusing on the stability of institutions and mechanisms of reproduction it ignores a process of knowledge accumulation that takes place in post-communist countries that in time allows for shaping the path or generating new paths through human agency and social interaction. Recognising these debates (Garud et al., 2010) my aim in this paper is to elaborate on the role of policy learning in mitigating the effects of path dependency on enterprise policy development in post-communist Albania. I look at learning both as subject to individual policy actors' efforts to interpret their worlds and make sense of the changing context they operate in but also as subject to external influences in the process such as from powerful stakeholders like EU or other international organisations that influence learning through their powerful enterprise discourses and material or symbolic incentives such as EU membership (Xheneti and Kitching, 2011). I combine, therefore, institutional perspectives, focusing on path dependence, and policy learning theories to develop a framework for studying both policy stability and policy change in post-communist contexts.

The main contributions of this paper are twofold. First, I provide empirical evidence on Albania, a specific, though often neglected post-communist context, with no prior tradition of entrepreneurship and hence, enterprise policy. Second, I contribute towards an improved understanding of path dependency approaches emphasising the implications of learning in a policy context for shaping the path. The data presented in this paper is drawn from two studies of enterprise policy development in Albania I have been involved in. They both draw on the use of documentary data (GoA, 2001; 2007; 2008a; 2008b) and interviews conducted in 2004 and 2009. The research also benefits from a longitudinal aspect since most of the policy actors interviewed were the same in both studies as shown in Table 1 below.

Table 1. Policy actors interviewed

	2004 (11 interviews)	2009 (13 interviews)
Public officials		
Department of Business Promotion (Ministry of Economy)	1	2
Albinvest	2	2
Department of Market Policies		1
Business Agencies/Associations		
The Union of Chambers of Commerce	1	2
Regional Development Agencies	1	1
Agro-Business Council		1
The Albanian-American Chamber of Commerce		1
The Industries Confederation	1	1
Albanian Industrialists and Investors Association		
Donor programmes		
German Agency for Technical Cooperation (GTZ)	1	
European Bank for Reconstruction and Development Business Advisory Programme for Albania		1
Southeast Europe Enterprise Development (SEED, World Bank)	1	
Small Business Credit and Assistance (SBCA USAID)	1	
Financial institutions		
National Commercial Bank of Albania	1	

In Section 2, I briefly review the literature on path dependency before moving on to discussing how I conceptualise policy learning using concepts from the learning literature and EU studies. Next, I present an overview of Albania and analyse enterprise policy development in the past 20 years emphasising features of stability and change. I conclude by discussing the research findings, their theoretical and policy implications and their contribution towards the accumulation of knowledge on post-communist countries.



## 2. PATH DEPENDENCY

Path dependency and its associated meanings ‘history matters’ or ‘the past influences the future’ (North, 1990) has gained special appeal in recent years especially when discussing the slow institutional change in post-communist transformation economies. In post-communist contexts, path dependency has manifested itself in the coexistence of old and new behaviours, the power of old elites, learning processes, policy choices at the beginning of transition and their implications (Nee and Cao, 1999; Smallbone and Welter, 2009). Path dependency was originally developed to interpret the persistence, or lock in, of sub-optimal solutions, i.e. backward technologies due to their increasing returns, despite the availability of better alternatives (David, 1985; Arthur, 1989). North (1990), thereafter, adopted this concept to explain institutional hysteresis in his historical perspective of institutional change, emphasising that once a choice about a particular institutional set-up has been made, it will be reflected in future ones. The use of path dependency has now proliferated across various disciplines including regional studies (Martin and Sunley, 2006), organisational studies (Vergne, 2011; Garud et al., 2010), political sciences (Pierson, 2000; Thelen, 1999; Greener, 2005; Kay, 2005) and institutional economics (North, 1990).

Studies of path dependency highlight two of its defining features. First, contingency such as small events, random circumstances or historical accidents set in motion a particular sequence of events with deterministic properties (Mahoney, 2000; Pierson, 2000; Schwartz, 2003). Institutional change is thereafter considered to be a very incremental and endogenous process subject to changes in the values and mental models of people; the institutional framework becomes stable and durable due to a number of self-production mechanisms; and mainly disrupted by exogenous shocks suggesting that fast changing environments may be too unstable to sustain path dependency (Eisenhardt and Martin, 2000). In the case of post-communist contexts, path dependency has often been applied to the critical juncture the collapse of communism provided, the policy decisions taken at the beginning of transition, as well as the effect of institutional legacies in the outcome of these policy decisions (Johnson, 2001; Stark and Bruszt, 1998).

Second, self-reinforcement mechanisms, the other defining feature of path dependency, are mainly sustained through institutional inertia (Mahoney, 2000). Institutional arrangements cannot be highly flexible since their emergence is to allow for impersonal exchange; as such, complexity is inherent in the concept of institutions. Complexity and inertia, therefore, reinforce each other and complicate the altering of an institutional framework. A path becomes persistent for a variety of reasons of economical, political and social nature respectively known as increasing returns, power and legitimacy considerations (Mahoney, 2000; Lindner, 2003; Schwartz, 2003; Kuipers, 2009). When policy makers have invested resources and expertise in a certain policy path it is not efficient to challenge the status quo because of the benefits of learning effects, coordination effects, adaptive expectations, as well as costs imposed by irretrievable investments (North, 1990; p. 91). The power argument emphasises the interests of those with bargaining power not to relinquish the status quo, i.e. the elite that have a stake in maintaining the existing institutional arrangement will make sure to promote its reproduction given their access to disproportionate material, information and knowledge-related resources. Finally, the legitimacy explanation of path dependency is related to the consolidation of certain policy fields where certain actors’ beliefs and ideas take prominence into the process.

Whilst the literature discusses all these arguments as distinct self-production mechanisms, I argue that they all have in common two particular features: power and the socialisation of actors. Consequently, the powerful will *impose or subtly coerce* their social realities on others. Power, however, does not rest only with domestic governmental actors as path dependency approaches argue. Post-communist governments, in particular, being bound to EU membership incentives, are prone to EU or other international organisations’ influences that affect or sometimes dominate the enterprise policy (Xheneti and Kitching, 2011). Additionally, those with better access to knowledge and learning will be in a better position to change/shape the path. Experts, according to Fischer (2003), ‘have the ability to constitute, control, and legitimize the very issues that we take to be the subjects of deliberation’ (p. 114). This does not imply, however, that knowledge and learning are constant. In today’s fast changing and interdependent environments, knowledge and learning are frequently changing challenging actors’ beliefs and values and changing/adapting their policy lenses accordingly. Therefore, discourses and learning are continuously shaping and contingent upon not only experts’ own meaning making processes but also upon their interaction with the domestic and transnational policy setting.

Third, recognising the above, path dependency should be adapted to explain both stability and change (Kuipers, 2009; Djelic and Quack, 2007). Knowledge of mechanisms of institutional reproduction, recognising the differing set of ideational and material foundations where institutions rest; their



accommodation of, or resistance to change pressures provides some answers to reversing or changing a certain path (Thelen, 1999; Mahoney, 2000; Pierson, 2000; Lindner, 2003). Additionally, changes in the policy environment – ideas and discourses, resources and/or external incentives/pressures, all induce change in actual policy structures giving scope to a process of adaptation/mutation and lesson drawing (Peck, 2011; Rose, 2003). I argue that in a policy context, the role of policy learning is crucial, since conceptually, learning has a special emphasis on change (Zito and Schout, 2009), shaping contexts and perceptions of individuals (Bennett and Howlett, 1992; Schout, 2009).

### 3. CONCEPTUALISING POLICY LEARNING IN POST-COMMUNIST CONTEXTS

Learning, despite its overlapping conceptualisations and operationalising difficulties (James and Lodge, 2003; Nedergaard, 2006; Bomberg, 2007; Zito and Schout, 2009), has been an integral part of organisational studies, policy studies and more recently EU integration studies. Learning has been defined as ‘a change in beliefs or the degree of confidence in one’s beliefs’ as a result of observation and interpretation of experience (Levy 1994; p 311). Learning is mainly an individual act; however, human interaction leads to collective /organisation understanding (Zito and Schout, 2009), hence, an emphasis on policy networks and epistemic communities, as carriers of learning in policy circles (Heclo, 1973; Sabatier, 1988). Whilst learning spans disciplinary boundaries, for the purpose of this paper, I utilise some concepts related to the nature of learning in policy circles, as well as learning sources, whether domestic or international, and their implications for policy change and development in post-communist contexts.

The first distinction has given rise to various conceptualisations of the types of learning, all similar, however, when distinguishing between simple learning, instrumental learning and social/ paradigmatic learning (Hall, 1993; Sabatier, 1998). Boundedly rational agents engage purposively in learning processes with the aim of solving a particular policy problem and improving organisational or policy performance. This could lead to simple and instrumental learning in view of recognised changes in objectives and instruments partly as a result of past experience or new/ updated information, or paradigmatic, double loop learning or social learning, when a transformative shift occurs in core values and beliefs about the problems that are in need of resolution or goals, objectives worth pursuing, as well as the means to achieve them. Several authors argue that for social learning to occur it is required the de-legitimation of the existing paradigm and the presence of a politically viable alternative one (Hall 1993; Sabatier, 1993). From a path-dependency perspective, simple and instrumental learning can lead to incremental changes to a chosen path, whilst paradigmatic learning is more analogous to the critical junctures arguments or periods of crisis that lead to a totally different path.

The second distinction is particularly linked to a wide body of literature on policy transfer (Dolowitz and Marsh, 2000) and lesson drawing (Rose, 1993) and the role of international organisations, key informants or think tanks in facilitating policy learning (Stone, 2001). Accordingly, post-communist governments are active agents who *interpret* their domestic and international circumstances and *choose* to borrow and adapt policy ideas to solve their policy problems, albeit in circumstances that shape, and often heavily constrain, such interpretations and choices. This could be especially relevant when considering these governments’ deficits in policy knowledge, resources and skills, as well as the conditionalities of EU or other international organisations (Xheneti and Kitching, 2011).

Third, despite the limitations of the policy transfer literature for identifying policy learning attached to policy transfer process, it is argued that learning should be the ultimate goal of every transfer (Dolowitz, 2009; Stone, 2004). This has instigated scholarly attempts to highlight the conditions under which individuals learn and the factors that facilitate/prevent learning (Zito and Schout, 2009). Hegemonic ideas, conditionalities, as well as cost/benefit rationalisations are all used by various disciplines or scholars to conceptualise the conditions under which policy ideas travel, policy makers learn and policy paradigms change (Dobbin et al., 2007). EU integration studies, for example, distinguish between the logic of consequences and the logic of appropriateness in EU policy adoption. The logic of consequences is a logic of action based on cost/benefit calculations of instrumental rational actors that might at best result in instrumental learning such as discourse adoption and/or institutional adaptation aimed at increasing legitimacy or political support. The latter one is based on persuasion and learning and hence adoption of EU norms because actors believe it is the right course of action (Schimmelfennig and Sedelmeier, 2004; Elbasani, 2004). Similarly, Dolowitz (2009) conceptualises learning as a continuum of hard and soft forms of learning as a result of voluntary or coercive policy transfers; with the latter creating conditions for policy mimicking or emulation as instrumental types of learning (Dolowitz, 2009). In other cases, policy borrowers engage in ‘hybridisation’ of policies taken from elsewhere, adapting them to local conditions or combining them with other policies to

create an ‘assemblage’ (Prince 2010).

Generally, a pattern of leaders and followers/teachers and students is observed by various authors when it comes to learning and policy development (Skogstad, 2007; Bomberg, 2007). Leaders make certain ideas prominent (i.e. the hegemony of the enterprise discourse), decide what policies to promote as best policy practices, set incentives to emulate success; in short, they directly or indirectly set the lessons to be drawn and shape the way policy is designed and implemented. Governments have drawn upon OECD and EU documents to develop enterprise policies, promote best policy practices and initiate international benchmarking processes to compare national policy outcomes (Stevenson and Lundstrom 2007; Mosher and Trubek, 2003; Hodson and Maher, 2001). International organisations, however, through their regular feedback to post-communist countries may also create a policy environment that puts pressure on delivery, results, performance that can lead policy makers to pursue instrumental uses of knowledge (Boswell, 2008; Skogstad, 2007). Enterprise policy, for example, is governed by Open Method of Coordination governance mechanisms – rather than by legally binding regulations - coordinating national governments’ policies towards EU objectives, while respecting member (and endorsing non-member) states’ autonomy in achieving these objectives. Under OMC, member states pursue EU-defined objectives, translated into national level indicators and targets, which are subject to periodic monitoring, evaluation and peer review in order to compare progress and identify best practices (Tholoniati 2010). The aim of OMC is to facilitate the exchange of experiences and reciprocal learning since OMC can lead to ‘experimentation, learning and the development of new procedures’ (Begg and Berghman, 2002, p. 192) and can provide flexibility to the policy process (Radaelli, 2003, p. 22). The OMC processes are also in tune with the new move to more participative governance involving local, regional and non-governmental actors. The possibility of an increased participation of local and regional actors, of social partners and non-governmental organizations has been described as a major advantage of the OMC, because it could contribute to new understandings by bringing together a variety of actors with diverse experiences and motivations and as such could promote learning and experimentation in a decentralised way (Mosher and Trubek, 2003: 76-77). However, the evidence has been inconclusive with regard to policy learning, pointing at institutional inertias (Zeitlin, 2005), as well as low political commitment on the side of national governments (Radaelli, 2004). Next, I turn to the case of enterprise policy development in Albania.

#### **4. ENTERPRISE POLICY CONTINUITY AND CHANGE IN ALBANIA-TIME AND LEARNING DIMENSIONS**

In this section, I present a brief overview of Albania, emphasising her particular institutional characteristics that might constrain or shape policy development. This is followed by a discussion of enterprise policy in Albania, following a historical perspective that allows for the time dimension of policy change and learning effects to be taken into account.

##### **4.1. Short outline of Albania**

Albania is situated in the Balkan Peninsula in South Eastern Europe. One of the main characteristics of Albania’s history has been its constant struggle to ensure its survival as an independent entity. Being occupied by the Ottoman Empire for five centuries, Albania gained its independence for the first time in 1912. In 1928 Ahmet Zog, who served the country as a prime minister from 1922-1924, proclaimed himself King of Albanians and transformed the country into a monarchy. Although in the late 1920s King Zog turned to Italy for economic assistance, the economy remained underdeveloped. In 1925, agriculture contributed over 90% of the national income (Zickel and Iwaskiw, 1992). Italy made some improvements in the Albanian infrastructure in order to open up interregional commerce; there were, however, real setbacks during World War II. As a consequence of her history of wars and instability and of her economic history as a feudal society transformed into a centralised communist society after World War II, Albania has remained poor and under-developed by all standards. The alliance with the communist bloc during World War II and the subsequent establishment of what the communist regime called the dictatorship of proletariat created another historical bottleneck for the country. During the communist period, Albania experienced all the features of a Soviet type system, if anything in an extreme and rigorous form. For a number of years, as a result of alliances with the communist world, Albania benefited from millions of dollars of credits, as well as technical assistance, since many specialists from allied communist countries came to work in Albania. This technical assistance improved considerably the living standards in the country. In this respect, Albania had relations with former-Yugoslavia (1944-1948), Soviet Union (1948-1956), and China (1956-1978). After 1978, Albania pursued a policy of self-reliance and complete isolation since Hoxha regarded all other communist countries as having betrayed the principles of communism. These autarkic tendencies

were focused on other aspects of social life too. Albanians were not allowed freedom of speech, free movement inside and outside the country; they had no connection with the outside world either through tourism or through other sources of information (Dimitrova-Grazjl and Simon, 2010). This isolation and self-reliance principle set Albania's socialist model apart from that of its neighbours (ACER, 2000) and led to an idealisation of the outside world, which persists today. Albanian scholars often speak about the myth of the West as *'the strongest drive for the creation of a new identity and a new inspiration, and at the same time, the finding of a new big brother to provide support'* (Lubonja, 2002; cited in Chiodi, 2007). This quote captures both the weakness of the Albanian state, and consequently the need for an international presence, as well as the symbolic incentives associated with openness to the West.

In 1991, Albania became a parliamentary republic with a unitary state structure and multi-party competition; national elections have been held five times. A characteristic of Albania over the transition period has been the weak capacity of the state in establishing and enforcing the rule of law and in the full implementation of reforms. Whilst other countries in transition shared the same problem, mainly related to the minimal state intervention model of economic transformation followed in early transition (Holmes, 1996; Vaughan-Whitehead, 2003), Albania's extreme poverty of state resources, its short history of statehood and a strong legacy of the party-state (Chiodi, 2007) created the need for a strong international presence in all political and economic developments in the country. Twenty years on democratic institutions remain ineffective and unstable (CEC, 2010; EBRD, 2010). Parliamentary control is limited and political dialogue is confrontational and obstructive. The public administration, though much improved, is highly politicised, and appointments lack transparency; elections have invariably been followed by purges of the previous administration (Austin and Ellison, 2008) that arguably lead civil servants to adopt short-term horizons when formulating and implementing policy. Policy-making remains authoritarian, with few non-government actors involved (Bogdani and Loughlin, 2007), ministerial coordination is limited and there is inappropriate use of public consultation (SIGMA, 2008; 2009). Weaknesses hamper the business environment, in particular, the recognition and transfer of property rights. Political corruption, tax regulations, inefficient government bureaucracy, policy instability and organised crime remain significant problems (WEF, 2010). Consequently, trust in political figures and institutions remains low (Dimitrova-Grazjl and Simon, 2010). These persistent problems contributed to the rejection of Albania's application for EU membership in November 2010 (CEC, 2010). Nevertheless, despite a general distrust by Albanian people in the state and its institutions, both the political elite and the population in general share the same aspirations towards Albania joining the EU. There is no doubt that EU integration acts as a great motivator for the political elite and the public administration to further strengthen the reforms in the country and those that get closer to this goal seem to be supported by the Albanian electorate (Elbasani, 2004). This short overview of Albania provides an indication that Albania, given its peculiarity, is an interesting case study of path dependency and learning. In the next sections I concentrate on the enterprise policy development focusing on the role of policy learning.

#### 4.2. First stage of transition – A journey without directions

Initial reforms focused on privatisation, liberalisation and stabilisation as part of a neo-liberal, 'Washington consensus' agenda (Hashi and Xhillari, 1999; Kajsiu, 2010). Subsequent reforms centred on improving the business environment, including strengthening public administration and law enforcement, tackling corruption and infrastructure development (EBRD, 1999-2010). Albania's private sector developed through a combination of privatization of state-owned enterprises and new firm formation after the liberalization of entry conditions. The liberalisation of entry conditions was not followed by the establishment of a business regulatory framework that 'created a 'free for all' atmosphere which, although very conducive to private enterprise did not encourage a sense of law' (Hashi, 2001; p. 223). Privatisation of small state-owned enterprises began in the early-1990s and was completed by 1995; privatisation of large state-owned enterprises still has some way to go in the oil, energy and insurance sectors (EBRD, 2010). As a result, since 2003 the private sector in Albania accounted for 75% of GDP and over 80% of employment (EBRD, 2009).

Originally, the enterprise sector developed as a result of the efforts of people to escape unemployment. The institutionalisation of enterprise policy only started in 2000s, following a wider recognition that fundamental reform of the institutional framework was necessary to create a market economy (Smallbone and Welter, 2009; Xheneti and Smallbone, 2008). This paradigmatic change was embraced by the Government of Albania too that in response, in 2001, formulated its first enterprise policy and expressed its commitment toward creating the corresponding institutions to carry it out reflecting this need for a more systematic approach towards enterprise policy development. As a result, national



strategies (GoA 2001a, b) were published, an SME Law No 8957 was adopted in October 2002, providing the legal framework for SME government support and the creation of a development agency for SMEs. The contents of the Strategy spelt out the commitment of the state toward start-ups and existing businesses in manufacturing as well as the stake placed by the GoA on the enterprise sector as the driver of economic development in Albania. The strategy, however, despite from creating the basis for the institutionalisation of enterprise policy achieved very little in terms of real impact on enterprise development. Interviews with public officials and other enterprise policy stakeholders in 2004 showed that the government was often concerned with its role as an initiator and designer of strategies but little efforts were placed in adapting these new discourses to new programmes and solution and their subsequent implementation. The lack of measurable and quantifiable targets, actions plans and resources to achieve objectives is an indication of passive discourse adoption. One reason for these poor records of policy programmes and policy implementation was a lack of resources, both human and financial resources. No purposeful policy learning incidents could be identified in a context where no policy research was conducted and no evaluation of programmes was delivered so there was little learning from past mistakes. One public official mentioned that evaluation has been a missing feature of policy making in Albania because *'things change very often, agencies change, directors change so there is no continuity'*.

Assistance to Albanian businesses was mainly offered through donor programmes, which for many years offered overlapping, short-term, unsustainable support that contributed little to the institutionalisation of enterprise development in Albania, as well as to the increase of skills and capacities of Albanian business support providers (Xheneti, 2005). Donor organisations were too eager to bypass the state in their efforts to support enterprise development. Donors, whose assistance was charged at commercial rates, tended to locate in the areas with most potential or supporting trading and importing activities, or businesses with a track record that could repay the high interest loans within a short period of time. This thinking contributed to a degree to the distorted economic structure in disadvantage not only of the poorest areas but also of industrial competitive and sustainable activities. Additionally, donor funding was often not used because of the over cautious policies of banks or other financial institutions. SEED, for instance, offered assistance to those businesses that needed loans over \$100,000 and that already had a track record. 20 years after the collapse of communism, the enterprise structure in Albania remains more or less the same. The majority of enterprises operate in the services and trade sectors and are located in the capital or nearby cities; innovation and competitiveness score poorly in World Bank or OECD reports on the SEE region.

Most importantly, most of the efforts of early transition were *'wasted'* in a regulatory environment that did not inspire confidence in investing in, and developing, business ideas. The unpredictability and instability of regulations in the first stage of transition failed to encourage compliant behaviour, thereby affecting the credibility of the government. To give just a simple example, the laws *"On Income Tax"* and *"On Profit Tax"* have been changed five times since 1993, the Law *"On Small Business Tax"* has been changed 4 times since 1993, the Law *"On Social Insurance"* has changed 20 times since 1993 and VAT exemptions 16 times since 1995" (Preci and Hetoja, 2001; p. 35).

...the agro-processing industry has to pay a 20% VAT not for the value it adds to the product but for the whole value including the price paid to the farmer...this is totally wrong...as the example of VAT shows if businesses would have to pay it the whole agro manufacturing industry would have gone bankrupt. In such cases businesses find easier to avoid paying taxes and the two parties just continue *'hating'* each other (Business Association 2, 2004).

In addition, poor specification of regulations created space for corruption because regulations could be interpreted subjectively and implemented to favour or penalise certain groups. The inadequate regulatory framework influenced the decisions of many entrepreneurs to enter the informal economy as illustrated above. The informal sector remains large, estimated at one third of GDP, mainly fuelled by weaknesses in tax policies, law enforcement and high levels of corruption (CEC, 2010; ILO, 2008).

### 4.3. The EU Accession prospect-Pressure to learn?

The EU prospect of the Western Balkan countries was not considered until the aftermath of the Kosovo war in 1999, when the EU expressed its commitment to the region through introducing the Stabilisation and Association Process which aimed at increasing cooperation and stability in the region but also offered a commitment by the EU to an individual path to EU membership of the WB countries subject to implementation of reforms. The EU has been praised by several scholars for fostering the momentum for reform in these countries through its reports and recommendations

that very often set the agenda for future challenges (Elbasani, 2004). The influence of EU has been felt strongly in designing and implementing enterprise policy too. The GoA embraced the enterprise discourse of economic development, employment growth, innovation since early transition (Xheneti and Kitching, 2011). There were hardly any policy makers or other social actors interviewed that would use an alternative discourse. The endorsement of the EU SME Charter<sup>1</sup> in 2003, however, added a whole new dimension to the way enterprise policy is formulated and implemented in Albania and helped in narrowing the gap between policy discourse and implementation. This does not exclude however, the still persistent finance, knowledge and legitimacy deficits, which GoA faces, in implementing enterprise policy (Xheneti and Kitching, 2011) and its persistent need to look at donor support for policy implementation. However, given these constraints, and a history of poor donor coordination, the GoA has established a donor forum where its objectives and policy problems are presented (Public Officials 1-5; Donor organisations 1-2, 2009)

In 2009, the private sector accounted for 80% of GDP (METE, 2010). Micro firms, employing fewer than 10 people, now comprise 96% of the Albanian business stock (METE, 2010), although the number of SMEs per capita is much higher in Slovenia, Poland and other post-communist countries (Estrin and Mickiewicz, 2010). Clear enterprise policy responsibilities have been allocated; the main responsibility for enterprise development is under the Ministry of Economy, Trade and Energy. The main policy actors are the Department of Business Promotion in the Ministry of Economy, Trade and Energy (MoETE), and Albinvest. The Department develops strategies and programmes to improve the legal and institutional framework for enterprise development and analyses and monitors policies to improve the business climate. Using best practices and experiences of countries in the region is listed as one of the responsibilities of the department, suggesting a conscious decision to learn.<sup>2</sup> Albinvest, on the other hand acts as an SME policy implementation unit, as administrator of government and donor funds, and as monitor/coordinator of SME support programmes. As public officials from both organisations interviewed in 2009 stated:

Our policy model is a European model. The EU SME Charter is the de facto model for all the member countries of the EU. Recently, the EU has expressed its support for small businesses through the Small Business Act, which for countries of the Western Balkans, all of us that want to integrate, will be the main orientation ... We will be oriented towards it because we want to become members of the EU. (Public Official 1, 2009)

The EU has been a trigger for many enterprise policy changes. It has acted as a guide for us. If you take into consideration that, from 2001, we had a strategy that was not a strategy, and we didn't know what we were doing, the EU SME Charter gave us focus ... The policy is now a system. We continuously look at the variables, and we know where we are, know where we are going and what we are aiming for. (Public official 2, 2009)

EU is the main actor from which we take ideas. This is related to the EU SME Charter and all the progress reports that EU formulates... The EU SME Charter has been incorporated in the policy making process because we try to take into account all their recommendations when we design a strategy as it was the case with the recent one [the 2007 strategy]. (Public official 4, 2009)

Therefore, a further strategy was introduced in 2007 (GoA 2007). The 2007 strategy, taking into account the recommendations of the EU SME Charter, aims to support enterprise in four principal ways, by:

- promoting an enterprising culture through introducing enterprise education into school curricula;
- improving the business climate through reform of the regulatory framework and provision of business support;
- developing businesses with internationalisation potential through training and support, technology and innovation promotion; and
- increasing enterprise financing through credit guarantee funds and micro credit.

The government that took power in 2005 made it one of its priorities the improvement of the business

1 <http://ec.europa.eu/enterprise/policies/sme/best-practices/charter/> It includes a package of policy measures in ten areas: Education and training for entrepreneurship; Cheaper and faster start-ups; Better legislation and regulation; Availability of skills; Improving on-line access; More out of the Single Market; Taxation and financial matters; Strengthen the technological capacity of small enterprises; Successful e-models and top-class small business support; Develop stronger, more effective representation of small enterprises' interests at Union and national level.

2 <http://www.mete.gov.al/mat.php?idm=732&l=e>



environment; reducing the administrative burdens to doing business and tackling corruption (Public officials 1-4; Business Association 1). Some steps towards the improvement of the regulatory framework in Albania were taken first, in response to a study conducted by FIAS on '*Removing Administrative Barriers to Investment*' in 2004. Most recently, the evaluations of the EU SME Charter conducted by the EU and OECD have been the basis of any policy reform. An SME policy index has been designed, which is being used to evaluate the countries of the Western Balkans on all dimensions of the EU SME Charter. This exercise, started in 2007, has been incorporated in revising policy actions and instruments and acting on those areas that are not scoring well in the Charter. The first evaluation of Albania's progress towards implementing the SME Charter emphasised poor performance across all ten Charter's dimensions (OECD and EC, 2009). The evaluation reported an institutional and legal framework underpinning SME policy that was largely reliant on *ad hoc* intervention and pilot projects, and in need of clear objectives. The 2009 evaluation rated Albania's policy performance as 'remarkable' because implementation improved on all ten Charter dimensions, particularly company registration and regulatory reform (OECD and EC, 2009). As a consequence of the regulatory reforms undertaken, Albania has improved its position in the World Bank Doing Business national rankings in recent years. Albania's ranking was 82<sup>nd</sup> out of 183 countries for the 2010 report, having risen from 86<sup>th</sup> (2009) and 135<sup>th</sup> in 2008. Specifically, Albania was rated very highly in terms of 'getting credit' and protecting investors' (ranked 15<sup>th</sup> in both in 2010). There have also been recent changes in income tax and bankruptcy laws (EBRD 1999-2009). Amongst the most cited examples of regulatory improvements in Albania in 2009 were the establishment of the National Business Registration Centre in 2007; the establishment of an export promotion fund, as well as a credit line guarantee, as recommended by the Small Business for Europe Act. With regard to the National Business Registration Centre policy makers stated:

...we were the last country in terms of business registration; 145 days and 1500 euro registration cost. Now we are the first of the list for two years because the model is a state of the art...the registration is done in a day and with the cost of Euro 1. It is the best model in the region; other countries' delegations have come to see how it works. (Public official 2, 2009)

The NRC has also provided an incentive for businesses to formalise since business operations are much easier currently...When the rules of the game are the same for all businesses, when businesses see that they are treated the same as their competitors in the market, their perception changes and there are indications that it has started to change. (Public official 5, 2009)

The EU SME Charter reports and recommendations by highlighting the state of enterprise policy and development in a country, in comparison to the other Western Balkan countries, put extra pressure on the policy environment triggering a need to look for solutions and make improvements. As one policy maker states:

It [the EU SME Charter] is an OCM in the sense that is not obligatory but it guides you and gives you the best practices, models and a benchmarking process. For example, if Serbia has done three steps ahead you cannot step back, you need to follow. (Public official 3, 2009)

I'd be naïve to say that this pressure does not exist but it is not something we are obliged to do, it is something we feel we have to; it is a pressure we feel about any policy that we should design and implement so that we are ready, when we become a candidate country or a member country of the EU, to harmonise with EU. (Public official 5, 2009)

Whilst this constant pressure from EU or other international organisations might imply a passive adaptation of solutions that go no further than a simple logic of consequentiality with limited possibilities for other than instrumental learning, it also engages policy makers in a process of discovery, where new ideas and interactions with international policy actors shape their mental frames and in consequence their way of interpreting policy and developing solutions. Public officials stated that:

Things have changed radically. Nowadays, there is more awareness amongst policy makers and institutions so when international consultants offer their expertise we ask them for something that is specific for Albania. 'One solution fits all' is not any more supported. This is a learning process and we have learned a lot...in the past legislation was designed to protect the interests of different policy makers such as not losing a job or not allowing the merging of different institutions. However, bells are ringing. (Public Official 5, 2009)

As the National Coordinator of the EU SME Charter, I think the EU has been very helpful and collaborative...I have been given information and advice; they have acted as a trigger for policy changes; and they have provided constant help through their experts. (Public official 2, 2009)

Whilst the empirical evidence is inconclusive with regard to social learning in the Albanian environment, the above quotes offer a slight indication that the public officials interviewed have started to reflect on new ideas and integrate them into contextually inspired solutions. This, however, is hard to pinpoint in an environment that places too much emphasis on enterprise policy convergence across countries through transfer mechanisms such as the Charter or the dissemination of best practices that might promote instrumental forms of learning (Xheneti and Kitching, 2011). Nevertheless, the influence of EU on enterprise policy development in Albania is undeniable. The second stage of transition was marked by several important junctures; the offering of an EU accession prospect, the political commitment of the government that took power in 2005 toward some business regulatory reforms, as well as the design of the policy index that intensified pressure for policy change by evaluating the progress of the Western Balkan countries on the charter's dimensions.

## 5. CONCLUSION

My aim in this paper has been to explore the path dependency and path generation features of enterprise policy development in post-communist Albania utilising concepts from the policy learning literature. I have discussed enterprise policy development from a historical perspective in order to identify both policy stability and policy change and the factors that influenced each of them in post-communist Albania. From a path dependency perspective the collapse of communism created a window of opportunity for introducing a completely new path in enterprise development. The impulse of early transition was for minimal state engagement in enterprise development in order to rupture the ties with the old communist path of state influence in all aspects of life. Nevertheless, policy development was left to spontaneity and the ad-hoc donor programmes of enterprise support contributed little to the institutionalisation of enterprise policy. The institutional vacuum and uncertainty of early transition not only weakened the state capacity but also led to a reliance on old and familiar ways of social interaction, deemed appropriate to cope with the situation. Following a paradigmatic change of the transition approach and a recognition of the role of institutions, the Government of Albania initiated efforts in institutionalising its enterprise policy. These were initially of a highly discursive nature and contributed little to policy learning since these new ideas were only rhetorically integrated into policy development. Several important changes in the domestic and international context such as the prospect of EU accession and the eventual endorsement of EU policy processes created opportunities for adopting enterprise discourses to strategies and policy actions; institutionalisation of enterprise policies; and policy feedback through a process of benchmarking and regular evaluation that led to various forms of instrumental learning.

Enterprise policy development, therefore, has been characterised by multiple junctures and shaped by many internal and external pressures for change over the past 20 years, which have altered enterprise-related institutional configurations. Communist legacies and early transition legacies continue to influence enterprise policy development through authoritarian policy making practices or weak state capacities and resources. Nevertheless, external pressures from EU and lesson drawing processes have generated diverse processes of institutionalisation of enterprise policy through learning from past problems or / and the experience of other countries.

Finally, the transnationalisation of enterprise discourses and policies, as well as Europeanization processes have brought the need to adapt path dependency approaches to account for continuous pressures for change rather than just for stability. New learning, whether instrumental or social and independently of the conditions under which it occurs provides pressures to alter institutional configurations. Consequently, path dependency approaches should account for the effect of existing policy structures/institutional legacies on individual and collective behaviour but also for the inclination of policy makers to shape these paths through their new interpretations of the past and new policy solutions in interaction and dialogue with other social domestic and international actors.

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## THE POSITIVE AND NEGATIVE ASPECTS OF FISCAL POLICY IN IMPROVING THE BUSINESS ENVIRONMENT

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### Abstract

In time when the last serious economic crises in the world had made impressionable implications on the economies of the developed and respectively transitional economies, the role of the government have become once again, since the great depression, one of the crucial economic agents that could create positive circumstances for the private sector in order to surpass the current crises. The active government policy through expansive fiscal policy had made impressive step in helping the private sector in supplying them with demand for their services, easier access to funds, simplified administrative procedures and etc. Especially, the lack of capital on the international markets and the fall in international demand forced the governments to intervene and to pull the economy out of recession with intensive government expenditure. This paper focuses on the measures that the government took and tends to take in enhancing the entrepreneurship and specifically on the Macedonian government measures. These measures could help the private sector to overcome the recession and facilitate the economic activity towards increased production and export, but it must also take into consideration the other negative side of this expansive fiscal policy. Exactly the alternatives of financing those budget deficits, which are common in many countries, could initiate intensive borrowing from the government in order to finance those economic activities. Once again, since the '80-ties, these kind of financing is a reason for unstable and irresponsible growth of the public debt/GDP ratio from the governments. Although, majority of the countries tend to increase the capital investments, but the fact is that most of that money goes for government expenditure. Precisely that excessive government expenditure in most countries is the reason for "crowding out" of private investments. This paper states the borrowing process of the government and their massive demand for capital that puts the private investors in undermined position in comparison to the government which is able to supply the capital through higher price. In other words, this paper is analyzing the positive effects from the government actions and the negative implications that the deficit finance could cause. The final objective of this paper is to detect the implications that may cause the government with the revenue and expenditure side measures in order to help the private sector.

**Keywords:** Budget deficit, Public debt, Public consumption, Tax cuts, Real sector.

### 1. INTRODUCTION

The fiscal policy is again the center of attention in the economic circles, since the last several years of active fiscal policies regarding the financial crises. The intensified government spending and reduced taxes had become initial instruments in the battle to prevent further decline in the nation's GDP levels and even try to neutralize the initial negative impact. Keynes had become once again, since the 1970-ties, in the center of world-wide discussions about the role of the government in the market economy. That active fiscal policy that recommends even accumulation of debt in order to stimulate the economy was applied by number of countries, especially those who already had enough fiscal space to do so. The others with high level of debts were found in uncertain conditions and try to react through monetary policy while in the same time were cutting on some excessive government expenditures and even raising taxes. In the first section of the paper, the attention is set on the instruments of fiscal policy and the potential measures that could contribute for better economic activity. The focus is set on several spending areas and on reducing some taxes in order to support the economy. The second section is analyzing the problem of several EU countries regarding debt sustainability as crucial element that had been used most often as source for getting out of the depression. The third section sets light on the fiscal policy measures taken in Republic of Macedonia which are in favor of improving the business environment.

## 2. INSTRUMENTS OF FISCAL POLICY

After the last serious economic crises, which started in housing and financial sectors, the consequences upon the economies were immense, registered through impressive fallback in the aggregate demand. So in case like that, again since the last “Great Depression” the way-out was in the concept of active fiscal policy in order to neutralize the negative shocks in the financial sector and in the level of national product. Again, it was on the fiscal policy through the implementation of fiscal instruments, such as tax cuts and increased government spending, to hold back the further decline in the aggregate demand.

In order to stop the negative tendency in the world economy, the IMF proposed intensive coordinative global fiscal stimulus that would depend upon the extent of decline in the private demand and intensive government response. Anyway, it must be taken into consideration that a lot of countries are not in position to force that kind of fiscal policy regarding their level of fiscal sustainability. The expansive fiscal policy would require budget deficits demonstrated with low taxes and high spending, and in terms of previous critical debt level would jeopardize the fiscal stability of the economy. This is especially the case of small and open economies which do not have easy access to capital, have high level of public and foreign indebtedness, and high risk premia. In that case it is essential the bigger countries to take more important role in the potential fiscal package.

That kind of fiscal stimulations need to be timely (need for intervention), vast (since the drop in the aggregate demand is large), lasting (since the duration of the recession will be long), diversified (since there’s uncertainty regarding the effectiveness of various measures), collective (every country will need to participate according to their capabilities) and sustainable (to avoid debt explosion in the future and possible negative effects in the short run). In other words, spending measures are more effective than tax cuts, because the increase in transfers will provide additional purchasing power for the households with low income which are more recognized as consumer oriented economic group of subjects.

When we are considering public spending measures we think on *public spending on goods and services*, *fiscal stimulations for consumers and fiscal support for the enterprises*. In downturn the government needs to continue with the current programs without possibility for suspending their realization. This is especially the case where the government is obliged to fulfill the balanced budget criteria, which fosters restrictive procyclical fiscal policy focused on reducing public spending and increasing taxes. On sub-national level that could be surpassed by government transfers that could help in preventing spending program cut backs. Exactly that kind of spending would trigger bigger aggregate demand than the initial government order, expressed as multiplier effect. The initial government demand would initiate increased production, work force and profit. Those paychecks will be used for providing goods from other enterprises in the economy. Final conclusion is that exist positive feedback between higher demand which leads to higher income, and in return higher demand. That would mean also new investment plans as response to the government demand. (Mankiew, 2008)

Although, government could also decide to increase the wages in the public sector, but it is shown that this measure is difficult to be reversed and is similar in effectiveness as transfers. Anyway, it is justifiable to boost public sector employment, if not temporary, with some new projects, such as accession in EU which needs additional force for fulfilling the new positions regarding the available funds coming from EU.

When comes to question support for the consumer in such exceptional circumstances the first argument is decline of wealth, which would lead the consumers to cut back spending; second, restrictive credit programs, described through difficult access to finances for suitable interest rate; and third, expected uncertainty which diverts people from consumption towards saving.

Another measure would be certain tax cuts. But it’s not clear if the announced decrease in some taxes would give the required boost for consumption, since the marginal propensity to consume in such time is pretty low. Then there are some other measures, such as incentives for buying new cars in countries like Germany and France.

In the case of firms, they are the first one’s that react in respect of fall in demand and stress out the potential negative implications immersing from government (re)actions. Also like the consumers and the firms intend to suspend any potential investment decision based upon uncertainty. It has been shown that short term cuts in corporate taxes have a small impact on the behavior of the enterprise. Another vital element, despite this positive measure of tax reduction, would be the fiscal policy direction. If the government decides to implement active, expansive fiscal policy, it is expectable to make some changes in the level of budget deficit. Now comes the crucial question which source will

the government use to fund the private sector, since decides to lower taxes and increases the spending. That budget deficit will have to be covered from additional resources from domestic financial market or international markets (foreign debt). For many countries the insufficiency of capital on global market and high interest rates forced them to orient towards domestic markets. But the problem arises when those economies are small and open, with low capital and have negative current account balance, fixed exchange rate regime and independent monetary policy. It is replicated as rise in interest rate due to intensive borrowing from the government, and finally reaction from the Central Bank in order to sustain and prevent drastic raise in credit price. In lot of development countries the Central Bank went on implementing restrictive monetary policy in order to contain the pressure on interest rates and announced vicious battle against speculative attacks on exchange rate and pressures for devaluation of the currency value. For example, in 2009 in Macedonia the government increased domestic debt through emission of 1 and 3 month government notes and it become competition to the treasury notes issued by the central bank, since both had the similar characteristics. The last were intended for regulating the money flow and the government notes for spending programs. This stressed out the necessity for coordinative approach between the monetary and fiscal policy in order to provide stable framework for macroeconomic policy. (Blanchard and Cottarelli, 2010)

The situation would be different in case of an open economy with flexible exchange rate mechanism. The active role of the government on the financial market would put pressure n the private sector, which in return is not able to follow the government lead in borrowing under higher interest rate. But that higher market interest rate would attract foreign capital and find destination as investment in domestic securities, and in return would cause appreciation of the exchange rate which will worsen the trade balance account. This situation is known as “twin deficit”. Precisely that higher interest rate would be essential for development countries in servicing public debt depending of their external debt. (Langdana, 2009)

Even in the situation of financing the budget deficit through inflation, buying government bonds by the Central Bank and increasing the money flow, the firms would hold down to their expectations on future inflation and potential devaluation of real value of the debt. That’s also risky, because firms will hold all the investment decisions in such unstable environment. That’s another reason why the governments need to be in touch and cooperation with business sector in order to produce economic growth that could shadow the government borrowing costs, instead of accumulating new debt in case of GDP decline. So that’s why the government should intend to find ways how to help the private sector (government guarantees on new credit, facilitated access to capital, etc.). Direct support through export subsidies is not recommendable, because it promotes policy of uneven playground for foreign companies, and potential retaliation and trade wars (bagger-my-neighbor policy).

### 3. DEBT SUSTAINABILITY ISSUES

When the government decides to give fiscal stimulations, it needs to make straight statement that the action will depend from the conditions in the economy. This is important from the aspect of financial markets, since they seek opportunities to question the medium term sustainability, which in return will have negative effects on the interest rates and consumer spending. That was the case in the European Union, where financial crises increased significantly the public debts. Starting from 2007-2011, the average debt ratio in Eurozone had increased by 10-60%. The four countries with the largest growth were Greece, Portugal, Spain and Ireland, faced with serious difficulties in respect of borrowing under better conditions on the financial markets. According to European Commission the main reason for debt increase was cyclical. Although, Ireland and Spain went into recession folding burst in the housing price bubble and eventually build up their debt. Also negative are the forecasts of the European Commission regarding the negative output gaps through 2012 in Eurozone countries (1, 6% of GDP following the peak in 2009 from 3, 8%), with exclusion of Malta and Slovakia. But we should try to see other crucial factor which makes the indebttness situation severe and that is the ageing process in EU. A lot of EU countries are aware of this problem and had increased the age border for retirement, since the low fertility rates are not positive indicator for healthier nations caused by gradually higher health care costs. It is for sure that the low growth of countries output is sign for structural reforms in order to reduce public expenditures, such as paychecks cuts in public administration, reforms in pension systems, reforms in labor markets, improvement of the competitiveness, etc.

In context of previous, it is necessary to make distinction between cyclical and structural deficits, because the first ones would rise in time of recession and decline in good times and the last in good times too. If the growth is satisfactory and the level of budget deficit small, it could be expected



adverse effect on the level of public debt.<sup>1</sup>

But the situation is very different if budget deficits had become large and structural, the rate of growth with tendency to decline and high interest rates. That kind of fiscal policy would lead towards debt accumulation and increase of debt/GDP ratio. This situation started to prevail in the second half of 1970-ties and appears even today in EU. The debt explosion puts the politicians in front of a tough choice that could not be postponed or neglect. It is necessary the rate of increase of interest component in public expenditure to adjust some other costs or even increase for the same amount taxes. It is proved as politically difficult to raise taxes as adjustment to interest outflows and that's the reason for timely and corrective political decisions. (Gaber, 2011)

In the last 20 years, Finland, Ireland, Spain, Sweden have made a major step in reducing their debt/GDP ratio through rapid growth. The growth effect is visible through: 1) faster increase declines the ratio, under everything else unchanged; 2) the faster growth tends to raise tax revenues without forcing the government to raise tax rates as unpopular measure and allows the government to make some cutbacks on the spending side. That kind of growth is possible only in countries that are far from technology frontier and made major reforms in budget process. Some countries that are close to that technology border succeed in reducing their public debt through growth, but mainly from adopted reforms in fiscal institutions. (Belgium, Canada, Denmark, Sweden) This implies that economic growth alone is not enough to cut public debts. Though, the institutional reforms are inevitable in order to prevent constant deficit oriented fiscal policy. (Von Hagen, 2006)

#### 4. THE FISCAL POLICY MEASURES IN FAVOR OF ENTERPRISES IN REPUBLIC OF MACEDONIA

The limit in monetary policy in case of financial crises shifted the response to the fiscal policy through coordinative approach directed to two areas: 1) enhancement of financial sector; 2) increase in the aggregate demand. As the rest of the countries in the world, Macedonian fiscal authorities were set in front of hard challenge – to turn towards fiscal stimulations which would facilitate the consequences of the financial crises and intercept the decline in economic growth and unemployment. They were pointed in two directions:

- Tax reforms (decrease of taxes, social contributions, custom duties)
- Increase of public expenditure (infrastructure projects, capital investments).

The fundamental goal of fiscal policy is to implement expansive fiscal policy which would act counter-recessive on short term in order to give support to the economic activity, and in the same time to preserve macroeconomic stability and debt sustainability. This option was supported with the low debt/GDP ratio (24%) that enables the government more fiscal space for increased government spending, reducing taxes, stimulations in the construction sector, subsidies in the agriculture, external funds for detaining liquidate of real sector, administrative reforms for better business environment, long term investments in the infrastructure (roads, energy sector, and etc). All this measures that were undertaken by the government in the last two years gave stunning results in preventing serious decline in GDP and even surprising growth of 5, 3 % in the last quarter of 2011 beyond the projection of 3, 5 %.

In order to provide support for the real sector, which was most affected by the financial crises, at the end of November 2008, the government published the First fiscal package of ten measures in total value of 330 million euro. These measures were composed of the following stimulations and effects:

- Write-off of all unpaid interests based upon taxes and contributions for social security. (gain upon December 31, 2008), with condition of total pay-off of the debt principle. If it is paid until April, 31 (then will follow complete interest write-off, 100%), if it is paid until May 1 - August 31 (70% interest write-off) and from September 1 - December 31 (50% interest write-off).
- Write-off of all overdue obligations of the corporations upon contributions for obligatory health insurance. (these debts that gain upon December 31, 2008 are put on still in the following 4 years until December 31, 2012, and in that period the interest rate is not included. If the companies complete their current obligations in time, at the end the whole debt and the interest rate will be written-off).
- Reprogramming of tax obligations. For all the companies that have difficulties to survive, it's

<sup>1</sup> This was the case of USA after the World War II and 1970-ties.



available payment off their own tax burden in installments.

- Transforming the demands upon public duties into permanent debt of enterprises as OHIS, EMO, EUROKOMPOZITI and TUTUNSKI KOMBINAT - PRILEP. The issue is about enterprises which have large accumulated lost for several years back and bad liquidity. In this manner, they will be able to confront their long-term liquidity problems and be prepared to become attractive for sale to some interested investors which will continue and expand their business activity. The goal of this measure is to attract foreign investor for the permanent solution of their problems.
- Regarding taxes – the profit in the future will be taxed only when it will be distributed as dividend, according to Estonian model.
- Cutting back on unproductive expenditures of the Government, ministries, agencies, funds, public enterprises and other state owned companies. (like as, costs for celebrating new year, gifts, etc.).
- For supporting the poorest farmers, the taxation is decreased for all that have annual income up to 1.300.000 den. In other words, the farmers with annual income smaller than 300.000 den will be exempted from taxation, while those above 300.000 till 1.300.000 den. Will have until 80% lower tax base.
- Reducing of rates for social contributions (on 4, 1 percentage points in 2009, for 3, 2 % in 2010 and 3, 7 % in 2011). With this measure, the costs for normal functioning of the enterprises and unemployment will be reduced and competition increased.

In order to improve the infrastructure and increase employment, the Government brought to light another, **Second package with anti-crises measures** in value of 8 billion euro. These measures were directed to increase the productive capital expenditures, which in 2009 were lifted to new level of 480 million euro. They are planed for roads, railways, energy infrastructure, schools, hospitals, sours, social apartments, sporting objects, etc. for the construction will be hired numerous Macedonian enterprises, which will provide work for many Macedonians and will engage other sectors. It is estimated that for realization of this Program, which will endure 8 years, on short-term will impact on the economic growth, mainly through the support of the construction sector, while on the long run this package of measures would improve the competitiveness of Macedonian economy.

Additional, on April, 2009 the Government step up with the Third package of 70 anti-crises measures intended for facilitating the consequences from the world economic crises on the Macedonian economy. In financial context, the package is worth 353 million euro, from which 173 million euro are budget expenditure cuts, and 180 million euro credit support for the enterprises. The package has 54 measures for facilitating export of goods and reducing the costs of the enterprises in the follow-up of regulatory guillotine, and 15 measures suggested from the chambers of commerce. Some of the most important measures are:

- Decline in expenditures for 10, 6 billion denars will secure top level of budget deficit from 2, 8 %, which is lower than many other countries in Europe. This level of budget deficit will provide macroeconomic stability, including exchange rate stability.
- The financing of the budget deficit will be full field through foreign assets. In other words, with importing 150-250 million euros from abroad, the total scope of assets will increase, as foreign currency. So, the banks potential will be more available for financing the enterprise needs for credit, instead for financing the budget deficit.
- The real sector will get credit infusion in amount of 180 million euro, from which 100 million are support from European Investment Bank (EIB), and the rest is expected to be mobilized from the domestic banks.
- The credit support will be directly forwarded towards employment support. The assets will be available for small and medium enterprises, which hire the largest number of workers. The basic condition for the enterprises will be to secure help for the workers to hold down for their jobs in these times of crises.
- The design of credit lines will solve the two biggest problems for the Macedonian companies: insufficiency of liquid assets and their price. Furthermore, 90 million euro (45 million euro from EIB and 45 million euro from domestic banks) will be used for short-term credits for working capital. In the same time, some of the assets will be used to reprogram credits in the same bank, which is very attractive.

- The additional 70 million euro will be used for long-term credits for investments (35 million euro from the EIB credit and the same amount from the domestic credit banks). The interest rate for both sorts of credit is subsidised from the government. For the final user, it should be 6 % annually. The burden of such a low interest rate will be on the government in order not to disincentive the participation of commercial banks in the programs. In other words, on the part which is co-financed by the government (50 % of every credit, and guarantee for that credit), the interest rate will be 1 %. That means that if the commercial bank charges 11 % on her cut (her 50 % from the credit); the total interest rate will not be higher than the default 6 % in the program. This means that the government has complete trust in the stability of the domestic currency. The government part in the credit (50 %) will be paid in denars, without currency clause. The duration of short-term (12 months) and long-term credits (5 years) clearly stipulates the government signal that there will be no change in the exchange rate.
- The credit support is meant for increasing the export. Thus, half from the projected credits may be used for support of export oriented enterprise activities. The package contains 54 more other measures focused on facilitating the conditions for export of goods.
- With the package of measures is anticipated that Macedonian bank for development and promotion will approve guarantees for executing contract liabilities, attendance of Macedonian enterprises on foreign markets, guarantees for good execution of services and other types of guarantees. The amount of assets for this purpose is 15 million euro.<sup>2</sup>

Besides these three packages of measures, the government continued in taking fiscal incentives through Fourth package of 24 fiscal measures in the area of tax policy, land policy, credit policy, property legal issues, agriculture, construction, social policy, measures in the regulatory guillotine.

Namely, according to Prime Minister Nikola Gruevski, the new anti-crisis measures:

- will modify the law of value added tax regarding the firms ability to pay obligations in respect of VAT on the 25th instead of 15th in the month, according to the legal change.
- will reduce the fee for the privatization of urban land by 30%.
- will prepare amendments to the Law on decentralization according to which the administrative procedure will end with a decision of second instance commission, and will improve the conditions for using the credit line from EIB and MBDP.
- Will prevent imports of products not manufactured by certain international standards accepted by Macedonia in order to protect the domestic producers and consumers from inappropriate competition and to facilitate the criteria for obtaining financial support.
- will be established fund of agricultural land intended to provide support for unemployed people living in rural areas and will shorten procedures and speed up more procedures in construction.

Extremely important to fiscal authorities is the awareness that the current crisis requires the deployment of the creative potential in the country, a wide process of consultation and openness to good ideas, to reach the best solutions. For this purpose, the government manages the process in ways that actively involves all chambers of commerce, businessmen, bankers and top economic experts, whose ideas are largely incorporated in the final decision of the government. Namely, according to economic experts and the positive results of the previous three packages of measures implemented by the government since the end of 2008 until 2010, contributed to improving the economic conditions, reduced the costs of the companies and facilitated the export and thus stimulated upward trend of economic growth towards the projected 2 % of the government and the IMF.

## 5. CONCLUSION

The final conclusion from this paper is that the government must at any cost find solutions and alternative routes for improving the macroeconomic conditions in any economy. This statement is supported by the recent actions taken by number of governments in order to initiate faster and stable economic growth. The measures that were taken vary from direct – discretionary fiscal policies to indirect – administrative reforms, temporary facilitations, creating economic councils as independent monitoring of economic policies of the governments which would provide transparency in budget policies, coordination's of monetary and fiscal authorities, accepting suggestions from economic chambers, and etc. despite the measures, the paper pays a little, but essential review on the issue of debt sustainability and addresses crucial problem related to the way on which governments tend to perceive fiscal policy. Especially states the problem of consistent budget deficit policy in good times that proved to be pro-cyclical and inappropriate in times of crises, and reduces the fiscal space of government and put everything on stake for some political points. That's way this question is becoming more popular in terms of suggesting some fiscal rules that would be helpful in creating and implementing stable fiscal policy. Also, the question of faster economic growth gives enthusiasm to the governments to prolong their responsible and disciplinary fiscal policy, normally in coordination with monetary policy. This paper is also significant and from the aspect of fiscal policy measures undertaken in Macedonia which had proven as essential for private sector to surpass the decline in demand. The decline in domestic demand was substituted by the government demand for goods and services and government investments in different areas, which has proven to be effective in stimulating the economic activity in the country.

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## THE ROLE OF LOCAL GOVERNMENT IN ENHANCING ENTREPRENEURSHIP ON EXAMPLE OF POLISH TOWNS

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### Abstract

Transformation of the political system, radically modified the development conditions for local communities in Poland. In the lives of local communities, the key role is now played by local governments whose powers and responsibilities are determined by relevant legislation. One of the main tasks of the local governments is to indicate directions for further socio-economic development and to ensure appropriate conditions for it. This is conducted primarily by creating the environment for the development of broadly understood entrepreneurship and innovativeness. Changes in Polish administration system and economic globalization have resulted in an increase of competition between the cities/towns. The competition concerning the usage of available opportunities has started and regarded such prospects as: investments creating new job opportunities, increasing number of tourists arriving to cities, increasing number of inhabitants and finally public financial means for city development as well as access to funds from domestic sources, but also from European Union funds.

The greatest chance for fulfilling the requirements of rapidly growing competition between territorial units had in particular these cities which created highly differentiated socio-economic structure which enterprises are able to participate in national or even international competition. At the same time, it does not mean that small an average cities or towns of ten, twenty or fifty thousand inhabitants do not have any chance in global competition about development. The active attitude of local self-government authorities and the policy of city development approved by them (including initiatives aimed at an increase investment attractiveness of the centers and attraction of business from outside) have a decisive influence on working out an adequate level of competition of a particular place.

In the above context, the aim of this paper will be presenting the role of the local government in enhancing entrepreneurship according to present situation in Poland and showing good practices of selected municipal offices which undertook some interesting initiatives aimed at business climate improvement.

The main research method used in this paper is analysis of case studies of two Polish towns located in Podlasie province. One of this towns – Zambrow – is an example of marketing activity of local authorities connected with a coherent concept of gaining European Union funds for urban area expansion, which allow to maintain the industrial identity of this place. The second example is Suprasl, very small town, which image of entrepreneurship is founding at the craftsmanship, tourism and agriculture.

**Keywords:** Local government, Entrepreneurship, Polish small towns.

### 1. INTRODUCTION

The city and process of urbanization have been subjects of complex issues since XIX century. In 1916 R.E. Park – the most important American urban sociologist – wrote: “The urban area is more than just an agglomeration of units equipped in all municipal amenities such as: streets, real estates, electricity, trams, telephones, etc. The city is also something more than a simple constellation of institutions and administration units: tribunals, hospitals, schools, police stations and offices of all variety. The city is rather a state of spirit, complex of customs and traditions, attitudes and sentiments inseparably, correlated with these customs and transmitted through tradition” (Czornik, 2004, p. 7). The above-quoted definition can form a starting point for further considerations; however, such a way of perceiving the city in particular illustrates the atmosphere of small or average-size cities or towns, and concerns bigger agglomerations in smaller sense.

The transformation of social, political and economic system in Poland, as well as dynamic development of local self-governments created better conditions for territorial units functioning. Municipal self-government authorities through democratic elections and development of market mechanisms enforced the application of modern methods of management at the local level (ed. Frankowski, 2000, p. 7).

Changes in Polish administration system and economic globalization caused the increase of competition between the cities (Kauf, 2002, p. 243). The competition concerning the usage of available opportunities has started and regarded such prospects as: investments creating of new professions and job opportunities, increase of number of tourists arriving at cities, increasing number of inhabitants and finally public financial means for city development as well as gaining money from domestic sources, but also from European Union funds (Komorowski, 2000, p. 157).

The greatest chance of fulfilling the requirements of rapidly growing competition between territorial units was received in particular by these cities which have highly differentiated socio-economic structure which comprised branches and enterprises able to participate in national or even international competition. Institutions functioning as customer service, administration, financial, trade and cultural centers appeared to be highly privileged here. At the same time, it does not mean that small and average cities or towns of ten, twenty or fifty thousand inhabitants do not have any chance in a global competition in development. The active attitude of local self-government authorities and the policy of city development approved by them (including actions for increasing investment attractiveness of the centers and actions to attract business from outside) have a decisive influence for working out an adequate level of competition of a particular centre (Staszewska, Wdowicka, 2005, p. 92-93).

On the grounds of a professional literature on this matter, basic factors for local development are (Jaroszynska, 2005, p. 12).:

- the needs of inhabitants;
- resources and assets of natural environment;
- infrastructure and the level of its development;
- level of education and social local culture;
- existing economic, scientific and personnel potential;
- official regulations encouraging local development;
- support of local authorities for social initiatives;
- employment resources;
- financial capital (in particular investment capital);
- modern technologies of production;
- access to attractive areas and space (investment areas);
- international relations and foreign cooperation.

For the expansion of the factors listed above to expand in particular cities a shift in the manner of management at the local level is needed. From a “managerial” attitude (which concerns mainly the administration of resources) to an “industrial” type (where the development and transformations within the urban area are stimulated). This transmission is strictly connected with the necessity of choosing the marketing orientation in management, but also with selection of more flexible approach to the way of financing of local development and with abilities of searching by local authorities ways of financing from outside sources (for example the European Union funds (Staszewska, Wdowicka, 2005, p. 102).

In this paper authors would like to consider two major ways that can decide about the development of the Polish cities (also those situated in peripheral, agricultural areas) by supporting entrepreneurship:

- Acceptance of marketing orientation in urban area management (preparation of promotion strategy of urban image) and preparation of a coherent and consistent concept of gaining European Union funds for urban area expansion.
- Development of entrepreneurship and craftsmanship on the base of local resources in the small towns in rural areas.



## 2. ACCEPTANCE OF MARKETING ORIENTATION ON URBAN AREA MANAGEMENT IN THE PROCESS OF ENHANCING OF ENTREPRENEURSHIP IN POLISH CITIES

Although implementation of a theory of territorial marketing to self-government practice is still limited in the Polish reality, it should be stressed that a constantly growing competition between the cities is the reason why they are forced to create a positive image of their city (Szromnik, 1996, p.8). It is highly important to stress that the above-mentioned trend can in a significant way decide about the success of not only big but also small and average cities and towns.

The urban image according to Kotler (1999, p. 160-161) is “a sum of beliefs, ideas and impressions that people possess about a specific place”. It is not established forever, but it is dynamic. It is a process of creation of common imagination of inhabitants and stakeholders concerning their environment of the daily life. Depending on the type of a receiver, the image created in connection to the inner environment (inhabitants) and outer image are differentiated. The inner recipients include: inhabitants of the municipal unit including local entrepreneurs, companies owners, local activists, local institutions, territorial self-government and public institution employees. The outer recipients are for example: national and foreign investors, investment funds, banks, governmental organizations and agendas, tourists, inhabitants of other settlement units as possible migrants, customers of service, educational and medical centers as well as teenagers as statistical pupils or students (Szromnik 1997, p. 39). The two following definitions must be now differentiated from each other and these are: “urban image” and “urban identity”. The initiative point of all actions taken up by local authorities regarding shaping urban image is a clear and precise definition of the identity of a particular territorial unit. This, however, constitutes a first step to conduct any actions and urban behaviour connected to creating pre-planned way of perceiving of a specific place. The urban identity defines the limits for these actions, granting them a particular coherence.

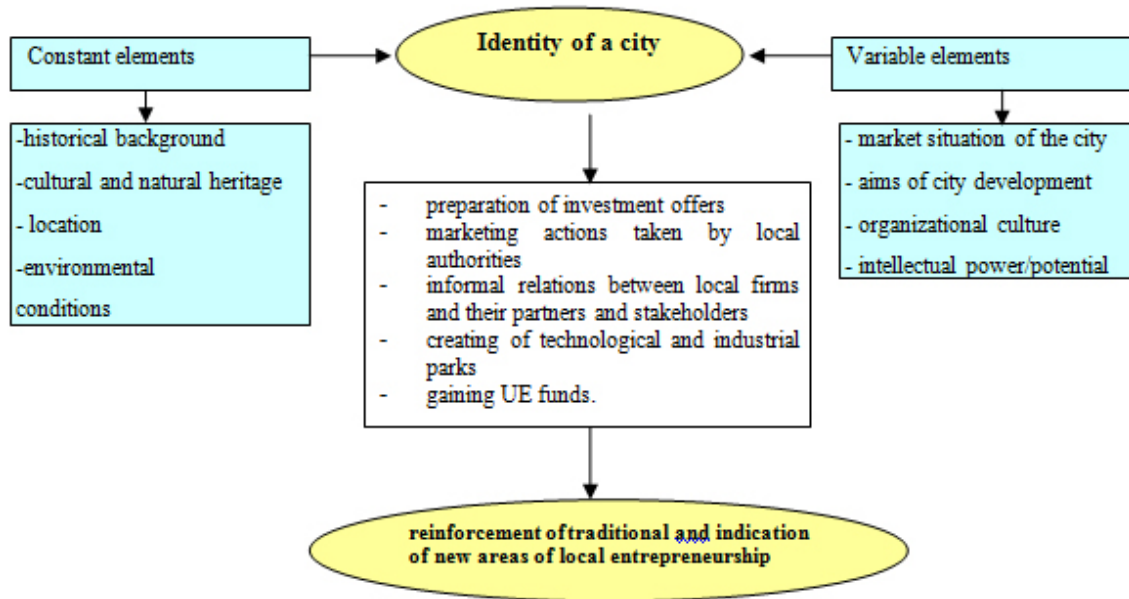
Taking into account the towns and cities of Poland it should be suggested to them the acceptance the following sample “identities”: tourist city, ecological city, multi-cultural city, historical city, boarder city, “small metropolis of countryside”, etc. Wroclaw is a good example of such city in Poland that built-up its identity from ashes. This city is particularly efficient in implementation into practice of marketing strategy which aim was to persuade teenagers from all over Poland to study in Wroclaw and link their future professional career with this town. Krakow has an image of old, cultural and touristic, European city. Problem how to build image concerns other important Polish cities, like Lublin and Lodz whose historical identities are strong, but touristic images rather weak.

The major point of urban identity is defined by Luczak (2000, p. 50) as “*a collection of historically dependent features characteristic for the city that distinguish them from others and are expressed by all actions that are taken up in order to create a specific character and personality.*”

Similar to shaping *corporate identity*, creating city identity is based on the three major fundaments of *corporate design* which means visual presentation of the city and its symbolism, *corporate communication* meaning city communication with its inhabitants and outer recipients of urban offer and *corporate behavior* which constitutes specific behavior of local authority representatives (Töpfer, Mann, 1995, p. 16).

Urban identity, in other words some complex individual image – is the way the city wants to be perceived and should be relatively stable, but also flexible in some way. The stability of the identity is based on the features of the city that does not change over time, as for example location of the city, its history, cultural heritage and nature. As far as the flexibility in an approach to the city identity should be derived from the necessity of the city to adjust to changeable conditions of the environment (the aims of the city expansion, its market positions, etc.). New goals of town identity are connected to activities of local elites and authorities in the process of creation of new job places and new investments.

Figure 1 City identity in the process of supporting local entrepreneurship



Resource: authors based on: A. Luczak, Istota tożsamości miasta, "Samorząd Terytorialny" 2000, no10, p. 50.

Local authorities as major subject of these actions based on the identity of a particular territorial unit should by its actions strive to diminish a dissonance between city identity and its image created both by its inhabitants and outer environment.

A strong and expressive urban image is the important stimulator of the development of local economy. As a result of the flow of investment or qualified personnel within the borders of the city, the parameters of local economy are changing, what simultaneously influences the quality of urban space. Moreover, a positive urban image in the eyes of its inhabitants creates more opportunities for local authorities to fulfill the tasks that can result in bigger social approval and happiness (Szymendera, 1996, p. 3).

Due to specific manner of city management that derives from the necessity of adjustment of local authorities' actions to the requirements of market economy, it is in the city's interest to care for significant and persistent creation of self-identity so that in consequence its image, that constitutes a relevant factor of this identity, was positive.

Creation of image of town at the base of its identity depends on strategy of local authorities related to profits from European projects and funds as a set of activities.

### 3. CHARACTERISTICS OF LOCAL ENTREPRENEURSHIP IN PODLASKIE PROVINCE

Podlaskie belongs to the least urbanized and to the most rural provinces in Poland. Most of population lives in towns - 55%. Podlaskie province area is 20180 km<sup>2</sup>, which gives its sixth position in the country. It is divided on 118 communities, among which 13 is urban, 23 is urban-rural and 82 is typically rural. Already this kind of division suggests that rural lifestyle is dominant, even in smaller towns. So it is worth to separate and pay attention to urban-rural centers, that once we were naming them small rural metropolis with fulfill function like: administrative, trade, workplace, entertainment, place of healthcare and education on higher and primary level, residence of banks and similar institutions to the banks. It also means that population of this small towns consist of rural social stratum (between 30% and 60%) or working indirectly in agriculture. Unfortunately agricultural population can not accumulate capital on development if the members of family do not work abroad. Small towns in periphery regions are characterized by rural identity and necessity of solving common with rural environment agriculture problems. Their inhabitants live from agriculture or use functional space that is created by the surrounding rural communities.

Multifunctional rural space development is a chance for the rural centers area and counteracts enforce rural people migrations. Mostly the target is holistically organized and flexible against the market - both in high area and middle farms, co-operative makers, agricultural groups, farmers association

that run non specialized production farms, planters, raisers and pickers or dual profession men – that entertain vacationers, tourists or work on railways, in local industry, agricultural service or in production of souvenirs that characterized specific region as for example: regions like Kurpie, Puszcza Bialowieska or other settled by minorities. The whole rural and comestible sector employs 25-30% people from among 44% presently working in agricultural in Podlaskie province. It means that the rest of rural population (also farmers from small towns) will have to live from the social benefits, find a workplace for themselves in town or abroad, study or start to work by public investments such as construction of motorways, fast railways, building the infrastructure of the frontier of the European Union on eastern border of the province etc.

An agreement in strategy for agriculture and development small towns should lead to fulfilling of the targets which are significantly superior to come down to the role of “bedroom” for Bialystok, a capital of province. In Podlaskie province strategy exists nine more detail assumptions that are second line targets against to rural areas and agriculture based entrepreneurship. It requires approval by administrative power of small towns for suitable strategy against mentioned assumptions like:

- farm rationalization and modernization,
- agricultural restructuring;
- developing produce processing base on communities area,
- improvement forestation,
- creating and building technical country infrastructure,
- construction of Centers of Market Agricultural Products in next communities area,
- promotion of positive Podlaskie countryside image,
- orientation on rural production,
- creating conditions for heath food production.

Second line targets provided substantiation strategic ways but they neither consist of timing their realization nor institution and people that are responsible for it. The most important need in current situation is not the number of maintained jobs in agriculture but transfer of some employment in agriculture to the industries connected with rural environment e.g. wood, alimentary , machine building, textile industries.

It is also worth to pay attention on those what economist called “pension backwardness”, which positively testify to agriculture just as low consumption agricultural fertilizer (70-80 kg chemical fertilizer per 1 ha) or natural fertilizer use for soil or wastes in feeding animals and the farmers role in natural food production.

The alternative in creating new jobs in Podlaskie suburban regions (Lomza, Suwalki, Bielsk Podlaski, Bialystok) and in district capitals should be jobs in services, agency on agriculture matter in *small rural metropolis area* (Poplawski, 1993), and even in *key countries and suburban countries*.

Agricultural policy led by the local governments for the small towns is a big chance for development and mainly should be realized by:

- grants for rural institutions development,
- preferential tax regulation in local taxes,
- giving specific financial allowance depending on location,
- bringing investments in wide agricultural business area,
- creation some forms that will help rural tourism located on valuable and protected nature area and also organizing entertainment of countries where the host is obliged by some code of behavior to arrange good rest conditions for visitors,
- promotion of secondary education and professional preparation against to agriculture in rural areas,
- promotion of new jobs in agriculture surrounding, mainly in Small and Medium Enterprise sector,
- creation of planning institutions – it mainly concern main and suburban rural areas,

- making new marketing firms, that will organize contacts between market and rural economy,
- exert pressure on localization of new financial institutions branch offices (banks, insurance agencies, producers representations),
- promotion cultural rural institutions that will keep local tradition such as: craft, craftsmanship ( from wicker, artistic blacksmithing and ironwork, paper decorations, waving). Coherent ethnography regions are: Kurpie Zielone rural region, Polish eastern orthodox church region, Tatars and Lithuanian region also have chance to pull especially Polish tourists,
- location for example. social houses mostly in rural areas and in Podlaskie province because in this district the number of that places is the lowest in Poland (only exists 22 social houses have 2031 places in this province, whereas average for voivodship is 5218 places in 59 houses) and other similar institutions, that would help create jobs especially for women outside agriculture.

Small towns in agricultural regions should try to set own development targets in regional policy of both state and European Union subsidies, which are granted for cohesive development of regions and realization frame programs. Enhancement of rural entrepreneurship is one of most important tasks of countryside areas development, particularly in East Poland, where an inflow of foreign investments was and is, up to now, very limited. Labor places creation in rural areas depends on internal sources of capital and entrepreneurial attitudes of its inhabitants. There will be presented two different case studies of small towns identity, mainly founded on local entrepreneurship and resources, but also external financial sources from Polish and European Union funds. These towns are situated in the peripheral, rural region of Podlaskie voivodship in East of Poland.

#### 4. MODERNISATION OF INDUSTRIAL IDENTITY. THE CASE OF ZAMBROW

Authors would like to illustrate the above-mentioned thesis with an example of a particular Polish town – Zambrow (24000 of inhabitants). This example is a good illustration of a previous thesis concerning the necessity of making changes in the way a particular city or town is perceived. Zambrow is a town of almost twenty three thousands inhabitants situated at the border of Mazowsze and Podlasie, at the south-west part of the Podlasie province. The town lies at crossroads of important communication routes – between domestic routes of eight, sixty four and sixty six.

As many other towns and cities in Poland, Zambrow during its almost six-hundred-year history has been characterized for both periods of its great economic development, but also a stagnation or a decline. The history of the town shows how within the passing years and changing “town-creation” factors, Zambrow transformed from a minor prince possession, trade settlement and a place making its living from a military service to a dynamic industrial centre that occurred in the sixties and seventies of the former century and had a significant influence on the economy of the whole province and country.

A crucial phase in the life of Zambrow began in 1949, when the decision about building a cotton factory in Zambrow was taken up in the Cabinet of Light Industry. In the Act on “a six-year plan of economic development and constituting the grounds of socialism for the years of 1950-1955 dated on 21 July 1950”, the building of Cotton Industry Centre of Zambrow was listed as one of the most relevant investments.

In 1950 Zambrow was a small, war-destroyed town, inhabited with only 4000 people. Until 1989 this amount increased for more than 1600%. The emerging of a cotton factory in town played a truly significant role in its growth. Cotton Industry Centre of Zambrow was the biggest workplace in the region, offering employment for about 3000 workers, which is why it is industry that has had a significant influence on the level of employment within the whole economy of district.

Economic transformation, expressed for example in a loss of outlets for textile industry, economic recession, restructuring and privatization of enterprises and the development of competition led to a major aggravation of the economic situation of cotton industry. This further resulted in a crisis in a dominant industrial function of Zambrow.

Numerous inhabitants of Zambrow lost their jobs what in consequence meant also a loss of a source of financial income; moreover, these workers often did not have any chance for employment in other branches of economy. This situation was followed by a 26% increase of unemployment rate what caused a significant aggravation of financial situation of local community.

In the nineties of the past century, when employment at Cotton Industry Centre of Zambrow was bound to be reduced, the community of Zambrow started heading in a search of a new strategy for



living. For the majority of them migration abroad, especially to the USA, has become such a strategy. For this day on, foreign departures of Zambrow's inhabitants form a significant feature characterizing the identity of the town described as a "dollar field".

The problem of unemployment together with foreign migration of Zambrow's inhabitants became the most burning issue of the town in the beginning of the XXI century. In 1999, the local authorities of the third term of office of Zambrow decided about the necessity of creating a long-run plan of the development of the town. The works over preparation of a document titled "Strategy of Zambrow development" that would define the vision of changes satisfying its residents, but at the same time being competitive against other towns and cities.

During the works over "Strategy of Zambrow development" the method of social dialog was applied. A questionnaire research was carried out among the town residents but also its local entrepreneurs. The aim of implementation of research projects was to define the most burning issues, of which the solution by the local authorities was expected for a long time.

As the effect of a joint effort of all people involved in preparation of the above-mentioned document, its final version has eventually been developed within few months.

The creation of the document: "Strategy of Zambrow development" formed a solid ground for defining the most important investment needs of the town. As it was stressed in the document, maximum high investment expenses should constitute an immensely strong impulse for the town expansion. On the other hand, being fully aware of the fact that growing burden of current expenses can – in a long run – make unable maintenance of high level of investment from the town's own financial means and became a reason for taking into account the necessity of looking for financial means from outside for bigger investments.

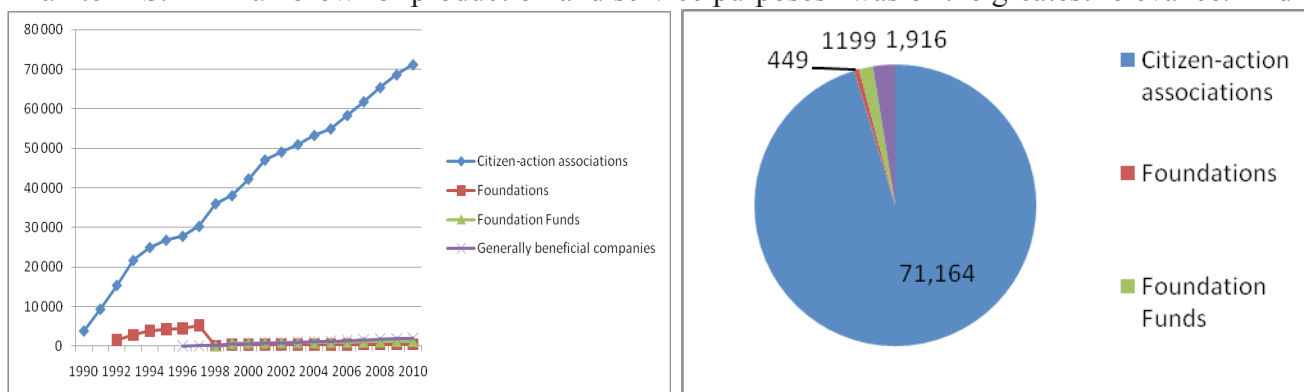
Within the years 2004-2006 twelve projects applied for a financial support from the European Union funds, the majority of them applied to Integrated Program of Operational Regional Development and tackled upon the following issues:

- green area adaptation;
- transformation of communicative layout within the town centre;
- renovation of a local hospital;
- renovations of local kindergartens;
- adaptation of industrial properties after PPB – Production-Construction Enterprise "Zamtex" S.A in Zambrow for production and service purposes.

Among all twelve applications made by self-government of Zambrow to Integrated Program of Operational Regional Development in the period of 2004-2006, not even one (despite receiving a high evaluation) after first consideration was granted a financial support. Only one project – transformation of communicative layout within the town centre gained it, but off the list of reserves.

This situation, however, did not discourage local authorities of Zambrow from further efforts to receive European Union funds.

Of all projects "adaptation of industrial properties after PPB Production-Construction Enterprise "Zamtex" S.A in Zambrow for production and service purposes" was of the greatest relevance. And



that was mainly due to the fact that it implied creation of new places for enterprise development, what in consequence meant 400 new job openings in town. It was then decided to form a municipal joint-



stock company called Real Estate Management and with its force apply for “Creating the Industrial Park of Zambrow” to other European Union Program – Sector Operational Program: “Increase of Enterprise Competition”. This move brought an expected effect and the town has been granted 7,5 million of Polish currency of donation. A complete implementation of the project costed 14 million. The Industrial Park of Zambrow created convenient conditions for forming brand new companies and development of those already existing. The aim of this investment was to initiate, but also improve local industry and in consequence whole local economy. So far contract with three foreign and domestic investors have been signed, and these include: Keylite Roof Windows (Ireland), Tefim Ltd. (Belgrad stationary company) and Oknorex sp. z o.o. (Polish company).

Due to a great interest of investors with industrial estates offered by The Industrial Park of Zambrow, local government has decided to adopt another market hall after Zamtex for production and service purposes. In September 2005, the Head of County of Zambrow transferred another market hall after cotton factory of a 7687,6 square meters (eastern part of weaving section). This project did not receive any funds either from Zambrow Program of Operational Regional Development or European Union Program – Sector Operational Program: “Increase of Enterprise Competition”, but it was placed on a list of projects that will be granted with financial support of the Operational Program: “Eastern Poland Development 2007-2013.”

The Mayor of Zambrow is currently planning the adaptation of the third market hall after cotton factory to broadening the Industrial Park of Zambrow. There is also another project included to the list of applications for donations out of Operational Program: “Eastern Poland Development 2007-2013” and that is the one concerning terrain adaptation for investment purposes.

The analysis of actions implemented by local government of Zambrow shows that the activeness and determination of local authorities, supported by wise and far-vision politics can lead to success. The emerge of the Industrial Park of Zambrow in town not only significantly reduced the problem of unemployment, but what is even more important – helped to develop local economy. Left useless after cotton factory halls are full of life again and the residents of Zambrow do not have to leave their town in search for employment in foreign countries. Today, Zambrow has new identity by which it distinguishes itself everywhere, within and outside of our country.

## **5. SMALL TOWN TRADITIONAL RESOURCES AND ENTREPRENEURSHIP. THE CASE OF SUPRASL**

Suprasl, as a very small town (3500 of inhabitants) situated in agricultural region, should implement a mediator role in realization above strategic targets, in receiving multifunctional agricultural region development. Nowadays management of this process requires preparing basis and staff which could help supporting farmers in production and sales. Towns like Suprasl should start to serve agricultural region in comprehensiveness mainly because of agricultural secondary schools existence that overrule about their role in country recovery and in creation modern agricultural service. Some European Union and current programs will be an indirect chance for Suprasl development because they will stabilized agricultural people area by a forestation program, programs connected with technical infrastructure improvement of the countries and aimed on development healthy food production, but also programs aimed at development of food processing industry. There should be used near connection among farmers and town inhabitants with tourists visiting the town in order to put in motion local fairs, being tourist attraction equally big like Uroczysko is. Also, there should be strengthened programs for young farmers so they could take over farms and have better financing.

Region of Puszcza Knyszynska and Suprasl is an ideal place for ecological food production. There exists a need for promotion it and create suitable service that will keep pro-ecology product, not mentioning the necessity of implementing law regulations creating new category products so that they could stress their better way of production without of usage agricultural chemistry in Podlaskie region. Pro-ecology and natural production of the product, its production simplicity, idyllic landscape and even horses usage should not symbolized backwardness of agriculture in Podlaskie region but nobility of agricultural product from this land on the scene in general agricultural Polish product. Marketing describes it as aiming product, so it could take place in consumers mind, awareness and be distinguished on the market from other products and subsidies. (Following the question: “Which liveliness product is first in your mind when you think about delicious natural product”? The answer is : There should appear product from eastern Poland and Podlasie, Suprasl green area).

The strong point of this area can be herbs production because of its huge potential and development, mainly in surrounding of national parks and reservations. Herbs production on this area is let by

the natural conditions and the lowest industry, communal, dust and air emission of pollution in the country. It was underlined in National Development Program for Poland - "Relatively the lowest pollution is made by lubelskie, podlaskie and warminsko-mazurskie provinces. The lag of Puszcza Knyszynska and reservations from Suprasl region should be an example of such environment value usage. The affiliation among environment protection and landscape care with agriculture function – affect countries in lags of national parks and landscapes. Natural cultivation and at least clean eco development ways of production should lead on receiving higher price of products from such regions.

The big Suprasl asset is education of own graduate staff in Technical Agricultural Mechanization College. Unfortunately students are not widely enough informed about Polish agriculture value, so that they exorcised feeling of unproductively and old fashioned agricultural. They should be proud of natural productivity and products.

Small towns, situated near the big metropolis are not able to save their own identity. In Poplawski work from 1994, "Towns on of the beaten truck. Contribution to sociology periphery" he had stressed that, among seven researched towns like Monki, Knyszyn, Ciechanowiec, Wasilkow, Bransk, Suraz, only Suprasl (next to Ciechanow) has stressed its own autonomy and identity. It is clearly seen on the background of Choroszcz, Wasilkow or even bigger Lapy, so towns in direct neighborhood of Bialystok. Mostly such towns are assimilated and "crushed" by metropolis. However, about Suprasl identity decides its tourist attractiveness and cultural visage. Promotion of Suprasl history is a significant element and it should be professionally made at first by usage of the Internet and then by the publications and conferences. It is mostly visible cultural carousal swing for example in Uroczysko. The Theatre Wierszalin Piotra Tomaszuka which has found its place in Suprasl, exerts stamp on cultural visage of this town and is well known not only in Poland but also out of state border. Art Collage in this town performs cultural role, promotes local patriotism, help in cultivate regional patterns and canons in art.

Also, culture religious Ortodox Church experience some renaissance in this town which is connected with Ortodox church defense and near buildings reconstruction. There are organized old motorcycle reunions and conferences in the town. Suprasl is visited by the way of many festivities that are taken place in Bialystok and region such as: Ortodox Church choirs festival called Autumn with Blues etc. Such things like "Polish Orient", Tatars track or Arboretum, but also relaxation centers which are situated in Suprasl and its near surrounding (for example Surazkow), guesthouses and well off people from Bialystok "dachas" are important and tourist attractive. From pine trees that were growing in this forests were built masts for the fastest selling ships of the world – clippers. This incredible tourist and cultural attractions can occurred important development factor via the Internet. Nowadays the health resort and relaxation function that Suprasl implement through Bialystok (to the II World War only well off inhabitants used benefactions of this town) is also important because of clean river, baths and Puszcza Knyszynska forrest existence. The health resort value for Suprasl should be strengthened by promoting it in Warsaw and abroad. The target will be achieved by utilizing cooperation with twin town from Switzerland and enter similar relations with other towns. We should also be prepared to relocation European Union border in the future, that will make stronger interest in tourist value on the north-eastern Poland, but towns with similar value to Suprasl is few in this part of the country. It will create an extra chance, because to Bialystok will be relocated some European Union institutions like (border services, logistic, banks and financial institutions, trade organizations) even Suprasl can achieve many profits from guests service that will visit this institutions.

French model gives directions that in Suprasl region should be lead "net country entertainment" program. It means such countries where all farms, in acceptance of the whole village, will submit and educate about running ways of attract attention and hold growing number outside guests, so that the goal could be achieved (Ceron, Passaris, Vinaver, 1996). Farmers should take care of visage and esthetic own farmyards, even then their farms only fulfill agricultural function. Coordinative and informative base, that promote this and similar programs, agro-tourism should be existed in this types of small towns.

Suprasl should also be promoted outside the state through taking part in cooperation twin town programs that was began with Switzerland.

Home industries in wood trade localized here are important element of Suprasl landscape. We think about numerous carpenters families who produce wooden houses and its furnishings. This kind of skills are appreciate not only in Bialystok but also outside province border. Crafts pulverization and entering new building models can lead to this tradition disappearance. The supposition is caused of natural client segment of this sector won't be those who are building new houses, but those who are building dachas, summer resorts in Zapiecek, Sokolda, Cieliczanka and those coming back to

country or pro-ecology oriented cities inhabitants. It is worth to promote some identification mark characteristic for Suprasl so that guests who see it will think about this region, something similar like Bialowieza has – bison wooden figure. It could give beginning souvenirs industry and help to change qualify at least some of the carpenters in Suprasl as well. There should be crate organizations that will represent Suprasl crafts. There exists opinion that wooden houses are natural, healthy and worm and much better than bricks are.

## **6. CONCLUSION**

Even the best programs can not be realized if there are no interested in their realization by the local elites. Zambrow town's development is realized through methods of enhancing entrepreneurship by local government, which is preparing areas for external investors and its promotion in Poland and abroad. It is an example of modernization of base for entrepreneurship through building an institutional support for investments (Zambrow Industrial Park). Suprasl has an intellectual elite, mainly teachers from high schools, significant personality, authorities who has been engaged in process of promotion: artists, actors from Wierszalin, clergy and economy elites who are tourist organizers, small and medium enterprise owners. They create autonomous space for entrepreneurship, rather family and traditional, based on crafts and tourist SME's. Local governments should coordinate and support realization of programs and take care about outside interests of the town, collect funds (particularly profit from European founds), promote initiative, think long-sighted category about future generations. Small place's success, located on the shadow of big metropolis or situated along the main roads in the peripheral regions depends on clear cultural identity of entrepreneurs and their own economy separate face. The autonomy of the local governments depends on theirs connection with environment that's how mechanism of democracy acts and how to profit from European founds to create new market possibilities . The problem is weakness of this mechanism and low level of small towns attractiveness in inhabitants eyes, which influence on image of this cities as the places attracting external investors.

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## IS CORPORATE SOCIAL RESPONSIBILITY THE WAY TO NON-PROFIT SECTOR SUSTAINABILITY?

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### Abstract

The non-profit sector is an important component in the economic and political environment of The Czech Republic. But it is no longer sustainable without professional management.

Non-profit organizations are not affiliated with the state and their efforts are aimed at helping all aspects of humanity. Non-profits operate in many publicly beneficial areas, such as social services, care for the disabled, solving social issues, environmental protection, culture and the protection of cultural monuments and community development. Many of these organizations are also significantly involved in the area of sport. The basic motivation of their activities is not a return on investment, but is rather goodwill and the desire to help others. Any profit is reinvested into the organization. This is common used specification. I see non profit non state organisations more as a commercial company. They have no typical financial targets, but in case they will be managed well, they can multiply their mission (help more people, strenght their information impact, change mind of bigger crowd, involve stakeholders, get regular sponsors, became attractive organisation for commercial partners). In this time NNO's in Czech republic have underemployment and very universal working positions. Company Director is also fundraiser, marketing manager, businessman, personal manager and many other function's. That influences his attitude to „less important activities“ and deadlines for them. Result of this is no Public relations, no marketing. But than it is like moving in circle, because when nobody knows what do you do, nobody want's to support your activities.

In the Czech Republic is non profit sector getting profesionalised. But still for bigger half of commercial companies are non profit non state organisations still not reliable partner, because they have no marketing and sometimes nearly no management.

Financial issues are quite difficult discipline also in non profit sector. There is not so many ways how to keep your organisation financed to be able to fullfill its targets. Economical situation in Europe is no longer stable. Non profit organisations need to have long term partners to be able to keep their mission. Growing trend of Corporate social responsibility in Czech companies and divisions could bring such a good opportunity for non profit organisations, but only if they will be prepared for this trend and be able to became a professional partner for commercial company.

**Keywords:** CSR, fundraising, non profit sector

### 1. BASIC FACTS OF NON PROFIT NON STATE ORGANISATIONS IN THE CZECH REPUBLIC

Non-profit organizations are not affiliated with the state and their efforts are aimed at helping all aspects of humanity. The basic motivation of their activities is not a return on investment, but is rather goodwill and the desire to help others. Any profits are reinvested into the organization.

The entities providing public services, entities working for their members, entities that finance the activities of other people, etc., belong to the non-profit sector. Non-profits operate in many publicly beneficial areas, such as social services, caring for the disabled, solving social issues, environmental protection, culture and the protection of cultural monuments and community development. Many of these organizations are also significantly involved in the area of sport.

„Public sector is a branch, where is social wealth beeing enlarged. Economists are reflecting presence and development of this sector as a institutional answer for governmental and market deficiency. When they are considering about government, they point out at its lower ability to satisfy needs of minorities. In the case of market they point on informational contradiction between producer and consumer, where non profit sector seemed like more trustworthy partner, because his main target is not financial profit “

Source [10] pg. 6

word non-profit is common used for:

„activities, which are not based on profit for those, who got his capital to that activity, but has other purpose and benefits, for subjects, which are based for non commercial – non profit,



or other than profit based purposes, or to achieve common, social good, to achieve non markets benefits, so for public good directly or vicariously. “ Source [10] pg. 14

### **1.1 System of Czech non profit non state organisations**

Non profit sector in the Czech Republic has got two separate levels – governmental and non governmental organisations. Governmental organisations includes in the broader concept of political parties, trade unions, professional associations, majority of schools, guilds, contributive organisations, etc. In the narrow concept of non profit sector we speak about non profit non state organisations (NSO), which are further divided due its corporate personality. Except above mentioned we can include here also so called citizen activities, which are solving some public benefit without legal definition (petitions, neighbours initiatives, small public events). [10]

### **1.2 Legal forms of Non profit non state organisations in the Czech Republic**

Four types of non-profit organizations (NNOs) exist within the Czech Republic, each having a wide range of representatives.

- **Citizen-action associations (71 164 in 2010)**

Connects people and companies, who are has got same targets and to fulfill it is usefull to get organised . Minimum of three Czech Citizen must be present to found citizen-action association. They have to write statutes of association and request Ministry of the Interior of the Czech Republic for permission. Citizen-action associations is the most common type of a non profit non state organisation with very simple organisational structure. These organisations are mainly connecting sportsmen, breeders, associations, hunters, firemen, women associations, educational organisations, ecological activities, etc.

- **Foundation and charities (1648 in 2010)**

Foundation is generally understood as a means and financial fond, founded by donated property of a individual person or group of them to some publically benefited target. Targets are mainly connected with sacred values, human rights or other humanitarian values, environmental protection, culture and historici monuments and traditions, science and sports development. Examples of Czech Foundations : Drop of Hope, The Tereza Maxova Foundation, The Foundation for Development of Civil Society, The Charter 77 Foundation, Our child, etc.

- **Legal entities established by the church or religious organizations (32 in 2010)**

These entities are voluntary religious communities based on the rules of the law Nr. 308/1991 Sb. Churches and religious organizations are very important part of civil society which is being formed in The Czech Republic. Biggest organisation from this group is Caritas Czech Republic.

- **Generally beneficial associations (1916 in 2010)**

These organisations are focused on giving fo generally benefiting services. These services are understood as services provided under rules and conditions which are same for all participants. Generally beneficial associations has to publish their economical results through year report [26]. It's economical profit must not be used for benefit of grounders, leaderboard or employees and must be used for giving of generally benefical services for which was organisation founded. (Man in Need, Kühn's Children's Choir)

### **1.3 Basic legislative scope of non-profit organizations**

Non-profit and non-governmental activities in the Czech Republic are regulated by the following laws, which determines the registration process, organizational structure, financial management, economical management and termination.

- Citizen-action associations comply with Act No. 83/1990 coll., on citizens' associations, as amended.
- Generally beneficial companies comply with Act No. 248/1995 coll., on generally beneficial companies and on alteration and amendment of some acts, as amended.
- Foundations and foundation funds comply with Act No. 227/1997 coll., on foundations and foundation funds, and on alteration and amendment of related acts, as amended.

- Churches, religious organizations and church legal entities comply with Act No. 3/2002 coll., on the freedom of religious worship and the status of churches and religious organizations, and on alteration of some acts, as amended.

#### 1.4 NNO members

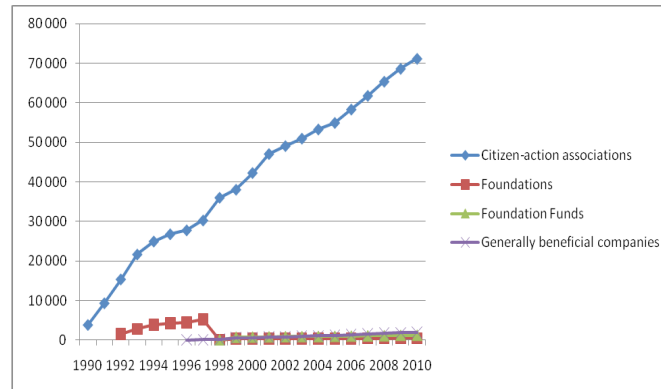
Citizen-action associations, which are established on the basis of associating citizens as members, are a type of NNO. Nearly half the adult Czech population (47%) are members of citizen-action associations.

Czechs are mostly members of sporting organizations (16%) and are often members of interest organizations such as gardening and cultivation (6%), volunteer firemen (6%) and fishermen organizations (5%). Fishermen have a greater membership base than Czech political parties.

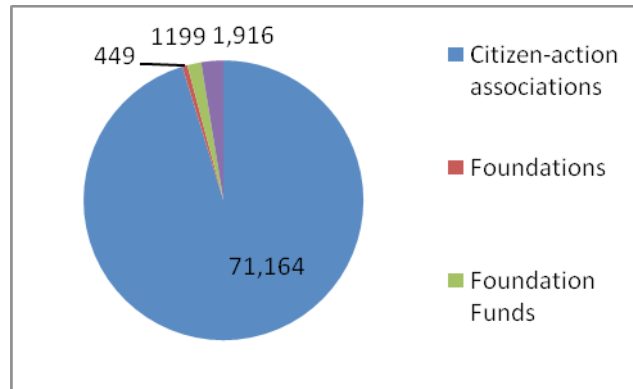
Table 1 – statistics of NNO in Czech republic 1990-2010

Non profit non state organisations - statistics				
	Citizen-action associations	Foundations	Foundation Funds	Generally beneficial companies
1990	3 879	-	-	-
1991	9 366	-	-	-
1992	15 393	1 551	-	-
1993	21 694	2 768	-	-
1994	24 978	3 800	-	-
1995	26 814	4 253	-	-
1996	27 807	4 392	-	*1
1997	30 297	5 238	-	52
1998	36 046	**55	**71	129
1999	38072	272	695	560
2000	42302	282	735	557
2001	47101	299	784	701
2002	49 108	330	825	762
2003	50997	350	859	884
2004	53 306	362	898	1 038
2005	54 963	368	925	1 158
2006	58 347	380	992	1 317
2007	61 802	390	1048	1 486
2008	65 386	411	1095	1 658
2009	68 631	429	1168	1 813
2010	71 164	449	1199	1 916

Graph 1 – statistics NNO 1990-2010



Graph 2 – number of Czech NNO's in 2010



### 1.6 Phases of the non-profit sector's development since 1989

The non-profit sector has a long and established tradition in the Czech lands. Foundations and associations have always had an important share in national, cultural and political emancipation. Its real beginning we can count since "Velvet Revolution" in 1989. These organizations and associations were disbanded during the totalitarian, fascist and communist regimes, when such independent public initiative was deemed undesirable. In 1989, a fundamental change was seen in this area. Thousands of NNOs began to operate and the non-profit sector underwent many changes. Since then, four stages of development within the non-profit sphere can be seen.

Two big changes occurred in period after the year 2000. Firstly, the reform of the public administration established the regions that influence the NNO situation. Secondly, EU membership brought an opportunity to enter into partnerships and utilize EU funds to support the activities of non-profit organizations. The Czech Republic's membership in the EU could in the future significantly strengthen the importance and influence of non-profit and non-governmental organizations and better help those who are dependent on their activities.

Nowadays is non profit sector in front of decision if start with professionalisation or rather finish with activities. Governmental sources for financing are year by year less available and if organisation want's to keep sustainable it needs to become a professional reliable and trustworthy partner for a commercial companies. For non profit sector in the Czech Republic is typical kind of amateurism in personal sources. Non profit organisation usually has a lack of employees and cumulated functions. (director is also marketing manager, businessmann, personalist and of course fundraiser). That has impal simply at delaying of non high priority activities which are for example marketing and Public relations. But that is beginning of the end. When nobody knows about you, you can have best results ever but you wont get any donation or other support for your activities.

### 1.7 Why talking about competitiveness in non profit sector ?

Because NSO today, to be able to keep their targets, goals or promises, has to compete to each other. There is just one package of finances dedicated for this purpose. Very important part of NSO financing are governmental grants or grant programs (EU, towns, regions, foundations). That is because minority of NSO's operates some production or other activities which could bring regular profit. Grant programmes are open for all organisations but they have to write the project proposal and wait for evaluation. They simply compete against each other. When there are two very similar projects, money goes to that one which is better introduced, which is well-thought-out, which has strategy, infrastructure, also good marketing and concept of sustainability.

### 1.8 Marketing communications and specificities of their use in non profit sector

Marketing of NSO differs from commercial only with product, which is not goods, but mission.

NSO's are nowadays in market environment exposed to quite high pressure and sometimes also competitive fight. Social advertising and marketing does not want us to buy but to change our behavior. That's why common used communication tools are trying more to shock and wake up our emotions. That is the simplest way how to force people act. Quite a lot of social campaigns would be banned in the case, they were commercial.

## 2 COMMERCIAL CONTRA NON PROFIT SECTOR, WHERE IS THE DIFFERENCE BETWEEN NSO'S AND COMMERCIAL COMPANIES? - MICROECONOMICAL ASPECTS

### 2.1 Company targets

In classical economical theory is the main expected company target maximalisation of profit. Alternative targets of company could be described not as maximalisation of momentary profit, but maximalisation of present value of future profits. [1]

Another company targets:

- sustainability
- reach maximum of market share (connected with profit maximalisation)
- turnover maximalisation
- grow and expansion

Recently of late we can meet more abstract targets like renown and honor building and corporate social responsibility (these two targets are measurable in the market value of companies brand or company by itself).

### 2.2 NSO's targets – comparison with commercial companies

When talking about NSO's we meet other targets than in commercial companies.

- **profit maximalisation**

Due Czech law non profit non state organisations, in the case they produce some profit, has to reinvest it in its own activities and to use it for fulfilling its own non profit mission.

It is a bit different from logic of commercial company. But if NSO's increases their income (get some grant for their activities), they can professionalise their services and improve their mission fulfillment.

- **sustainability**

This target we can find in both forms of organisations because longer working organisation knows better market of situation background, they have stable business partners and works more efficiently.

- **reach maximum of market share**

This target is due my opinion next to non profit sector interest. We can transmit it as a covering bigger capacity of market need (Churches, religious organizations and church legal entities can grow up its membership base, ecological organisations thanks to bigger amount of sympathisers could build up bigger projects- for example Greenpeace).

- **turnover maximalisation**

This target is connected with previous, at NSO's is valid only in case of increasing of beneficial reach of organisation. We can say that NSO's conveys to governmental institutions citizen's requirements. They are sort of mediator in communication. NSO's are closer to people, they can solve their troubles easier, better and quicker. Government could via NSO's help more efficiently and there where are needed.

Creation and work of non profit sector we can understand as significant expression of human's sense of culture. We can see it in the help for disabled people (transport for wheelchair disabled people – NSO Handicap?!), in solidarity with people who are disadvantaged (NSO Czech catholic charity, which accomodates homeless people in winter and gives them warm food) help to people in emergency situations caused by weather (NSO Human in need - flooding, tsunami), but also in the cases when people are responsible for their problems (NSO Drop In – drugs, alcohol) and last but not least voluntary help when people works just for their goodwill. We can say that existing of non profit sector is something what **makes human**.

### 3 ECOMICS OF NON PROFIT NON STATE ORGANISATIONS

#### 3.1 Targets of NSO's – defined on the base of comparsion with commercial companies

- development
- consciousness increasing
- fundraising for targets coverage
- grow up its membership base
- improving the NSO's status to business sector

#### 3.2 Raising the capital for NSO's activities - fundraising

Fundraising is one of basic managment tools how to keep organisation sustainable and how to acquire people who help NSO's with reaching it's mission

Due Ledvinová J.:

Fundraising :

- It is a branch which contains several methods and procedures how to get financial and other resources for activities of NSO's.
- „science“ about how to persuade others of the fact that organisation is able to solve important problems and that is significant part of society

Source [12]

The meaning of the word fundraising is to getting a financial resources to ensure organisations operation. It dont have to be only financial resources, but also voluntary work, material donations or services which supports activities of NSO's. Fundraising facilitates for those who has finances, goodwill but less time to support something reasonable through organisation which are occupying with defined problems. It is necessary to serve to donor an idea that his help could be usefull, not just ask him for money.

Also an important thing is to inform donor about how his money (or other form of support) is used, it brings far better feeling and also builds trustworth between donor and organisation.

We can see on-the-street collections, where some person stands and asks for money for some project, or sell some small items for “beneficent aim”, it is one of simpliest way how to contribute financialy. You can buy plastic flowers, pencils, braid, etc. unfortunately some of these contributions are awaking in people the feeling of wrongdoing and are based on emotional extortion. Organisers don't want us to support some good stuff, but they want make us to get them money as an excuse, that we don't do more to solve problem (magazine “Lev” and seller who screams to the crowd – Don't leave ill children to suffer – in this case we can say that the seller made a mistake). Big disadvantage is as well that “sellers” are hassling people, some days you can meet more different on-the-street collections on the square and what also sometimes happend is that “sellers” are cheaters. We can have a protest to the fact that those “sellers” are not working voluntary,



but they receive salary – provision from each single sold item.

### 3.2.1. Types of fundraising

- individual fundraising – gets money from individual donors (money not from business, but mostly from ordinary people – differs in the way how they are asked for their donation and in the amount of contribution)
- company fundraising – gets money from company donors
- own trade activities of NSO's – conduct business on the ground of Czech law (most on so called trade licence), giving paid serviced in the frame of its own main activities, organize of beneficial events and public collections.
- grant fundraising – gets money in calls for grant proposals from foundations, governmental organisations, self-governing authorities etc. [12]
  - - membership fee
  - - part of lottery revenues
  - - tax advantage for commercial donors– motivation for businessmen, when gives a financial contribution, he can save some tax charges

### 3.2.2 Fundraising methods

- personal meeting
- financial collection
- telephonic campaign
- post campaign
- Events management
- Grant proposal
- Printed commercial
- donor text messages (DMS)

Circles of donors are tightly connected with their way how NSO's are contacting them. It could be company with finances allocated for some specific purpose (grants from ministry office, self governing unit – towns, regions, private foundations, charities, Eurofonds). Next we can see random contributions (in the case some company has got good business results) and in last ten years we can meet in Czech Republic also part of CSR activities – when organisation founds its internal grant agencies – non profit organisations inside of big companies with defined target of contribution. (ČEZ, Vodafone).

### 3.2.3 Donors motivation












- Marketing purpose – sponsorship (sport advertising at stadium, outfits etc.)
- Corporate social responsibility – in Czech conditions bigger international companies – (energy services providers, international telecommunication companies, spedition service providers, etc.)
- Altruism – donors don't expect a profit, they do it just for good feeling from being donor.
- Personal motives (knowledge of problems) [12]

NSO's financing has got its particularities. Obviously we talk about organisations which does not provide any trade activity, so they can't compare and plan new economical period from their last years results and manage their economy. Grants are unpredictable and you also can't rely on individual donors. That is why NSO's should have strategy and make effort in marketing, fundraising and aquisitional activities to keep their organisation financed.

It is not a simple process, but we can say that with high quality of marketing activities and

with a very good communication is possible to improve position of NSO on competitive market. The amount of money dedicated for some target is always limited. Better project of renown NSO, with high quality communication background wins grant. That is why I consider marketing as a key activity for keeping of NSO on the market.

**Table 2 Biggest company donors overview in the Czech Republic 2010**

company	given money in summary (czk/year)	biggest donor CZ company / position	most generous company donor / position
CETELÉM ČR, a.s.	1 016 950	17	15
ČEPS, a.s. 	31 697 766	5	3
Česká pojišťovna a.s.	46 386 103	4	13
Česká rafinérská, a.s.	8 885 540	13	7
Česká spořitelna, a.s. 	53 130 091	3	14
Československá obchodní banka, a. s. 	29 737 732	7	16
GlaxoSmithKline s.r.o. 	9 018 083	12	4
Johnson & Johnson, s.r.o. 	30 717 102	6	–
KPMG Česká republika	9 478 506	11	1
Metrostav a.s.	13 263 703	10	11
Nestlé Česko s.r.o. 	17 366 738	8	6
OKD, a.s. 	134 000 000	2	2
PwC Česká republika 	1 719 815	16	5
Provident Financial s.r.o. 	5 263 923	14	9
Siemens Group ČR 	5 034 290	15	–
Skupina ČEZ 	374 528 313	1	10
STEM/MARK, a.s.	174 000	18	8
Vodafone Czech Republic a.s.	17 013 209	9	12

-  Company uses the LBG evaluation method of CSR  
 Company with governmental participation

More information you can find on table source: [www.byznysprospolecnost.cz](http://www.byznysprospolecnost.cz)

**LBG evaluation method – CRI index :** The Corporate Responsibility Index (CRI), is a leading business management and benchmarking tool that enables companies to effectively measure, monitor, report and improve their impacts on society and the environment. The framework for the CRI was developed by Business in the Community (BITC) in the UK in 2002 in consultation with business. Source[34]

## 5 COOPERATION WITH NSO'S WITH COMMERCIAL COMPANIES IN THE FRAME OF THEIR CSR STRATEGY

CSR concept is relatively new attitude. The connection of economical, environmental social targets, which are often existing in company parallelly, brings competitive advantage.

In the frame of Czech republic is CSR implemented gradually, but nowadays is CSR topic for management of middle and bigger companies. Czech subdivisions of an international companies do have its own CSR department or at least person responsible for CSR activities established in company structure. Czech Republic as a post-communistic country is still missing the implementation of CSR system into company strategy, in the minds of managers and employees, systematical planning of CSR and also the attitude of Czech people is progressing to CSR's benefit. They are becoming interested in CSR issues.

Five six years ago was nearly impossible to buy BIO food in common supermarkets, simply because there was no demand from consumers. Today we can find mainly in Fast moving consumer goods

category really wide selection of several products in Bio quality – typically fruits, free range eggs, milk, meat, vegetables, flour, etc..

CSR does not command anything. It says how you can find new solutions to reach better results and higher long-term profits with reference to surroundings.

### **5.1 Partnership between NSO's and commercial company.**

**Socially responsible company is active in all three pillars (economical, ecological and social),** in the frame of each chooses activities due its targets, and also requests and needs of its stakeholders. Company which produces energy is more interested in ecological topics, company which produces sweets for children is interested more about children issues and brings information about healthy lifestyle etc.

### **5.2 Case study : Tesco**

Long term partnership is more efficient for both sites than random donor contributions. Each super and hyper market Tesco keeps long term partnership with one governmental or non governmental organisation in its locality. Mostly are chosen those organisations which takes care about disabled or disadvantaged people (asyl houses, abandoned children, poverty stricken people, handicapped people, mothers in need etc.). Partners organisation receives from Tesco material and financial support in the frame of its limits.

How Tesco choose partners organisation?

Non profit organisation is mostly searched in the occasion of new supermarkets opening. With some time reserve Tesco company representative visits several local organisations and evaluates if is it suitable corporate cooperation principles. Than realises public opinion poll, when asks inhabitants of locality, which of them needs material and finance help most.

Organisation, which has got the biggest public support becomes long term partners organisation.  
Source : [29]

## **6. CONCLUSION**

In the Czech Republic is non profit sector getting profesionalised. But still for bigger half of commercial companies are non profit non state organisations still not reliable partner, because they have no marketing and sometimes nearly no management.

Financial issues are quite difficult discipline also in non profit sector. There is not so many ways how to keep your organisation financed to be able to fullfill its targets. Economical situation in Europe is no longer stable. Non profit organisations need to have long term partners to be able to keep their mission.

Growing trend of Corporate social responsibility in Czech companies and divisions could bring such a good opportunity for non profit organisations, but only if they will be prepared for this trend and be able to became a professional partner for commercial company.

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## MAPPING OF REGIONAL CLUSTERS IN SERBIA

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## Abstract

Ever since Michael E Porter's seminal 2003 article "The Economic Performance of Regions" on the link between clusters, economic development and innovation, many others have emulated and expanded on his analysis using cluster maps and associated statistical techniques. One of the most developed cluster-mapping methodologies is a 3-star analysis of regional clusters, developed by the European Cluster Observatory and universally applied across the countries of the European Union. There are no cluster-mapping analyses of countries in the Western Balkans, however, mostly due to a lack of reliable statistical data at sub-national tiers of government. This paper describes a pioneering attempt to apply the cluster-mapping methodology of the European Cluster Observatory to conditions in the Republic of Serbia and to derive conclusions that would be useful and dependable for academics and policy makers. The research shows three key findings: firstly, 11 cluster categories, largely in the services sector, concentrate in the major cities of Belgrade, Novi Sad and, to some extent, Niš; secondly, a number of cluster categories (13 in total) are insignificant, with low levels of employment and/or a small number of registered companies; and thirdly, the remaining 14 categories are distributed across Serbia.

**Keywords:** Cluster Mapping, Agglomerations, Regions, Serbia

## 1. INTRODUCTION

The geographic and urban agglomeration of enterprises has attracted the attention of economists for more than a century. The first empirical research was conducted by Alfred Marshall, who used the term *industrial districts* to describe the advantages generated by locating businesses in the same geographical areas (Marshall, 1890).

In the literature, the term *industrial district* is used interchangeably with the term *business clusters*, or simply *clusters*, widely promoted by Michael E Porter, probably the most prominent scholar in this field. At the same time, the term *industrial districts* has continued to be used by a group of (mainly Italian) scholars, led by Giacomo Becattini, one of Italy's most influential and world-renowned social scientists (Paniccia, 2006). This paper will use the term *cluster*.

Clusters have become a subject of intense research and economic analysis, starting with the study conducted by Michael E. Porter in his book *The Competitive Advantage of Nations* (Porter, 1990). Porter defines clusters as *a geographic concentration of interconnected companies, specialised suppliers, service providers, firms in related industries, and associated institutions in particular fields that compete but also cooperate* (Porter 1998, p.197). Sölvell et al (2008) rephrased Porter's definition of clusters as referring to *groups of companies and institutions co-located in a specific geographic region and linked by interdependences in providing a related group of products and/or services*.

Because of the proximity between them - both in terms of geography and of activities - cluster constituents enjoy the economic benefits of several types of positive location-specific externalities, such as access to specialised human resources and suppliers, knowledge spill-over, pressure for higher performance in head-to-head competition, and learning from the close interaction with specialised customers and suppliers (Marshall, 1890; Krugman, 1991; Ketels, 2004; Sölvell et al, 2008).

In the seminal article *The Economic Performance of Regions*, Porter designed a cluster mapping methodology based on examining patterns of employment across geography in different types of industries across the SIC system of classification (Porter 2003). That article has inspired many others to emulate and expand cluster analysis in the area of advancing statistical studies and the creation of so-called cluster maps.

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The first analyses in Europe that applied Porter's methodology in cluster mapping was one carried out in Sweden in 2003 (Linqvist et al, 2003; Ketels, 2004). This analysis paved the way for Swedish economists from the Centre for Strategy and Competitiveness at the Stockholm School of Economics to establish the European Cluster Observatory, which designed a methodology and conducted similar analyses across other EU countries (Sölvell et al, 2008; EC DG Enterprise and Industry, 2007).

Cluster-mapping analyses in the countries of the Western Balkans are lacking, however, mostly due to inadequate statistical data at sub-national level. The purpose of this paper is to provide an empirical analysis of concentration patterns of employment and enterprises at different territorial levels within the Republic of Serbia, and as such it represents the first cluster-mapping analysis of any of the countries of the Western Balkans. The analysis employed the cluster-mapping methodology that was developed by the European Cluster Observatory, modifying it to suit the conditions particular to the Republic of Serbia.

Geographic focus in this paper interchangeably refers to the level of administrative districts and to the local (city and municipal) level.

## 2. CLUSTER-MAPPING METHODOLOGY

In the article *The Economic Performance of Regions* (Porter 2003), three differing types of industries that constitute a regional economy are examined. The first type is *local industries*, with employment distributed across all regions (employment levels being roughly proportional to regional population). The second type is *resource-dependent industries*, with employment located primarily where the requisite natural resources are found. The third type is *traded industries*, which are not resource-dependent. These industries locate in a particular region based on broader competitive considerations, and concentration of employment varies markedly by region.

In his article, Porter separates results from the distribution of employment by industry into three further categories, using figures for the variation in employment by geography (the location quotient, or LQ): (i) the share of national employment for all states with  $LQ \geq 1$ ; (ii) the mean location quotient (LQ) for the top five states ranked by LQ; and (iii) the employment GINI coefficient. After examining the pattern of employment across geography in many industries, Porter established cut-offs for each variable: employment in states with  $LQ \geq 1$  of  $\geq 50\%$  of total employment; mean LQ of the top five states  $\geq 2$ ; and employment GINI of 0.3 (Porter, 2003, p.559).

**Table 1:** The Thirty-eight Cluster Categories of the European Cluster Observatory

Cluster Category	Cluster Category	Cluster Category
Aerospace	Entertainment	Medical Devices
Agricultural Products	Financial Services	Metal Manufacturing
Analytical Instruments	Fishing and Fishing Products	Oil and Gas Products and Services
Apparel	Footwear	Plastics
Automotive	Forest Products	Power Generation and Transmission
Biopharmaceuticals	Furniture	Processed Food
Building Fixtures, Equipment and Service	Heavy Machinery	Production Technology
Business Services	Heavy Construction Services	Publishing and Printing
Construction Materials	Hospitality and Tourism	Sporting, Recreational and Children's Goods
Chemical Products	Information Technology	Textiles
Communications Equipment	Jewellery and Precious Metals	Tobacco
Distribution Services	Leather Products	Transportation and Logistics
Education and Knowledge Creation	Lighting and Electrical Equipment	

Source: Sölvell et al, 2008, p.108

The European Cluster Observatory developed a methodology based on the Porter approach described above. The Observatory measures the concentration of employment in 38 cluster categories (presented in table 1). Cluster categories are specific groups of industries that tend to locate in the same places (EC DG Enterprise and Industry, 2007, p.7). The categories are built using the NACE classification system and combining one or more 4-digit industries irrespective of the 3-digit industry they belong to. The Observatory methodology focuses on mapping regional clusters using European Union NUTS 2 regional divisions. A *regional cluster* is defined as the phenomenon in which *employment in a given region in a particular cluster category meets cut-*

*off criteria in terms of share of cluster sector employment, share of regional employment, and specialisation* (EC DG Enterprise and Industry, 2007, p.10).

Regional cluster concentrations by the Observatory methodology are measured in three dimensions (Sölvell et al, 2008): (i) size - absolute number of employees (>10,000 jobs is the standard benchmark for a regional cluster), (ii) degree of specialisation (regional sector employment is at least two times expected levels) and degree of regional market labour dominance (>3 per cent of total employment in a particular sector). Each of these three measures of cluster size, specialisation and labour market dominance are accredited with a *star*. The largest and most specialised clusters receive three stars.

The approach to the mapping of clusters in the Republic of Serbia was based on the conceptual framework of the methodology developed by the European Cluster Observatory, involving the analysis of agglomeration within these 38 sectors. However, in order to meet the needs and conditions of the Republic of Serbia, it was necessary to modify the methodology yet the applied changes limited possibility for compare the findings with other countries. Therefore, the applied methodology rather serves the needs of inter-regional comparison within Serbia than the comparison between Serbian and other EU regions.

As noted above, the European Cluster Observatory only uses employment data to evaluate the strength of regional clusters. Serbia is a transitional economy which still has a significant number of non-privatised large socially-owned enterprises, from which many employees have been laid off but are nevertheless registered as employed. Moreover, in some sectors (e.g. automotive, biopharmaceuticals, heavy machinery, jewellery and precious metals, oil and gas products and services, etc), a single company accounts for the entire employment in a sector in an observed geographical area (especially at district level) and therefore cannot be considered as clusters since they are incompatible with the accepted definition. Furthermore, employment statistics per sector are generally inaccurate since there is no reliable system of employment data collection.

As a compromise, in addition to employment data, the analysis of Serbia included data on enterprises (company demographics), with each cluster graded in the same manner and with the same implications as apply to employment data. Rationale for including company data was based on the assumption that companies are registered and operate in a sector they have a comparative advantage in within a given geographical area. Company data therefore provides a better basis than employment data for calculating cluster scores for the geographic agglomerations of Serbian industry and services. Furthermore, company data is relatively reliable since the Serbian Business Registers Agency keeps a single registry of all commercial entities in Serbia. For that reason, the herewith-presented analysis took both the data on the number of employees and the data on the number of enterprises into account.

The second significant methodological change was in the definition of a threshold for size, dominance and specialisation, since the figures applied by the European Cluster Observatory were excessively high for Serbian conditions. In the case of Serbia, clusters were classified with a star for criteria on size if employment or the number of companies in a regional cluster represented more than 7%<sup>2</sup> of national employment or the total number of companies in the sector concerned. The same cut-off of 7% was also applied in the case of dominance. For specialisation, meanwhile, a cluster was awarded a star if the regional specialisation ratio in the respective sector exceeded the national one.

At the time of the analysis, there was an ongoing discussion to define NUTS 2 level regions in Serbia. Consequently, in geographical terms, the analysis focused on administrative districts (equal to the NUTS 3 level) and on local level cities and municipalities. Furthermore, since Kosovo is governed under the United Nations' Security Council Resolution 1244, there was a constraint in accessing the necessary data and therefore this region and its five administrative districts had to be excluded from the cluster-mapping analysis.

Moreover, when the analysis was conducted, Serbia was using NACE, Rev. 1 as a basis for the classification of enterprises modified to Serbian conditions, which was consistent with UN ISIC, Rev 3. However, analyses by the European Cluster Observatory principally use NACE, Rev. 2. In 2010, Serbia adopted a new system for classification of enterprises that complies with current EU standards.

<sup>2</sup> The cut-off criteria of 7% was used in cluster-mapping exercise in Turkey, on which basis policy makers in Serbia decided to use the same figure.

### 3. DATA

Data was collected from two different sources: (i) the Serbian Business Registers Agency, which supplied the complete business registry for December 2009, and (ii) the Republic Institute for Health Insurance, which supplied information on the number of employees per company as at February 2010. The data on employment included only officially registered employees, not those employed informally, in the so-called “grey” sector.

These two sources were merged into a single data set with information on 337,000 companies and entrepreneurs, and 1.2 million employees. Companies in liquidation or bankruptcy were purged from the dataset.

Although the dataset include some data on Kosovo, this was insufficient to reach any valid conclusions.

### 3.LIMITATIONS TO THE ANALYSIS

There are a number of limitations that may affect the results of the cluster mapping. However, the following three limitations are identified as being the most important.

Firstly, employees working in branch offices of an enterprise are registered at the headquarters of the enterprise, regardless of their actual place of employment. This weakness particularly pertains to large companies with activities spread out over Serbia (banks and insurance companies, public enterprises, oil/gas and energy companies, etc).

The second limitation relates to the dependency of the analysis on the accuracy of the classification of these companies. According to the business registry law, companies have to choose a main classification code in which their business operates. Nevertheless, companies may be registered under one classification code and then operate and supply goods or services that relate to another.

Thirdly, the applied methodological changes limit the comparability of the results with other EU regions.

The analysis presents only a statistical mapping of the geographic concentration of employment and companies per cluster sectors. Lack of financial data has limited the analysis in terms of determining the economic strength of the identified clusters.

### 4.KEY FINDINGS

The data, which is analysed by sector using geographical mapping, allows us to make the following three key observations:

Observation 1: Belgrade, Novi Sad and occasionally Niš are dominant in those cluster categories that are typically considered as service industries. These categories comprise: Business Services; Communication and Equipment; Distribution Services; Education and Knowledge Creation; Entertainment; Financial Services; Hospitality and Tourism; Information Technology; Publishing and Printing; Sporting, Recreational and Children’s Goods; and Transportation and Logistics: in total, 11 cluster categories.

Observation 2: Fourteen cluster categories are dispersed across Serbia. These cluster categories include: Agricultural Products; Apparel; Biopharmaceuticals; Building Fixtures, Equipment and Services; Chemical Products; Construction Materials; Forest Products; Furniture; Heavy Construction Services; Lighting and Electrical Equipment; Metal Manufacturing; Plastics and Rubber; Processed Food; and Production Technology.

Observation 3: A number of cluster categories are insignificant in Serbia with low levels of employment and/or a small number of registered companies. These are: Aerospace; Analytical Instruments; Automotive Components; Fishing and Fishing Products; Footwear; Heavy Machinery; Jewellery and Precious Metals; Leather Products; Medical Devices; Oil and Gas Products and Services; Power Generation and Transmission; Textiles; and Tobacco. Each of these 13 cluster categories accounts for less than 1,000 companies in the Republic.



## 5.CONCLUSION

Agglomerations and concentrations of firms and employment have been studied for more than a century. In the last two decades, research in this field has intensified among academics and policy makers as clusters have become widely recognised as a valuable tool in fostering economic development. In that regard, many methodologies and tools have been developed in order to better understand the benefits and possible constraints of the agglomeration of economic activities per sector.

Cluster mapping is the methodology first developed by Michael Porter and subsequently further advanced by the European Cluster Observatory. The methodology is based on the observation of the employment distribution within 38 cluster categories in NUTS 2 regions of the European Union. In order to obtain reliable and robust results, the employment statistics need to be complete and accurate, which is the main obstacle in applying this methodology to transitional and developing countries.

Employment statistics from the Republic of Serbia are not reliable since there are no institutional mechanisms that can accurately determine how many employees are in Serbia at any given moment. Moreover, the high level of grey employment distorts the official statistics. A solution was found in using the concentration of companies in addition of employment since these statistics are significantly more reliable. Nevertheless, using companies as a subject of analysis also has its shortcomings, mostly due to the methodological issues concerning their classification per sector.

This paper describes a pioneering attempt to adapt the standard cluster mapping methodology to the conditions extant in the Republic of Serbia and to draw conclusions that are useful and reliable for academics and policy makers. However, there is a need to extend this research in several respects. Firstly, the research should be extended to the geographic coverage of the NUTS 2 planning regions as established by the Law on Regional Development of the Republic of Serbia. Secondly, in 2010, Serbia adopted a new system for the classification of companies based on NACE Rev 2, which is consistent with current EU standards. Thirdly, the European Cluster Observatory has recently increased the number of defined cluster categories from 38 to 42, which should also be taken into account in any future research. The findings of this analysis also need to be verified with qualitative research to be conducted at the district and municipal level.

Despite its limitations, the paper draws valuable conclusions that are useful and reliable for a wide range of academics and policy makers. The key findings of the analysis highlight three main observations: there is a high concentration of service industries in Serbia's three largest cities; 14 cluster categories are dispersed more widely across Serbia; and a number of cluster categories are insignificant in Serbia with low levels of employment and/or a small number of registered companies.

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Part Six:  
Growth, EU funding, FDI, Transition

## INTERACTION OF LEADING AND SUPPORTING FACTORS FOR THE SME COMPETITIVENESS

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### Abstract

The *main goal* of this research was to investigate the SMEs competitiveness in terms of leading and supporting factors, and to compare the influence of these factors on SMEs performance. The study focused on four leading and four supportive factors. For each of these factors the respective indexes were constructed and calculated on the basis of 300 Bulgarian SMEs. Through the econometric modelling the research addressed the interaction between two groups of factors. The main findings related to the factors ordering - with some of leading factors stepping back and supporting ones becoming more important in the times of crisis.

**Keywords:** SMEs, Competitiveness factors, Interaction, Performance

### 1. INTRODUCTION

The SMEs competitiveness depends on many factors, which have been usually considered as firms' external, internal, and related to entrepreneur factors. Following the concept of *sustainable competitive advantages* (Porter, 2004, p. 126) these factors could also be divided into two other groups. The first group includes factors for achieving sustainable competitive advantages (leading factors), and the second group comprises other supporting factors. Leading factors are contingent to the economic environment, including the stage of country development, while the supporting factors are more invariable. According to Porter, the most important condition for achieving sustainable advantages is the firms' continuous improvement and innovation (ibid, p. 123). This is because innovations lead to the creation of unique brands, technology, marketing channels, etc., which are difficult to imitate. In the present global, network and the information economy, innovations are increasingly linked with ICT applications, international quality standards implementation, and the internationalization of firms' activities.

Sustainable advantages, however, depend on other factors like the quality of institutions, human resources, technological capacity, access to finance, etc., which form the group of supporting factors. As the literature review indicates, there has been limited research on the SMEs competitiveness in general, and on these two groups of factors, in particular. That is why advancing the understanding of the interaction between these factors under different conditions ("normal" growth vs. crisis) will help entrepreneurs and policy makers by indicating context specific measures for the improvement of SMEs competitiveness.

### 2. LITERATURE REVIEW

Competitiveness is a multidimensional construct, which includes a combination of factors (assets and processes) that determine the firm's performance. A framework of different competitiveness models is presented by Ambastha and Momaya (2004, p. 57), which is however difficult to operationalize and empirically test. Investigating the competitiveness of subcontracting SMEs, Lu *et al.* (2008) propose 35 variables grouped in eight clusters. Using Porter's framework, Yan (2010) demonstrated the significance of competitiveness factors such as cost reduction, differentiation, innovation, strategic alliances and the environment for Chinese SMEs. Szerb and Ulbert (2009) analysed the competitiveness of Hungarian SMEs under seven pillars (factors). As a rule, global competitiveness indices (Global Competitiveness Index, World Competitiveness Yearbook, Doing Business, etc.) do not refer to small businesses. The Global Entrepreneurship Index and The Global Entrepreneurship and Development Index (Acs and Szerb, 2010) measure the level of entrepreneurship, and not the SMEs competitiveness. These, and other competitiveness models, followed the traditional distinction of factors as external, internal, and related to the entrepreneurs, without distinguishing between most important (leading) and supporting factors.

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Greater attention was given to leading factors in the literature on innovations, ICT and quality standards implementation, and firms' internationalization. In a global competitive environment, SMEs survival depends on firms' innovation (Bilton and Cummings, 2010), and there is evidence that innovative SMEs grew faster in comparison to the rest (Rosenbusch *et al.*, 2010). Raisch *et al.* (2009) demonstrated that companies with sustainable competitive advantages maintained two types of innovations - exploration and exploitation (organisational ambidexterity). The supporting factors for the firm's innovation are internal, such as strategy, human capital, and intra-firm training; external, such as industry sector, regulations, access to finance (Galankis, 2006, p. 1231); and linked to the entrepreneur's characteristics - learning, market orientation, etc. (Masurel *et al.*, 2003).

A substantial literature was devoted to the ICT and e-commerce adoption by SMEs as a key to growth (Simpson and Docherty, 2004). There are several theoretical models to research the IT adoption in SMEs (Ramdani and Kawalek, 2007, p. 55), and researchers use combinations of these models. The implementation of international quality standards is also crucial for SMEs as it contributes to overcoming some market failures (Knut, 2004, p. 327). Today SMEs are under a growing pressure from their major clients to certify in order to continue to work with them (Baumol, 2009). Creation of own trademarks and brands is another way for SMEs to move higher on the value added chain (Humphrey and Shmitz, 2002). As the ICT and quality standards acceptance, and the creation of own trademarks are a form of innovations, the factors influencing their application in SMEs are similar to those for innovation in general. Many researchers have revealed also the growing significance of "early internationalized" or "born global" firms (Rialp *et al.*, 2005). Internationalization could be considered also as a kind of innovation, which explains the similarity of factors for two processes (Ruzzier *et al.*, 2007; Jansson and Sandberg, 2008; Williams and Shaw, 2011).

Amongst supporting factors, the institutional environment has attracted attention. Institutional analyses of SMEs development reveal the advantages of strong institutions and the disadvantages of weak ones (Xheneti and Smallbone, 2008). The inefficiency of formal institutions leads to the creation of non-productive, rent-seeking entrepreneurs (Desai *et al.*, 2010). The institutional analysis of SMEs, however, occasionally makes connections to other competitiveness factors. SMEs access to finance is the other important factor. It has been discussed under potential market failures due to information asymmetries (Shane and Cable, 2002) and reputation concerns (Kon and Storey, 2003), but often without connections to other competitiveness factors. The increasing globalization of business raises the significance of strategic management (Smith and Tushman, 2005), which is also rarely included in the SMEs competitiveness models. Crucial for all type of innovations is accelerated intra-firm training (Wang *et al.*, 2010) and human capital development (Smith, 2000, p. 89).

In summary, few models seeking to explain the SMEs competitiveness have relied on the general framework of firms' internal and external factors. Besides, the significance of these factors was analyzed mostly under conditions of "normal" economic development or growth, neglecting periods of unstable economic development and crisis.

Based on the literature review and the particular national context, the following *research questions* were investigated: Which are the key factors of the SMEs competitiveness? Can we distinguish between the most important (context leading) and other (supporting) factors for the SMEs competitiveness? How do these two groups of factors influence the SMEs performance by interacting with each other? The *main hypotheses* were the following:

- H1. The higher level of innovation activity accounts for higher SMEs performance.
- H2. The SMEs internationalization impacts positively their economic performance.
- H3. SMEs with own trademarks and patents excel higher economic performance.
- H4. SMEs with implemented quality standards demonstrate better performance.
- H5. Better access to finance contributes significantly and positively to higher level of innovation, internationalization, trade mark and patents registration, quality standards and ICT adoption, and firms' performance.
- H6. Good management practices (ICT and e-business adoption, staff training, strategic planning and marketing, etc.) lead to higher level of innovation, internationalization, trade mark and patents registration, quality standards and ICT adoption, and firms' performance.
- H7. The SMEs size positively impacts innovation, internationalization, intellectual property activities, quality standards and ICT adoption, and firms' performance.
- H8. Export oriented SMEs develop a higher degree of innovation, intellectual property activities,

internationalization, quality standards and ICT adoption, and firms' performance.

### 3. RESEARCH METHODOLOGY

The main goal of this research was to reveal the SMEs competitiveness factors in terms of context specific (leading) and supporting factors. Precisely, the goal was to establish to what degree, and in which ways, these two groups of factors influence the SMEs performance under crisis economic conditions. The measures of competitiveness ranged from simple indicators to complex indexes (Buzzigoli and Viviani, 2009). The situation with Bulgarian SMEs was analyzed through the prism of 8 key factors. Five of these factors were compound variables, represented by indexes: (1) innovations; (2) internationalization; (3) own trademarks and patents; (4) access to finance; and (5) good management practices. The other three factors were implemented quality standards, export orientation, and size. Following the Porter idea about two types of competitive advantages, the factors were separated into two groups. The first group included factors for achieving sustainable competitive advantages (leading factors), while the second group contained supporting factors. Here we included the ICT and e-business adoption factor in "good management practices", and not as separate leading factor. These groups of factors formed the conceptual model (Fig. 1).

Figure 1. Conceptual model

<p><b>I. Leading factors for sustainable competitive advantages</b></p> <ol style="list-style-type: none"> <li>1. Innovations</li> <li>2. Internationalization</li> <li>3. Own trademarks and patents</li> <li>4. Quality standards implementation</li> </ol> <p><b>II. Supporting factors for competitive advantages</b></p> <ol style="list-style-type: none"> <li>5. Access to finance</li> <li>6. Good management practices (ICT and e-business adoption, staff training, strategic planning and marketing)</li> <li>7. Company size</li> <li>8. Export orientation</li> </ol>	<p>SMEs performance in times of crisis</p>
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Based on the conceptual model, a standardized questionnaire was created and duly filled in by 300 SMEs managers with the help of interviewers in February 2011. The sample included SMEs from manufacturing (13%), services (40%), construction (6%), and trade (41%). Among them 89% were micro, 9% small, and 2% medium sized by number of employees. 12% were from the capital, 76% - from district and 10% from small cities, and 2% - from villages.

The companies' performance in times of crisis was defined not in term of growth indicators, but in terms of *lack of or less*: release of staff; difficulties in debt payments; decrease in sales; and reduction in yield.

Firstly, five indexes were constructed as ratio between the sum of individual scores and the maximum sum of scores of the constitutive items, and multiplied to 100.

(1) The INNOVATIVENESS index consisted of two equal components: 1) establishment of innovation infrastructure, which included: availability of R&D unit; specialized staff for R&D; use of research institutes or research fellows; specialized staff training; keeping and updating a professional library; cooperation with institutions in education and science; introduction of ICT in sales; and 2) development of new products: issuing of new products on the market; improvement of existing products; development of new products to be launch on the market soon.

(2) The INTERNATIONALIZATION index had two equal components: 1) participation in specialized events like: exhibition/fairs in Bulgaria; exhibition/fairs abroad; cooperative stock exchange; international business forums; business delegations; and 2) international trade activity: import of raw materials, products and services; export of own products and services (availability of exports; share of exports in the total output; share of export sales in the total turnover).

(3) The TRADEMARKS AND PATENTS index contained the following three components: 1) availability of trademarks and patents at home country and abroad, and such forthcoming registrations; 2) availability of sufficient financial resources for registration of trademark, patent or other intellectual property; 3) level of awareness in respect to the value and opportunities of the brand, as well as with the possibility of registration of such in the EU.

(4) The index ACCESS TO FINANCE contained 15 equal components, which indicated the use of the following financial instruments by the companies: investment bank loan; bank loan; loan for



working capital; bank loan for special purpose; overdraft; credit card; financial leasing (for purchase of equipment, automobiles, etc.); venture capital; loan from family and friends, means of the owner(s) of the company; other financial instruments; EU pre-accession funding; EU structural funding; government funded programmes; third party government programmes; other support received.

(5) The index GOOD MANAGEMENT PRACTICES was based on three equal components: 1) level of the ICT usage as a function of implementation of management information systems, and application of internet technologies; 2) level of implementation of policies to improve staff qualifications as a function of assessment of staff qualifications, and availability of trainings enhancing staff competences; 3) level of development of market strategies as a function of availability of short, medium and long term business plans, and implementation of marketing strategies for domestic and foreign markets. The index accounted for the application of these practices in the last and previous five years.

There was no index for the Quality Standards Implementation, because only few companies have adopted such standards. Most of the individual variables were scored on two-point scales (presence/absence), and few on five-point scale. All indexes took values from 0 to 100, distributed in the intervals (0-20 low degree; 21-40 rather low; 41-60 average; 61-80 rather high; 81-100 high degree). Index formulae are given in the Appendix 1.1.

Table 1. Cronbach's  $\alpha$ , number of items, means and standard deviation of indexes values

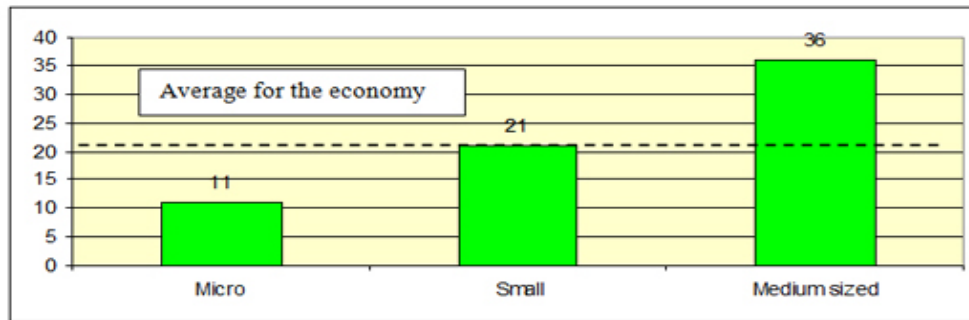
Indexes	No of components/ items	Cronbach's $\alpha$	Mean	SD
1. Innovations	2 components (7+3=10 items)	0.61	12	19
2. Internationalization	2 components (5+4=9 items)	0.57	4	11
3. Trademarks and patents	3 items	0.67	4	10
4. Access to Finance	15 items	0.47	8	9
5. Best practices:	3 components (7+8+7=22 items)	0.61	24	13
Overall total (1,2,3,4 and 5)	5 indexes (59 items)	0.63		

Secondly, three types of econometric models were used to track the inter-relations between competitiveness factors and their effects on companies: structural models (systems of equations between all factors), regression models identifying the determinants of each factor, and logit/probit models explaining the economic performance. In all models we control for supporting factors, as well as for other characteristics like size of settlement, gender, age and background of the entrepreneur (see Appendix 1.2). After running the specified models, and testing for multicollinearity, heteroscedasticity, and other econometric problems, we have identified the most significant relations. Estimation output is presented in the Appendix 1.3.

#### 4. RESULTS AND DISCUSSION

In 80% of the SMEs the innovation activity was *weak*, in 11% - *rather weak*; 5% had *neither weak, nor advanced*; 3% - *rather advanced*; and only a negligible 1% had *advanced* innovation activity. The innovation activity in the medium-sized enterprises was over three times higher, and in the small firms - almost twice higher than in the micro-enterprises. The mostly innovative companies were from the manufacturing, while least innovative were in the trade. As other researchers have shown, the SMEs sector still suffered of the innovation management deficit (O'Regan *et al.*, 2005). The significant factors for the SMEs innovation were: *size, average age of the equipment, entrepreneur's education, access for finance*. The innovation activity increased with the company size by number of employees (Fig. 2); it was greater in enterprises with newer equipment and vice versa; it was positively associated with the level of the entrepreneur's education; and it augmented with the lighten access to finance.

Figure 2. Mean values of the Bulgarian SMEs innovation index by size



After Schumpeter, many authors revealed the significance of entrepreneurs for the innovations (Cosh and Hughes, 2000; Masurel *et al.*, 2003; Migdadi, 2009; Omerzel and Antoncic, 2008; Wang *et al.*, 2010). Other researchers have also stressed the lack of appropriate sources for financing was the most embarrassing factor for innovations (Applied Research and Communications Fund 2007, p. 14). In early 2011 nearly 1/3 of Bulgarian SMEs maintained their own library of professional literature, and roughly 1/5 had provided their employees training in innovation. However, only 10% had sufficient funds to finance innovation activities. This explains the observation that barely 3% of the SMEs had a R&D unit and personnel responsible for such activity. The cooperation with scientific institutes, universities and academia was also limited - 4% of the SMEs have used scientific research, and approximately 10% have collaborated with universities. The insufficient partnership with research organisations obviously had a negative effect on the innovation scores of the researched SMEs (Doloreux, 2004; Hewitt-Dundas, 2006).

The worsened access to finance expressed in the fact, that in 2010 only 13% of SMEs declared that they developed and promoted new product on market; 16% improved considerably already existing products, and 9% were developing new one to be launch on the market soon. The other researchers have also outlined that most often the SMEs innovations were in products in spite that they went out together with process oriented ones (Bala Subrahmanya, 2001). The innovations are difficult to accomplish where the equipment is outdated (Corrocher *et al.*, 2009) as in our case. As a whole, the ability of SMEs innovativeness varies significantly in function of their size, available resources, industry sector, and business environment (Burrone and Jaiya, 2005).

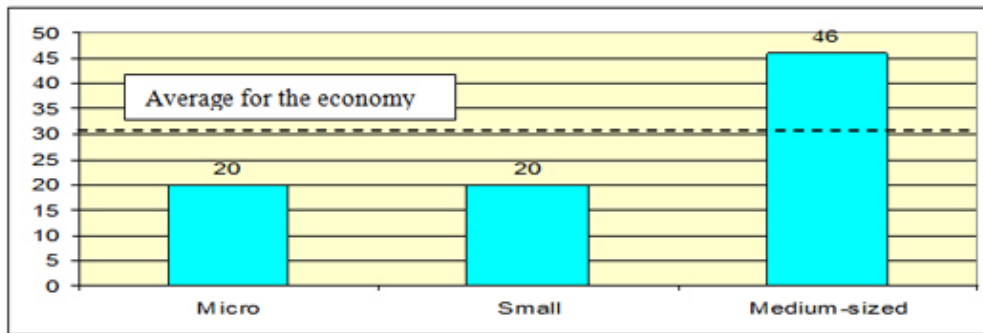
The EU Innovation Index classified the member countries into four groups: leaders; followers; average innovators; and modest innovators. Bulgaria (with Lithuania, Latvia, and Romania) felt in the last group with a level of innovation quite below the EU-27 average (EC 2011, p. 4). The country innovation profile revealed that Bulgaria performs relatively better on some indicators, related to human resources, while the weaknesses were mainly in respect to entrepreneurs' innovation activities, intellectual assets, and patents (Ibid, p. 25).

In 2010, 12% of the Bulgarian SMEs have made *imports* and 5% have made *exports*. 77% of the exporting enterprises directly traded their goods and services on the foreign market, while 17% exported through dealers or agents. Nearly one third of the exporters were suppliers to foreign companies, and a quarter of them had suppliers outside the country. More than 1/4 of the exporting firms could not ensure consistency in quality and quantity of exported products. The level of awareness of the international markets has been low - only 6% of the businesses thought that they have sufficient and recent information about these markets. There was some activity in terms of participation in exhibitions and fairs, the most frequently visited ones were abroad - almost 20% of SMEs managers stated that they participated in such exhibitions. The SMEs managers had participated in other events too, like business delegations, international business forums, etc., but the share of such participation was still relatively low. Participation of SMEs in clusters affected few of the firms – only 4%. The interviewed owners/managers indicated that most frequently performed cluster activities were training, innovation and public private partnerships. The most recognized benefit from participation in a cluster was finding new partners.

According to the values of the internationalization index, 95% of the SMEs had a *low* degree; the remaining 5% had *rather low* or *neither low, nor high* degree. Companies with *rather high* and *high* degree of internationalization were observed only occasionally. Most internationalized were medium-sized enterprises - more than twice than the micro- and small firms (Fig. 3), and those from

manufacturing.

Figure 3. Mean values of the Bulgarian SMEs internationalization index by size



The other researches on the SMEs internationalization also suggested that those from the manufacturing were most active in comparison with trade firms (Matlay and Fletcher, 2000, p. 442). Other factors with significant influence on the SMEs internationalization were *company size and innovation activities*. The level of internationalization increased with the number of employees, as well as with the degree of innovations. Obviously the small size continues to hamper the SMEs internationalization, mainly because of insufficient resources. The small business often have no strategy for going on the external market, and consequently their internationalization seems accidental (Westhead *et al.*, 2002). The present data confirms the related with the innovation model, according which each consecutive stage of internationalization is regarded as a kind of innovation (Gankema *et al.*, 2000). These stages (innovations) are easier to accomplish in new created small firms, as they have not inherited routine administrative practices (Autio *et al.*, 2000).

Humphrey and Shmitz (2002) demonstrated that SMEs could be more successful by developing higher quality or creating their *own brands and trade marks*. This is a difficult task in the extremely competitive EU market. In 2010 only 8% of the Bulgarian SMEs have registered trademark in the country, and 2% - abroad. Regarding patents, these registrations were 4% and 1% respectively. The share of forthcoming registrations of trademarks and patents was also insignificant. A very low level of awareness of the value of the intellectual property, as well as of the possibilities for registering such in the EU was observed.

The values of the own trade marks and patents index showed that 94% of the Bulgarian SMEs had low level in these activities; 4% - rather low; and 2% - average level. There were only isolated cases of *advanced* patent activity. This situation can be explained by the insufficient financial resources - only 7% of the firms had enough money for registration of trademark, and 5% - for patent registration. The patent activity was most developed among the small enterprises where it was almost twice higher than in the micro-enterprises. The fields of manufacturing and trade were most developed in terms of patent registration. The significant factors for these activities were: *company size; innovation activity; and good management practices*. The patent activity increased with the company size; firms with the higher level of innovation were more active in the intellectual property development; greater application of good management practices was positively related with firm's patent activities.

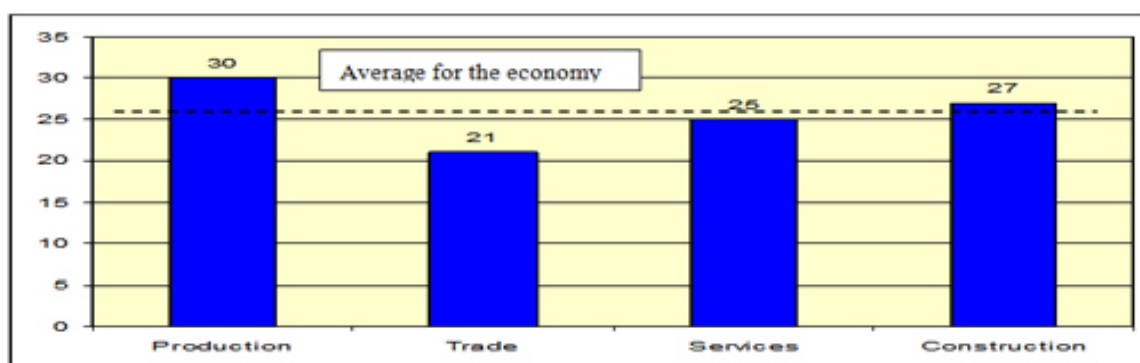
In early 2011, the access to finance was *very difficult* for 93% of the enterprises. Only 6% have *rather difficult* access, and 1% - *neither difficult, nor easy*. These findings correspond to the ECB data for 2009-2010, which reported the deterioration of access to finance for all SMEs in the EU (ECB, 2010). The biggest difficulties in financing were observed in the micro-enterprises, where the average index values were two times lower than in the medium-sized enterprises. Businesses in manufacturing and construction had relatively easier access to finance - higher than the average for the economy. The services had the worst position in getting funding. The main and the only significant factor influencing the access to finance was the *enterprise size*. The larger the enterprise, the easier the funding it gets ( $p < 0.05$ ). Not only in Bulgaria, but everywhere the banks grant credits to smaller enterprises under a higher interest rate and a greater guarantee, which is due to the higher information asymmetry. Because of that the small business prefer using internal funds to external financing (Klapper *et al.*, 2006). In 2010, the most common sources of funding were the resources of the owner (42%), loans from friends and relatives (17%) and bank loans (14% of the SMEs have investment loans and loans for working capital). Venture capital was used by a small share of businesses.

At the same time instalments on bank loans for working capital and loans from relatives and friends have been paid with the highest difficulties. 10% of the SMEs had overdue payments, and 32% had been late in paying their obligations last year. There was also a delay in payments received from customers during the previous year: 55% of the SMEs have encountered this problem, and 15% have been expecting their revenues on average over 91 days. The difficult access to finance was also related to the limited investments made last year - about 1/3 of the enterprises have bought new equipment (35%); 30% invested in staff training and advertising, 22% - in development of new or improving the existing products, 9% introduced management information systems, and 4% invested in intellectual property.

The *good management practices* revealed that the most widespread was the application of internet technologies: 37% of SMEs had a website, and 27% - electronic signature. The share of SMEs applying information management systems was small (less than 6%). The training of the personnel was not a part of the everyday life of most SMEs, but was relatively developed - 37% of companies have applied internal and 17% external staff training. 69% of SMEs had short term planning, 16% - medium term, and only 3% - long term planning. One third of enterprises have developed marketing strategies, but only 17% have done marketing surveys in domestic, and 4% - in foreign markets in the last year.

The values of the index for good management practices showed a certain uptake - 45% of the firms occupied *low* or *rather low* level, while 10% applied such practices to a more considerable extent. However, still no SMEs developed these practices in *high* degree. The application of good management practices in the medium-sized enterprises was twice higher than in the micro-enterprises. These practices were prevalent in the manufacturing and least common in the trade (Fig. 4).

Figure 4. Mean values of the index for good management practices by sector



The significance of the sector in the application of the new ICT and other good practices was in line with data from other researches (Zhu *et al.*, 2006; Love *et al.*, 2005; Zhu and Kraemer, 2005; Oliveira and Martins, 2010; Lin and Lin, 2008), which could be explained by the specificity of products/services (Dinlersoz and Pereira, 2007). Other significant factors were related to: *enterprise size; type of settlement; average age of both the employees and the company; age, education, and gender of entrepreneurs; and innovation activities*. The adoption of good management practices increased with the company size. This result confirmed the positive relation between company size and the level of the ICT use (Baldwin *et al.*, 2004; Fabiani *et al.*, 2005; Hsu *et al.*, 2006; Pan and Jang, 2008), which is due to the greater financial (Hwang *et al.*, 2004) and human resources (Morgan *et al.*, 2006). Smaller companies operate usually in niches, where the benefits of new technologies might be not evident (Pontikakis *et al.*, 2006), and they faced higher risks in the ICT implementation (Bruque and Moyano, 2007). Besides, the information management in SMEs is relatively simple, and because of that it attracts fewer resources (Ramdani and Kawalek, 2007, p. 49). In line with other findings, these practices are more developed in SMEs situated in bigger cities and less developed in smaller settlements (Forman, Goldfarb and Greenstein, 2008).

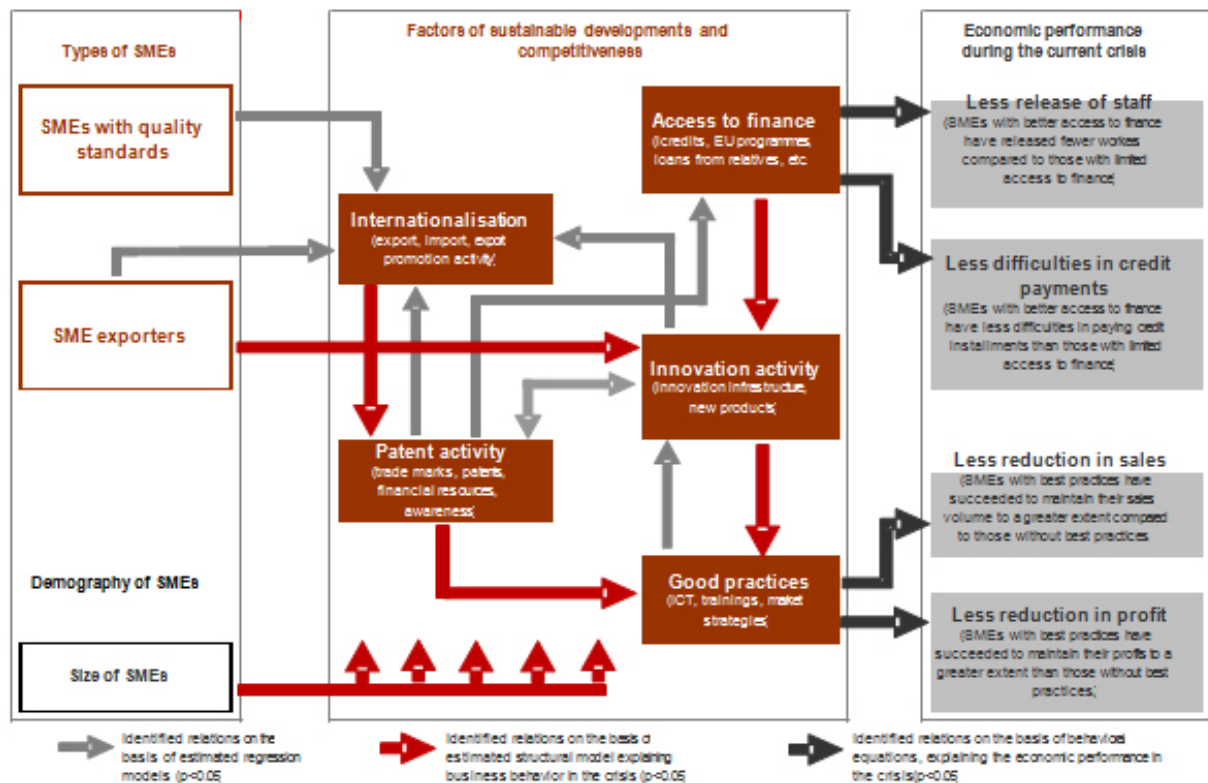
The application of good management practices was higher in companies with smaller average age of employees and vice versa. The adult employees, who have accustomed to old practices, and who have greater difficulties in acquiring new skills, may hamper the introduction of the new ICT applications (Beatty *et al.*, 2001; Scupola, 2003; Fabiani *et al.*, 2005). The development of good management practices augmented with the level of entrepreneurs' education and age, which underlies the key role



of owner/manager of a small firm for the adoption of new technologies (Matlay and Fletcher, 2000; Culkin and Smith, 2000). The higher level of the company innovativeness was positively related to the application of good management practices, which was found in other researches too (Bao and Sun, 2010, p. 173; Wang and Cheung, 2004). The present data revealed that women entrepreneurs in Bulgaria applied good management practices to higher degree than men.

On the basis of the estimated econometric models, the significant driving forces for the SMEs performance under crisis were identified (Fig. 5). According to the illustrated configuration, innovations had *indirect* positive impact on the SMEs performance within a transmission mechanism of good management practices (H1). It turned out that in crisis conditions the competitive advantages of innovations still matter (to some extent), but affect firm's performance through the accumulated by good management practices human capital. Thus the medium-sized and micro enterprises with a higher index of innovativeness had made layoffs in 2010, while the enterprises of the same sizes with a lower innovativeness index had made no such layoffs. This could be due to some sectors specificity, as different sectors were hit differently by the crisis. For instance more innovative SMEs in manufacturing have released employees in comparison with less innovative ones, while the situation in the construction sector was just the opposite.

Figure 5: Interaction of competitiveness factors and their impact on the SMEs performance in times of crisis



The positive influence of the internationalization on the SMEs performance was also *indirect* through its effect on the intellectual property activities and therefore through good management practices (H2). This could be due again to sector specific conditions, as the crisis affected both internationalized and domestic oriented enterprises. On the one hand, the enterprises, whose turnovers had not suffered in the crisis, were more internationalized. On the other hand, firms which had experienced personnel cuts were more internationalized. More internationalized manufacturing SMEs released personnel in difference to those operating only on the internal market, while in the construction sector the internationalized companies did not lay off staff.

The impact of own trademarks and patents development on the SME performance in times of crisis was similar to that of innovations – positive, but indirect through good management practices (H3). In 2010 enterprises with a higher index of patent and trademark activity (from all sectors and size groups) had experienced labour force contractions, while those with a lower index had retained their employment. SMEs with implemented quality standards were more innovative and more internationalized. This



factor had also a positive, but quite *indirect* influence on the SMEs performance (H4).

Thus the first four hypotheses received only partial support. The impact of four leading factors on the SMEs performance, which were considered as more important for their competitiveness, turned to be positive, but more or less indirect.

The access to finance has affected *directly* the SMEs performance (H5). The enterprises with better access to financing have released less number of employees or haven't done it at all. On the contrary, enterprises from all sectors with a lower index of access to financing have made layoffs. The limited access to finance has also affected regularity of debt payments. The access to finance emerged as the most important and almost independent factor for the company performance. It impacted positively also the degree of innovation, and indirectly – the adoption of good management practices and firm's internationalization. It was influenced only by the firm's size and intellectual property activities.

Good management practices affected *directly* SMEs financial results (H6). The enterprises with higher level of such practices (ICT and e-business adoption, staff training, strategic planning and marketing) have undergone a reduction of sales and profits to a lesser extent or have not incurred any. Furthermore, the SMEs with a higher index of good management practices had no personnel layoffs in 2010 unlike the ones with a lower index values. This was true, however, only for trade and construction, while in services and manufacturing the relationship was the opposite. Good management practices contributed positively to higher innovativeness, and through it – to higher trade marks and patent development, and greater level of internationalization.

The SMEs size was at the bottom of the stronger development of all investigated factors for competitiveness, which proved the H7. Export oriented SMEs had a direct and positive impact on the innovation, through it - on good management practices, intellectual property activities, and internationalization, and thus – on final company performance (H8).

## 5. CONCLUSION

These results revealed relatively new relationships between factors for the SMEs survival in turbulent times. It turned out that the *leading role* of innovations, trademarks and patents, quality standards and internationalization in achieving sustainable competitive advantages was not always valid, but rather in times of "normal" functioning of the economy or smooth growth. In times of crisis, these factors became *supportive*, while some supportive transformed into most important. Innovation and internationalization, which are fundament for mid-term business success, cannot lead to immediate positive impact on sales and profits, which is crucial in crisis periods. When the economy catches up again on the growth path, however, these factors could be the engine of growth.

The other plausible explanation of the observed factors ordering could be related to the country stage of development. It might be that this factors configuration is typical for the efficiency driven economies, and not for innovation driven or factor driven ones (Porter *et al.*, 2002), but this hypothesis needs to be checked.

Another conclusion was that the survival of SMEs in conditions of crisis depended mainly on previously accumulated (through good management practices) and current usage of human capital. In times of crisis when the access to finance was aggravated and accompanied by high level of inter-company indebtedness and decreased sales, the short run business success required an efficient use of available human capital. Other studies have also confirmed the importance of human capital (Johnson *et al.*, 1996), and concluded that businesses must keep good practices considering as their structural capital (Ngah and Ibrahim, 2009, pp. 8, 9). Human capital stocks at company level refer not only to availability, but also to establishing competence, i.e. staff training. According to Warner (1996), "*learning and innovation in modern economies are inextricably linked*" (Warner, 1996, p. 348). Therefore, companies with limited resources (SMEs) or countries with limited natural endowments should invest in human capital as a strategy for competitive advantage (Chen *et al.*, 2005).

The estimated relationships between factors for competitiveness and economic performance in crisis allowed for identification of the SMEs, which were sustainable in the short run, and therefore could contribute to the overcoming of the crisis. Such companies were mostly medium-sized, with greater access to financial resources, and with higher implementation of good management practices. In the medium term, however, higher competitive potential have SMEs, which innovate, register patents and trademarks, and have a higher level of internationalization. This study has fully confirmed three of the research hypotheses (H5, H6, and H7) and partially the other five. The interpretation of results, however, was limited by the small number of SMEs as well as the prevalence of micro-enterprises

in the sample (the latter are not typical in innovation, internationalization, intellectual property and application of modern management practices). Therefore, further surveys with greater representation of bigger SME are needed.

The perspective of there being two groups of competitiveness factors does not in itself reveal new factors, but introduces a new perspective on the traditional dimensions of internal, external, and related to entrepreneur factors, and their interactions. It provides much-needed empirical evidence about configurations of SMEs competitiveness factors, and contributes to the development of current theories, and the convergence of theory and practice. Being highly specific, these configurations will serve better to inform the practices of entrepreneurs and SMEs policy makers, as they will indicate *context specific measures* and policies.

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## APPENDIX 1

### 1.1. Index formulae

#### Index „Innovation Activity”

The index accounts for the innovation activities of the entrepreneurs in the previous and in the past



five years. The formula by which the index is calculated as follows:

, where:

$$IRD_i = \frac{\frac{\sum_n RDbase_i^n}{\max\left(\sum_n RDbase^n\right)} + \frac{\sum_m RDproducts_i^m}{\max\left(\sum_m RDproducts^m\right)}}{3} \cdot 100$$

$IRD_i$  is the index that measures the innovation activity of entrepreneur  $i$ ,  $RDbase_i^n$  indicates whether the entrepreneur  $i$  does activity  $n$ , associated with the establishment of innovation infrastructure,  $RDproducts_i^m$  indicates whether the entrepreneur  $i$  does activity  $m$ , associated with the development of new products.

### **Index „Internationalisation”**

The index accounts for the activities related to the internationalization of the SMEs during the last year. The index formula is:

$$ITN_i = \frac{PR_i + EX_i}{2} \cdot 100$$

$ITN_i$  is the index that measures the degree of internationalization of firm  $i$ ,  $PR_i$  shows the promotion

$$PR_i = \frac{\sum_m PR_i^m}{\max\left(\sum_m PR_i^m\right)}$$

activities carried and is equal to:  $EX_i$  measures the degree of foreign trade

and is equal to:

$$EX_i = w_1 \times \frac{Im\ port_i + Export_i}{2} + w_2 \times \frac{Exp\_output_i + Exp\_turnover_i}{2}$$

, where

$w_1$  and  $w_2$  are respectively the weights (in this case assumed to be equal respectively to 40% and 60%),  $Im\ port_i$  and  $Export_i$  indicate the presence of relevant import and export  $Exp\_output_i$  is the export share of total production in enterprise  $i$ , and  $Exp\_turnover_i$  - the share of turnover that comes from exports.

### **Index „Trade marks and patents”**

The index formula is as follows:

$$ITM_i = (w_1 \times Re\ gistrations_i + w_2 \times Financing_i + w_3 \times Awareness_i) \cdot 100, \text{ where:}$$

$ITM_i$  is the index, which measures the degree of patent activities in enterprise  $i$ ,  $Re\ gistrations_i$  is an indicator corresponding to the already made and expected registrations of trademarks and patents at home country and abroad by company  $i$ ,  $Financing_i$  measures the extent to which company  $i$  can finance the registration of trade marks, patents or intellectual property,  $Awareness_i$  measures the extent to which company  $i$  is informed about the opportunities and brand value, and the possibility

of registering such in the EU,  $w_1$  is the weight of the registered intellectual property in the final index, which in this case is equal to 60% and  $w_2$  — the weight used for the availability of funding and the level of awareness in the final index, which in this case is equal to 20%.

### **Index „Access to Finance”**

The index considers whether the companies have used different financial instrument in the last year. The formula used for the calculation of the index is as follows:

$$IAF_i = \frac{\sum_n FinInstrument_i^n + \sum_m Programme_i^m + \sum_k FamilyFriends_i^k}{\max(\sum_n FinInstrument_i^n + \sum_m Programme_i^m + \sum_k FamilyFriends_i^k)} \cdot 100 \quad \text{where:}$$

$IAF_i$  is the index of access to finance for entrepreneur  $i$ ,  $FinInstrument_i^n$  measures whether the entrepreneur  $i$  uses financial instrument  $n$ , provided by banking, investment and other financial institutions,  $Programme_i^m$  measures whether the entrepreneur  $i$  uses funding program  $m$ , granted by the Government, the EU funds and third parties,  $FamilyFriends_i^k$  measures whether the entrepreneur  $i$  uses loans from source  $k$ , received by the owner(s) of the enterprise, family and friends.

### **Index „Good management practices”**

The index accounts for the application of good management practices in the business during the previous and the past five years. The index formula is:

$$IBP_i = \frac{ICT_i + HR_i + BS_i}{3} \cdot 100$$

$IBP_i$  is the index, which measures the implementation of good practices in enterprise  $i$ ,  $ICT_i$  measures the usage of ICT by enterprise  $i$  and is calculated as follows:

$$ICT_i = \frac{\frac{\sum_n MIS_i^n}{\max(\sum_n MIS_i^n)} + \frac{\sum_m Internet_i^m}{\max(\sum_m Internet_i^m)}}{2}, \quad \text{where } MIS_i^n \text{ shows the use of management information system } n, \text{ and } Internet_i^m - \text{use of internet technology } m.$$

$HR_i$  measures the extent of implementation of human resources policies and is calculated as follows:

$$HR_i = 0.4 \times Qualification_i + 0.6 \times \frac{\sum_k Training_i^k}{\max(\sum_k Training_i^k)}, \quad \text{where } Qualification_i \text{ is an indicator of the high qualification of the personnel and } Training_i^k \text{ shows the involvement of staff in training } k.$$

$BS_i$  measures the extent to which firm  $i$  uses marketing strategies and is calculated as follows:

$$BS_i = \frac{\frac{\sum_t Plan_i^t}{\max\left(\sum_t Plan^t\right)} + \frac{\sum_j MS_i^j}{\max\left(\sum_j MS^j\right)}}{2}, \text{ where } Plan_i^t \text{ indicates the existence of planning period } t, \text{ and } MS_i^j \text{ indicates the presence of developed and implemented marketing strategy } j.$$

### 1.2. Econometric models

The structural models are based on the following specification. Let  $\mathbf{X}$  be the vector of all factors for sustainable competitiveness (calculated indexes):  $\mathbf{X} = (X_1, X_2, X_3, X_4, X_5)^T$

Then the structural model defined through a system of equations is as follows:  $\mathbf{X} = \mathbf{AX} + \mathbf{BZ}$ ,

Where  $\mathbf{A}$  and  $\mathbf{B}$  are matrices of coefficients as follows:

$$\mathbf{A} = \{\alpha_{ij}\}, \quad i, j = 1, \dots, 5, \quad \alpha_{ij} = 0, \quad \forall i = j$$

$$\mathbf{B} = \{\beta_{ij}\}, \quad i = 1, \dots, 5, \quad j = 1, \dots, 7$$

And  $\mathbf{Z} = (Z_1, Z_2, Z_3, Z_4, Z_5, Z_6, Z_7)^T$  is the vector of control variables.

After empirically testing all possible combinations of interdependencies between the factors for competitiveness, two systems of equations have been identified and used further in the analysis. Regression models used are trying to explain the linear dependence of each factor for competitiveness on the rest through:

$$Index_{factor \text{ for competitiveness } i} = \mathbf{X}' \mathbf{Z} \mathbf{a}'$$

where  $\mathbf{X}$  and  $\mathbf{Z}$  are vectors of factors for competitiveness and control variables respectively, and  $\mathbf{a}$  and  $\mathbf{a}'$  are coefficient vectors. For example, the index for innovations is explained by the rest indexes for competitiveness and the control variables.

The third type of models are logit/ probit models and follow the following specification:

$$Effect_i^k = \alpha_0 + \alpha_1 X_{1i} + \dots + \alpha_5 X_{5i} + \beta_1 Z_{1i} + \dots + \beta_7 Z_{7i} + u_i,$$

where  $Effect_i^k$  denotes the various types of effects as defined above.

## 1.3. Estimation output

Structural model of the inter-relations among the factors for development and competitiveness	System 1		System 2	
	(1) Dependent variable - Innovation activity	(2) Dependent variable - Best practices	(3) Dependent variable - Internationalisation	(4) Dependent variable - Patent activity
<b>Factors</b>				
Innovation activity	-	0.26**	0.14**	-
Best practices	0.68**	-	-	-
Internationalisation	-	-	-	0.42**
Patent activity	-	0.60**	0.27**	-
Standards	-	-	11.13*	-
Exports	19.08**	-	-	-
Number of employees	-	0.25**	0.10**	-
Size of the settlement	-	-5.75**	-	-
Constant	0.26**	31.16**	-0.01	2.25**
Estimation method	WLS		WLS	
R-squared	0.35	0.45	0.32	0.22
Adjusted R-squared	0.34	0.43	0.30	0.22
Number of observations	167	132	188	220
			** $p < 0.01$	* $p < 0.05$

Regression models, explaining the factors for development and competitiveness	Dependent variables				
Factors	Innovation activity	Internationalisation	Best practices	Patent activity	Access to finance
Innovation activity	-	0.06**	0.26**	0.23**	-
Standards	-	8.15**	-	-	-
Patent activity	-	-	0.60**	-	0.24**
Access to finance	0.32*	-	-	-	-
Exports	30.0**	40.5**	-	-	-
Number of employees	0.13**	0.06**	0.25**	-	0.06**
Size of the settlement	-5.19*	1.31*	-5.75**	-	-
Constant	17.8**	-2.23	31.16**	0.52	-
Estimation method	LS <sup>1</sup>	LS <sup>1</sup>	LS <sup>1</sup>	LS <sup>1</sup>	LS <sup>1</sup>
R-squared	0.24	0.75	0.45	0.25	0.13
Adjusted R-squared	0.23	0.74	0.43	0.25	0.12
Number of observations	254	247	132	205	206
				** $p < 0.01$	* $p < 0.05$

<sup>1</sup> Newey-West HAC Standard Errors & Covariance

Behavioural equations, explaining the effects of the economic crisis	Dependent variables			
Factors	Decrease in sales	Decrease in profit	Difficulties in debt payments	Released staff
Best practices	-0.33**	-0.30*	-	-0.02*
Access to finance	-	-	-0.12**	-0.05**
Constant	33.4**	32.7**	-3.00**	-0.45*
Estimation method	LS <sup>1</sup>	LS <sup>1</sup>	Logit	Probit
R-squared	0.14	0.13	-	-
McFadden R-squared	-	-	0.18	0.11
Number of observations	174	169	277	172
			** $p < 0.01$	* $p < 0.05$

<sup>1</sup> Newey-West HAC Standard Errors & Covariance

**THE ANALYSIS OF KEY CHALLENGES AND CONSTRAINTS TO THE STABILITY AND GROWTH OF AN ENTREPRENEURIAL SECTOR IN SERBIA**

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**Abstract**

Macroeconomic business conditions in Serbia are still quite unfavorable in the post-recession period. Unfavorable business conditions are reflected primarily in: a negative Trade Balance and Balance of Payments, high rate of inflation, which still cannot be reduced to the level of targeted single-digit inflation, high unemployment rate and, consequently, a low standard of living. Although the growth of the entrepreneurial sector is identified as a key factor in the development of Serbian economy and overcoming the burning problem of unemployment, Serbia is faced with many issues related to the evolvement of this sector as well as its increased participation in the economy. Data submitted by the Serbian Business Registers Agency show that the number of newly established entrepreneurs in Serbia in 2010 are for the first time less than the number of those that have gone out of business over the previous year. These data were the basis for the analysis of constraints and factors that brought about this situation. The high mortality rate of entrepreneurial ventures indicates the presence of a large number of problems that limit the development of entrepreneurship in Serbia. Besides the impact of the global economic crisis and macroeconomic instability, which generally adversely affect the stability and growth of entrepreneurship in Serbia, a survey carried out on entrepreneurs and managers of SMEs by the Republic Agency for Development of Small and Medium Enterprises and Entrepreneurship revealed a number of other restrictions to the entrepreneurship expansion in Serbia. Some of the key constraints are: lack of financial resources, administrative obstacles, the insufficiency of qualified labor, lack of information on markets and technologies, non-compliance with standards, and other less significant issues. Therefore, objective of the paper is to stress the influence of the major problems and restrictions to the development of the entrepreneurial sector in Serbia. Constraints to the growth of entrepreneurship are going to be perceived through the prism of (insufficient) financial investments that the government makes to overcome them. Also, by using statistical analysis methods, it will be tested whether and to what extent each of these factors affect the number of start-ups and the number of their employees. Based on these results, certain recommendations to the economic policy makers will be given. They will focus on the measures, which can be taken to eliminate the key problems and encourage the development of entrepreneurship in Serbia.

**Keywords:** Entrepreneurship, Serbian Economy, Constraints to Growth, Start-ups.



## 1. INTRODUCTION

Entrepreneurship, as the carrier of technological changes, new products and services, stands for one of the key driving forces of the development of global economy. Newly opened businesses play a big part in innovations of products and services that change the way in which we live and work. At the same time, entrepreneurial organizations generate a great number of new jobs all over the world, create added value, contribute to the increase in demand for other companies' products. In a word, they stimulate economic development of the national economies and of the global economy in general.

In transitional economies, entrepreneurship plays even more important part because it contributes to the development of market economy by the creation of new jobs, establishment of open competitive markets and by imposition of constraints on the market power of public enterprises (McMillan and Woodruff, 2002, pp. 153-170). Entrepreneurial organizations are of special importance for developing countries as well, because they create wealth, alleviate poverty and produce long-term benefits for the entire society (taxation of entrepreneurs provides for the finance that can be invested in the improvement of infrastructure as well as of systems of education and health care) (Donald and Liedholm, 1998, pp. 61-74). In a word, the development of entrepreneurship and establishment of entrepreneurial organizations have a great significance for the developed countries, as well as for the developing countries and transitional economies. For that reason, recent times have seen even more serious research of the essence of entrepreneurship (Gartner, 1985. pp. 696-706, Kirzner, 1973. p. 9, Bygrave and Hofer 1991. pp.13-22), as well as the enquiry of problems that might slow down its development and finding measures that can help remove those problems.

Entrepreneurs all over the world have traditionally been facing the problem of the provision of initial capital (Moore, Petty, Palich, Longenecker, 2008. pp. 306-308). Start-up bank loans are often seen as unfavourable because of the high risk that the entrepreneurial business involves and the long period of return on investment in innovation (Petersen and Rajan 1997, pp. 3-37). Besides, entrepreneurs' access to market capital is difficult (Westhead, Storey, 1997, pp. 197-201), which is why the provision of sources of funding can stand for the serious problem in the development of entrepreneurship (Berger and Udell, 1998. pp. 613-673). For that reason, many countries establish development funds that serve the purpose of funding start-ups (Stefanovic, Ivanovic-Djukic, 2011, pp. 187-208). More often than not, entrepreneurs' access to modern technology and market is difficult as well and they also lack information on market opportunities, standards and regulations, which endangers their effectiveness and efficiency, flexibility, and, at the worst, affects the profit. Tax policy, legal-administrative procedures and legal regulations in the field of entrepreneurship can also stand for the constraining factor in the development of entrepreneurship (Krik, Price, Gatt, Rae, 2008).

These challenges can even be higher in transitional countries, such as Serbia, due to the inherited structural and other economic problems from the past. This paper will examine the specific problems of the development of entrepreneurship in Serbia. The purpose of the paper is to provide an in-depth analysis of the problems and constraints the entrepreneurs face in the process of establishment of start-up business in Serbia. The aim of the paper is also to test the significance of the identified key problems and constraints and perceive the impact that the funds the Government provides for their removal have on the increase/decrease in the number of entrepreneurs in Serbia. Application of appropriate statistical analysis methods will be used for the purpose of testing whether, and to which extent, each of the analyzed factors influences the number of entrepreneurs and the number of new entrepreneurs. Finally, on the basis of the achieved results conclusions will be reached and recommendations on the measures for the removal of the most significant problems and constraints to the development of entrepreneurship in Serbia will be given to the creators of economic policy.

## 2. THE DEVELOPMENT OF ENTREPRENEURSHIP IN SERBIA AND THE PROBLEMS FACED BY ENTREPRENEURS UNDER THE CONDITIONS OF THE ECONOMIC CRISIS

After the political changes that happened in Serbia in 2000, the new Government recognized the sector of small and medium enterprises and entrepreneurs (SMEEs) as the key driving force of economy. For that reason, great number of measures have been taken for the reform and development of this sector (Strategy for the development of SMEEs 2003-2008<sup>1</sup>, has been adopted and Republic Agency for the Development of SMEE (RAD of SMEEs) has been established which is responsible for the implementation of this Strategy; laws and regulations of importance for this sector have been changed with the purpose of alleviating legal-administrative barriers etc.) (Filipovic, 2003).

<sup>1</sup> After that, the Government adopted the new Strategy of the development of competitive and innovative small and medium enterprises for the period 2008-2013 (Serbian Government, Belgrade, 2008)

All mentioned measures contributed to the development of entrepreneurship in Serbia. This fact is supported by the increase in the number of SMEEs and the number of their employees, which is shown in Table 1 in Appendix.

Nowadays, similar to the situation in EU countries, the number of SMEEs is dominant in Serbian economy<sup>2</sup>. However, their number of employees is not as proportional, which shows that their potential for the employment of labour has not been fully exploited yet. When the data on the basis of which the total amount of GDP that entrepreneurs achieved in 2009 (193,688 million RSD) (SO of RS, 2009) was slightly less than the one achieved by small enterprises (whose share in the achieved GDP of all companies amounts to 18.2% (SO of RS, 2010) is taken into consideration, we see that SMEEs are becoming all the more significant segment of the overall economy, that their participation in economic structure is all the more significant and that they continually increase its impact on the creation of GDP and profit in the Republic of Serbia.

However, present condition in this sector in Serbia can still not be regarded as favourable due to the existence of a great number of problems and constraints. Serbian economy, whose decades-long problems have resulted from unfavourable economic structure and systemic inefficiency of economic subjects, is recovering with difficulty from the impact of the world economic crisis. Insecure business ambience is primarily reflected in negative trade balance and balance of payments, high rate of inflation (which can still not be reduced to the targeted level of single-digit inflation), uncertainty related to changes in dinar exchange rate, business insolvency, insufficient inflow of foreign direct investments, high rate of unemployment, and, consequently, low level of living standard of the population. Thus, for example, when macroeconomic indicators for 2007 (one year before the world economic crisis) are compared to macroeconomic indicators for 2010, the results are the following: GDP growth rate in 2007 amounted to 6.9% and in 2010 to 1.8% (in 2009 it was negative and amounted to -3.1%); trade balance is still negative (in 2010 it was -5,228.5 mil E) as well as the balance of payment of the country (in 2010 it was -929 mil E); foreign direct investments amounted to 1,821 mil E in 2007 and in 2010 to 860 mil E; rate of unemployment amounted to 18.8% in 2007 and to 20.0% in 2010; rate of inflation amounted to 11% in 2007 and after its reduction to 6.6% in 2009, it became double-digit again (10.3%) in 2010 with the tendency for further growth (in April 2011, in comparison to the same period last year, it amounted to 17.7%) (NBS, 2011). Although the first quarter of 2011 saw certain revival of economic activities (which are reflected in the growth of GDP, increase of export, increase of employment), macroeconomic climate is still unfavourable and achieved results, as shown by certain indicators, insufficient for the removal of negative effects of the world economic crisis from the past few years, as well as for the overcoming of the decades-long negative heritage in the development of Serbian economy.

Under these unfavourable macroeconomic conditions, it is difficult for SMEEs, which should become the engine of economic development of Serbia, to do business. It is also reflected in the fact that in Serbia in 2010 the number of entrepreneurs who went out of business was bigger than the number of new ones, which happened for the first time since the filing system has existed (SBRA, 2011). Namely, in the course of 2010, 35.299 new entrepreneurs were registered, which is 10% less than in 2009. In 2010, 37.168 entrepreneurs were deleted from the register, which is 2% more than the previous year. Due to the fact that in 2010 the number of closed enterprises and entrepreneurs who went out of business was bigger than the new ones, there are no positive effects on the growth of employment in Serbia. Instead of amortizing the losses of workplaces in big companies that have problems in doing business, in the last two years (2010 in comparison to 2008) more than 140.000 people among entrepreneurs were deleted from the official register of the employed (Ekonomija.org., 2011).

Table 2 Number of new entrepreneurs

Year	Number of new entrepreneurs
2007.	47951
2008.	43375
2009.	44000
2010.	35299

Source: SBRA, Belgrade, 2011

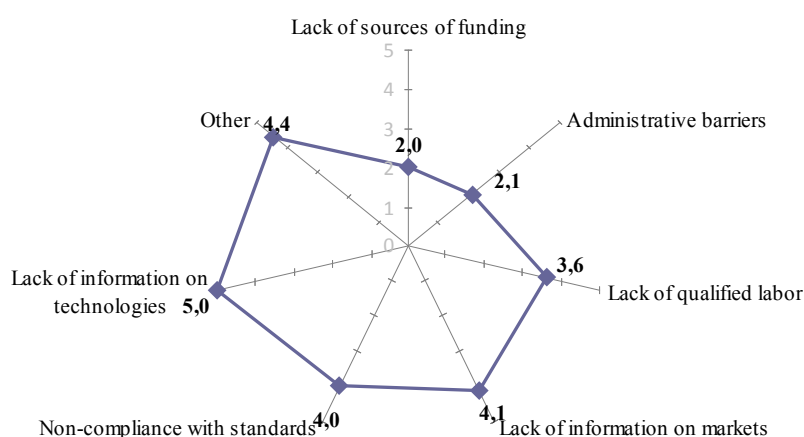
2 According to the data of the SO of RS for 2009, micro and small enterprises represent 96.66% of companies and employ 33.76% out of the total number of people employed by them. However, in contrast to micro, small and medium enterprises, entrepreneurs are not companies and are filed in the separate register in the Serbian Business Register Agency (SBRA). Entrepreneurs do the bookkeeping on the principle of simple and double-entry bookkeeping and only the ones who do the double-entry bookkeeping are obliged to submit financial reports to the National Bank of Serbia (NBS) and the SBRA.

This unfavourable trend has continued at the beginning of 2011. Out of the ones which are considered as existent, thousands of them have left the system of value added tax, which means that they are practically “dead”, i.e. that they do not work. These worrying data have stood for the starting point of the analysis of the factors that have a constraining impact on the development of entrepreneurship in Serbia.

### 3. CONSTRAINTS AND PROBLEMS IN THE DEVELOPMENT OF ENTREPRENEURSHIP IN SERBIA

Tending to identify some of the key problems and constraints that unfavourably influence the development of entrepreneurship in Serbia, we started from the Report of the RAD of SMEEs dealing with the conditions, needs and problems of SMEEs and realized on the basis of the survey of a sample of 3.000 SMEEs in Serbia (RAD of SMEEs, 2009). Surveyed units were economically active SMEEs, i.e. the ones that submitted annual financial reports for 2008 to the SBRA and the NBS, as well as the entrepreneurs that are not in VAT system. The results of the survey are shown in Figure 1.

Figure 1. The main problems in the business of SMEEs in Serbia



Source: RAD of SMEEs, Belgrade, 2009

Due to the fact that the lack of funds, administrative barriers and the lack of qualified labour were identified as some of the key constraints to the development of entrepreneurship in Serbia, they will be the focus of special interest in this paper.

Provision of initial capital stands for the most serious constraint to the development of entrepreneurship in Serbia. On the basis of the survey of Serbian entrepreneurs, it was shown that own funds were regarded as the most secure source of funding of start-up business in Serbia. This is supported by the data on the basis of which more than 50% of entrepreneurs use their own funds or private loans in the process of investment, because they regard these as the most profitable source of funding (RAD of SMEEs, 2009).

However, entrepreneurs often lack enough of their own sources of funding. Since the capital market in Serbia is underdeveloped and the entrepreneurs' access to that market limited, entrepreneurs are forced to ask banks for loans. Since prospective entrepreneurs and newly opened enterprises have short credit history, the banks regard them as high risk category of debtors and therefore insist on high insurance against risk in the form of mortgage or pledge. Because of the great number of cadastral problems, it is very difficult to put a mortgage on the majority of real estate in Serbia, which is partly resolved by the intervention of the Republic Guarantee Fund (RGF). Besides, loan terms and conditions are considered to be unfavourable<sup>3</sup> in Serbia (interest rates range from 8-12%, loan repayment period mostly ranges from 1 to 5 years, loan approval costs amount to 1-2% of the approved loan, grace period ranges from 6-12 months), which is why small number of entrepreneurs decide to ask for commercial banks' loans.

State funds, such as Development Fund of the Republic of Serbia (DF of RS) and NEA, which are

<sup>3</sup> Research shows that 40% of the population think that loan terms and conditions for start-ups in Serbia are unfavourable, 50% think that they are moderately favourable and only 10% of the population claim that loan terms and conditions are favourable.

intended for start-up businesses, play an important part in the process of funding entrepreneurial ventures in Serbia. For example, funds that the DF of RS allocated to start-ups in Serbia in the past four years and the funds that are planned for 2011 can be seen in Table 3 in Appendix.

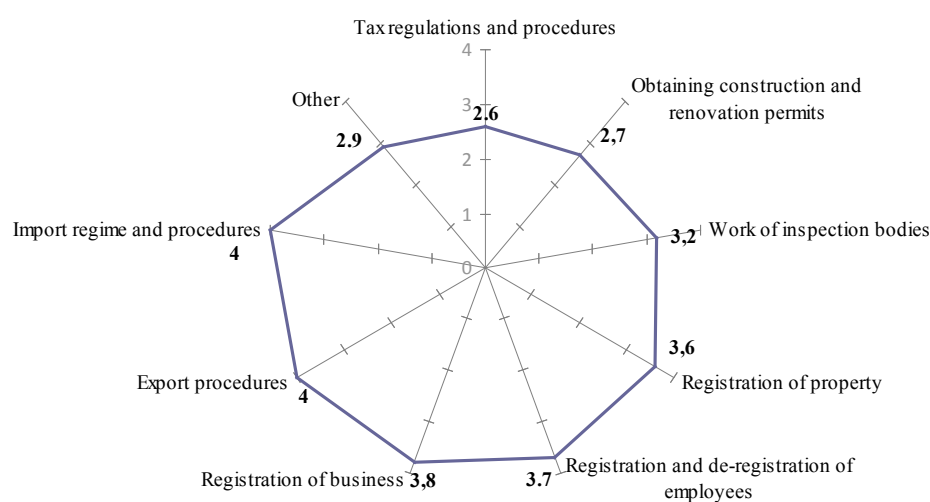
Also, funds provided by the NEA stand for the significant financial support for the development of entrepreneurship. However, these funds are limited. Data on the realization of program of subventions for self-employment of the NEA are given in Table 4 in Appendix.

Apart from the lack of financial resources, there is also a great number of other problems that accompany the approval of the sources of funding. Processes of allocation of funds at the DF and NEA are realized on the basis of public calls. Allocation of funds is performed once or possibly a few times a year. It means that the funds are not available to prospective entrepreneurs during the whole year. The consequence of such a system is that the focus of the ones who apply for the funds is the possibility of obtaining the sources of funding and not the start-up of business. However, apart from numerous problems connected with the process of approval of financial resources by the DF of RS and NEA, their role is of crucial significance for the starting of entrepreneurial activities in Serbia.

Entrepreneurs in Serbia are still facing very complex procedures and regulations which are related to opening, closing or re-registration of an enterprise/entrepreneur. It is necessary to change the behaviour and the way the public administration works, both of which need to be more transparent and more efficient because the process of registration of enterprises in Serbia is very bureaucratized, complex and long-lasting and the costs are high. With respect to this, some steps have been taken with the purpose of improvement of conditions of registration of new business and reduction of a number and costs of procedures (for example, the project called "Regulatory guillotine").

In the past few years, a significant step forward has been made in the field of establishment and registration of SMEs in all countries of West Balkans and Serbia. Nevertheless, results of research show that those problems still burden entrepreneurs in the process of successful business start-up. Thus, the Report of the RAD of SMEs on the condition, needs and problems of SMEs (RAD of SMEs, 2009, p.12) shows that administrative barriers are still highly positioned on the list of entrepreneurs' problems, which can be seen from Figure 2.

Figure 2. Key administrative barriers in the business of SMEs in Serbia<sup>4</sup>



Source: RAD of SMEs, Belgrade, 2009

Nevertheless, certain step forward in the field of establishment and registration of businesses has been made in Serbia, which can be seen in Table 5 in Appendix.

It seems that the process of registration and establishment of a business no longer stands for a burdening problem in the process of starting a business in Serbia. However, when the problems

<sup>4</sup> The Figure has been made on the basis of the data from the Report of the RAD of SMEs. Respondents ranged the problems by using grades from one to eight, grade 1 standing for the highest intensity. Average grades have been shown in the Figure.



related to obtaining all permits (the most problematic being construction permits), registration of property, registration and de-registration of employees are taken into consideration, overall process of starting a business is significantly prolonged. Serbian entrepreneurs themselves regard these problems as urgent.

Apart from the above-mentioned problems, entrepreneurs also pointed out problems related to tax regulations and work of inspection bodies. Therefore, according to recommendations coming from OECD (OECD, 2009), further attention should be directed to the improvement of efficiency and transparency related to the number of days needed for the completion of the overall process, costs and minimal capital requirements, as well as to provision of on-line registration. With respect to on-line registration, Croatia and Serbia are the only two countries from West Balkans that offer the possibility of on-line application for a great number of permits and licenses. However, the issue of electronic signature has not become fully operative in Serbia yet, which is why on-line procedures still cannot be fully completed.

Apart from these, the problem of entrepreneurs' education, especially in the field of strategic planning and management, stands for the urgent issue in the development of entrepreneurship in Serbia. Overloaded with a great number of everyday operational activities, entrepreneurs are left with not much time to deal with strategic issues of growth and development of an enterprise. Absence of strategic approach may result in stagnation of business activities and of enterprise itself. In most cases, stagnation and inefficiency result from the lack of managerial knowledge and skills. Moreover, incompetence in strategic planning and management reduces the chances for mere survival of an enterprise (Predić, Stefanović, Djukić, 2011, pp. 219-233). This results in the high rate of mortality of SMEs in Serbia, whereas low percent of businesses reach the phase of growth and development.

According to the Report of the RAD of SMEs, professional qualifications of the owners in Serbia are in compliance with the needs of the business in little more than half of the cases. This compliance is bigger when it comes to technical profiles (40%), whereas the compliance is smaller in cases of economic-managerial profiles (17%). Also, among the surveyed entrepreneurs, the greatest number of them are with secondary education (47%), and 44% are with higher education and university education. When the data on the basis of which 80% of micro enterprises' founders and 70% of small enterprises' founders are managers themselves is taken into consideration, it can be seen that the problem of insufficient professional qualifications can be the problem for the successful growth and development of SMEs.

When national institutions are taken into consideration, in recent years, the leading role in the field of informal education, i.e. education and trainings of entrepreneurs, has been played by the National Agency for Regional Development (NARD) in cooperation with regional agencies. They offer various forms of financial and non-financial support, as well as various projects of support for entrepreneurship. With respect to this, in 2010 only NARD approved 60 million RSD (little more than 568,720 euros) to 320 SMEs within the scope of the Program of support for the development of competitiveness of SMEs (NARD, 2011). The Program aims at providing direct support for the development of competitiveness of SMEs through participation in covering costs of consulting services (preparation of business plans, market research, certification and standardization, improvement of the process of production, introduction of new systems of quality, implementation of innovations). It is achieved in the form of grants.

Regardless of that, certain steps towards improvement of education and trainings of entrepreneurs are started to be taken in Serbia. In cooperation with the Ministry of Economy and Regional Development of the Republic of Serbia (MERD of RS) and the DF, NARD participates in the realization of the Program of start-up business loans (NARD, 2011). NARD participates in the part that is related to non-financial support, and all this enables the provision of a unified package of non-financial and financial support for future entrepreneurs. NARD also organizes start-up trainings as a form of support for the realization of this credit line. In the course of four public calls (starting from 2007), 655 trainings were held with the total of 9739 attendees. Table 6 in Appendix provides unified statistics of approved loans and trainings for starters in business, i.e. future entrepreneurs.

It is planned that 4400 attendees pass this kind of training in 2011. In this way, the total number of entrepreneurs who passed the training will reach 15000. The aim of organizing these free trainings is to provide Serbian entrepreneurs and starters in business with higher level of knowledge. Apart from that, this Agency offers non-financial assistance in the form of trainings, seminars, consulting and mentoring services to owners of SMEs (NARD, 2011).



#### 4. MODEL OF RESEARCH, HYPOTHESES AND DISCUSSION OF RESULTS

On the basis of the Report (survey) of the RAD of SMEEs on the problems and constraints to the development of entrepreneurship in Serbia, the most significant identified problems and constraints are: lack of sources of funding, administrative barriers and the lack of qualified labour. For that reason, the idea was to test the identified factors by the application of appropriate methods of statistical inference, i.e. to perceive the impact of each specific factor and of combination of all factors on the number of new entrepreneurs on the basis of regression model.

Namely, as a consequence of negative impact of these factors and prolonged impact of the world economic crisis on the Serbian economy, the number of entrepreneurs decreased in the course of 2009 and 2010 with the tendency for further continuation of this negative trend. We are of opinion that the decrease in the number of entrepreneurs in Serbia directly resulted from the state's reduction of programs of financial and non-financial incentives for the development of entrepreneurship. This reduction by the state, which was specially expressed in 2010 when compared to previous years, resulted from the spillover effects of the world economic crisis on Serbia. Spillover effect is also reflected in the fact that the decrease in the number of entrepreneurs and their employees did not occur in 2008 when the world economic crisis had the highest impact all over the world. This is because the direct causes of the economic crisis were not to be searched for in Serbia (but on the global financial market). Nevertheless, its postponed effect had an impact on other sectors and economies of many countries, including Serbia. Those spillover effects of the world economic crisis in Serbia reached culmination in the course of 2009 and 2010, which resulted in further fall of the level of economic activity, deterioration of macroeconomic conditions of doing business, and, consequently, reduction of state's financial and non-financial incentives for the development of entrepreneurship. Finally, this resulted in the fact that the number of new entrepreneurs was smaller than the number of the ones who went out of business and subsequent reduction in the number of entrepreneurs and their employees in the course of these years.

In accordance with the above-stated remarks, we will try to test the following starting hypotheses:

$H_1$ : There is a statistically significant connection between the number of new entrepreneurs and the most significant problems/factors that have an impact on the development of entrepreneurship in Serbia and that were identified in the course of survey of entrepreneurs.

$H_2$ : Under the conditions of prolonged impact of the effects of the world economic crisis on economic activity in Serbia, only the state's active measures (in the form of direct financial allocations from the budget) for the programs of financial incentives for start-ups can result in the increase in the number of new entrepreneurs.

$H_3$ : Enhancing the level of qualifications of prospective entrepreneurs through trainings on the establishment of start-ups, i.e. increase in the number of attendees who passed those trainings can positively affect the development of entrepreneurship in Serbia

With the purpose of examining whether there is a stochastic link between the above-mentioned variables, regression analysis has been applied. Dependence and link between the two variables can be generalized by the inclusion of several variables into the process of examination. With this purpose, appropriate *methods of multiple regression analysis* are applied. The task of regression analysis is to find and test the model that shows random values.

The role of dependent variable (Y) in the model is given to the number of new entrepreneurs in the period 2007-2010, whereas the following are treated as independent variables:

- Amount of allocations from the DF for start-up loans (X1),
- Subventions for self-employment of the NEA (X2),
- Cost (% of income per capita) – X3,
- Paid-in Min.Capital (% of income per capita) – X4,
- Amount of approved loans for trainings (X5),
- Number of trainings (X6),
- Number of attendees (X7),
- Average amount of loan per training (X8).

Validity of the hypothesis  $H_1$  can be checked by testing the direction and the degree of quantitative

agreement between variations in the number of new entrepreneurs and variables which define the most significant identified problems in the development of entrepreneurship (variables  $X_1, \dots, X_8$ ). For that purpose, Pearson's simple linear correlation coefficient ( $r_{yx}$ ) was calculated, with simultaneous testing of the significance of its evaluation. Namely, analyzed agreement between previously defined dependent variables and the number of new entrepreneurs was isolated. The results are shown in the following Table:

Table 7 Pearson's simple linear correlation coefficients

	$r_{yx}$	p-value
$X_1$	0,373	0,627
$X_2$	0,711	0,289
$X_3$	0,829	0,170
$X_4$	0,781	0,218
$X_5$	0,317	0,683
$X_6$	-0,417	0,583
$X_7$	-0,376	0,624
$X_8$	0,790	0,210

According to the results from the Table 7, among the identified variables, the ones that belong to the group of direct financial incentives for the entrepreneurs' start-up ( $X_1$  i  $X_2$ ) have a significant and positive impact on the growth of number of new entrepreneurs. Statistically speaking, subventions for self-employment of the National Employment Agency have more significant impact, which is shown by the value of Pearson's correlation coefficient  $r_{yx2} = 0,711$ .

Positive correlation link between variables that are related to administrative barriers ( $X_3$  i  $X_4$ ) and the number of new entrepreneurs points to the fact that although the state tried to facilitate the process of establishment of entrepreneurs, it did not have statistically significant impact on the number of new entrepreneurs and the number of their employees. Cost reduction and paid-in minimal capital in the analyzed period did not result in the increase in the number of new entrepreneurs. Therefore, a conclusion can be drawn that the costs of registration of entrepreneurs do not have a significant impact on the opening of entrepreneurs' businesses in Serbia, i.e. that the impact of other factors is more significant.

Variations in the number of new entrepreneurs show negative direction of quantitative agreement with the number of organized trainings and the number of attendees ( $X_6$  i  $X_7$ ), which means that the increase in the number of trainings and the number of attendees did not have statistically significant impact on the increase in the number of new entrepreneurs. Increase of the amount of loans for trainings ( $X_5$ ) shows positive direction of quantitative agreement with the number of new entrepreneurs. Since the negative direction of quantitative agreement between variables that are related to the number of attendees and the number of trainings on the one hand, and the number of new entrepreneurs on the other hand was not in accordance with the starting hypotheses, the idea was reached to introduce new variable into analysis. This new variable was obtained from the amount of approved loans for trainings and the number of trainings, and that was the average amount of approved loan per training ( $X_8$ ). The value of simple linear correlation coefficient, which shows isolated agreement of this variable with variations in the number of new entrepreneurs  $r_{yx8} = 0,790$ , points to the extremely significant direct correlation link.

Achieved results point to the existence of dependence between the number of new entrepreneurs and the defined independent variables, which confirms the starting hypothesis  $H_1$ .

In accordance with the hypothesis  $H_2$ , multiple linear regression model was used for testing the form and direction of dependence between the number of new entrepreneurs and variables  $X_1$  i  $X_2$  which belong to the group of factors that represent the financial support for the development of entrepreneurship. On the basis of the data for the period 2007-2010, the following three-dimensional regression model was evaluated:

$$Y = 13035,53 + 0,001X_1 + 0,002X_2$$

Value of regression coefficient  $b_1 = 0,001$  shows that the increase in the amount of allocations from the DF for start-up loans has a positive impact on the average increase in the number of new entrepreneurs. Also, positive value of regression coefficient that stands by the second independent variable  $b_2 = 0,002$  shows that the increase in subventions for self-employment results in the increase in the average number of new entrepreneurs. At the same time, the results show that the subventions of the NEA

for self-employment have twice as strong positive impact on the opening of new entrepreneurs' businesses. Measures of representativeness of this evaluated regression model, i.e. multiple coefficient of determination  $R^2=0,919$  and standard error of the regression  $S=1511,66$  show that the model is representative and it can be used for further predictions of the number of new entrepreneurs. These results confirm hypothesis  $H_2$ .

The impact of financial aspects of state incentives, which belong to the group of factors that have an impact on the rise of the level of qualifications of prospective entrepreneurs, on dependent variable can also be analyzed. With that purpose, the link between  $Y$  and variables  $X_5$  and  $X_8$  should be observed. Evaluated three-dimensional regression model has the following form:

$$Y = 26571,98 + 0,001X_5 + 0,036 X_8$$

Value of regression coefficient  $b_1 = 0,001$  points to the direct link between the amount of loan and the number of new entrepreneurs. Also, the parameter  $b_2 = 0,036$  shows that the increase in the average amount of loan per training has a stimulating impact on the number of new entrepreneurs. Value of multiple coefficient of determination  $R^2 = 0,624$  points to the fact that 62,4% of variations in the number of new entrepreneurs can be explained by variations in variables  $X_5$  i  $X_8$ , which points to high representativeness of the evaluated model. These obtained results also support hypothesis  $H_2$ , which means that the state's financial incentives for entrepreneurs have the most significant direct impact on the starting of new entrepreneurs' business.

With the purpose of testing hypothesis  $H_3$ , coefficients of partial correlation for the set of variables ( $Y$ ,  $X_5$ ,  $X_7$  i  $X_8$ ) were evaluated which show the degree of quantitative agreement between two variables. At the same time the impact of other variables from the selected set was tested. Obtained values and their significance levels are shown in the Table 8.

Table 8 Correlation matrix

	Number of attendees	Average amount of loan per training	Number of new entrepreneurs	Amount of approved loans for trainings
Number of attendees	1,000	-0,798	0,422	0,784
p-value	.	0,412	0,723	0,427
Average amount of loan per training	-0,798	1,000	0,210	-0,251
p-value	0,412	.	0,865	0,838
Number of new entrepreneurs	0,422	0,210	1,000	0,894
p-value	0,723	0,865	.	0,296
Amount of approved loans for trainings	0,784	-0,251	0,894	1,000
p-value	0,427	0,838	0,296	.

Results show that from the set of selected variables the strongest direct correlation link exists between the number of new entrepreneurs and the amount of loans for trainings. However, when the link between the number of attendees who passed the trainings before the establishment of start-ups and the number of new entrepreneurs is taken into consideration, it can be said that there is a direct agreement between them, but that the degree of this agreement is lower than expected. If this result is taken into consideration, it can be said that the hypothesis  $H_3$  is only partly confirmed, i.e. that the factors from the group of financial incentives for the development of entrepreneurship have much bigger impact. In this way, results of the survey of SMEs and entrepreneurs have been indirectly confirmed, on the basis of which the lack of funds was identified as the most significant problem in the development of entrepreneurship in Serbia.

## 5. CONCLUSION

Our research confirmed the results obtained on the basis of the survey of the owners of SMEs and entrepreneurs conducted by the RAD of SMEEs, as well as the starting hypothesis on the dominant impact of the state's financial incentives on the development of entrepreneurship in Serbia, and, consequently, on the increase in the number of employees. Those financial incentives can occur in the form of direct subventions for self-employment or in the form of favourable loan conditions for prospective entrepreneurs. The results of the research showed that subventions for self-employment, especially the ones given by the NEA, were of greater significance. Therefore, our recommendation is that the amount of funds that the NEA allocates for this purpose should be increased in the period to come. With this regard, it is desirable to provide much more financial incentives for the development of entrepreneurship at the national, as well as at the local level. For example, local communities can play a vital role in the provision of micro loans and micro leasing for new enterprises on their territory. They can also allocate the funds from the budget and connect micro loan institutions and entrepreneurs. Moreover, local communities can assess the local entrepreneurs' needs for start-up loans and lobby and encourage institutions that deal with micro loans to meet those needs.

Apart from direct funding, it is very useful to provide guarantees for the entrepreneurs and establish local guarantee funds. This measure can bring about the improvement of availability of loan capital to entrepreneurs' business ventures in a municipality, because the guarantee enables entrepreneurs to get the loan under more favourable conditions<sup>5</sup>. Pursuant to the existent legal regulations in Serbia, guarantees are provided exclusively by the RGF. In most cases these guarantees amount to 50% of the principal, i.e. of the loan, and in specific cases to 80%. Problems occur because of the way of functioning of the RGF which the banks ask for guarantees and not the end clients. Local communities, i.e. local authorities need to fight for the change of this system and cancellation of a specific monopoly that exists now. In this way, opportunities will be opened for the local communities to start establishing their own guarantee funds. At the same time, several local communities may be connected, which is desirable, or the partnership of the public and private sector in this field may be formed.

One group of activities that belong to the group of non-financial services but that is related to funding is the provision of advice which are related to funding. Due to the fact that serious problems of entrepreneurs are connected with financial negotiations with banks (since entrepreneurs are usually insufficiently acquainted with financial institutions' business techniques) as well as with the access to formal financial market (since entrepreneurs usually do not possess significant property that could serve as security), they could be helped with advice or education on financial planning, financial institutions' technology of work and the like.

When non-financial incentives for the development of entrepreneurship are taken into consideration, besides the established positive link between the reduction of administrative barriers and the establishment of start-ups, further attempts should be made with the purpose of raising the level of qualifications and trainings of prospective entrepreneurs. Therefore, it is necessary to take measures to increase the number of prospective entrepreneurs who passed trainings on the issues of importance for the establishment and management of entrepreneurial venture. Some steps of that kind have already been taken since one of the conditions for getting the subventions for self-employment of NEA is the previously attended training organized by this institution. However, those trainings need to involve much more people, including prospective entrepreneurs, and not only the ones who are registered as unemployed persons in NEA. Therefore, it is expected that the state's activities, reflected in the measures of the NARD, should bring about positive results in the form of future increase in the number of new entrepreneurs in Serbia.

<sup>5</sup> High interest rates are the consequence of the high risk of loans, i.e. of the risk that the debtor will not return the principal. Guarantee that the debtor will return the principal reduces that risk, enables and stimulates loan approval, and reduces interest rates.



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## Appendix

Table 1. Number of entrepreneurs in Serbia and their employees<sub>1</sub>

Year	Month	Number of entrepreneurs and their employee (000)		
		Total 3= 4+5	Number of entrepreneurs	Persons employed with entrepreneurs
2004	March	464	208	255
	September	477	210	267
2005	March	513	228	285
	September	531	230	300
2006	March	536	228	308
	September	572	242	330
2007	March	566	239	327
	September	573	245	328
2008	March	574	245	329
	September	568	245	323
2009	March	500	210	290
	September	485	211	274
2010	March	455	199	257
	September	427	183	244

Source: Statistical Office of the Republic of Serbia (SO of RS) – Semi-annual report on the employees and employees' salaries RAD-1/P; Survey<sub>2</sub> conducted for the purpose of supplementing the semi-annual report RAD-1; Semi-annual report on private entrepreneurs and their employees RAD-15; National Employment Agency (NEA).

Table 3. Amount of funds from the DF for start-up loans per year

Year	Amount of funds from the DF for start-up loans in euros
2007.	approximately 23,000,0001
2008.	24,830,700
2009.	32,328,710
2010.	20,853,080
2011.	11,141,252

Source: DF of RS

Table 4. Subvention for self-employment of NEA

Realization of the program in the period 2004-2010

Year	Number of recipients	Amount in euros
2007.	5465	8,953,811
2008.	3386	4,968,228
2009.	2307	3,127,646
2010.	2217	3,352,038

Source: NEA, Belgrade, 2011.

Table 5. Starting a Business in Serbia

Starting a Business data	Doing Business 2007	Doing Business 2008	Doing Business 2009	Doing Business 2010	Doing Business 2011
Rank	-	-	-	75	83
Procedures (number)	10	11	11	7	7
Time (days)	18	23	23	13	13
Cost (% of income per capita)	10.2	8.9	7.6	7.1	7.9
Paid-in Min.Capital (% of income per capita)	7.6	8.0	6.9	6.1	6.0

Source: Doing Business Report, 2011.

1 Kvartalni monitor br. 23, Beograd, oktobar–decembar 2010.

2 Labour Survey is the survey which helps examine the characteristics of labour and events on labour market according to the activities in the observed week and not in accordance with the formal status of surveyed people. The survey is conducted in accordance with the standards of International Labour Organization (ILO) and the requirements of EUROSTAT, which is why the results of the Labour Survey can be regarded as internationally comparable.

Table 6. Approved loans and organized trainings for starters in business

Year	Number of credits	Amount of approved loans for trainings in euros	Number of trainings	Number of attendees
2007.	1522	25,242,302	64	1037
2008.	2279	31,611,174	216	3024
2009.	2824	42,781,312	230	3217
2010.	1367	20,853,080	177	2430
Total	7992	-	655	9739

Source: NARD, 2011

## **BUSINESS DEVELOPMENT AND GROWTH DESPITE THE GLOBAL CRISIS: THE CASE OF CROATIAN SMALL COMPANY**

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### **Abstract**

#### **INTRODUCTION**

Situation in the Croatian textile industry for many years has been quite difficult. One of the major causes of the slow growth of the textile industry is the reluctance of existing firms to adapt to new market conditions. This situation is further worsened with the influence of global recession in recent years. Domestic textile industry is in a very disadvantaged position, because the business concept has not changed for decades as ultimately reflected in its position in the global competitive environment. Croatia is not the only country which experienced the effects of crisis namely in the textile industry. The crisis in textile industry is present in the whole world, mostly because of cheap labor from China and Eastern countries. The situation is difficult, but not so black as shows us the example of small Croatian company Merkur. Merkur expanded into new markets and reported a remarkable growth in turnover of 5% which is an excellent result in today global crisis and a good indicator of future business. How did they do it?

#### **RESEARCH METHODOLOGY**

This paper was brought up using the case study method to present a successful small company that has managed not only to maintain the existing level of business in this time of global recession, but to enhance and expand into new markets. Using the case study method the authors were able to deeply and comprehensively analyze all of the key determinants of small business enterprises that have influenced the final successful result.

#### **RESULTS**

Using the tools of market research the owners of this company have received valuable information about the characteristics and appearance which should have the final product as well as the preferences of the target market. Among the other things, the management of the company has used new marketing tools in their marketing strategies. The Social Networks like Facebook and Twitter showed to have the greatest importance.

**Keywords:** SME, Business strategies, Social networks, Global crisis

## 1. INTRODUCTION

Small businesses are important for growth and development of each economy, including Croatian. In the past, textile and apparel industry in Croatia played an important role in the economy growth. Unfortunately that role has changed in the past decade. This paper focuses on the subject that speaks about the successful operations of small enterprises in the global economy and gives foundation for motivating new measures for better SME development in Croatia. The future of SME's is determined by their natural, technological, market, economic and social environment. Adaptations to external conditions depend on balance, and a compromise between flexibility and specialization for future development. Taking risk for future development of SME's is the basic characteristic of entrepreneurs and market economy. Our study emphasizes the importance of SMEs for the Croatian economy and highlights the importance of using Social media and Internet and make transparent success factors and development of SMEs in the development of Croatian economy as a whole. Research has found that small firm that grows, tend to develop profitable and expanding market niches that are often quite narrow and appear difficult to describe by objective, industry or market wide variables (Storey, 1996, 1997 and Storey D.J.1996). This paper addresses these afore mentioned topics by positioning the research in the broader SME growth literature, as internationalisation is a means of achieving SME growth. The research approach incorporated in-depth interview with the owner-manager of SME in retailing sector in theCroatia. In Croatia, SME's are the largest group according to the total number of companies (99% of the total number of companies), employ a little less than a half of total number of employees (45%), and achieved 43% of income, and 35% of profit of the whole economy (Strugar, Škrtic, 2006, p. 236-238). In the period 2000-2005, the share of SME's declined by several percent in total number of employees, total income and profit, which can be considered as consequence of competitive pressure increase and process of globalization. Managing small business growth identifies many opportunities and difficulties for the entrepreneur. We introduce an entrepreneurial perspective toward enhancing growth opportunities within the small business sector. In SME's the decision-making process is significantly different than in large companies. We look at initiatives facilitating the growth of small businesses. The paper commences with a literature review on the identified services marketing initiatives, followed by chapter about textile industry in Croatia, research methodology, findings and finally recommendations.

## 2. THEORY REVIEW

### 2.1. Entrepreneurship and economic growth

Small firm growth is a research area that has attracted considerable attention in recent years. Small businesses have always been a catalyst for economic development. Most employees have been employed in small and medium enterprises. An organized entrepreneur works in a coordinated way which enhance the employment level as well as GDP. Entrepreneurs are mostly known as the risk takers and the innovators. Entrepreneurship is the practice of starting a new business in response to identify opportunities. There are several different criteria by which companies are included in the group of small businesses; number of their employees, their share in total revenue and their share in total profit. SMEs are comprised of three categories of firm: the micro firm (less than 10 employees), the small firm (less than 50 employees) and the medium firm (less than 250 employees). There are different types of entrepreneurial activities depending upon the type of the organization. Entrepreneurship is basically creating something new e.g. new products, exploring new methods of production, face the challenges etc. Entrepreneurship is often associated with the true uncertainty, particularly when it involves bringing something new. So entrepreneurship is the process of discovering and starting a new business. Firstly the meaning of entrepreneurship is defined as: An entrepreneur is an organized person who wants to do job in that organized way where he will be able to transfer the idea into new ways. (Schumpter, 1950). The person is able to willing the job in a very coordinated way to manage the organization.

**Entrepreneurship** is the process of new inventions of opportunities to develop the value of new organization (Fisscher at al: 2005). It is clear from the definition that entrepreneurship is the process of creating new ways and ideas so as to create the value of an organization whether it is new or an already existing organization. The entrepreneur is that factor of production which develops the new things in the culture, something good for the society to meet the requirements of the consumers (Buchholz and Rosenthal, 2005) It is very clear that an entrepreneur is a person who creates something new in the society so that it is helpful for the consumer.

All the definitions discussed above, almost revolve around the same meaning. Different writers have



written different definitions but almost all have the same meaning about the entrepreneurship.

**Economic Growth** indicates the progress in the economy. Another way to describe the economic growth is that, to enhance the economic development in the country in a very smooth and organized way. So the economic growth term is used to emphasize on the economic progress in the country which leads to increase in per capita income. Economic growth has two aspects; one is positive and the other one is negative. In a positive sense of economic growth means the increment in this variable and vice versa. The GDP is a component which shows the overall economic growth in a country. It is the most important macroeconomic variable which is used to calculate all the final good and services produced in a country in a year. It is a broader concept which confirmed with the economic progress. It is basically a positively related to the better living standard of the citizens which concerns with the employment level of a country. Thirdly there is another variable i.e. employment which is most commonly recognized in the macroeconomic indicators. The employment is basically the contract between two parties i.e. employee and employer.

## 2.2. Stages in development

There are three types of entrepreneurs in the development stages; the first generation entrepreneurs who are the innovators and risk takers and who are the first who are taking step in their family to start a new business, second are the modern entrepreneurs who are checking the feasibility of the business according to the market situation. They see the present market situation that what business is mostly in. Third ones is the classical entrepreneur, the one who gives more importance to consistent returns than to growth. They have a more concern on the customer and marketing needs.

## 2.3. Growth in the small firm

“Growth” in the small firm is usually related to an increase in turnover, profitability, number of employees, and/or financial assets – the same criteria in fact as is used as “success” indicators. A high growth rate within small firms is not unusual because if the firm is small a relatively modest amount of growth may result in a high growth rate. Thus the main reason for the high rate of growth may be more to do with the original size of the small firm (Brown, 1995), than with “tripling a little [being] much easier than doubling a lot” (Heller, 1988). It is generally accepted that smaller organisations grow more quickly than larger ones, and that young firms grow more quickly than old ones (Deakins, 1999). Rapid growth within (even highly profitable) smaller firms has often led to their premature collapse through cash flow imbalance, with immediate finance requirements causing a cash crisis and crippling the firm (Barrow, 1995; Bennett, 1993). It is recognised that as a small firm grows instinctive management becomes insufficient (Pleitner 1989) with the need for well-designed and managed systems, controls and procedures becoming paramount (Stewart, 1990). The firm must become more “institutionalised” (Cohn and Lindberg, 1974), more bureaucratic (Stanworth and Curran, 1981), and systematic (Ackelsberg and Arlow, 1985), these kinds of structures and systems being the antithesis of many small businesses which paradoxically have flourished while being flexible with inherently informal management processes. Growth of the firm to beyond a level where the owner/manager can manage it effectively often sparks a crisis (Stewart, 1990). The pervasive influence of the small firm owner/manager has already been noted. His/her capacity to change as the company grows will have a significant bearing on the success of the company. More fundamentally, his/her attitude to growth of the firm will largely determine whether or not the firm is actively “grown”. Evidence suggests that the many owner/managers seek to restrain the growth of their firm and that this is connected to their attitudes towards growth and control (Gray, 1993; Cannon, 1991).

## 2.4. Attitudes to growth

One of the difficulties for the owner/manager is that while an autocratic management style may prove successful while the firm remains small, there is a need for both management style and organisational structure to change to as the firm grows (Burns and Harrison, 1996). Growth itself, however, is not necessarily a goal for small firm owner/managers (Stokes, 1995), as they attempt to maximise success (as defined in their own personal terms) while restricting the size of the company to a level with which they are comfortable (Burns and Harrison, 1996). The size of the business will be a function of two factors – the owner/managers’ image of the business itself and the marketplace within which the firm operates (Birley, 1996). The goals and aspirations of the owner/manager have significant implications for small firm growth.

### 2.5. Intuition versus planning

The small firm owner/manager has little time to think strategically about the business (Brown, 1995), with resource constraints necessitating intuitive decision-making (Tibbits, 1981). Generally he/she does not believe that formal strategic planning will benefit his/her business (Orpen, 1994), despite recommendations that the small firm owner/manager should “adopt a judicious balance of the formal and informal in their planning systems” (Mc Kiernan and Morris, 1994). Evidence suggests that many successful small businesses do not practice what is conventionally described as strategic management (Pleitner, 1989). Complicated theories and highbrow formal processes are deemed to be unsuitable for small firms as owner/managers will not use them (Hogarth-Scott, Watson and Wilson, 1996), opting instead “...to engage in informal management practices than to adopt sophisticated planning and control techniques for good reason” (Martin and Staines, 1994, p. 26). Much of the available literature on marketing planning is written for and about large business (Brooksbank, 1996; Lancaster and Waddelow, 1998) and is of little use to the small business owner/manager.

### 3. INTERNATIONAL SMALL BUSINESS GROWTH

Internationalisation is a route for business growth where businesses seek to expand their activities beyond domestic markets. The objective of this research is to examine the process of internationalisation in a sample of Croatian SME. In particular, topics such as the reasons why owner/managers export, their choice of international market, the market entry strategies adopted and the challenges encountered in internationalisation are the subject of this study. Growth is a multifaceted phenomenon that is commonly associated with firm survival, achievement of business goals and success, or scaling up activities (Storey, 1994; Kinsella et al., 1994; Delmar and Wiklund, 2003; Wickham, 2004; Dobbs and Hamilton, 2007). Business growth may take different forms (employment, revenue, market share and product development), albeit not necessarily all at the same time. Furthermore, typically in the small firm growth occurs in a local and national context before the owner-manager considers internationalisation of business activities (Pope, 2002; Cremins, 2006). Owner-managers may be exposed to the same challenges in achieving growth, but given the heterogeneity of small firm growth differences occur in how these are managed by the owner-manager (Kinsella et al., 1994; Barkham et al., 1996; Gibb, 2000; Wickham, 2004; Donohoe and Wyer, 2005). Wickham (2004) proposed that the owner/managers’ perception of how it would impact on their personal role in the business determined the strategies adopted to pursue firm growth, where one such strategy is *internationalisation*. With regard to the challenges faced by the owner/manager in growing the business, the literature broadly classified them into internal and external (Morrison et al., 2008; Niskanen and Niskanen, 2005; Pasanen, 2006). Internal factors relate to the owners’ intention and motivation to grow the business and their access to and effective utilisation of resources (Kinsella et al., 1994; Storey, 1994; Barkham et al., 1996; Morrison et al., 2008; Niskanen and Niskanen, 2005; Pasanen, 2006). The external factors include a range of economic, political, societal/demographic, technological and regulatory aspects that are largely outside the control of the owner-manager. It is important that the owner-manager is aware of how these will impact on business growth strategies. The internal factors are within the control of the owner/manager and will therefore greatly determine the type of strategies adopted to avail of the opportunities in the international marketplace. For this reason the internal factors, in particular the reason why owner-managers chose international firm growth, the strategies adopted and the challenges encountered in the achievement of international growth, are of most interest in this study.

The survey involved in-depth interview with an owner of the SME in Croatia. The data show that the owner decided to export due to a lack of alternative market opportunities in the Croatian market. He chose the Serbian market as their first location and adopted a phased approach to internationalisation. The primary challenges experienced by owner/managers related to the establishment of strategic alliances and partnerships to facilitate international firm growth are insufficient market research, lack of customer familiarity and difficulties in balancing the dual management of firm activities in the domestic market and new international markets. The findings emphasise the need to examine SME internationalisation as a series of interrelated activities that should be embedded as part of the overall growth strategy of the firm as opposed to a separate strategy. Suggestions are put forward for government policy to develop more SME targeted financial and non-financial supports to develop the export capabilities and competencies of owner/managers and to assist them establish strategic

#### 4. MANAGERS MOTIVES FOR GROW THEIR BUSINESSES INTERNATIONALLY

The factors inducing international firm growth are generally categorised into a dichotomy of positive and negative factors that align with the determinants of general firm growth (Czinkota and Tesar, 1998; Lawless, 2007). Positive reasons are associated with the proactive seeking out of international market opportunities by the owner/manager. Conversely, owner/managers may only consider international market expansion due to a lack of growth opportunities in domestic markets. In this latter instance the owner-manager adopts a passive and risk-adverse approach in the choice of market and the type of market entry strategy adopted (Czinkota and Tesar, 1998; Lawless, 2007). Additionally, a variety of micro and macro environmental factors contribute to a firm's decision to export. These include factors associated with the customer and competitive, social, cultural, economic and technological characteristics of the international business environment, and provide positive or negative determinants for SME internationalisation (Bell, 1995; Tybejee, 1994). Once the decision to export is made the owner/manager needs to evaluate the suitability of their product or service in its current form for acceptance in new international markets. The level of adaptability required and the availability of financial resources to support the modification of the product or service, and in functional areas such as international marketing, selling, production and distribution, will impact on the feasibility of the export activity. Concurrently, the owner-manager must assess their own commitment to international firm growth and the availability of the necessary knowledge and skills to do so. Small business owners and entrepreneurs have the perceived desirability, feasibility and propensity to act to grow their small businesses. Such entrepreneurial intentions are depicted in Krueger, Reilly and Carsrud (2000). Furthermore, there is a strong link between these elements and overall profit and growth of an organisation (Heskett et al., 1997). Organisational profit and growth are linked to customer loyalty, satisfaction and value via the strategic implementation of referral, related sales and retention strategies (Heskett, Jones, Loveman, Sasser and Schlesinger, 1994).

#### 5. TEXTILE AND APPAREL INDUSTRY IN CROATIA

Since the end of 2008 to November last year in Croatian textile and apparel industry has lost 4020 jobs. In the future there will be an even greater loss of jobs. Due to the decrease in domestic sales of products Croatian clothing and textile industry companies have significantly reduced the production of its products. According to information from the Croatian Commercial Chamber in the future will reach even greater decline and loss of jobs due to tough competition in the market. Prospects are only those companies that are financially consolidated and modernized.<sup>3</sup> Textile and apparel industry in Croatia is one of the most important Croatian industries. Despite the many changes and difficulties caused by the decrease in the market and the recent war, the textile and apparel industry maintained a very important place in the Croatian economy. Since dressing is daily need in a man's life, and also considering the traditions and development of textile and apparel industry, we can claim with certainty that they have good prospects for future development in the Republic of Croatia. In recent times, exports of textile and apparel industry remained at the level of the war years, with a slight rise in the imports. The share of textile industry in exports is 17.3%, and imports only 6.2%. It is particularly important in the textile and garment industry, Croatian has 46 600 employees, which considering the number of employees in manufacturing industry amounted to 17.3%. This is a very important fact, because these industries have a significant influence on the overall employment rate, the more so because they employ about 75% of female labor force. For the textile and clothing industry continues to operate successfully it is necessary to modernize and reorganize production. Service industry should continue to be a substantial amount of total production. But above all it is necessary to have your own product known on the European and world markets. To achieve this we need to develop our own creation of high quality products competitive in the global market. Despite the high competition of cheap textiles from Asia, high quality modern textile design or just attractively designed textiles can still be profitable to qualify for the world. It is in particular the approach and methods of work and we see our chance, of course with proper use of marketing strategies.<sup>4</sup>

3 <http://www.index.hr/vijesti/clanak/izumire-li-hrvatska-tekstilna-industrija-u-dvije-godine-izgubljeno-4000-radnih-mjesta/535735.aspx>

4 [http://www.privredni.hr/index.php?option=com\\_content&task=view&id=1802&Itemid=2](http://www.privredni.hr/index.php?option=com_content&task=view&id=1802&Itemid=2)

## 6. GLOBAL CRISIS AND SME

Since the beginning of the economic crisis in 2008, it has been noticed that plummeting production has had a major effect on SMEs in the EU. The European Commission's annual report on SMEs shows that the crisis has hit medium and large companies harder than small and micro ones. A major issue SMEs have to cope with is that of access to financing. The profitability of SMEs in the EU is under huge pressure, which diminishes the number of new market entries and increases the number of exits. Implicitly, the phenomenon entails growing unemployment. At the level of the European Union, SMEs stand for 99% of all enterprises. The world economy seems to recover faster than certain economists anticipated, mostly because of the drop in aggressive interest rates, of the emergency credit of the central bank and the governmental financial stimulus. According to analysts, the European Union's economy has left behind the free fall period and is gradually recovering. The main factors determining the recovery are the scope of the problems in the banking sector (showing in harsher lending terms) and the obstacles as to restoring people's confidence. The slow export growth rate (notably to the Eurozone) and the drop in foreign investment in the region are another two factors further influencing the recovery. Recovery in this part of Europe largely depends on a pickup in the activity of small and medium-sized enterprises (SMEs), which were seriously affected by the credit crunch the economic crisis entailed. The adverse impact on most SMEs causes a decline in the development rate and a rise in the number of bankruptcies (Gabriela, 2011, p. 129-140).

## 7. SME AND SOCIAL MEDIA

Facebook and Twitter are dominant social networks. Ignoring the social media movement won't make it go away, therefore, the best strategy is to use them in marketing purpose. Social Media Networks have more than 300 million users. There are also slightly more female than male users. How can we use them productively? They have become important for any business because *they changed the way people use the Internet*. Facebook was originally created for students to keep in touch. Facebook page, intended as a business or professional platform can be an important marketing tool which is free of costs. Twitter is what is known as a Microblogging. It is really easy for companies to open the site profiles of the company and gather the information who likes the product that the company offers, or the company. Fans have the opportunity to comment on the company's public profile, as well as photos. Additional benefits provided by social networks are the statistics on the number of visitors, fans, the number of comments, etc. Small businesses without a web presence may consider setting up a Twitter or Facebook profile or page as a no-cost way of connecting and advertising online. The next step is the research of influence of Social media and Internet on SME's development. The preliminary research results shows that only 6 % of companies do not have a web site, and among SME's this figure is much higher-17%. In the SME category, all the companies involved in the IT application development or service have a web site (Strugar, Škrtić, 2006, 236-238). They help small businesses grow and expand. Social networking sites could be helpful for generating a network of loyal customers. As well as through them can reach the target market segment, they are an excellent medium for finding business partners.

## 8. RESEARCH METHODOLOGY

In-depth face-to-face interview was the primary means of data collection. Finally, the focus of the research was on the owner-manager who owned and managed their own firm, only single plant. Information was obtained on the profile of the firm and from interview with the owner/manager; the characteristics of the owner-manager (age and nature of prior work experience), the factors that influenced his decision to export and the international growth strategies adopted. Owner/manager was encouraged to describe the challenges he encountered in the implementation of strategies for international firm growth. The analysis of the data reflects the key themes that were investigated in the interview. The research approach incorporated in depth interview with the owner/manager of SME in retailing sector in the Croatia with the current theory.



## 9. MERKUR'S PROFILE

Merkur is a small family business established in 1992. for production and sale of textiles. Headoffice is in the Vinogradska 2, Pitomača. At the beginning there were only three seamstress employed together with the owner. Today, twelve seamstress are engaged in production. Initially, the owners were focused on the production of clothes and goods for children's baptisms and special occasions. Materials for sewing the clothes were purchased from small and large manufacturers from Croatia, Italy and Germany. Production began on home machines that were already owned, and material procurement was initially in very small quantities. The lower floor of the private house was completely renovated and adapted for the production. During the time, family acquired additional knowledge and skills and invested it in the purchase of new sewing machine. In 1995. they invested in the acquisition of the entire machine park. 1996th begins with the production (sewing) of baptismal garment. The idea of seamless child baptismal clothing came from the parents of today's owner Matija Škrinjar, Josip and Nada Škrinjar, who were dealing with retail sales of textiles, saw the need for baptismal clothing. They already had an experience in selling the textiles and realized that there is a demand for baby clothes for baptism. They started with production of only a few outfits for boys and girls. They produced baby shirts and linen ornament for wrapping the candles.

Over the time, the range of baby clothes expanded and begun their collaboration with the largest wholesalers of textiles in Croatia - Tekstilpromet. Additional assortment extension happened in 2003 and the owners immediately experienced the serious sales growth. The older son, Zlatko Škrinjar joined the family business after he graduated at the Faculty of Economics in Zagreb His arrival brought some changes in the company related to the target market. They began with the processing and analysis of the market which resulted in increased demand for their products and increasing list of customers. They employed additional employees. Customers were chosen according to the geographical orientation - the goal was in every major city across the country to have at least one large and reputable buyer, retail chain, etc. With existing Tekstilpromet, covering the whole Croatia, the new customers were Minako – for the whole Slavonia region , NAMA on the Zagreb territory and KTC – for northwestern Croatia. Zlatko, who started his own company for sport marketing, quit the family business and left it to younger brother Matija Škrinjar. Matija continued to invest in new technology, machinery, education, monitoring market trends, and achieved significant growth in production. The production in period from 2004 until 2008 grew more than 35% annually. The assortment was available in all the majors and some smaller shops in Croatia. The company had a constant tendency to grow.

## 10. BOUTIQUE „LITTLE ANGEL”

In 2008 Matija decided to open a boutique in Zagreb in the Shopping Mall Importanne Gallery. Although they had plenty of major businesses with the wholesalers, they decided to try retail. He decided to offer his products to regular customers. He thought he would thus have an opportunity for listening the market better, seeing how customers react on their products and to directly obtain information about individual preferences and possible changes in the assortment. Ideas for new models come following the global children's fashion trends and from visiting a specialized children's fashion fairs. Little by little he managed to achieve cooperation with some foreign business partners

In 2010, with the opening of new Shopping Malls in Zagreb, the traffic in the Importanne Gallery has dropped drastically, and so does the attendance of boutique "Little Angels". They found themselves in thankless situation from which they had to be drawn as soon as possible if they wanted to retain their customers. In these difficult moments for the family business Matija even thought about closing the „Little Angel” boutique. Profits from sale were minimal and „Little Angel” was faced with closure. In a conversation with his friend that occurred by chance, Matija got some helpful tips for recovering the company. He decides to surrender his friend marketing activities and leadership of the boutiques, and a free hand to do whatever she thinks might help in the recovery of the boutique. They recognized the value of free advertising through the internet social network, Facebook and Twitter. They opened the Facebook profile of the company in October 2010, and it immediately gave the results; sale have increased significantly and the global awareness of the boutique was spread out. The profile page has more than 2000 friends and more than 5000 fans. Benefits offered by Facebook profile pages turn to be huge; information literally travels as the speed of light! Members give their suggestions regarding the design, color, details etc. The marketing manager designed the contest for the prettiest baby up to one year on the Facebook. The contest lasted for one month. The grand award was shooting for the Mercury's new catalog and a gift package of baby clothes worth 1000 kn. All items in the shop were photographed once again. The new catalog has exceeded the expectations of wholesalers who



were thrilled. The same products from the new catalogs had higher sales than when they were in the old catalog and Matija and his new marketing manager were often faced with the questions: Is this new in the catalogue? It further convinced Matija that the esthetic appearance of the catalog is very important in this business. They created a new web page and activated a web shop. Almost every day they were receiving new orders. Sometimes it demanded even working on holidays. They often organized the various contest and always try to keep their customers pleasantly surprised. Customers were encouraged to freely give an advice about new products, choice of colors, the new models etc. Any advice was welcome. The website for group discounts turned out to be an effective marketing tool for advertising. They had a set of eco-diapers down by 50% and gained many new customers. The new assortment for 2011 has already been made and they don't intend to stop one that. Customers might choose to combine what they want from the provided assortment. They strive to be flexible and meet all customers' demands, so it is possible to order the clothes of your desire and needs. The packaging of their products is their concern. In the future they plan to achieve more of some of their ideas. So far, they have 150 products in their assortment.

### **Export**

Matija completely turned to wholesalers who are his most important business partners. Business is still expanding, aided by the fact that a lot of small trades that are engaged in the same business collapsed due to recession, and now they are a leader in the manufacture of baptismal equipment in Croatia. They exhibited a number of craft fairs organized by the Croatian Craft Chamber and independently; Graz, Celje, Munich, Zagreb, Split, Pula, Rijeka, Osijek .etc. where they realized the potential business contacts. The fair that was held in early April in Mostar, brought them the first export to Bosnia und Herzegovina. The first shipment of good happend in May. They have focused on the Herzegovina market.

### **Future plans**

In 2009. Merkur was present on a solo exhibition at the fair in Cologne (one of three world's largest specialized fair for the baby up to 1.year) - Kind + Judged. So far, they have achieved significant business results. It is because they succeed to constantly listen to their customers and follow market trends, invest in market research to keep pace with time and requirements and invest in expansion.

Future plans are related to the modernization of production by building more production facilities. It is interesting to note, especially in these difficult times of crisis, they succeed all of this *without any loan*, and all financing was done from their own resources.

They are currently in the process of obtaining certification and quality labels from CCC. Since they have a representative on the German market, their efforts are directed on achieving co-operation with one of renowned European commodity house. The Merkur's target markets are young married couples, expectant parents, pregnant and lactating women and therefore they choose to appear on Mom and Baby fairs. The materials are mostly imported, with the finest quality fiber and prices are formed depending on the prices of raw materials. In these times of recession they accomplish to operate successfully. Market monitoring helped them to exceed the challenges that competition could not keep track and additionally took over the customers and expand product range. They had growth of 10% in 2009 and 6% in 2010%. At a time when the entire textile industry is dropped on the knees and numerous textile factories were closed they succeed to survive thanks to effective *marketing strategy* and an open mind of managers to *new marketing tools*.

## **11. IMPLICATIONS**

Internationalization is one of the ways small business growths. In order to encourage the export of Croatian companies they need to be furnished with additional information. Understanding the pattern of SME export activity and the challenges they encounter in the process is a fundamental foundation on which to develop appropriate policy and for the design of suitable management support and training initiatives for owner/managers who wish to achieve export growth. For instance, why owner-managers embark on international firm growth, the choice of international market, the market entry strategy adopted and the difficulties encountered in achieving successful international firm growth are issues worthy of investigation. Furthermore, the availability of new marketing tools in the form of social networks enables small businesses without a web presence to consider setting up a Facebook profile or page as a no-cost way of connecting and advertising online.

## 12. CONCLUSION

Research has found that small firm that grows, tend to develop profitable and expanding market niches (Storey, 1996., 1997) that are often quite narrow and appear difficult to describe by objective, industry or market wide variables. One of the successful ways to reach the narrow target markets are Social Networks. The role of Social Networks is thus extremely important, and this paper shows that Social Networks within SME's are still considered as a neglected resource with only operational but not strategic importance. This attitude can be changed by action, education and popularization of benefits of Social Networks among SME's, adaptation. The consequence of this process can already be recognized in growing number of Internet business users. Given that social networks do not know the physical boundaries, their greater use for business purposes can be expected. Development of SME's and intensive IT technology application could be the key factor in company's development.

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## SMES AS FACTOR OF ECONOMIC GROWTH IN BOSNIA AND HERZEGOVINA

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E-mail: [igor.zivko@sve-mo.ba](mailto:igor.zivko@sve-mo.ba)**Abstract**

The most important economic challenge that is posed by policy makers in Bosnia and Herzegovina is a challenge to start new development cycle that will ensure economic progress and better standards of living for residents. In this sense, a priority is to create conditions for increasing competitiveness of the economy.

The main sources of growth of the private sector are in stimulating business environment, supporting development of entrepreneurship and attracting foreign investment. In Bosnia and Herzegovina there has been a noticeable improvement in the removal of administrative barriers to domestic and foreign investment. However, strengthening entrepreneurship has been established as a prerequisite for faster development of the private sector, especially for SMEs growth. The basis of competitiveness lies in the nature of the environment in which businesses operate, which means that the business environment should be incentive for investment, be transparent and efficient in providing all necessary information, natural and human resources, physical infrastructure, financial resources, scientific, information and technology infrastructure. The ability of firms to achieve competitive advantage does not depend not only on their strategy, innovation and jobs, but also on external factors and institutions. Macroeconomic reforms are necessary but not sufficient condition for productivity growth and competitiveness. Microeconomic reforms are also essential, and they occur at the level of the enterprise. SMEs in the context of entrepreneurial restructuring should be the bearer of economic growth. To be able to realize their role as such, it is necessary to remove the restrictions which is generally expressed through an adverse environment for their development and growth.

In this paper the authors will analyze key internal and external constraints for development of SMEs in B&H. On the base of scientific analyze, this article should give recommendations for further improvement of economic policy that should be in function of faster economic development and better competitiveness of B&H economy.

**Keywords:** SMEs, Economic growth, Entrepreneurial restructuring, Competitiveness.

**1. THE ROLE OF SME S IN IMPRUVING NATIONAL COMPETITIVENESS**

Modern approach to economic development and new theories that arise in response to the problems of modern economies less and less importance attach on factors that are favorable macroeconomic context, cheap labor, abundant natural resources and economic policies which encourage development by protecting industries.

Modern approach to economic growth and development search for answers how to ensure a sustainable growth and better quality of life. The general view of the answer lies in sustainable competitiveness that is focused on companies and industries rather than the economy as a whole.

The competitiveness of the economy implies a sustained growth in productivity and business, that affect the macroeconomic and microeconomic business environment. Level of competition determines the productivity. Therefore, the state has to take measures to increase the overall social productivity.

The most important challenge of economic policy in the B&H is the challenge of starting a new development cycle that will ensure GDP growth and better standard of living. Therefore, the priority of economic policy makers is to create conditions for increased economic competitiveness.

However, to develop a competitive advantage is not easy. Competitiveness requires a strategy based on knowledge, a thorough knowledge of consumer behavior, cooperation and rivalry among firms, external orientation and positive partnership between the government and the private sector.

The basis of competitiveness is in the nature of the environment in which businesses operate, which means that the business environment should be incentive for investing, transparent



and efficient in providing the necessary information, natural and human resources, physical infrastructure, financial resources, research, information and technology infrastructure. The ability of firms to achieve competitive advantage depends not only on their strategy, innovation and jobs, but also on external factors and institutions. Macroeconomic reforms are necessary but not sufficient condition for the increase of social productivity and competitiveness. Microeconomic reforms are also essential, and they occur at the level of enterprises. That is why the joint action of government and business is important to create an environment for competitiveness. The process of improving the competitiveness involves a partnership of governments, business and academic communities, which all must work together on the challenges of the global market posed to country.

Compared to previous years, there has been a noticeable improvement in the removal of administrative barriers to domestic and foreign investment. However, requirements necessary to create conditions for improved competitiveness of the domestic economy are not designed. Strengthening entrepreneurship in B&H has been established as a prerequisite for rapid development of the private sector, especially for SME growth.

Compared with other transition countries, B&H has the lowest SMEs number per 1000 inhabitants. Starting a business is the most expensive in the region, and more expensive compared to other countries, indicating that government have to speed up reforms needed to create a business environment more suitable for development of SMEs.

## 2. KEY REASONS FOR UNDERDEVELOPMENT OF SMES IN B&H

There are a many factors that limit the opportunities for development SMEs in B&H. However, the key reasons for SMEs underdevelopment are the following:

- 1) The inherited economic structure of the country based on large companies and complex integrated business systems. The restructuring of large systems is not yet complete and many of them have not been privatized. Through the reconstruction of these business systems it is possible to create a large number of SMEs that can operate significantly easier. Small and medium enterprises as the main factor in the development of the country gain importance in the transition period and post-privatization restructuring. Competitiveness of economies in transition economies in general is possible to increase on different ways: 1) more efficient production of goods produced in the country, 2) introduction of new or improvement of existing products, processes and organizational structure, 3) more efficient allocation of resources and capacity between sectors, 4) faster implementation and costs reduction of structural changes, especially those that are conditioned by technological changes.
- 2) The slow pace of privatization and the whole process of transition to the market economy.

- 3) The inconsistency of economic policies and legislative measures at the level of B&H legal framework: strategic directions and instruments of development of SMEs have been established at the entity level without adequate coordination and harmonization at the country level. The Council of Ministers in 2009. adopted a document entitled "Strategy for the Development of SMEs in B&H for the period 2009.-2011. Republic of Srpska adopted a 'Strategy for the development of small and medium enterprises' for the period 2006-2010., and the Federation of Bosnia and Herzegovina was adopted by the 2007th The 'Development Programme'. In Republic of Srpska the Agency for SME's has been established, and together with 4 regional and 20 local agencies makes a basic network to support their development.

However, it is necessary to take into account the Entity and regional differences in the development of SMEs. Emphasis should be placed on decentralization in accordance with regional specificities. This means that it is necessary to guide the development of SMEs in accordance with local specifics. Discrepancies between the institutional framework is the fourth key factor that hinders the development of SMEs in B&H. It is also necessary to respect the specificities of industrial policies, which determine the position of SMEs.

It is important to emphasize that the concept of SMEs is not uniform, but vary significantly according to different stage of development and certain specific economic structure. In this regard we should respect the existing economic structure, industrial and other sectors, and in accordance with that specifics create policies supportive for the development of SMEs.



The structure of SMEs in Bosnia and Herzegovina:

Number of employes	Total entities	%
1-9	151.107	93,6%
10-49	8.712	5,5%
49-249	1.476	0,9%
TOTAL	161.295	100%

Source: Strategy for the development of SMEs, 2009.-2011., Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina.

### 3. KEY LIMITATIONS IN THE DEVELOPMENT OF SMES

Limitations in the development of SMEs in B&H can be divided into two groups.

a) The first group consists external constraints:

- Weak support for manufacturing SMEs
- The dominance of micro enterprises,
- Unequal institutional support and territorial development of SMEs
- Low levels of investment in research and development,
- Lack of entrepreneurial culture and business ethics,
- Insufficient involvement of SMEs in the creation of draft laws,
- Insufficient investment in business infrastructure,
- Excessive bureaucracy.

The second group consists internal constraints (derived from the company):

- Low-level knowledge and skills in new technologies, ICT, management, etc.
- Outdated technology,
- Focus on the traditional industry (low productivity and technological development),
- The orientation on local market,
- Low competitiveness and limited ability to export.

The largest number of companies in B&H belong to the category of micro enterprises (with the number of employees less than 10), which is about 95% of all SMEs. These companies are among the most sensitive group.

The main causes of deterioration of small and medium-sized enterprises in B&H are: lack of development of the business climate and legal framework, lack of adequate state support, lack of cheap sources of financing business and unfair competition, lack of competent managers and a low level of entrepreneurial education and behavior. According to the indicator, the time needed for the start business in B&H lags significantly behind the countries of the region. According to a Survey of business environment, B&H is on the 160th place of 180 countries ranked according to the start-up and business registration. In 2010. year, the registration process lasted 60 days in B&H, while in Macedonia it took 4 days, in Croatia 22 days, in Serbia for 13 days to do the same thing.

#### 4. INSTITUTIONAL SUPPORT TO THE DEVELOPMENT OF SMES

Institutional support to the development of SMEs is one of the most important preconditions for development of entrepreneurship and competitiveness. That support to entrepreneurship and SMEs should be based on creating a network that includes:

- Business support agencies,
- Business associations,
- Clusters,<sup>1</sup>
- Support the creation of favourable environment for business.

Measures and activities aimed at strengthening the business support environment include:

- Financial support for SMEs and entrepreneurship development,
- Acceleration of the procedures and reduction of the business registration's costs,
- Reducing the financial burdens and taxes,
- Creation and development of business infrastructure,
- Partnerships and clustering of SMEs,
- Education of entrepreneurs (through education, training programs, etc.),
- Strengthening the innovative and technological competitiveness of SMEs,
- Strengthening the role of ICT in SMEs,
- Internationalization of SMEs business, especially with foreign investment,
- The integration of gender principles in the development of SMEs, with an emphasis on strengthening women's entrepreneurship.

For majority of countries foreign investments are very important factor of promoting economic growth - technology, capital and knowledge that are transferred to the countries recipients of investments - remove the insufficiency of these resources, which are crucial factors of growth in world term. That is why the B&H have to take measures with the aim of instigating direct foreign investments. It is clear that direct foreign investments represent a necessary integrating factor to world economy. However, a fundamental assumption for the inflow of direct foreign investments is the realisation of all-encompassing institutional transformation and general economic stabilisation.

EU experience in supporting the development of SMEs can be helpful, especially in terms of the accession process. However, the use of these experiences has to respect the level of development and specific conditions in B&H. SMEs are the backbone of EU economy: they provide 2/3 of total private sector employment, represent 80% of the total job creation and produce more than a half of the EU added value. The new EU policy strategy cares very much for the regional innovation systems and clusters as the main factor of competitiveness. The aim is to build world-class clusters with the necessary dimensional strength, since most clusters are too small in size to compete globally.<sup>2</sup> The European Commission has developed and implemented a range of policy measures specifically to support SMEs in Europe. These policies are aimed at creating the conditions in which small firms can be created and can thrive.

SMEs and their development have been incorporated into most EU policies and programs. The European Commission has undertaken several initiatives to promote entrepreneurship and SME development, such as the European Charter for Small Enterprises and the Entrepreneurship Action Plan. Implementation of European Charter for Small Enterprises is an essential part of the Lisbon strategy. It is clear that long-term development of the economy depends on successful entry into the Western European market. But, low efficiency of economies seems a natural barrier of entry into the market in Western Europe, therefore the construction of national competitive advantage is the only way to overcome this obstacle.

EU priorities in the development of SMEs and their use in B&H can be summarized in the following

- 1 A cluster is a form of strategic alliance or group of related enterprises from a branch. This group includes producers of raw materials, governmental and nongovernmental organizations, and even educational and scientific institutions that have joined together to solve common problems. It is believed that clusters increase the productivity and competitiveness of companies, which then become more powerful in the national and global sense.
- 2 Marco Lapriore: Supporting Enterprise Development and SMEs in Europe, EIPASCOPE, 2009./2.

paragraphs:

- Progress in implementing the European Charter for SMEs,
- fulfillment of commitments of the European Partnership for B&H,
- implementation of the Integration Strategy of Bosnia and Herzegovina to the EU,
- removing other administrative barriers for business and SMEs,
- Improving the business environment for SMEs.

In economies in transition is generally necessary to create a basic assumptions to support the development of SMEs. The most important of these assumptions are:

- Macroeconomic and political stability,
- Functioning of markets and institutions to provide services of commercial development, of SMEs;
- The legal framework that supports the start-up and development of SMEs, but also extinguish the enterprise;
- Access to information for SMEs is the most important factor which determines their survival and growth,
- Monitoring and adoption of new knowledge,
- Liberalisation and the abolition of visa requirements for equal performance of entrepreneurs from the foreign markets.

Advanced elements of the competitiveness of SMEs are related to their access to the new technologies and the ability of competition in the global market, which are necessary instruments of improvement of their work. For example, to a large extent it can increase the export competitiveness of SMEs through clusters formation, or through other intercompany connectivity (ie connectivity between large and small enterprises, formal and informal cooperation among local SMEs at the regional level, etc.).

## 5. FINANCING SMS DEVELOPMENT AND ENTREPRENEURSHIP

SMEs in low and medium income countries have lacked access to financial product and services. Microfinance institutions serve the micro enterprises, while banking sector have typically concentrated on large corporations. SMEs fall between these two markets. Thereby there is financial gap commonly described as the „missing middle”.

Fastering a dynamic SMEs development is seen as a priority among economic development goals in economies in transition. SMEs are a primary driver for job creation and GDP growth.

SMEs face more severe constraints to growth than large companies, their lack of critical size resulting in reduced access to market, skills and capital.

Typical business background in emerging economies is<sub>3</sub>

Corporate and multinational	0,1%
Large companies	0,9%
Small enterprises	20%
Micro enterprises	65-75%

Five Strategic areas form the foundation for SME banking performance<sub>4</sub>:

<sup>3</sup> The World Bank, January 2010.Issue No.30., page 2.

<sup>4</sup> IFC SME banking CHECK Diagnostic Toolkit

## 6. FALI TABELA GRAFIK

Key activities at each of the five stages of the SME banking chain are<sub>5</sub>:

- Understanding the SMEs market,
- Developing product and services,
- Acquiring and screening SMEs clients,
- Serving SMEs clients,
- Managing with information and knowledge.

In B&H banks the high demand for soft loans for private investment can not yet be met. This points to the fact that banks can not be sufficiently well and safe place for funding domestic enterprises and households. Experience with a number of credit lines intended for small and medium-sized companies shows that they can give a strong impetus to the development and financial and manufacturing sectors, and thus to overall economic growth.

In such a context, government has to create the framework conditions for private sector development to become sustaining. Current priorities for government with respect to the environment for SMEs development include encouraging the banking system to adopt and recognise the SMEs sector as a potential market for a range of financial products, facilitating the development of venture capital funds for that minority of SMEs that seek external equity, and working in partnership with the private sector to establish an effective support infrastructure. In this regard, government policies can help subsidizing and promoting the development of certain segments of the economy. Such an incentive is given with the establishment of the Development Bank of the Federation of B&H in 2008. and the Development and Investment Bank RS in 2006.

Therefore it is necessary:

- To raise capital development banks,
- Decentralize Development Bank of the Federation B&H to create conditions for easier and faster access to customer funds,
- Subsidize part of the cost of capital, interest, incentives to investment and employment,
- Introduce new lines of credit that will encourage the reconstruction of the company voted in the privatization process, etc.

Poor condition of private sector is one of the main causes of inadequate allocation of funds within the banking system. There is an evident lack of quality projects to absorb the available funds. For many years the share of loans to the households was greater than to the companies, only in recent years this relationship is changing in favor of the company. This relatively low share of loans to corporate sector has resulted in a lower level of investment, and thus an unsatisfactory level of economic growth.

In doing so, the inadequacy of financial resources is not in the top of the list that limits the development of SMEs, but those are primarily the inefficient bureaucracy, corruption, inadequate or discouraging tax system and regulations. The main problem is the lack of quality investment projects which could be realized with an acceptable risk. Therefore, it is necessary to create educational support that will enable the development of entrepreneurial ideas and profitable projects.

SMEs are mainly oriented towards the banks, not the capital market, for raising funds. In B&H, The World Bank is implementing the project "Project to facilitate the financing of small and medium-sized enterprises." The aim of the project is to provide better access to finance for SMEs in the context of the global financial crisis. In this sense, the project provide US\$ 70 million (60% in FB&H and 40% for RS), funds for working capital and investment projects for small and medium enterprises. The interest rate is variable and will be determined based on the 6-month LIBOR interest rate for the euro and by adding a 0.17% margin included by the World Bank. The fee for the preparation of the project is a once 0.25% of the amount of the loan with a repayment period of 25 years, including a "grace period" of 10 years.

Funds are placed by commercial banks, and the success of this project depends on the ability of commercial banks to provide financing for small and medium-sized businesses under more favorable conditions. Project implementation will also depend on the ability of companies to prepare proposals for sub-projects for commercial banks.

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5 The World Bank, January 2010. Issue No.30., page 3.

Full transparency in combination with the process of pre-qualification of commercial banks, will promote competition between banks and ensure that reasonable interest rates will be charged to the users.. SMEs will have the opportunity to choose the most favorable conditions and terms of the loan offered by any of the eligible banks.

## **7. CONCLUSION**

SMEs should be one of the pillars of BiH's economic development. In this sense, it is necessary to define the overall SMEs development policy in the context of regional and local specificities. Policy development of SMEs should be focused on removing barriers and encouraging environment for the emergence and development of new enterprises.

This paper has identified the most important limitations in the development of SMEs, particularly: inadequate education and training of entrepreneurs, lack of a simple and inexpensive business start, inadequate legislation and regulation, skills and knowledge insufficiency, poor on-line access to company registration and tax requirements, difficult access to the benefit of using the advantages of the single market, disincentive taxation and finance, bad presentation of medium and small enterprises.

The main question is: how to improve competitiveness of SMEs? The positive business environment and efficient public business support at all levels are the most important factor in the competitiveness of SMEs. Further improvement of economic policy that should be in function of faster economic development and better competitiveness position of B&H economy is necessary. Special attention should be focused on:

- Improving administrative efficiency at the national and regional level,
- Improving business competitiveness through e-business services,
- Providing advisory services to SMEs,
- Creating incentive investment climate
- Supporting cluster development.

A key factor for SMEs development in the developed economies are clusters. They offer a new way of thinking about economic development, giving the new role of business to the governments and institutions. They are development tool that should be recognized by state, entities and local authorities in BiH, who should encourage their formation and growth.

Clusters are binding factor with similar companies in a particular field and they have to become widely accepted component of national and regional development plans. That process involves a partnership of governments, business and academic communities.

That is why B&H need new policies for the development of SMEs, aimed at removing barriers and creating an enabling environment for their establishment and development. Effective policies must take into account all the specifics of B&H. In this way it is possible to ensure sustainable economic development in which SMEs should be one of the pillars of creating a growing competitive economy.



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**POLISH PRESIDENCY IN THE EUROPEAN UNION IN THE CONTEXT OF THE EXPANSION OF UNION INTO WEST BALKANS COUNTRIES - POLITICAL AND ECONOMIC ISSUES.**

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**Abstract**

On the first of July 2011 Poland assumed the presidency in the European Council which will last over six months and will host the executives of European Union. The top priorities of this guidance are the following: the first priority is concerned with the growth of the EU's budget for oncoming years. The second topic covers the issue of Eastern Countries Partnership, and finally the third one touches upon the subject of the European Union's expansion of the countries located in Western Balkans.

First of all Poland should actively support the Balkan countries aiming at their full integration into European community. Controversially, Poland may be perceived as a kind of an obstacle or a bridge dividing East and West, EU and Russia, countries of the post-Soviet regime. Positive atmosphere accompanying EU expansion into Balkans and support given for Polish government in this field area, Polish Foreign Policy creates an opportunity to achieve real political success, both in domestic and international context.

Poland can play the role of a leader and a promoter of the increasing membership in the European Union: Croatia, Macedonia, Bosnia and Herzegovina. Their accession to the European community is presumably more likely than the adaptation into EU of Ukraine or Belarus. Furthermore, Poland maintains positive relations with all countries from the Balkan region and is considered as a plausible and credible partner. As an active promoter of quick entry of the Balkan countries into EU, Poland will gain support and recognition on the international ground, particularly because both EU and the U.S. are keen to join Balkan countries into European community.

**Keywords:** Polish presidency, European Union, Western Balkans, Political issues, Economic issues

**1. INTRODUCTION**

The region of Europe expanded through the East-West pivot still dominates in Polish Foreign Policy. The contemporary diplomacy and the modern strategy for international relations prove that Polish Foreign Policy should proceed in a multi-vector way and should be characterized by the diversity and the heterogeneity. Accordingly, in Polish Foreign Policy, next to the East-West dimension, the thread of south countries, particularly Balkans, should appear. Acceptance of such a strategy would be exceptionally consistent with the policies appointed by the European Union's committee which in XXI century prioritize the theme of Balkan and other south countries.

So far, in Polish Foreign Policy West Balkans were perceived as a region of marginal importance. Nowadays, the situation begins to change and Balkan politics starts to upgrade in the hierarchy of strategic priorities of Polish presidency in the European Union. Even though West Balkans do not occupy leading position, the fact of incorporation of this theme reflects positive atmosphere and attitudes.

On the first of July Poland assumes the presidency in the Council of Europe, taking up the leadership of the European Union for over six months. The priorities of this leadership consist of three major points. First point touches upon the subject of European Union's budget for the oncoming years. The second point covers the theme of East Partnership, and finally the third topic relates to the subject of European Union expansion in the countries of West Balkans (Todorova, 2008, pp.251-301).

In overall, the engagement of the European Union countries in Balkans was the most noticeable and active at the beginning of the 90s of XX century within the context of peacekeeping mission, giving financial support and during the process of expansion. The West, not unduly, recognized that the best and actually the only one guarantor of the stabilization in this region is the integration into European Union. As a result, the action of accession of Balkan countries into European Union is strongly supported by all the members of the Union, unlike the action of accession of East Europe or Turkey (Balcer, Krawczyk, Wóycicki, 2009, pp.12).

## 2. THE EUROPEAN UNION TOWARDS THE WEST BALKANS AND UKRAINE

The EU countries have recognized that the existence of the wide zone of instability in the Balkan region would pose a serious threat. The support of this thesis may be proved by the fact of hasty adoption of Bulgaria and Romania into UE, despite the problems those countries faced. The zone of instability was torn into two halves. The first is concerned with the situation in Russia, Belarus and Ukraine. The second is concerned with the problems in Kosovo, Serbia, Macedonia or Bosnia and Herzegovina.

Activity of EU in West Balkans is definitely stronger than in the East and is still increasing. Balkans, until the moment of stabilization, are treated as a competition for the Union's engagement in the East Europe, since the prospect of Ukraine accession into EU prolongs to 2030.

Possible membership of Ukraine in NATO and EU does not constitute a common political interest for USA, EU and Russia. Most probably Ukraine will not join those structures (at least in the future decade) and will remain in the Russian's zone of influence. The chance of full integration with the West, outlined before Ukraine in 2005, was merely an illusion. In fact, Ukraine have never stand this chance, since neither EU, nor US and Turkey do not perceive Ukraine as a principal partner in the interests, but rather as a buffer between Europe, Turkey and Russia.

Both EU and USA avoid political confrontation with Russia, which traditionally treat Ukraine as its zone of influence. The attitude of most of the Union's countries and Turkey towards Russia was accurately concluded by American political scientist Walter Russell Mead: 'The actual interests of US and Russia, despite appearances, are fundamentally consistent with each other. Both countries crave for geopolitical stabilization. In East Asia and West Europe terrorism and religious fanaticism is hugely despised. Russia needs the right to 'veto' in the matters of Ukraine foreign policy - America is not able to grant the right answers and should deal with it (Kaczorowski, 2010, pp.4).

Concluding the above considerations, it should be stated that the strategic partnership of Poland and Ukraine is possible, however, in the further perspective. Poland should still support Ukraine in its process of integration with EU, but only when the real chances appear. At the moment, such a chance and international situation do not exist. If such an opportunity appears, Poland should get directly involved. The key for gaining this aim may be hidden in the intensification of operations in Balkan countries.

Furthermore, positive operations of Polish diplomacy in East Europe, in the importance measure, depend on the development of the situation in Balkans. With no explicit success on this ground, the progress of the integration of Partner countries is concerned with the Balkan theme. That is why, Poland should not perceive the dimension of south only instrumentally by the prism of Polish East Politics. What is worth stressing, the integration of West Balkans will not be an easy process for EU and will proclaim a serious challenge for Common Foreign Policy and Security. Poland should support Balkan initiatives and at the same time should open the way for European integration of the countries of East Partnership.

Nevertheless, Balkans become a priority and the expansion of Union's integration are going to be directed on south-east. Such a scenario should motivate Polish government for a greater involvement into the Balkan theme.

Common Security and Defense Policy (CSDP) is inextricably linked with West Balkans. The following initiative may be compared to a litmus test of the European dimension of safety and security in this part of Europe. Possible defeat in the Balkan region may be seen as a holistic failure of CSDP. Two thirds of soldiers, policemen, judges and EU officials are currently engaged in CSDP mission. On the other hand, the development of CSDP will be extremely difficult without strengthening EU and NATO cooperation, which is particularly significant for Poland.

## 3. EU STABILIZATION MISSIONS IN THE BALKANS

West Balkans region remains to be of crucial importance in the world arena for the development of good EU – Balkan relations. It may be proved by the example of KFOR mission in Kosovo - EU protectorate. The mission will be eventually transferred to EU. Position of Poland on this ground is particularly strong, since one of the largest contingents in Kosovo (EULEX) and EUFOR in Bosnia constitutes 10% of all soldiers and officials (there are more than 200 Polish soldiers in Bosnia (more than 10%) - (Balcer, Krawczyk, Wóycicki, 2009, pp.12).

The administrative and police mission EULEX in Kosovo in the framework of Polish contingent of

international police officers, officials and lawyers constituted about 8%). This represents a significant manifestation of Polish involvement in international missions in Balkans, and the organizations created at the initiative of Brussels to the regional integration of South East Europe (eg. the Stability Pact for South Eastern Europe - present Regional Cooperation Council).

As a result, the reapproachment of cooperation between Poland, Ukraine and Lithuania occurred, within the common battalion in Kosovo and joint actions of Polish and Scandinavian group of 'blue berets' in Bosnia. Poland should draw a conclusion from this beneficial situation and demonstrate its involvement in this part of Europe. Unfortunately, Polish contingent intends to be withdrawn from Bosnia.

Moreover, Poland should perceive Balkans as a bridge between Central Europe and Turkey, as an area of Russian 'lawyers' operations in Europe (traditionally, Russia has some very loyal allies in Balkans, they are: Greece, Serbia, Bulgaria, Bosnia (Republika Srpska), Montenegro and a region of gas and oil transit from Asia to Europe. That means, the Balkan region of great energetic potential (Balcer, Krawczyk, Wóycicki, 2009, pp.13).

#### 4. THE ISSUE OF POLITICAL AND ENERGY SECURITY IN EUROPE

Energy security is one of the top priorities during Polish presidency. Poland have to present the issue of energy security in the context of politics, also with the respect to the whole Union. There is no denying that without Balkan countries being incorporated into EU in the rising energy market, it will be extremely difficult to guarantee energy security for, at least, few Member States.

In February 2011 on the energy summit of the Visegrad Group, Romania, Croatia, Bulgaria, Bosnia and Herzegovina the declaration of diversification of gas supplies to Central Europe was adopted. This diversification of supplies is meant to be achieved through the construction of gas terminals on Krk, in Swinoujscie and Constanta, and the Nabucco pipeline (gas from Azerbaijan, Central Asia, Middle East). This initiative seems to be relevant because of Russia's plans to build South Stream pipeline in West Balkans, frequently perceived as a competition for Nabucco. Russia's project is of great significance for the energy security of Central Europe and Ukraine. What is more, Russia possesses huge political influence in Serbia. Moreover, Russia affects the situation in Bosnia and Herzegovina through their support given to the Serbian Republic (one of the components of B&H). Balkans, again in the history of Europe, became the area of political confrontation among Russia and countries of West Europe.

Generally speaking, membership of West Balkans In EU will mean the expansion of coalition of new members of EU. Poland should take advantage of the correlation between Balkans, Ukraine and Moldova (the strategy for Danube countries, Black Sea Synergy, the Organization for Cooperation of the Black Sea, Moldova's membership in numerous organizations, Balkan, Central European Initiative) to tighten the bonds between those countries and the EU. Poland could have played major role in building and strengthening this cooperation since Balkan-European foreign policy direction remains indeterminate.

After 1989 countries of West Europe (especially Italy) endeavored to the createation of so-called „pentagonal” - the union of south-central Europe with ommission of the rest of south-central European countries, Poland including. Notwithstanding, one conflict in Bosnia completely shattered those plans and Polish response for Italian actions was the initiative for the creation of the Visegrad Group, Czechoslovakia and Hungary, and then subsequent founding of this group of Central European Free Trade Association (CEFTA)- (Balcer, Gromadzki, 2010, pp.1)

In the subsequent years Slovenia, Romania, Bulgaria and Croatia joined the organization. In 2004 Poland abandoned this organization, however still remains to be an important contributor to CEFTA Central Europe in the development of the regional cooperation in West Balkans. Between 2003-2007, CEFTA members became an independent experts to the European region (according to: Adam Balcer - director of „Enlargement and Neighbourhood Policy the EU”; in demosEUROPA - Centre for European Strategy Gromadzki Gregory - has worked at Stefan Batory Foundation and the Eastern Studies Centre).

What is more, greater involvement of Poland in West Balkans can contribute to stronger cooperation within the Visegrad Group. Beyond any doubt stays the fact that for Hungary, Slovakia and Czech Republic, Balkan region is far more important, from the natural reasons, than Eastern Europe. However, in general, support for the expansion of EU is one of the most noticeable and also common characteristics joining new EU members (countries of East and Central Europe, Baltic countries,



Bulgaria and Romania). Furthermore, one of the staunch supporters of West Balkans being included into EU is Sweden (the co-initiator of Eastern Partnership), which also supports the extension of the Union into Eastern countries.

Common diplomatic front could cover, by its range, east and south direction. In this issue Poland would play the role of a leader and a propagator of inclusion of Croatia, Macedonia, Bosnia and Herzegovina, or Montenegro into EU. Poland maintains positive relations with all Balkan countries and is perceived as a reliable partner. As an active and staunch supporter of a prompt admission of Balkan countries into EU Poland would have obtained support and recognition of the international community. American and EU politics concerning the issue of integration of West Balkans seem to be very coherent.

Positive completion of the integration process of West Balkans into EU seems to be of crucial importance for the position of EU on the World arena. Moreover, it also affects the relations of EU with Russia and USA. Stabilization and integration of this region continue to be one of the biggest challenges for Union's Foreign Policies, which may be exemplified by numerous projects as peacekeeping missions, protectorate, or financial aid. Operations, mentioned above are still desired and needed, since the potential sources of threat or danger for West Balkans' stability still exist.

The threat of war was ultimately averted, however the local conflicts of a national (Cziomer, Zyblikiewicz, 2007 pp. 259-262, 358-363), or of an ethnic character (Gniazdowski, 2008, pp.123-140), terrorist attacks (Holyst, 2011, Bantetas, Nash, 2003, pp.17-49), an increased activity of organized criminal structures (Holyst, Chang, 1998, pp.3ff), or a deep economic crisis (as in Greece Kaplan, 2010, pp. 369-390) cannot be utterly exterminated and excluded. Moreover, in several Balkan countries (especially in Kosovo, Gibas - Krzak, 2010, pp. 100-266) corruption and the weakness of state institutions become a serious problem. This problem matter has significantly changed in Kosovo during past few years, since in the past the major problems were religious and ethnic animosities. An illustrious example here may be represented by the fact of detention of central bank chief of Kosovo, just the day after the decision of The International Court of Justice, confirming the legality of unilateral declaration of independence (Winnicki, 2009, pp. 107-109).

## 5. POLISH PRESIDENCY IN THE CONTEXT OF ACCESSION OF WEST BALKANS INTO EU

The areas mentioned above require active and strong engagement, as well as new assertive strategy towards Balkan countries. Polish presidency should promote new European strategy, Balkans inclusive. The problems which may accidentally appear during the integration of West Balkans process may undermine the credibility of EU as well as the Union's ambitions to serve the role of a global force. Furthermore, it should be stated that problems concerning West Balkans affect transatlantic relations. United States wish Europe solved the problems (read Balkan issues) on its own, without any help of USA ally. The leading role of Polish diplomacy is to strengthen the relations between EU and USA in the context of Balkan countries, emphasizing the independence of European countries in the transatlantic area.

Poland as a country assuming EU presidency should be actively involved in the process of integration of Balkans into EU, mentioning the fact that Polish society speaks enthusiastically about the EU direction of extension. According to the Eurobarometer studies from 2008, the level of acceptance of Poles to integrate each of West Balkan countries is currently the largest among 27 Member States. Although the most Poles favour the adoption of Croatia (EU average is 52 percent), there is also high support for Serbia, Montenegro, Bosnia and Herzegovina. The controversial Kosovo or Albania also obtained, 44 and 48 % of support.

Positive view of Polish society, presented above, is actually very coherent with the declarations made by Polish politicians in the depicted area. During the last visit of Polish Foreign Minister Radosław Sikorski in Belgrade, the representative of Polish government insured the chief of Serbian diplomacy Vuk Jeremić of strong Polish support for West Balkans inclusion into EU structures, through the presidency in the General Affair Council which decides about the expansion of EU.

Polish Foreign Minister defined Serbia as kindred Slavonic country. Moreover, the Minister concluded that Poland and Serbia are bound together by history and sympathy. Therefore, it seems natural that Poland supports European aspirations of Serbia, at the same time encouraging Serbian government to continue with their internal reforms, which hopefully will create an opportunity for full integration. Minister Jeremić expressed his true hopes that during Polish presidency Serbia will formally become a candidate country for EU. What is more, Jeremić thanked Poland for being one of the 'loudest and most famous allies of Serbia on their way to EU' (Wandelberg, 2008, pp. 434). Jeremić also praised



Poland for being consistent supporter of not only Serbia but also other Balkan countries during European integration. Paying attention on a good economic situation of Poland, Jeremić mentioned his wishes to intensify cooperation between the two countries in economic, trade and investment area.

Unfortunately, on the trade ground of Poland with Balkan region countries situation presents to be rather bad. In that the level of Polish trade with the countries of Balkan region presents to be extremely weak. Virtually, the real investment of Polish entrepreneurs do not exist. According to the European Stability Initiative report, total value of Polish trade with the seven countries of Balkan region is lesser than the trade with Latvia. In general Polish investments in Balkans are literally not visible. Unlike the example of Czech investments, using historical ties with the Balkan states (Austro-Hungarian heritage) continues to develop extensive commercial contacts not only with Balkans permanent partner - Croatia, but also with notorious on the public arena - Albania, where Czech building contractor companies are very active (Kaczorowski, 2010, pp.4).

However, some contacts exist giving a hope for the further development. For instance, all EU countries (Poland including) approved of preferential export regimes concerning Balkans (the data concerns B&H). According to this contract agreements until the end of 2013 Bosnia and Herzegovina will abolish duty. Nowadays, 95% of goods being imported to B&H are exempt from custom duties. Furthermore, EU together with B&H government signed up a contract Stabilization and Association Agreement (SAA) as well as contract concerning avoidance of double taxation (Agreement on Avoidance of Double Taxation - due to the limited scope of this study, the text was subjected to analysis of trade and economic situation, only of some Balkan countries. Consciously abandoned discussion of Croatia, which will soon be connected to EU and therefore, this subject is now extremely exploited).

## 6. POLISH ECONOMIC COOPERATION WITH B&H AND SERBIA

Polish economic cooperation with B&H is implemented on the basis of: EU Council Regulation No 2007/2000 from 18 September 2000. The Regulation introduces exceptional trade measures for countries participating in the process of SAA. It was the Agreement between the Government of the Republic of Poland and the BiH Council of Ministers relating to B&H legal succession in relation to contracts signed up by Poland and the countries of former Yugoslavia. The contract came into force on 18th of February 2008 together with European Commission's Interim Agreement with B&H on the liberalization of trade, binding from 1st of July 2008 (Ministry of Foreign Affairs of the Republic of Poland, Informant about countries of the world economy, the Internet source, see the bibliography)

In the export matters from B&H to Poland, machinery and mechanical appliances, metal ores, chemical substances and plastics dominate. In the import from Poland to B&H, wood, textures and their derivatives, products of agricultural industry, machines and mechanical devices are in the forefront.

According to the data from B&H Statistical Agency, Poland in terms of trade turnover is placed on 15<sup>th</sup> position of trade partners of B&H. In 2010 the structure of Polish foreign trade with B&H decreased and a positive balance of foreign trade exchange decreased from 36,48mln euro to 13,92mln euro (Ministry of Foreign Affairs of the Republic of Poland, Informant about countries of the world economy, internet source, see the bibliography).

In the period of 8 months in 2010 in the lead of Polish export were furniture – 5,19mln euro, then live animals – 3,34mln, then on the third place – pulp, paper and related products – 2,02mln, finally tobacco, cigarettes 1,51mln, cotton and its derivatives – 1,08mln and diesel oil - 0.99 mln (Ministry of Foreign Affairs of the Republic of Poland, Informant about countries of the world economy, the Internet source, see the bibliography).

Polish import structure also has changed significantly. On the first place were reactors, boilers and machinery – 5,63mln. The second product imported from B&H was aluminum – 3,68mln, third clothes – 3,48mln, fourth iron ores and concentrates - 2.63 million, and finally on the last place were various chemical products - 2.45 million € and steam turbines - 1.64 million € (Ministry of Foreign Affairs of the Republic of Poland, Informant about countries of the world economy, The Internet source, see the bibliography)

The next area reflecting business relations between Poland and B&H is concerned with the mutual investments.

In 2010 most successful were companies from the mining and Combined Heat and Power industries – Polish Mining Machinery (UGS) from FAMUR, KOPEX, RAFAKO and JUG-POL Groups from Warsaw (railroad industry). In total the investments were in the amount of 45mln euro (Ministry of

Foreign Affairs of the Republic of Poland, Informant about countries of the world economy, The Internet source, see the bibliography).

In 2010 Polish companies have participated in major trade fairs in B&H, including 'ZEPS' - industrial fairs in Zenica (06.10.2010) where more than 500 companies expose annually (approximately 150 of them deal with the metal processing). Furthermore, within the regional cooperation 05.10.2010 special delegation of seven Polish companies was invited by B&H Chamber of Commerce to Sarajevo. The major organizer from Polish side was Economic Club of Silesia and Polish companies which attended the fairs (all of them for Lower Silesia) were the following: „Edex”; from Ostrow Wielkopolski - automotive industry, „Spomasz”; of Naklo - catering equipment manufacture, „Fanina SA”; from Przemyśl - manufacture of electrical equipment, „Mysak Group”; from Poznań - the production of machinery for food treatment and chemical industries, „KOOL”; in Wrocław - distribution of rolling bearings, „Re-invest” in Legnica - implementing new technologies in mining and „Pol World Travel” (Ministry of Economy of the Republic of Poland, Informant about countries of the world economy, internet source, see the bibliography). - Tour. (See more on so-called „black p.a.” image of Serbia and Republika Srpska in the world, by which it is only the government and the Serbian population has been given responsibility for the last war in the Balkans).

The Republic of Serbia is another country requiring the improvement of economic and trade relations with Poland. However, the year 2009 has produced a sharp decline in the volume of trade caused by the general economic slowdown (esp. in Serbia) and international crisis.

According to the data from Ministry of Economy, Polish export reached 148,5mln (decrease of 32,1%) and import reached the sum of 48,2mln euro (decrease of 51,9% in comparison to 2008). Moreover, relatively high positive balance still persists, at the time of study it was 100,3ml euro.

In 2010 revival of foreign trade between Poland and Serbia was noted. The dynamics of Polish export overtook significantly the dynamics of import, which affected positive trade balance. In the end of 2010 the exchange of goods between Poland and Serbia was 358,7mln EUR (an increase of 87,1%), Polish export inclusive: 281,6mln (an increase of 89,6%) and import: 77,1mln EUR (an increase of 59,9%). (Ministry of Economy of the Republic of Poland, Informant about countries of the world economy, internet source, see the bibliography).

In Polish export dominate: engineering products, agri-food products, mineral products, products of wood and paper industry, light industry products, machines and devices, and finally woodwork. In import dominate: mechanical and electrical equipment, wood and woodwork, chemical products, agri-food products, wood and paper industry as well as light industry products (Ministry of Economy of the Republic of Poland, Informant about countries of the world economy, internet source, see the bibliography).

Nevertheless, it should be clearly stated (with the regret) that the volume of trade with Serbia is still on the niche position in Polish International Trade - 0,15% of Polish export and 0,05% of Polish import. For Serbia, the volume of trade reached 1,7% of all international trade. (Ministry of Economy of the Republic of Poland, Informant about countries of the world economy, the Internet source, see the bibliography).

In 2007 there was a significant increase in Polish investments in Serbia. According to NBS data, in 2008 their value stood at U.S. \$ 10.1 million (net foreign direct investment in Serbia in total - 2.195 million. USD in 2007). Among the leading Polish investors are: KOPEX Group – the company won the privatization tender for 4 factories in Nišu (MIN Holding Co., MONT AD, MIN Holding Co., FITIP AD, MIN Holding Co., OPREMA and MIN AD Holding Co. AD SIVI LIV) and TELE - FONIKA Kable SA, company which overtook Serbian cable factory - Fabrika Kablova Zaječar. Polish investments in the IT sector were also reported. Assecco Group Poland intercepted three leading Serbian companies in this sector. For 11 months of 2009 Polish investments in Serbia reached approximately 2.5 million USD (Ministry of Economy of the Republic of Poland, Informant about countries of the world economy, The Internet source, see the bibliography).

Cooperation between Serbian and Polish governments is gradually expanding. According to the information obtained from the Embassy, contacts were established within the EU programme EXCHANGE (EXCHANGE Programme, internet source, see bibliography) which was sponsored by the European Union within the CARDS 2004 (total value of the program - 5.3 million EUR.). The implementation of the programme was launched in January 2005 and its completion was scheduled for December 2007. The amount of funds assigned for Polish-Serbian government projects under the programme reached 343,810 000 EUR (Ministry of Economy of the Republic of Poland, Informant about countries of the world economy, the Internet source, see the bibliography).

Considerations, presented above clearly depict the gaps in Polish-Balkan economic relations. Poland should verify existing situation by initiating a series of activities aiming at economic revival of Polish-West Balkan communication. First of All, Poland should take care about positive political image and good climate of Balkan countries (especially Serbia, Bosnia and Herzegovina – Republica Srpska), since these countries may also be regarded as prospective EU Polish allies. If Poland will look after positive relations, it will pay off in the future when West Balkan countries become full EU members. Despite the fact that Balkans become beneficiaries of EU funds, they are too small to constitute serious competition for Poland. Although, it should be remembered that there will be as many as seven countries from West Balkans being incorporated to EU, which is more than a quarter of today's number of EU countries. Even in the context of Lisbon Treaty, the right of each of them is important - regardless the population. Therefore, activity in the Balkans must be perceived as a long-term investment.

## 7. CONCLUSION

Summarizing, Polish government, especially during played role of a leader in the European Council, should explicitly support the Balkan countries aspiring for their full European integration. Poland became a bridge between East and West, between the EU and Russia and between countries of the post-Soviet reality. Positive climate for EU expansion towards Balkans and support of Polish government in this area, creates a great opportunity for Polish Foreign Policy to achieve real political success, both in national and international context.

Nevertheless, Polish presidency provides an excellent opportunity to improve the situation. The existence of Polish expert bodies dealing with the issues of Balkans gives hope for the future. These include primarily Centre of Eastern Studies, which deals with the analysis of political, economic and social developments in Polish neighborhood, the area of Central and Eastern Europe, and Balkan Peninsula. The Centre of Eastern Studies is particularly involved in the discussion about the European Union's eastern policy, the challenges of energy security, political transition processes and socio-economic Polish partners of east.

The Centre of Eastern Studies is also intersted in this stimulating debate. It is also involved in both expert, and information support for analytical Polish decision-makers. According to experts long-lasting commitments in Balkans will prove that Polish Foreign Policy is not just focused on Eastern Europe but also wants to engage into Balkans.

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## THE IMPLICATIONS OF STRUCTURAL FUNDS IN REGIONAL DEVELOPMENT AND INCREASE WELFARE IN ROMANIA. CASE STUDY: GORJ COUNTY

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### Abstract

Regional development is a complex process which supports each territory in building its future on the basis of its own territorial capital and, thus, contributing to reducing disparities between different geographical areas. Regional development policy is a set of planned measures, promoted by local and central public administration authorities, in partnership with different actors (private, public, volunteers) used to ensure dynamic and sustainable economic growth by efficiently using regional and local potential to improve living conditions. The main areas of interest of regional policies are: enterprise development, labor market, attracting investment, technology transfer, SME sector development, infrastructure improvement, environmental quality, rural development, health, education, culture.

Despite acute problems inherited, the specific county and always insufficient resources, local government capacity has improved steadily. Can identify five major factors that have defeated resistance to change led system and continuous modernization of the administrative act: political will, political competition, public and media pressure, taking over the *acquis communautaire* and accessing external funding. However, the factor that caused the biggest change in mentality and way of addressing the local government authorities was the opportunity of accessing external funding grants since 2001, so PHARE actually triggered the modernization of the administrative capacity of the county by implementing projects to be presented below. The results are presented and analyzed in a case study which seeks development strategy and coordination of sectoral policies, in accordance with territorial issues.

**Keywords:** Resources, Modernization, Access to external grant funds, PHARE

### 1. INTRODUCTION

Regional development is a new concept aimed at boosting and diversifying economic activities, stimulating private sector investment, helping to reduce unemployment and ultimately improve living standards. In order for the regional development policy to be applied, there have established eight development regions, which comprise all of Romania. Each development area includes several counties. Developing regions are not administrative-territorial units, they do not have legal personality, and are the result of an agreement between the county and local councils.

The primary objectives of regional development policy are: reducing the existing regional disparities, especially by stimulating balanced development and revitalization of disadvantaged areas, preventing production of new imbalances, linking with government sectorial development policies, fostering inter-regional, national and international cooperation, thus contributing to economic development which is in accordance with legal provisions and international agreements concluded by Romania.

The principles underlying the development and implementation of regional development policies are: decentralization of decision-making process, from the central / governmental, to the regional communities, the partnership between all stakeholders in regional development, planning - the process of using resources to achieve set targets, cofinancing - the financial contribution of various actors in implementing programs and projects for regional development.

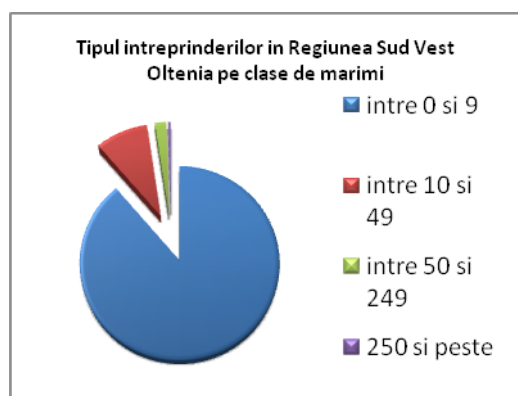
The country's whole economic system collapse and the decline since 1989 made the issue of territorial priorities, one of the key concerns of regional development policies to be very hard to fight. Meanwhile,



Romania has faced considerable pressure from the EU to meet membership criteria in the rules and principles of Community regional policy in order to reduce development disparities between regions.

The fundamental objective of regional development policies is to reduce regional disparities, and the achievement of a balance between economical and social development levels of different areas.

An



objective of regional policy, particular to this period, is to facilitate structural and sectorial adjustment, to support restructuring processes and economic recovery, restoration and boosting of the competitive ability of regions, supporting European integration processes.

Most countries, including economically developed ones, are facing regional disparities and, accordingly, apply strategies and policies for regional development. But must be noted that the difficulties arising from regional imbalances and the possibilities of solving them can not be addressed without taking into account the general level of development of each country.

The eight regions have certain particular features in terms of their economic structure, making certain sectors to play a decisive role in their future development. Such economy of southern regions (South - East South - Muntenia, South - West Oltenia) is influenced by the evolution of the agricultural sector, its holding in these areas covers over 15%, making the years of adverse conditions for agriculture, the GDP growth to be adversely affected. There are also regions with important tourist potential (Northern Bucovina region - East the coast and Danube Delta in the South - East, etc.) their economic developments being influenced also by the utilization of this potential. Another feature is the areas where the extractive industries had an important role (Jiu Valley Basin in the South - West Oltenia) and whose economy was affected as a result of the broad restructuring of the mining sector.

Romania's transition to the market economy situation continues to reflect artificially created problems during communism.

Currently, Romania confronts major development problems (Stegăroiu V., 2007) whose solving requires implementation of the regional strategic development measures. These issues will be analyzed in the following subsections.

If we compare Romania's situation with that of EU Member States, is apparent that the disparities between regions is relatively low compared to other regions in the EU countries. The process of creating regions led to eight regions with a relatively uniform level of development. The only notable exceptions are Bucharest - Ilfov, relatively developed compared with all other regions and the North-East region which is less developed, from an economical and social point of view.

This development is noticed regionally between regions Northeast, Southeast, South, West and South West regions, North - West, Center. A map of regional disparities in Romania allows spacial location of poverty and under-development in two main areas of the country: Northeast, including the historical region of Moldova and the South, the largest agricultural area in the country. By contrast, Western regions, the Center and Bucharest-Ilfov are the richest and most developed in terms of income, technical equipment facilities, human resources and economic potential (Monterides G., 2002).

Chronic underdevelopment is focused in peripheral areas, towards the border, namely the North-East - on the border with Moldova and in the South - along the Danube and the border with Bulgaria.

Besides the global order gaps, can also be identified specific problems that each area confronts. Thus, counties with the most decreased level of life standard are included in two major areas of poverty: North East - Botosani and Vaslui and South - Teleorman, Giurgiu, Calarasi and Ialomita.

The Northeast counties mentioned are characterized by generalized poverty, with few material

resources and a high rate of infant mortality, of migration and unemployment. Counties in the South, especially Calarasi Giurgiu and Teleorman, represent typical examples of a cultural poverty, characterized by low education and high rate of infant mortality.

A feature of regional development in Romania is the mosaic structure of economic development at sub-regional level. Virtually, in all regions are both relatively developed areas as well as underdeveloped areas.

Should be noted that there are still major disparities within regions, where predominantly agricultural counties coexist with the more developed counties. This phenomenon has gained momentum because of the impact of economical restructuring, especially felt in mono-industrial areas, whose population has been heavily affected by unemployment due to closing of unprofitable state enterprises. Of less developed regions there are part also the border regions - regions that border with Moldova and Ukraine - and the regions along the Danube. The different causes of disparities in intra-regional social and economic development, cause quite unpredictable future developments.

The decline of small and medium sized cities can be observed especially in mono-industrial cities, and was generated mainly by industrial restructuring. Along with the traditionally leftbehind regions, there have appeared areas of industrial decline with a high rate of unemployment.

Following the introduction of market economy system, the resources were directly allocated to regions that can use them to maximum capacity. Therefore, poor regions that have been artificially industrially developed during communism have known the adverse influences of transition and the structural reorganization process. Except some companies with foreign capital, the new facilities reorganized after 1990 did not have the specialization and the necessary technology to combat his foreign competition (Monterides G., 2002).

The low level of attractiveness of regions is particularly due to the decreased level of technical and social infrastructure development. Paradoxically, there are certain situations where the low life conditions contrasts the sustained level of economic activity. It is the case of Constanta County, for example, where only a small proportion of the population of this county benefits from the economic growth, most of them living in poverty.

One of the serious problems facing Romania in the post-revolutionary period was the socio-economic decline of many large urban centers and the reduction of their role in the development of adjacent areas within.

The regional disparities tags indicate that there are significant discrepancies in both economic, social and technical and in terms of quality of life. The most dynamic changes were recorded by the indices of the infrastructure and demographics. The most remarkable positive dynamics was that of the index showing the growth of personal car numbers and telephone subscriptions. The urbanization level expressed as a percentage of the population living in the urban areas has remained relatively invariable, suggesting that the population has migrated massively from rural to urban areas or vice versa.

Apart from the problems inherited from communism, the major causes which led and still lead to even more growth of regional disparities can be summarized as: the location and extent of domestic and foreign investment bodies in these regions, loss of competitive capacity of the enterprises, the acceleration of the influenced reform process, in a slower or a more alert pace, the increasing of regional disparities, the specialized workforce, the traditional crafts and trade, the infrastructural potential, the influence of migration, the proximity to sources of raw materials, the proximity to domestic and foreign markets, the existence of disadvantaged areas or areas that benefit of government or international programs.

The process of stimulating regional activities, as well as their coordination with government policies to promote inter-regional cooperation is included in a general effort to link the entire territory necessities, as well as the necessities of the geographical, economical and cultural regions of the country. The regional development process must also be examined in the broader context of European integration process and therefore in the process of adapting and preparing Romania to the European institutional structures in order to successfully implement policies and structural funds.

In the short term, however, regional policy should be submitting to focus particularly on reducing the negative effects caused by the process of the transition economy, especially on industrial reorganization.

Local and regional communities have, until now, an innovation capacity for this purpose and,

unfortunately, have not become more flexible, in order to respond effectively and quickly to new challenges and changes required by the process of reorganization of the economy.

Bearing in mind that free initiative and entrepreneurial spirit are basic prerequisites of development, the regional policy strategy there should be oriented towards creating conditions for the development of the innovation capacity of territorial communities for the purpose of adopting new activities that will gradually replace the inefficient activities.

Agriculture in this region has a major role, accounting for about 18%. The industry also has an important share in the region's economy, providing about 30% of regional gross domestic product.

Regarding existing businesses in South-West Oltenia region, depending on the number of employees they can be represented as follows (Figure 1):

Fig.1 Type and share of enterprises in South-West Oltenia in total country

South - West - Oltenia has a share in the total economy gross domestic product of about 8%. Evolution of GDP in South-West Oltenia region is reflected in Table No. 1.

Table 1 Evolution of GDP in South-West Oltenia -Million current prices –

GDP	2004	2005	2006	2007	2008	2009
Dolj	6554,1	7266,9	8839,4	10675,0	11315,5	10942,39
Gorj	4652,9	5120,1	5984,1	7613,9	8025,05	7599,73
Mehedinti	2620,2	2688,6	3246,6	3755, 6	3992,2	3716,74
Olt	3695,2	3937,6	4560,4	6808,8	5911,4	5686,77
Valcea	4187,3	4907,3	5958,7	6808,8	7230,9	7035,9
Region Total	21709,7	23920,5	28589,2	34419,6	36415,6	34922,47

**Source:** Romanian Statistical Yearbook 2008, National Institute of Statistics Publishing House, Bucharest, 2009

Table 2 Evolution of percentage of GDP in South-West Oltenia

	2010	2011	2012
DOLJ	0,2	2,6	3,9
GORJ	-0,3	2,2	3,5
MEHEDINTI	-0,8	2,3	3,3
OLT	0,2	2,6	3,6
VALCEA	0,1	2,5	3,7
REGION TOTAL	-0,1	2,5	3,6

**Source:** National Commission for Prognosis

We can see that approximately 14% of businesses in Romania are located in South West Oltenia region, of which 13.89% are enterprises with employees undertaking a number between 0 and 9; 14.45% are companies with a total staff between 10 and 49 employees, 14.29% enterprises with a number of employees between 50 and 249 employees and 7.08% companies with more than 250 employees.

As the result of increased structural imbalances and the deficit of economic performance and competitiveness continued employment dropped by 2005, when most counties in the region have recorded increases except Gorj which keeps a decreasing trend due to the restructuring of the extractive industry.

Statistical surveys on labor costs have highlighted the following structure in the average number of employees in the South-West Oltenia (Table 3).

Table 3 Average number of employees in South-West Oltenia -Thousands-

	2004	2005	2006	2007	2008	2009	2010*	2011*	2012*
DOLJ	121	119	125	134	136	134	133,2	133,1	134
GORJ	83	79	78	81	79	80	79,7	79,5	80
MEHEDINTI	46	47	48	49	49	47	46,9	46,9	47,4
OLT	68	69	68	73	75	72	72,4	72,5	73,3
VALCEA	77	79	81	84	84	82	81,5	81,6	83,1
TOTAL	395	393	400	421	423	415	413,6	413,6	417,7

**Source:** Romanian Statistical Yearbook 2008, National Institute of Statistics Publishing House, Bucharest, 2009

\* Provisional data according to the National Commission for Prognosis

## 2. IMPACT OF EXTERNAL FUNDING ON DEVELOPING ADMINISTRATIVE CAPACITY GORJ

In line with national policy and strategy for reform and modernization of central and local government, but also exposed to constant pressure exerted by civil society and local media, makers of the county and local authorities have responded positively to the need of constantly changing system. Despite acute problems inherited, the specific county and always insufficient resources, local government capacity has improved steadily. You can identify five major factors that have defeated the resistance to change led system and continuous modernization of the administrative act: will policy, competition policy, public pressure and the media, taking over the *acquis communautaire* and accessing external funding.

When the local program aligned with local decision makers about the natural governing decisions and superior echelons of political parties, local political competition generated by the examination, represented by the electoral cycles, was undoubtedly one of the factors that forced the authorities and elected Local begin to accept change and reform. This, plus the increasing pressure exerted by population and NGOs, supported by media, wishing to eliminate corruption and improving quality of service. These pressures have led authorities to learn not only from past experiences and mistakes, but also of successful actions, and multiplying by taking examples of best practices at local, national and EU.

However, the factor that caused the biggest change in mentality and way of addressing the local government authorities was the opportunity of accessing external funding grants since 2001. Initially viewed with great apprehension by local mayor, grants schemes originally made available by the European Union through PHARE program actually began the process of upgrading administrative capacity in the county.

Thus, the first substantial projects through impact and value was accessed under the scheme MARR - Grant (Mining Affected Region Reconstruction) for reconstruction of mining areas affected, program only for Gorj and Hunedoara county. Under this scheme, during 2001-2002, local authorities from 20 municipalities of the county have developed 22 projects totaling 3.5 millions Euro, representing water supply, rehabilitation of roads and schools and infrastructure development business SMEs. The impact of these projects on population and especially the local mayor has started a real competition in the local government in terms of accessing grant funds by participating in tenders for projects financed by foreign or national.

This was followed (2002-2003) by financing scheme PHARE RO 9904.01.04 - RICOP through which local authorities, SMEs and NGOs have accessed and implemented 15 projects totaling over 2 millions Euro in areas such as : public works, active measures for employment and social response measures.

Faced with fierce competition for grants access to both county and national level, government has had to develop the ability to write and implement projects, leading to better staff training and inevitable acquisition procedures of compulsory work and good industry practices. That development of local



administrative capacity led to the location of Gorj county during 2004-2005 among the 10 counties in the country access to the Measure 2.1. - Rural infrastructure, financed by SAPARD Program (Special Pre-Accession Programme for Agriculture and Rural Development). Under this program local authorities in the county have implemented 25 projects with a total value exceeding 29 millions Euro.

Another important impetus was the launch of the Program “ Modernization Fund for development of local Administration”, in which during the period 2006-2007, local authorities have implemented 17 projects with a total value of over 500.000 Euro. Though relatively small, the local government modernization projects funded in areas such as modern information dissemination and management of the budget mayor and local resources with the active participation of local community, the development of local networks, upgrading information systems collection of local taxes etc..

Result of institutional development and experience gained in this competition authorities in the period 2001-2008, local and county has developed over 100 projects with domestic and external financing with a total value exceeding 50 millions Euro.

Currently, the administration must face the competition challenges accessing the Structural and Cohesion Funds, which requires mobilization of all stakeholders converged in the ongoing development of administrative capacity at district level also supplies nearly unlimited opportunities for economic and social development . Finally, authorities must seize the opportunities especially for Operational Programme Administrative Capacity Development (OP ACD), which finances the whole problem still facing public administration structures.

The main purpose of this research is to provide support so that participants in making socio-economic development strategies of Gorj county can benefit from an objective source, containing relevant information for identifying major issues and priorities. Research has as main objectives:

- Presenting a selection of data the most important characteristics of socio-economic and cultural space of this county.
- Identify key development issues at district level in order to assess potential factors and regional differences.
- Presentation of data and information on local community members to the perception of critical issues.
- Evaluation and correlation potential for development at county level, with priority axes of operational programs for the 2007-2013 period covering the current research in the county.

Data for analysis were collected from the Department of Statistics Gorj County in the National Institute of Statistics, questionnaires as a representative sample of households and individuals.

The main objective of this research was conducted by the County Department is to collect detailed statistics in order to characterize the level of living standards. This was done by collecting information on various social issues: living conditions, education, occupation, income, expenses, etc..

Social-economic development strategy 2007-2013 of Gorj county was developed by the PHARE 2004 program as a component for adopting and implementing the *acquis communautaire*. This strategy aims to increase partnership and planning capacity and therefore the absorption capacity of European funds at district level in order to obtain the following results: identifying and promoting the real interests of local communities, promoting social dialogue and communication among all parties involved in the development process, linking the county with the regional strategies and fostering partnership initiatives, responsibilities and strengthen relational ties in order to increase opportunities for accessing funds.

Balanced development of all regions will be achieved through an integrated approach, based on a combination of public investment in local infrastructure, active policies to stimulate and support business to maximize local resources, by following priorities:

- Supporting the sustainable development of urban growth poles. This priority aims to increase the quality of life and creating jobs in cities, the rehabilitation of urban infrastructure, improving services, including social services and development support structures in business and entrepreneurship;
- Improvement of regional and local transport. This priority axis aims to increase regional accessibility and mobility of people, goods, and services to promote sustainable economic development;

- Improvement of social infrastructure. This priority axis aims to create prerequisites for improving public access to essential services and contribute to achieving European economic and social cohesion by improving the infrastructure for health, education and public safety and social emergencies.
- Strengthening regional and local businesses. This priority axis aims at establishing and developing business support structures of regional and local importance, industrial rehabilitation and support regional and local entrepreneurial initiatives, to facilitate job creation and sustainable economic growth;
- Sustainable development and tourism. This priority axis aims mainly sustainable recovery and promoting cultural heritage and natural resources with tourism potential and improving the quality of accommodation and tourist infrastructure to increase attractiveness, develop the local economies and create jobs.
- Technical assistance. The objective of this priority is to provide support for implementation, transparent and effective program.

Gorj has a weaker economical and social status, being told by government decree as underdeveloped area. This special status derives from the typical profile of mono-industrial region, based almost exclusively on the mining sector. Therefore, the situation is quite critical for mining affected towns and surrounding rural communities, given the high unemployment due to restructuring of the mining industry, problems environment affecting the entire ecosystem surrounding the low participation of citizens in solving local problems, because of low education and aging. Most people around the age of 20 years have left these mono-industrial areas in search of jobs in EU countries. Thus, the population dropped dramatically, raising issues of local governance process as a whole. These economic and social causes made him Gorj a “status quo” which is among the counties with the greatest potential to receive EU structural funds, as a tool for cohesion and convergence in less developed regions. Therefore, without tools or programs to promote youth participation in local development agenda, there is a high risk of not-coordination of expenditure and waste of funds diffuse.

Development Strategy is designed to integrate and link solutions to priority areas: infrastructure, human resources and business environment, agriculture, environment and natural resources, social.

The main sources of funding for implementing the development strategy are considered local and county budgets, state budget funds and EU structural and cohesion that are accessible through operational programs. Establishing the priorities of development was in accordance with diagnostic analysis and opinions based on future beneficiaries of the strategy, which means about 1,500 representatives of local communities in the county.

Development Strategy aims to coordinate programs and sectoral policies (social services, education, health), in accordance with territorial issues in order to eliminate differences in development between the urban and rural poor and to integrate disadvantaged.

Of the subjects interviewed in 59.6% households living in rural areas while only 40.4% are urban. Average income per household in this sample is 1612.63 lei. Median is at 1386 lei, which means that in 24 of the 47 households surveyed their members have an income less than 1386 lei. The result is not surprising given the fact that the majority of the population lives in rural areas.

As regards the period in which homes were built, it shows that 10.6% of them were built in 1968 and another 10.6% of them in 1988. Since then, in rural areas (with the highest weight in the sample), fewer houses were built mainly due to the low level of income, the maximum value for this variable was reached in 1995. Therefore, we conclude that, after these years was very difficult for people to build new homes.

The total expenditure incurred by households in one month can vary greatly, as shown in Table 3. We can say that average monthly expenditure per household is about 1001 lei and the 24 units listed total expenses were over 759 lei. This trend is due mainly to rising prices and stagnant wages. If we consider the expenditure categories (food, non food and service) can be seen that the average expenditure for food is greater than the other (approx. 286 million), though very small amount, covering only basic needs. The amount spent on non-food products will follow closely, while the services situation is different.

Table 4 The total expenditure incurred by households in one month can vary greatly Total expenses

	N N	Minimum Minimum	Maximum Maximum	Medie Aver- age	Deviație std. Std deviation.
Cheltuieli alimentare Food Expenditure	47 47	77.50 77.50	749.50 749.50	286.1068 286.1068	141.32853 141.32853
Cheltuieli nealimentare Non-food expenditure	47 47	15.80 15.80	969.50 969.50	276.0891 276.0891	250.33842 250.33842
Cheltuieli servicii Expenditure on services	47 47	.00 .00	888.00 888.00	172.2000 172.2000	157.56354 157.56354
Valid N Valid N	47 47				

Variables related to the purchase of land and buildings show a disturbing reality: none of the members of households did not buy land or buildings, therefore the amount entered is invalid. Expenditure on new construction is almost the same trend as only two of the 47 households reporting such expenditures. Therefore we are entitled to say that real estate investments are very low and that the landscape has become unattractive because of this influence.

If we analyze the evolution of credit and monthly deposits, note first that almost all households survey record monthly pay their debts to various credit institutions on the other hand, only 12.8% have deposit accounts. The amount of monthly payments on loans of 1090 lei, while average income per household is 1612 lei say that public debt is enormous.

Should be also taken into account educational level and employment status of the 129 people in the questionnaire. It seems that most of them graduate schools of arts and crafts (professional) (26.4%) followed by high school graduates (20.9%) and those with higher education (17.8%). It should also noted the relatively high proportion of the full uneducated (untrained) (13.2%).

Table 5 The distribution of persons according to occupation. Educational level

	Frecventa Frequent	Procent Percentage	Procent Valid Valid Percent	Procent Cumulativ Cumulative Percent
Fără școală absolvită Without graduated school	17 17	13.2 13.2	13.2 13.2	13.2 13.2
Primar (clasele 1-4) Primary (grades 1-4)	19 19	14.7 14.7	14.7 14.7	27.9 27.9
Gimnazial (clasele 5-8) Secondary (grades 5-8)	27 27	20.9 9.20	20.9 20.9	48.8 48.8
Profesional Vocational	34 34	26.4 4.26	26.4 26.4	75.2 75.2
Treapta I liceu (clasele 9-10) Stage I high school (grades 9-10)	1 1	.8 .8	.8 .8	76.0 76.0
Liceal (clasele 9-12) Secondary (grades 9-12)	23 23	17.8 17.8	17.8 17.8	93.8 93.8
Postliceal Secondary	3 3	2.3 2.3	2.3 2.3	96.1 96.1
Universitar de scurtă durată Short university	2 2	1.6 1.6	1.6 1.6	97.7 97.7
Universitar de lungă durată Long university	3 3	2.3 2.3	2.3 2.3	100.0 86.3
Total Total	129 129	100.0 100.0	100.0 100.0	100.0

Occupational status in Table 5 shows the distribution of persons according to occupation.

In line with trends experienced at the country level, 36.4% of the 129 people surveyed were retired, only 17.8% employed, 10.1% students and other 10.1% people home, the rest are occasional workers, unemployed or students. This distribution shows the difficulties faced by the fact the whole country.

Table 6. The sector performed using the database shows that of the 129 respondents either did not work “part time”. Occupational Status

	Frecvența Frequency	Procent Per- centage	Procent Valid Valid Percent	Procent Cumulativ Cumula- tive Percent
angajați Employers	23 23	17.8 17.8	17.8 17.8	17.8 17.8
Lucrători în activități Workers non agriculture activities neagricole	5 5	3.9 3.9	3.9 3.9	21.7 21.7
Agricultori Farmers	2 Two	1.6 1.6	1.6 1.6	23.3 23.3
Asistați social Socially assisted	3 3	2.3 2.3	2.3 2.3	25.6 25.6
șomeri Unemployed	8 8	6.2 6.2	6.2 6.2	31.8 31.8
pensionari Retired	47 47	36.4 36.4	36.4 36.4	68.2 68.2
Elevi Pupils	13 13	10.1 10.1	10.1 10.1	78.3 78.3
Studenți Students	3 3	2.3 2.3	2.3 2.3	80.6 80.6
Casnice Domestic	14 14	10.9 10.9	10.9 10.9	91.5 91.5
Alte categorii Other	11 11	8.5 8.5	8.5 8.5	100.0 86.3
Total Total	129 129	100.0 100.0	100.0 100.0	100.0

Figure circle sector performed using the database shows that of the 129 respondents either did not work “part time”. Level of development of firms in the county is relatively low, so are unwilling to make hiring “part time”. Also, unemployment is a top, representing more than 82%. Same percentage population without a job, result from the distribution of employment contracts in which a majority (81.2%) answered that are not employed. Most others are employed on fixed-term contract. We conclude that job stability for the respondents (many from rural areas) is very low. Analysis of variables is by nothing more optimistic. This shows that the majority fight for a decent life, while others take their existence under normal living standards. In urban areas the situation is not that bad, but the country’s population leads a hard life. Instability of jobs and therefore uncertain revenues and increasing number of pensioners and socially assisted is an alarming problem and thus conclude to important issues that are slowing the development of this county.

### 3. CONCLUSIONS AND RECOMMENDATIONS

In order to realize the regional reform objectives designed to create a more flexible territory, consider that these recommendations are not of no bearing:

- adoption of a law of development as an organic law;
- completion and stabilization of the developing regions;
- strengthening the role and position of CNDR;
- continuation of regional building and institutional strengthening;
- development of cultural partnership;
- development of an integrated information management system.

The relatively recent emergence of regional development as a major occupational and as national policy, on the recommendation of the European Union over the past decade was made, unfortunately, without recovering the informational, statistics, formative, educational, and cultural disability that our country will have in report to the Western European countries. The recovery occurred in jumps, with the justified concern that the fulfillment of minimum requirements be done as quickly as possible for the prospect of joining and this field to be classified as satisfactory in terms of capacity-fulfillment of European Union member state. But from here, to create prerequisites to develop a specific character state policy based on broad involvement of different categories of institutional, economical and social actors, both centrally and regionally, based on recognized principles and objectives of development and a freely consented partnership is a long way. To pave the road, I consider that a responsible approach to the field should start from the quality of education and training of all the human resources involved, a real education process to represent a real long term investment for the success of regional development policy but also of other policies aimed at achieving economic and social cohesion.

We conclude by saying that a key factor for the regional development of Romania is the optimal

planning of available resources based on the local potential of development regions, taking into account not only economic disparities, but also social needs.

Having many of the beauties of the country, Gorj is a region with great opportunities for sustainable development. The problem discussed in this research is whether the actual state of this region enables smooth integration with other counties.

Although data analysis revealed great difficulties for the inhabitants of the region, particularly those from rural areas into national development strategies, they seek to discover the potential opportunities and to allocate more adequate resources available for welfare and progress so much expected.

Issues such as regional development strategies, implementing policies on regional labor market, establishment of regional centers of innovation, execution of transfer centers, technology would give efficiency at regional level while limiting the functions of design, supervision and assessment of central governments. Regions should also assume jurisdiction on the implementation of county-level economies of scale and / or subsidiary of: vocational or university education, health, environmental protection, regional planning infrastructure, burdens on regional economic development.

In accordance with the priorities of economic and social development make these recommendations for the next three years to conduct county:

- In agriculture: a modern and competitive agriculture, high quality products and various technologies, a large search marketing, specialized farms, with performance management using modern technologies and environmental associations of farmers.
- Infrastructure: access roads to the sites of modern cultural, social and tourist facilities and building new roads, parking lots, sidewalks in all cities, all towns ring road, competitive systems both drinking water treatment and waste, supply gas, Internet, public lighting, educational institutions, health, social and cultural modern and functional, information centers for disaster in every locality.
- Environmental and natural resources: water and air, land consolidation, biodiversity, protected nature reserves, a system of collecting, transporting and storing waste.
- Human resources and business: financing by local investors or outside of small and medium competitive and attractive, young specialization in various fields, especially IT.
- In the social field: effective social services, in line with European standards, to promote equality.

In conclusion, we could say that the government and local authorities should have regard to the issues identified and to act accordingly, because change takes time to be successfully implemented and Romania must catch up with other countries in South - Eastern Union European.

County is and will continue to be the major active participant in the development of the South - West Oltenia because of the significant industrial forces and natural resources, tourism and human diversity.



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## FOREIGN AID AND ECONOMIC DEVELOPMENT IN TRANSITION ECONOMIES – VICIOUS CIRCLE VS. BETTER TARGETING

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### Abstract

This paper deals with the impact of foreign aid on economic development in transition economies, especially analysing the case study of Bosnia and Herzegovina (BiH) in the area of support to economic and entrepreneurship development. Firstly, it presents theoretical fundamentals and historical development of foreign aid in general, its different modalities, and then gradually focuses on the impact and necessity of its long-term duration, sustainability and the most important issue of better targeting and more effective usage. In general and subject to different estimation techniques it has been proved that official development assistance promotes economic growth, but also facilitates development of entrepreneurship sector. This paper intends to discover whether this conclusion applies to all development countries, especially transition ones, as there has been limited evidence presented to date. In the context of post-conflict and triple transition process in BiH – economic, political and social challenges seem to be vastly demanding for underdeveloped institutional capacities. Therefore, dialog between foreign donors and domestic stakeholders reveals lack of long-term dedication to priority task of job creation within small and medium enterprise (SME) sector, which is considered to be the most needed stimulant to economic development in general. The paper will critically analyse various channels through which foreign aid has been given to date in BiH. The case will then be made for a need to break from a vicious circle of limited effectiveness and lack of responsibility for that on both sides – senders and receivers. The key for better usage of foreign aid is in increased capability, accountability and transparency on both sides. Focusing on capacity development in these three areas should then lead to better targeting of foreign aid in priority sectors, such as entrepreneurship. Conclusion of the paper is that foreign aid as a form of foreign funds is of fundamental value for transitional economies, due to the fact that it has a potential to facilitate certain economic activities. The impact of robust and large amounts of foreign aid on sustained growth has been substantially limited in transitional countries, especially in BiH, however, that does not reduce its potential, if both donors and local stakeholders are to take a different approach for future better targeting and achievement of its long-term effectiveness.

Keywords: Foreign aid, Economic development, SME, aid efficiency.

### 1. INTRODUCTION TO FOREIGN AID – THEORY, HISTORY AND EMPIRICS

*“Aid has a positive impact on growth in developing countries with good fiscal, monetary, and trade policies but has little effect in the presence of poor policies...”* claim Burnside & Dollar (2000). The authors investigated the relationship between foreign aid, economic policy and growth of per capita GDP using a new database on foreign aid developed by the World Bank. Regressions in which the dependent variable of growth rates in developing countries depends on initial per capita national income, an index that measures institutional and policy distortions, foreign aid and then aid interacted with policies. Easterly (2003) argues that achieving a beneficial aggregate impact of foreign aid remains a puzzle, and that aid agencies should set more modest objectives than expecting aid to *“launch the takeoff into self-sustained growth.”* But, some introduction into the issue of foreign aid needs to be made first.

Foreign aid or development cooperation (also development assistance, technical assistance, international aid, overseas aid, Official Development Assistance (ODA) or development aid) is aid given by governments of mainly developed countries and their various agencies to support the economic, social and political development of developing countries. It is distinguished from humanitarian aid by focusing on alleviating poverty in the long term, rather than a short term response. Most development aid comes from the Western industrialised countries but some poorer countries also contribute aid. Aid may be bilateral: given from one country directly to another; or it may be multilateral: given by the donor country to an international organisation such as the World Bank or the United Nations Agencies (UNDP, UNICEF, UNAIDS, etc.) which then distributes it among the developing countries. The proportion is currently about 70% bilateral 30% multilateral. About 80-85% of developmental aid comes from government sources as official development assistance (ODA). The remaining

15-20% comes from private organisations such as “Non-Governmental organisations” (NGOs), foundations and other development charities (e.g. Oxfam). In addition, remittances received from migrants working or living in diaspora form a significant amount of international transfer. Private consulting firms, such as PricewaterhouseCoopers and Deloitte, are increasingly being contracted by donor agencies to manage and implement elements of their aid program, due to their perceived ability to perform higher quality program management and delivery. Official Development Assistance is a measure of government-contributed aid, compiled by the Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD) since 1969. The DAC consists of 22 of the largest aid-donating countries.<sup>1</sup>

Many scientist have analysed the theory and practice of the ODA, some of them claim that ODA should be aimed at improving the economic fabric of a country, export possibilities or local production, but also that it should be given more generously to good performers, as successful projects strengthen economic capacities to finance further improvements in human development (Raffer and Singer, 1996. p. 203). At the same time, Raffer and Singer criticise ODA by saying that aid and development finance are currently ridden by numerous faults, that money is spent on useless prestige projects based on political or military objectives of the donors, making people in development countries worse off, which has led to so called ‘aid fatigue’ and demands that one should get rid of aid. However, they suggest that it is better to get rid of the faults and to evolve mechanisms that improve the quality of aid and development finance. Other scientists argue that aid is in decline, but not dying and that developmentally speaking much more can be done with much less (Browne, 1999). Brown claims that the priority is not on the improvement of aid, but on its nature, and that it is no longer a choice of ‘how’, but of ‘what’. Some other authors have analysed the impact of aid in much wider perspective taking into consideration political and stability issues. Therefore, Joanna Macrae (2001) is basing her analysis of postconflict countries claiming that much more fundamental review of aid strategies in chorincal political emergencies is required. In addition to that, she argues that the uncertain legitimacy and weak capacity of recipient states confined aid responses to the projectised, decentralised and supply-oriented models of relief, failing to address developmental objectives. All said above is fully applicable to situation in Bosnia and Herzegovina. There is also argument in literature that trade is better than aid, but evidence suggests that some aid appears to be have been productive, much has not and it is difficult to draw an overall balance, while benefits of international trade and foreign investment should by default be beneficial and at least give opportunity for poor countries to grow out of poverty. This dilemma is analysed by Albert Berry (in J. Freedman, ed. 2000) who emphasises the need for a new and more effective set of international institutions to protect the interests of the more vulnerable developing countries by giving them some influence in how their economies are affected by the rest of the world.

If developing country is at the same time going through postconflict recovery, Forman & Partick (2000) refer to triple transition process which involves security, democratic and socioeconomic transition, that are all complex, costly and risky. They claim that sequence and duration of these transitions can vary significantly, assisted by emergency, reconstruction and ultimately development assistance, that should all restore some lasting degree of political stability and self-sustained economic growth. Hjertholm and White (2000) present a good overview of main developments in history of foreign aid given in Table 1 below.

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<sup>1</sup> [http://en.wikipedia.org/wiki/development\\_aid](http://en.wikipedia.org/wiki/development_aid)

**Table1 Schematic overview of main developments in the history of foreign aid**

	<i>Dominant or rising institutions</i>	<i>Donor ideology</i>	<i>Donor focus</i>	<i>Types of aid</i>
1940s	Marshall Plan and UN system (including World Bank).	Planning.	Reconstruction.	Marshall Plan was largely programme aid.
1950s	United States, with Soviet Union gaining importance from 1956.	Anti-communist, but with role for the state.	Community Development Movement.	Food aid and projects.
1960s	Establishment of bilateral programmes.	As for the 1950s, with support for state in productive sectors.	Productive sectors (e.g. support to the green revolution) and infrastructure.	Bilaterals gave technical assistance (TA) and budget support; multilaterals supported projects.
1970s	Expansion of multilaterals especially World Bank, IMF and Arab-funded agencies).	Continued support for state activities in productive activities and meeting basic needs.	Poverty, taken as agriculture and basic needs (social sectors).	Fall in food aid and start of import support.
1980s	Rise of NGOs from mid-1980s.	Market-based adjustment (rolling back the state).	Macroeconomic reform.	Financial programme aid and debt relief.
1990s	Eastern Europe and FSU become recipients rather than donors; emergence of corresponding institutions.	Move back to the state toward end of the decade.	Poverty and then governance (environment and gender passed more quickly).	Move toward sector support at end of the decade.

*Note:* Entries are main features or main changes, there are of course exceptions.

**Source:** Reproduced from Hjertholm and White (2000), p 81, Table 3.1.

## 2. AID QUANTITY, QUALITY AND EFFECTIVENESS

According to OECD (2009) data most Official Development Assistance (ODA) came from the 23 members of the Development Assistance Committee (DAC), or about USD 120 billion in 2009. In 2007 a further USD 11.8 billion came from the European Commission while all non-DAC countries gave USD 5.56 billion (OECD, 2011). The largest DAC donors in 2009 were the United States (USD 28.8 billion), France (\$12.6 billion), Germany (\$12.1 billion), United Kingdom (\$11.5 billion) and Japan (\$9.5 billion). The largest non-DAC donors in 2007 were Saudi Arabia (USD 2 billion) and Turkey (\$0.6 billion). However, none of these countries met the UN target of giving at least 0.7 percent of the Gross National Income (GNI) as aid. United States (0.21% of GNI) and Japan (0.18% of GNI) were ranked 19 and 21 respectively out of the 23 DAC countries. The only countries meeting the targets in 2009 were Sweden (1.12% of GNI), Norway (1.06% of GNI), Luxembourg (1.04% of GNI), Denmark (0.88% of GNI), and the Netherlands (0.82% of GNI).

There is also much debate about evaluating the quality of development aid, rather than simply the quantity. For instance, tied aid is often criticized as the aid given must be spent in the donor country or in a group of selected countries. Tied aid can increase development aid project costs by up to 20 or 30 percent. There is also criticism because donors may give with one hand, through large amounts of development aid, yet take away with the other, through strict trade or migration policies. The Commitment to Development Index measures the overall policies of donors and evaluates the quality of their development aid, instead of just comparing the quantity of Official Development Assistance given. Aid effectiveness is the degree to which development aid works, and is a subject of significant disagreement. Many econometric studies in recent years have supported the view that development aid has no effect on the speed with which countries develop. Negative side effects of aid can include an unbalanced appreciation of the recipient's currency (known as Dutch Disease), increasing corruption, and adverse political effects such as postponements of necessary economic and democratic reforms (Kaufmann, 2009). An excerpt from Dr. Thomas Dichter's (2003) recently published book *Despite Good Intentions: Why Development Assistance to the Third World Has Failed* reads: "This industry



has become one in which the benefits of what is spent are increasingly in inverse proportion to the amount spent - a case of more gets you less. As donors are attracted on the basis of appeals emphasizing “product”, results, and accountability...the tendency to engage in project-based, direct-action development becomes inevitable. Because funding for development is increasingly finite, this situation is very much a zero-sum game. What gets lost in the shuffle is the far more challenging long-term process of development.” An inquiry into aid effectiveness by the UK All Party Parliamentary Group (APPG) for Debt, Aid and Trade featured evidence from Rosalind Eyben (2009), a Fellow at the Institute of Development Studies. Her evidence to the inquiry stated that effective aid requires as much investing in relationships as in managing money. It suggests Development organisations need to change the way they work to manage better the multiple partnerships that the Accra Agenda for Action recognises is at the core of the aid business. In relation to this specific inquiry, Dr Eyben outlined the following points:

- Achieving impact requires investing in relationships, development organisations need to support their staff to do this. At the moment, the opposite is happening.
- In multiple sets of relationships there will be different ideas about what is success and how to achieve it and this should be reflected in methodologies for defining and assessing the impact of aid.
- Helpful procedural harmonisation should not mean assuming there is only a single diagnosis and solution to any complex problem.
- In addition to measuring results, donors need to assess the quality of relations at project/programme, country and international levels against indicators agreed with partners.
- Decisions on aid need to be made on a case by case basis on the advice of well-informed country offices.

Dr Eyben lists some more recommendations relating to UK aid solely, but the set of the above mentioned conclusions relating to aid effectiveness seems to be applicable to a great number of developing countries, including the relationship between donors and recipients in Bosnia and Herzegovina.

### **3. DONOR AID FLOWS TO ECONOMIC DEVELOPMENT SECTOR INCLUDING SUPPORT TO SMES - EVIDENCE AND IMPACT FROM BIH**

Economic development and social protection sector is of critical importance for the BiH progress in economic, social and political arenas. There are several development strategies – Country development strategy, Social inclusion strategy, Employment strategy, Export promotion strategy, and above all there is Stabilisation and Association Agreement (SAA) as an additional impetus for reforms, which paves the way to EU integration and additional EU funds for development. However, there is a strong need to synchronise, harmonise and coordinate all the mentioned strategies, and most urgently develop and implement appropriate action plans.

When it comes to SMEs and improvement of business climate sub-sector according to Donor coordination forum’s data, (DCF) which includes 11 active bilateral donors (USAID, DFID, JICA, etc) and 6 multilaterals (EBRD, EC, UNDP, WB, etc) total contribution to Economic development and social protection sector and its sub-sector of Small and Medium-Sized Enterprises and Improvement of the Business Climate has been 784.004.612€ to date. This sector received 32% of total ODA in 2009 and 42% in 2010. In 2009, support to SMEs and the improvement of business climate was given a major boost by adoption of BiH Small and Medium-Sized Enterprise Development Strategy 2009-2011, through which the access has been gained to Competitiveness and Innovation Framework Programme (CIP) fund. Support to Small and Medium-Sized Enterprises (SMEs) and Improvement of the Business Climate sub-sector is comprised of direct donor support to the development of SMEs in the Industrial sector, including accounting, auditing and advisory services as well as tourism policy and administrative management.

This strategy envisions the establishment of the Council for Entrepreneurship. The formation of a state-level SME agency and SME fund is foreseen. According to this strategy, the functions of a SME agency will be incorporated within a sector in the BiH MoFTER. Some proposed activities include measures to enable SMEs in BiH to close the gap in technological development and competitiveness with companies from the EU and neighbouring countries. Additionally, the adoption of this strategy will enable BiH to obtain access to the CIP fund. In the absence of the Law on the Promotion of

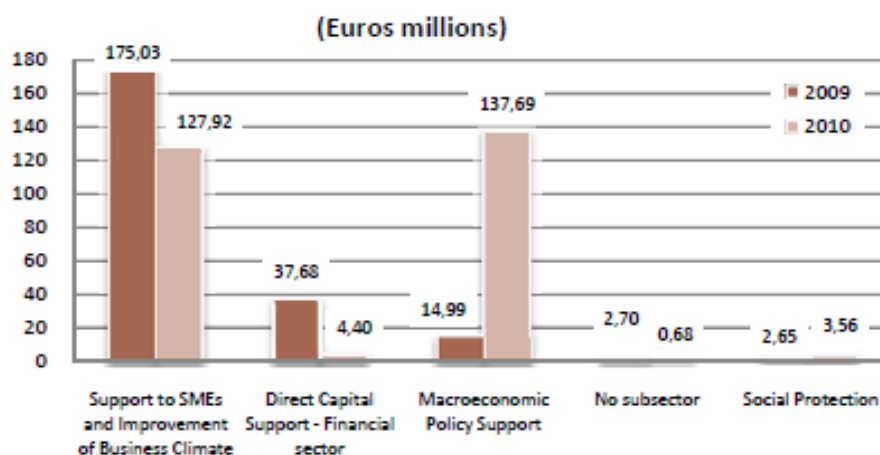
2 All data and figures presented are available in the Donor Coordination Forum database - [www.donormapping.ba](http://www.donormapping.ba)



SMEs in BiH, which is currently in parliamentary procedures, the implementation of the strategy is delayed. A state-level law in the area of SMEs is necessary to create conditions for use of IPA funds as well as other foreign resources to support the development of SMEs. The adoption of such a law is a European Partnership short-term priority for BiH.

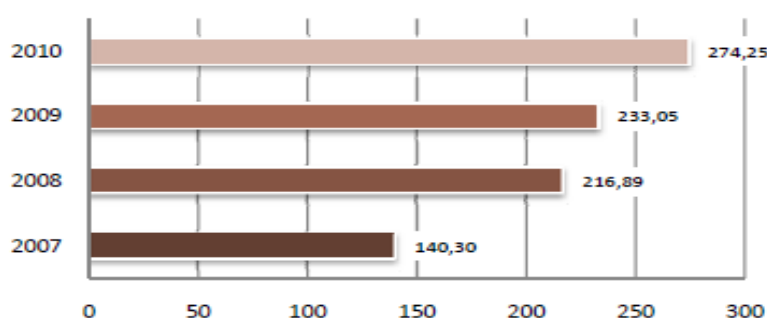
The figures presented in the paper below give the overview about the quantity, dispersion and donor allocations to the Economic development sector and its relevant sub-sectors in BiH.

Figure 1. Aid flows per sub-sector in the economic development and social protection sector 2009-2010



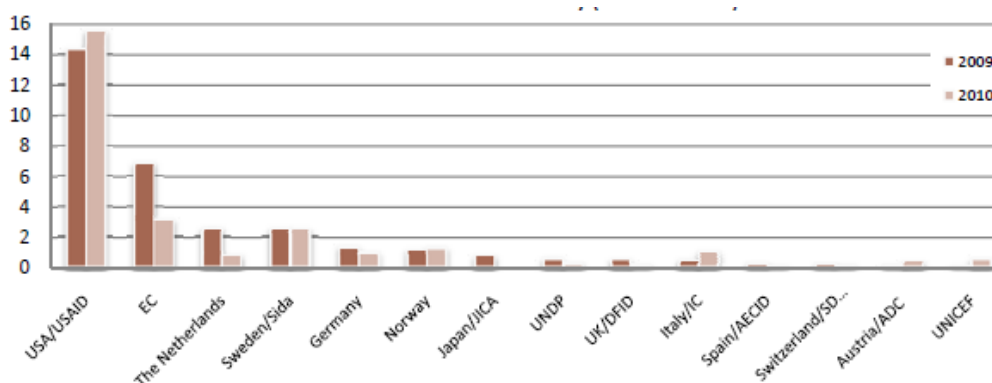
As it can be seen SMEs and improvement of business climate sub-sector received the largest part of ODA funds in 2009, whereas in 2010 it comes second, as it was overtaken by support to Macroeconomic policy support.

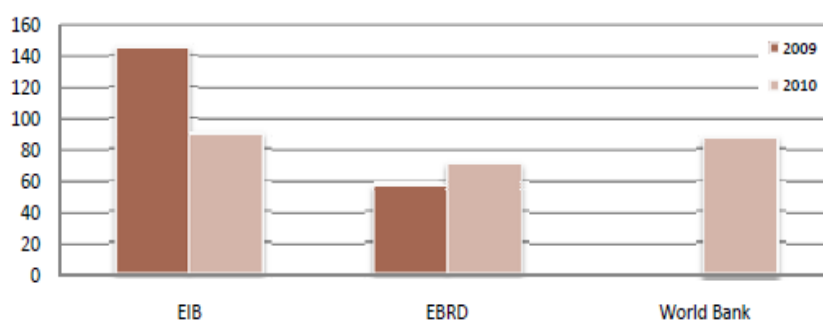
Figure 2. Aid flows to Economic development and social protection sector 2007-2010 (Euros millions)



Total support to the overall sector recorded continuous increases from 2007-2010, with significant increase of fund in 2010 in comparison with 2008 and 2009 allocations.

Figure 3. Aid flows to Economic development and social protection sector per donor – countries and IFIs in 2009 and 2010





#### 4. CONCLUSION

It has been said that total amount of ODA spent for the reconstruction of the Balkans is significant, ranging between €6-6.5 billion per annum from 1995-2006. On average BiH received about \$730 million per year from 1996-2002. At \$1,400 per head, assistance in the first two post-war years in BiH was higher than any other international state-building project since the Second World War. For many observers, foreign aid to the Balkans has a mixed record and very scarce evidence on its implementation and effectiveness. Many consider the Balkan as a mix of weak states and international protectorates with low growth record, pervasive corruption, high unemployment, and public disaffection. Some studies that focused more specifically on the economic effectiveness of assistance have also reached limited and mainly negative conclusions, arguing that external aid has had a very weak positive impact on the economic performance of the Balkan countries, including BiH, too.

This article presented foreign aid allocations to economic development sector and gave more recent data for 2009 and 2010. As it has been presented here, total allocations to Economic development and social protection sector in 2009 and 2010 was more than 500 million of Euros – more than 70 million in grants and almost 450 million in loans. There is a growing consensus in the literature that official assistance should only flow to those countries that are likely to use it well, as judged by their policies and institutions. It has also been concluded that aid can assist in the domestic dialogue on these policies and institutions, but it cannot make them come about through conditionality.

While aid effectiveness is clearly helped by appropriate domestic policies in recipient countries. However, BiH domestic political economy is too strong to be influenced by aid flows, at least in anything beyond the very short run. As this paper argued, in the study case of Bosnia and Herzegovina vicious circle of huge allocations of foreign funds, both in grants and loans, have made a very limited contribution to the overall economic growth and development. dialog between foreign donors and domestic stakeholders reveals lack of long-term dedication to priority task of job creation within small and medium enterprise (SME) sector. This sector is considered to be the most needed stimulant to economic development in general. Therefore, the vicious circle of limited effectiveness and lack of responsibility exists on both sides – senders and receivers. The key for better usage of foreign aid is in increased capability, accountability and transparency on both sides. Focusing on capacity development in these three areas should then lead to better targeting of foreign aid in priority sectors, such as entrepreneurship. Conclusion of the paper is that foreign aid as a form of foreign funds is of fundamental value for transitional economies, due to the fact that it has a potential to facilitate certain economic activities. The impact of robust and large amounts of foreign aid on sustained growth has been substantially limited in transitional countries, especially in BiH, however, that does not reduces its potential, if both donors and local stakeholders are to take a different approach for future better targeting and achievement of its long-term effectiveness.

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## FACTORS CONCERNING THE ECONOMIC GROWTH: HR DEVELOPMENT IN INSTITUTIONS THAT SUPPORT ENTREPRENEURSHIP

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### Abstract

Entrepreneurship is one of the driving forces for achieving high results within an economy. Starting from the development component as its basic feature, entrepreneurship is a key cause of economic growth and employment bearer. When we talk about entrepreneurship, a particularly interesting question is the one about its status in transitional economies, where due to the breakdown of large industrial facilities and the rapidly actualization of the sector of small and medium enterprises led to the emergence of a “spontaneous entrepreneurship”. This type of entrepreneurship has its features that don’t look like a mature enough entrepreneurial activity that relies more on intuition than on scientifically tested and proven actions and as such it continues to have its impact on the future development of the overall economy in these societies. This is why this issue deserves special attention.

One of the main obstacles, regarding the development of entrepreneurial climate, is the condition of the human resource factor (HR factor), which is part of the numerous administrative - bureaucracy factors and obstacles. Large number of failures are identified and determined in the policies for human resource development, starting from the primary selection of employees in already existing and working organizations and institutions, which reflects further working life of institutions. It also affects the process of creating entrepreneurial climate. For that purpose, we are stressing out the need of improvement in the area of the entrepreneurial supportive policies, engaging the entrepreneurial development, starting from the institutions which already are established and their main field of work is supporting the entrepreneurial development.

The whole approach regarding the improvement of the human resources is divided in two phases. The first one has its main focus on the employee selection process. The second phase is human resource development policies, within institutional frameworks. These two phases have a tight connection and are supported with accurate data which derives from our research, where the main focus is put on the current condition with the human resources factor in both, state and public organizations (state organizations which have a leading role in entrepreneurial development and private organizations as a carrier of the entrepreneurial development functioning) in the country. For that purpose, we point out the need and credentials for organizational restructuring with concentration on institutions that support entrepreneurial development.

**Keywords:** Entrepreneurship, Entrepreneurial development, Entrepreneurial climate, Economic growth, human resource factor.

### 1. INTRODUCTION

Contemporary trends of the global economy, the turbulent environment and the pressure as a consequence of the trend of globalization dictate suitable modes of operation of enterprises and national economy. This atmosphere, on one hand opens new unusual opportunities for progress, but it also represents a kind of a threat for the economic subjects that have problems adjusting. As an imperative of modern living, entrepreneurial behavior occurs at all levels of action: individuals, companies and entire countries. Starting from the development component as is basic feature, entrepreneurship is a key cause of economic growth and a bearer of employment opportunities. It is not surprising that the development of an entrepreneurial climate is an issue that occupies a central place in the Lisbon agenda set by the European Commission as part of the European Union policies for achieving high results in terms of economy. However, when talking about entrepreneurship we must keep in mind that there is a difference in the treatment of this question depending on whether it is a developed, undeveloped country or a country in transition. The economic system in developed countries is fully mature and established, but the situation in the countries in transition is quite different. Indeed, the second have a situation when the economic system along with society in general are in a transitional

period that has yet to form a new mode of functioning of enterprises, new institutions are being established, the whole way of thinking and acting as individuals is being changed and etc. Such is the case with the Republic of Macedonia, as a case study, where the transition is submitted with the mass privatization process and with the change in the ownership structure in industrial giants. This resulted with a great economic and social insecurity among the population. Increased unemployment caused the appearance of a so-called “spontaneous entrepreneurship” through massive formation of small and medium enterprises. Companies were established without a previous analysis of the environment, without a plan and strategy. Founders didn’t have a prior entrepreneurial knowledge so they acted intuitively, and as a result enterprises were faced with a high degree of failure. In this situation it is obvious that the key question is the situation of human resources, the level of knowledge and skill at their disposal, and the readiness to respond to new conditions.

## **2. DEVELOPMENT OF ENTREPRENEURSHIP AND CONSEQUENCES OF TRANSITION PROCESS**

Common for transition economies that are affected by a process of mass formation of small and medium enterprises is facing the problem of the unpreparedness of the social system for accepting and supporting this process. Usually problems arise around the unsatisfactory state of infrastructure, difficult access to finance, unfavorable tax policies, but special attention deserves the weakness of institutions and administrative and bureaucratic obstacles that appear as major inhibitors to the process of entrepreneurship. Those are the maladjusted legal regulations and long procedures that hamper the process, for example: the problem concerning the application of contractual rights, the ineffectiveness of the legal system, corruption, procedures for registration of enterprises, especially the complex procedures on closing them. Just as an example we specify the Republic of Macedonia on this issue, the analysis shows that despite the surpass transition process there are still unsurpassed interferences. The report of IFC-Doing business in 2010 shows that in the group of eight countries (Japan, Slovakia, Montenegro, Hungary, Bulgaria, Croatia, Macedonia and Czech Republic), Republic of Macedonia with 115 index is in the penultimate place because of the complexity of the procedure for the closure of enterprises, only the Czech Republic falls behind.

However, what this paper highlights is precisely the question of the adequacy of staff, a value that is missing in the overall process of development of entrepreneurship and economy. Speaking of staff we must point out that this problem is present in both cases: staff as owners/managers and employees within organizations/enterprises. With the first ones the lack of proper business education is evident. Very often it is present the opinion that with the completion of the regular school learning, upgrading and personal development ends as well. Such incomplete personnel don’t have the capacity to handle the challenges of the contemporary environment. Most of the instruments and opportunities that are provided by the institutions remain unused because of doubts caused by a lack of knowledge. Also the mass appearance of inseparability of the ownership functions from the management function. Usually the owner who has a general versus a specialized knowledge is the one who performs multiple functions: organizer, salesman, financial manager etc. and as a consequence of this serious difficulties arise in the conduct of enterprises in terms of lack of adequate planning, effective marketing, rapid and unplanned expansion and etc. On the other hand the problem of inadequate staff is the basic reason a good part of the estimated reforms to fail. This phenomenon is present because of the fact that the appropriate methods and techniques for selection of required personnel are rarely practiced. The selection and promotion of staff in organizations and expectations and abilities of staff need to correspond with the conditions of work and requirements which are imposed by the tasks. Studies on the field have shown that in the process of selection of staff and making the ultimate decision for employment are being avoided and still as an unsurpassed obstacle is the appearance of personal interests.

## **3. ANALYSIS OF INSTITUTIONS WHOSE MAIN FIELD OF WORK IS SUPPORTING ENTREPRENEURIAL ACTIVITIES IN EAST MACEDONIA**

Since the process of decentralization has been intensified (July 2005) local authorities were concerned with mobilizing local resources and reinforcing the economy (as a responsibility of the local government). Previous experiences show that in order to animate the entrepreneurial ideas and initiatives, the main key factor is the role of the local government their organization, hr factor, the will to face and deal with administrative bureaucratic procedures and obstacles as well as dedication on realization of local plans for development and entrepreneurial activities. Around 20 years ago, local governments were taken away the authorization of the economic functions connected to the



local economy development. The level of centralization of the finances in early transition years was relatively low (less than 2% of the net budget incomes were intended for the local governments. With the new territorial separation and fiscal decentralization there has been improvement of the condition, but what is considered to be a problem is the capacity for transformation of most of the municipalities in the Republic of Macedonia, especially East Macedonia. The local government in the East region doesn't have local ministry of economy that seriously affects entrepreneurial development, especially considering the fact that this local ministry of economy can follow the process of providing information for entrepreneurial analysis as well as reinforcing entrepreneurial initiatives and simplify the process of application. Other municipalities that include a local ministry of economy, are facing other problems, especially undeveloped HR strategies and low capacity of qualified workforce in the field of entrepreneurship and development of the local economy. The measures that have been undertaken from the local authorities in the central area of East Macedonia have resulted with few institutions (Table 1): The business incubator, Local Economy Development (LED) office and East Plan regional development Center.

Table 1: Summary of institutions that support entrepreneurial activities in the East Region of Macedonia.

Name of the institution	Business incubator	Local Economy Development LED office	East plan regional development Center
Number of employees	4	5 regional centers, 8 local offices (1 office 13 employees)	/
Type of service	technical, managerial, law and economy consultancy services, administrative services, possibility of using shared equipment and offers workspace for less price then the available commercial workspace	Developing and leading local economy policies, distributing information to small and medium enterprises (SME), organization of promotional activities, fairs etc.(for SME), creating and promoting programs for SME support, institutional support and active collaboration in a manner of developing local network for institutions that support SME and other consultancy activities related to SME.	Building up the capacity of networks in local and rural communities, business sector, stimulation the local and regional development, promoting and reinforcing the principles of public-private partnership etc.
Self financing	Since 2000	/	/
Weaknesses	Lack of qualified staff to provide services such as preparation of business plans, innovative ideas and new set of measures for motivating young entrepreneurs	Lack of qualified staff capable of conducting trainings to raise awareness of entrepreneurship, strategic approach and long term plan for development of SME sector	/

The main issue regarding the functionality of these formations is considered to be the usage of capacities and the nonexistence of long term action plans. It should be noted that the German Society for Technical Collaboration GTZ has been working in Macedonia since 1993. It works on behalf of the Federal Ministry for Economic Cooperation and Development (BMZ) in the areas of sustainable economic development and water. It's priority areas of work in Macedonia is economic reform and development of the market system and promotion of democracy and civil society. Particular emphasis is placed on cooperation beyond national boundaries, promoting an understanding between the various ethnic groups and strengthening decentralized structures. Cluster development initiatives are an important new direction in economic policy, building on earlier efforts in macroeconomic stabilization, privatization, market opening, and reducing the costs of doing business. Clusters also exist on the territory of Macedonia, especially the cluster for textile development, since the East Region of Macedonia especially the central area is considered as the center of textile industry in Macedonia.

In order to acquire information about the main obstacles for starting and developing business in the East region of Macedonia, with a special concentration on the central area, questionnaire was attained regarding 100 respondents and conducted in the central region of East Macedonia (the municipality of Shtip, 2010). Figure 1 shows that obtaining finances for opening a business is stated as the main obstacle for starting up a business. Figure 2 emphasizes the obstacles for constraining a business development, where working capital is stated as the main constraint.

Figure 1: Obstacles for starting a new business in East Macedonia (central region)

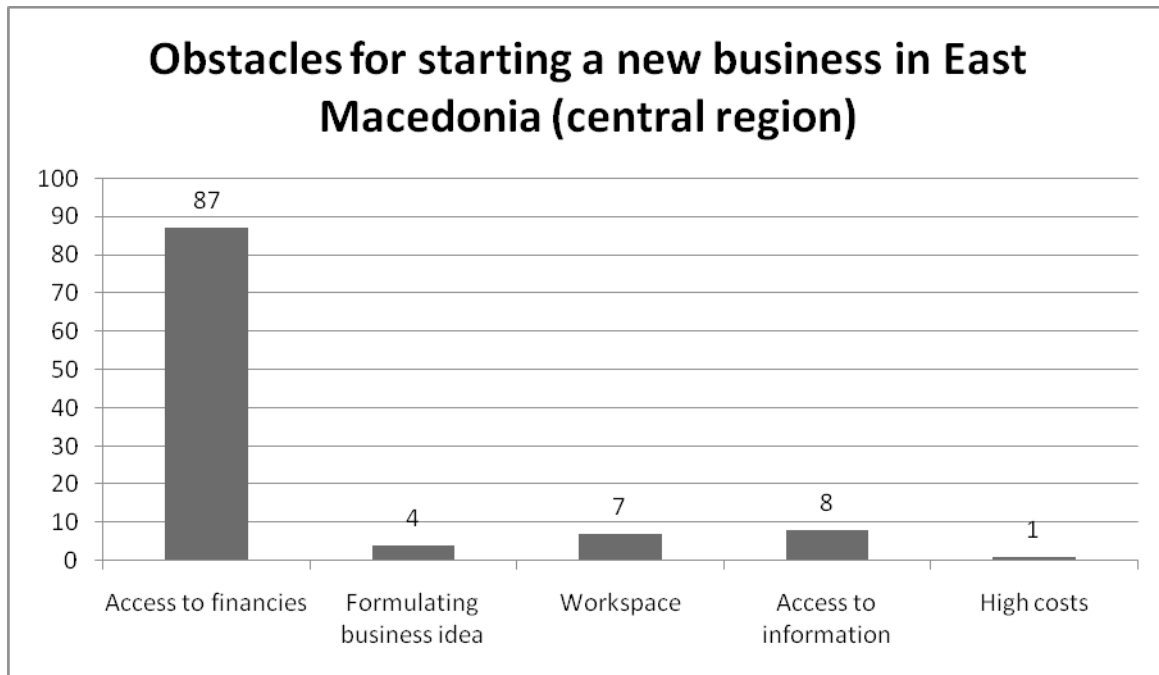
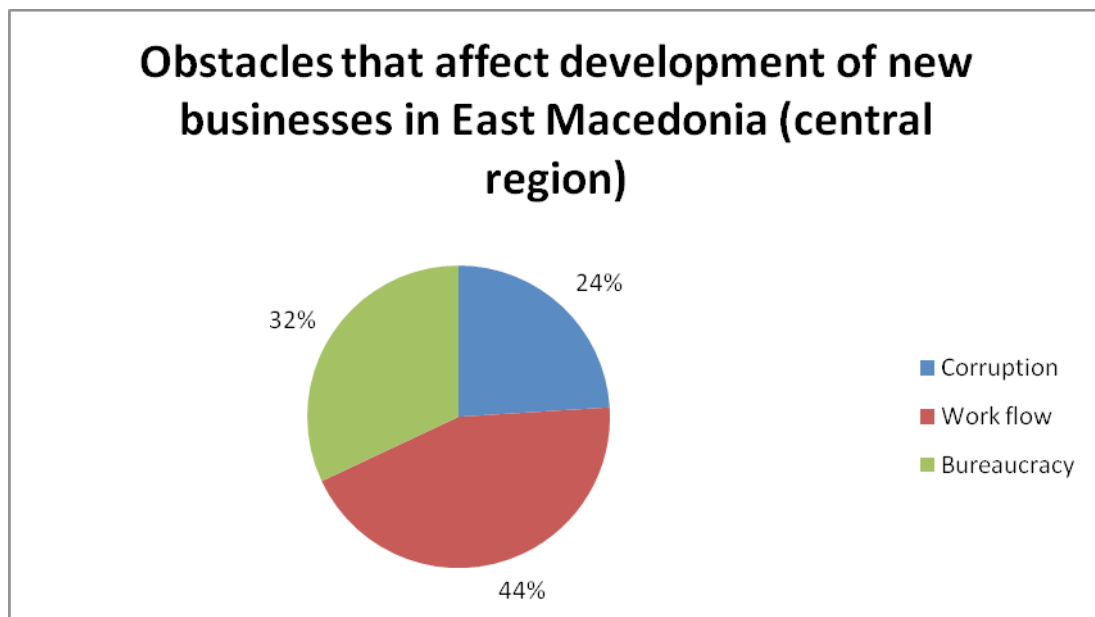


Figure 2: Obstacles that affect development of new businesses in East Macedonia (central region)



Access to information and formulating a business idea as stated previously are the main obstacles for starting up a business in the East region of Macedonia which can be eliminated by reinforcing the idea of creating a selection process for further employments. This will have an impact on the bureaucracy factors which are considered to be an obstacle for business development in the region. Both constraints can be included as a part of an HR strategy program for further development of institutions which support entrepreneurial ideas and activities.

#### 4. CURRENT SITUATION WITH THE HR FACTOR IN STATE AND PRIVATE ORGANIZATIONS IN EAST MACEDONIA

As previously mentioned, the inseparability of the ownership functions from the management functions determine the lack of adequate staff in organizations. The fast growing number of spontaneous entrepreneurs and short life organizations seems to be a trend that unfortunately has a significant effect on economic growth. One of the biggest operational challenges in establishing an organization is considered to be finding, hiring and retaining qualified workers.

Figure 4: What is the biggest operational challenge in managing a company?



The situation in Republic of Macedonia with the HR factor can be previewed from our research made in 39 state and private organizations (219 employees) where 46% of the organizations are public organizations (100 employees out of 219). Most of the employees are part of public organizations that count 51-250 employees (36%). Only 4 employees come from public organizations that count less than 10 employees. Among the factors that were examined in the research, the most contributive information arises from the questions which apply directly to selecting and retaining qualified workers in organizations, work motivation, defining work specifications as well as directions for better organizational climate and better employee performance. Causes which decrease work performance initiate lack of motivation towards achieving organizational goals and as such need to be examined carefully and concretely. They are the ones that can be used for further indicators for completing a work evaluation process. If we consider human's need for achieving personal goals and combine them with achieving organizational goals in order to provide existence, employees are constantly seeking for higher salary, better working conditions, etc. Vroom rejects the idea that people have fixed set of needs and is trying to take in consideration human's variability and complexity. Retaining employees is a part of a motivational system that needs to be implemented into the organization. This system provides working conditions and employees are motivated to stay on their current job positions and be productive. Every human being has their own personal goals and their motivation for work arises when they are facing different expectations which are connected with these goals. So far as a most used selection method are the personal interview and the resume (CV), but very often they are performed incompetently, improvised and the results obtained from them are not used as the basic for making the final decision. Therefore, state organizations are facing a serious issue of lack of work motivation caused by problems that occur at work, where employees that are not qualified and have lack of experience in the specified field are dealing with high level of stress at work because they can't complete the specifically given tasks. On the other hand, private organizations have a different approach to the process of selection, since their funds are limited and nongovernmental, the selection process is stricter, usually the job specifications are given in the work application and candidates are facing series of tests in order to be chosen for the specific job position. If we compare both state and private organization with specific concentration on motivation towards achieving organizational goals, we can make a conclusion that the motivational level is not the highest but it is satisfactory and requires further work especially in creating strategy for increasing work motivation.

Motivation towards achieving organizational goals in state organizations vs. private organizations.

- Not motivated at all – (13% for state organizations vs. 10% for private organizations);
- Not motivated – (15% for state organizations vs. 16% for private organizations);
- Motivated enough – (62% for state organizations vs. 57% for private organizations);
- Completely motivated – (10% for state organizations vs. 17% for private organizations).

Precisely defined job specifications are closely connected to work quality. When one organization is facing low quality of job specifications and work expectations, the level of employee motivation decreases because employees are facing an issue of working without knowing what the employer is expecting from them. The situation in the Republic of Macedonia concerning the existence of programs for retaining employees in public organizations is on a satisfactory level (56% of the employees answered that their organizations have a program for retaining and encouraging qualified workers to stay on the current job positions, even 6% have been offered a higher hierarchy job position). Employees also consider their work activities well defined (60% of the employees answered that their job specification is on a high level - position 3 out of 4 where 4 is the highest grade). Another challenge that entrepreneurs are facing now is dynamic business environment. In this competitive business environment, customers need requirements, technology, government rules and regulation, product life cycle, financial market, economy and politics. As entrepreneurs are the most important variables in the business, institutions for entrepreneurial support should understand them and react to fulfill what they expect constantly. Entrepreneurs are becoming more demanding and are constantly seeking for answers and support from the government and institutions that support entrepreneurship. Despite entrepreneurs which have to be able to adapt to the changes, also institutions that support entrepreneurship should prepare for this issue. Many of these institutions have been established in the past 10 years, there was a fast growing number of training bodies, consultancy institutions, commercials about institutions that support entrepreneurship etc. East Macedonia, comparing to the other territory, has a lack of functioning institutions for entrepreneurial support. Entrepreneurs have to be warned about the obstacles and factors that might jeopardize their growth. Institutions need to take measures concerning job restructuring and setting goals according to their institution's needs as part of motivational work strategies.

## 5. CONCLUSION

The Republic of Macedonia principally seeks to develop the entrepreneurship and to adjust the flow of the contemporary economics. Many political measures have been undertaken to facilitate the development of small and medium enterprises, numerous strategies and programs have been brought for the development of entrepreneurship and SME sector, institutions have been established precisely to support this sector and so on. However, a good part of the results of the reform do not correspond with the expected, and established institutions (agencies, centers and offices for local development, etc.) stagnate on the initial level, instead of stimulating the environment, the development of entrepreneurship and SME sector. This situation is precisely because of the inadequate staff that does not possess the required capacity. Current government policies in the Republic of Macedonia considering the condition of the human resources predicts reforms so-called a new model for HR managing in the area of public administration. This model predicts 4 levels of career (level A, level B, level C and level D) and retains professional development and work assessment. The promotion is done so that the employee is evaluated every year. Usually the condition for promotion requires 3 years of work, but early promotion can be done after 2 years of work. If the grades were positive in the last two years, the employee can be promoted in the next level. The promotion is followed by higher salary for every level of career: level A (5%); level B (10%); level C (15%) and level D (20%).

In the moment this model is used only for promotion of public administration employees, but considering the fact it has on work motivation, our recommendation is to be used in other organizations, institutions and companies. Because institutions for entrepreneurial support include minimum number of employees, this model will have restricted use especially considering the vertical rotation of employee on hierarchy level, which in this case is impossible. As our research conducted in the center of the East region of the Republic of Macedonia, in the future these institutions need to improve their employee selection processes. This involves usage of stricter methods for employee selection that will guarantee a needed working capacity.

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## THE LEGAL FRAMEWORK AND ITS INFLUENCE ON THE SCOPE AND THE STRUCTURE OF THE FDIS – THE CASE OF THE R. OF MACEDONIA

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### Abstract

The Foreign Direct Investments (FDI) is a form of venture capital which provides the foreign investor acquiring rights to ownership, control and management on the basis of invested capital. The experience has undoubtedly affirms the fact that FDI is one of the fundamentals that enables and accelerates the economic development of a national economy. Among other things, each national economy must have adequate legislation that will enable smooth attracting of foreign capital.

The core motivation for conducting this research paper is analysis of the changes in legislation and their impact on the scope and structure of the FDI in the Republic of Macedonia during the last decade.

The crucial aim of the paper is to look upon the legal aspects for attracting the FDI. However, to some extent the paper covers the institutional mechanisms that profiled the framework for doing business.

The subject of the research are the laws that regulate this area, also the laws related to the fiscal sector, foreign trade, foreign exchange operations, the area of labor relations, etc..

The results of research done lead to the conclusion that the legal framework, as a significant factor of the business environment in a country, has a very strong influence on the intensity and the structure of the FDI in the Republic of Macedonia. Over the last decade Republic of Macedonia has achieved significant results in this field, but there is a need for further improvement of the relevant legislation yet. This is more important considering the insufficient volume of FDI.

**Keywords:** Foreign Direct Investments (FDI), Legal Framework, Republic of Macedonia.

### 1. INTRODUCTION

The Foreign Direct Investment (FDI) represents such form of investment of capital which obtains the foreign investor gaining of right to ownership, control and management on basis of the invested capital. According to the definition of the International Monetary Fund the foreign direct investments are investments which aim is to gain permanent interest in the enterprises, which operate out of the investor's country and by that the essential intention of the investor is to enable and achieve effective management with the enterprise where he invests in (Kapor, 2007, p. 9). This is connected to certain minimal share in the ownership capital (equity) in the company (most frequently 10%) so as this investment to be able to be treated as foreign direct investment and which enables effective participation in the management. It is similar definition of OECD according to which a company with foreign direct investment is such company where one investor owns 10% or more of the regular shares or votes of an enterprise, or a company where the foreign investor owns less than 10% of common shares or votes but still there is possibility effectively to influence on the company management (Kapor, 2007, p. 9).

The main holders of the foreign direct investments are the international corporations. Besides their basic interest recognized in profit maximizing and expanding the capital for their owners, the international corporations realize other strategic goals, such as expanding the volume of their economic operations based on new resources, securing more market opportunities and realizing more efficient production and more competitiveness (Kapor, 2007, p. 10).

From the other side the basic motive for attraction of foreign direct investments for each country is securing means which are missing for work and development that enables realization of projects and programs in conditions when own means are not sufficient (domestic savings/accumulation) or when

the conditions for its engagement are inconvenient. It is obvious that on the macro level, with the help of FDI one country could stabilize and make sustainable the balance of payments, but also it could improve the conditions on the domestic market, it could decrease the level of unemployment, and the last but not least, to transfer a technology and know-how. All of the previous has its positive impact on the economic growth.

The economy of the R. of Macedonia which at the beginning of the 1990s to the beginning of the new millennium passed through the process of transition, has been transferring into market oriented economy and the investor's interest is increased for it from all over the world. Namely, the national treatment of the foreign investors, the protection of the ownership, the stabile legal and business surrounding influence the economic and before all the political stabilization of Republic of Macedonia, which represents a basic precondition for the increase of investors' interest. The improvement of the investment climate the capable and qualified labor, the fertile tax policy transformed into lowest tax rates in Europe, influences the investors to take into consideration Macedonia as a potential country for investments of their capital.

The legal system in Macedonia has been constantly improved in the direction of continuous encouragement and support of the economic progress of the country, the globalization flows and the political development. It is significant to mention the adjustment of the domestic legislature towards the legislature of EU, which goes according to the confirmed dynamics of Macedonia with the Agreement for stabilization and association. That means that many legal decisions are closer or identical to the corresponding in the developed European countries. In the passed period there has been implemented regulatory guillotine, which enabled confirmation of the boundaries and the drawbacks which influenced the management procedures connected to the realization of the necessary steps for investments and the development of entrepreneurship in Macedonia. After statements, the observations and findings from the made guillotines the government of the R. of Macedonia took steps for the removal of the boundaries and drawbacks which resulted with the increase of the efficiency and the effectiveness of the management procedures. In that direction many of the Government measurements are in the direction of faster realization of the business plans and project of the investors. The tax policy, the human potential, the enforcement of the service, obtaining process as well the simplification of the management procedures, but also the development in the field of the protection of intellectual and industrial property, they all are considered as advantages in the direction of attraction of investments and also taking into consideration that such parameters and fields are most frequently the crucial preconditions for entrance of foreign investors in one country.

Aware for the importance of the multilateral and bilateral agreements that R. of Macedonia has concluded which from their own side refer to the field of investments, an attempt has been made all of them to be covered in this paper. It is certainly important because in that way the investor can clearly notice whether the country he comes from has signed an agreement for avoidance of double taxation, agreement for free trading or an agreement for support and mutual investments protection in the R. of Macedonia.

## 2. CONSTITUTIONAL BASIS FOR FDI

With the independence and the adoption of the Constitution in November 1991 R. of Macedonia found the constitutional legal frames for the new social order and establishment of new economic system. The obvious intention for establishing of an economy based on market principles, it was firstly easy confirmed as one of the basic values planned in the constitution of the R. of Macedonia defined as "freedom on market and the entrepreneurship". Further, the Constitution additionally confirmed the market principles on which new economic regulations are based, planning guarantees and limitations of the same. Namely, according to the Constitution the freedom of market and the entrepreneurship is guaranteed. The Government supplies equal legal status of all subjects on the market. The Government takes measures against the monopolistic status and the monopolistic behavior on the market. Freedom of the market and the entrepreneurship can be limited with law solely for defense of the country, environmental and nature protection, or people's health.

Having in mind the capacities of the national economy and the economic subjects in Macedonia the Constitution additionally gives support for entrance of foreign investors through the guarantee of the safety for taking (export) of the invested equity and the equity that they invested in Macedonia. That is in Article 59 and it has been planned to foreign investors the right of free export and the invested equity and gain are guaranteed. The right gained on bases of the invested capital cannot be reduced by law or other provision.

### 3. LEGAL FRAMEWORK FOR FDI

The most significant fields for the foreign direct investments are represented in one common cycle starting from: registration of the business, employing adequate labor, starting with the business, tax burdening, agreement, obligations for trading, reinvestment, protection of the investors, and closing of the business.

Initiation of business - This part covers the possibilities for registration of a commercial company and the most important fields that could be the subject of interest for the investors such as the concessions and public-private partnership, mineral raw materials, energetic, commerce with securities, funds, stock markets etc. So, this part covers all that is important before the beginning of the business. When initiating a business in R. of Macedonia, there are several key institutions. Namely, the authorized institution for initial registration of the business is the Central register where for only four hours and without the necessity for initial capital, one could open the several types of commercial companies: trader-individual, public commercial company, company with limited liability - DOO, company with limited liability of one person - DOOEL, joint stock company, limited company and limited company with stocks. In the frames of the Central register, technical offices are formed as well which prepare the overall documentation for initiation of a company, which additionally reduces the expenses and the time necessary for registration of a company. To the investors it is on their disposal the Agency of foreign investments of the R. of Macedonia in any phase of the investment process. For the necessities of the entrepreneurs and the support of their business, the Agency for the support of the entrepreneurship of the R. of Macedonia has been formed. The commission for securities is liable for efficient and legal functioning of the market of long term securities and protection of investors' rights. This institution is liable for implementation of The Law on securities, The Law on investment funds and the Law for taking over of the joint stock companies.

The key laws for initiation of business in the Republic of Macedonia are: Law on commercial companies (28/2004, 84/05, 25/2007; 87/2008), Law on single desk system, and leading of commercial register and the register of legal entities (84/2005, 150/2007; 140/2008), Law on Central register (50/2001, 49/03, 109/05, 88/2008), Law on concession and other types of public-private partnership (7/2008; 139/2008), Law on mineral raw materials (24/2007, 88/2008, 52/2009), Law on energetic (63/2006, 36/2007, 106/2008), Law on securities (95/2005, 25/2007, 7/2008), Law on the investment funds (9/2000, 29/2007, 12/2009), Law on foreign exchange operations (34/2001, 81/2008), Law for establishment of Foreign Investments Agency of the R. of Macedonia (37/2004, 81/2008), The Law on establishment of Entrepreneurship Agency of the R. of Macedonia (60/2003), etc.

Labor/employment - Qualification of the labor, the legal provisions of this sphere are certainly in the focus of investors' attention because without workers it is impossible to enter in serious investments. In this area the most important laws and provisions have been covered that are interesting for the investors. In the employment part the provisions are covered that regulate the labor market. The most important state institution of this sphere is the Employment agency which frameworks cover the procedure for registration of employed people which is simplified with shortening of terms, reduction of benefits and the documentation that is asked from the companies. Still, the biggest news represents the introduction of system for contracting the calculation and payment of gross salary of workers since January 2009. Simultaneously as a compositional part of this system is the integrated payment of all social transfers and the personal income tax by the Department of Public Incomes. With the adoption of the Law for peaceful solution of the labor lawsuits (87/2007) out of court procedure through mediation by which the terms of the procedures themselves are shortened, the expenses have been reduced and the workers are returned on the labor market faster. Regarding the employment procedures the most important laws are as follow: Law on labor relations (62/2005, 106/2008, 161/2008), Law on compulsory contributions from the social insurance (142/2008), Law for peaceful mediation of labor lawsuits (87/2007), Law on employment and work of foreigners (70/2007, 5/2009), Law on pension and disable insurance (80/1993, 153/2007, 152/2008, 161/2009), Law on initiation of employment (62/2006), Law on disable persons (87/2005, 88/2008, 161/2009), Law on employment and insurance in case of unemployment (37/1997, 102/2008, 161/2009), Law on agencies for temporary employments (49/2006), etc.

Initiation of business/work. At the start of its business, each investor is interested for the possibilities of crediting and financing of business plans, obtaining of different permits and licenses, the obligations that result from taking account for the environment, different advantages that technological industrial zones offer and certainly the ownership relations as fundament of the civilization. The releasing of the procedures for business initiation is just the first pillar of the regulation reforms that are implemented in Macedonia. In that direction with the project regulation guillotine, hundreds of laws have been

simplified and their sub legal acts and the obtaining of licenses and permits for business running is released and cheaper. Also, the introduction of the rule “the silence is an approval” represents a powerful instrument for pressure towards the administration to reply on the citizens’ requests and businessmen in the prescribed term, because on the contrary it will be considered that the answer is positive.

The documentation and the terms for obtaining licenses and permits is considerably reduced with new changes of the Law on construction land and the Law for construction. The procedures for construction permits are simplified but also the foreign legal and physical entities will be able to gain the ownership on construction land.

The fees and compensations at the land registry office, the Customs and the Bureau of meteorology are reduced. With the new Law on Banks which enabled departments of well known foreign banks in Macedonia to be opened and by that the approach to capital necessary for financing of new investments projects is released.

The credit registers in the frameworks of the Central (National) bank is additionally upgraded and there is a procedure at the moment for foundation of new investment projects.

In order to achieve larger efficiency in the registration of the ownership rights and its overall functionality and digitalization to the end of 2008, large reforms are taken over the Land registry department. With the strengthening of human resources and introduction of ITC technology, the process and the work procedures of the land registry have been improved.

For business initiation it is essential to emphasize the laws that refer to the possibilities for crediting, ownership, the environmental protection and certainly the free economic zones. Also, connected to credits there should be mentioned: Law on banks (67/2007), Leasing law (4/2002, 49/2003, 88/2008) and the Law on contractual pledge (5/2003). For the ownership regulation the most important are the following: Law on ownership and other property rights (18/2001, 92/2008), Law on land registry of real estates (40/2008), Construction law (51/2005, 82/2008), Law on construction land (82/2008, 143/2008) and Law on privatization and rent of construction land in state ownership (4/2005, 13/2007, 165/2008).

During the last 10-15 years, the environmental protection has been gaining more and more importance for the business running. From the point of view of the investor the most important are the following laws: Law for the environment (53/2005, 24/2007), Law on nature protection (67/2004, 84/2007), and Law for waste management (68/2004, 107/2007, 102/2008, 143/2009). The free economic zones are regulated by the Law for technological industrial zones (14/2007, 103/2008, 130/2008).

The tax burden is maybe the most essential part in the investment decision, but also during the period of business running. That is why, the most important legal decisions in the area of taxes have been covered as well as the contracts for avoidance of double taxation in Macedonia that it ratified with other countries. The laws in this area confirm the most important tax burden which would be interesting for the investors. In that direction the implementation of policy for larger economic freedom of business flat rate income tax has been introduced and flat rate personal income tax which rates are only 10% and by that Macedonia has the lowest package of taxes in Europe. It is essential to emphasize that the reinvested income is completely exempted from taxation. In that area there should be taken into consideration: Law on income tax (74/2006, 160/2007), Law on personal income tax (74/2006, 160/2007), Law on value added tax (44/1999, 114/2007, 103/2008), Law on property taxes (61/2004, 102/2008), Law on the amount of default interest rate (65/1992), Law on communal fees (61/2004; 92/2007), etc.

When taxes are in question it is important to mention that in the frames of the Department of Public Incomes separate offices have been established for small and medium sized companies and by that an attempt has been made for adjustment and releasing of the administration procedures for tax payments of this type as tax payers. Large tax payers can send by Internet tax forms and opinions to the office for large tax payers and by that the processing has been considerably fastened and also the time for tax payment.

The contract for avoidance of double taxation promotes the economic cooperation between the R. of Macedonia and other countries especially in the domain of stock exchange, services and common investments and by that stimulation and intensifying of the economic financial relations between the countries is enabled. The R. of Macedonia has ratified 30 contracts for avoidance of double taxation, generally with these contracts the avoidance of double taxation of the resident of one or the other country has been regulated referring to income taxes (personal income tax and income



tax) and property tax. In that way the residents of one state gains the same tax treatment in the other state. Correspondingly, the rights of the state are regulated where there are cases which will make the taxation and which will not, as well as which state is entitled to make payment of certain tax obligation. Also, with the contracts the dividends, interests and the incomes of copyrights are also treated and etc. R. of Macedonia has concluded contracts for avoidance of double taxation with the followings states: Croatia 17/95, Turkey 45/95, Poland 17/97, Italy 34/97, China 49/97, Russia 7/98, Albania 16/98, Sweden 21/98, Ukraine 21/98, Slovenia 31/98, Netherlands 13/99, Bulgaria 23/99, France 23/99, Taiwan 44/99, Egypt 7/2000, Denmark 48/2000, Switzerland 55/2000, Romania 7/2002, Czech Republic 7/2002, Iran 7/2002, Finland 7/2002, Hungary 12/2002, Belorussia 96/2005, Spain 96/2005, Moldavia 130/2006, United Kingdom and Northern Ireland 47/2007, Latvia 47/2007, Germany 86/2007 and Austria 152/2007.

Contractual obligations/commercial conditions. When the investor runs its business in Macedonia it is of exceptional importance the fields such as commerce, export/import, customs, contractual relations, the freedom on market and the completion as well the contract of free commerce with EU and other states that is, all areas that influence the running of business commerce and obligation relations. These fields are regulated by the Law on commerce (15/2004, 129/2006 и 63/2007, 88/2008), the Law on e-trade / e-commerce (133/2007), Law on competition protection (4/2005, 70/2006, 22/2007), Law on taking over of joint stocks companies (4/2002, 36/2007), Law on customers protection (38/2004, 77/2007, 103/2008), Law on customs (39/2005), etc.

Sufficient improvement has been reached in the releasing of the export and import. Namely at the Customs procedures for goods transit more efficiently and faster are implemented. With the introduction of single desk system the procedures have been considerably shortened as well as the documents which are necessary at export import. R. of Macedonia has concluded three multilateral contracts for free market The Stabilization and association agreement, EFTA and CEFTA<sup>1</sup>. Also it has concluded bilateral contracts for free trading with Turkey and Ukraine.

Reinvestment is the area of exceptional importance for Macedonia because the gained capital of the investor is essential to be invested here and that purpose large tax relives and advantages are on his disposal. In the part of investment and reinvestment the Government offers special advantages, planned as tax relives that are through supportive tax policy in the part of reinvestment. By exempt that is the reduction of tax rates the investors and the businessmen can reinvest their income that they earned in Macedonia. The provisions that support the reinvestment are mainly included in the Law on value added tax (44/1999, 114/2007, 103/2008), the Law on income tax (27/2006, 159/2008), the Law on personal income tax (74/2006, 160/2007, 159/2009) etc.

Protection of investors. Wide spectrum of legal regulations manage this material which includes the contracts for investments protection as well. For the protection of the investors' rights and improvement of cooperative operating, the Law on commercial companies is fully applied. At the same time, the Commission of securities adopted new sub legal acts by which the provisions for information announcement of joint stock companies have been strengthen and measures have been introduced by which it is sanctioned the use of inside information. Special attention has been dedicated to the protection of the minority share holders, who in the past used to be blackmailed and interrupted freely to operate with their capital. Regarding the foreign investors the legislature in Macedonia guarantees free transfer and repartition of capital and income.

In order to avoid double taxation and large mutual protection of investments bilateral contracts have been concluded to guarantee the same. Namely, the contracts for support and mutual protection of investments are concluded in order to attract foreign investments and in the frames of efforts and

1 With the Stabilization and association agreement, the R. of Macedonia took over the obligations for liberalization of the market with the European union, signing of contracts for free trading with states from the region and etc. With joining to EFTA asymmetrical approach in the commercial running has been secured with the industrial and the agricultural nutrition products on behalf of the R. of Macedonia. By that the Macedonian industrial products are exported freely without customs on EFTA states markets for the necessities of 12 million people. The Central European contract for free trading (CEFTA 2006) represents important step in the efforts for economic integration of the countries from the South East Europe (region) From the economic aspect the increase that is the possibility for creation of a single zone for free trading will be especially acceptable for the countries with small sized market such as Macedonia. This contract beside the liberalization of the stock commerce for the first time opens space for increased cooperation between its members and in the following areas: services, trading, public supplies, investments, and protection of the intellectual property.



activities of the Government for promotion of the cooperation with other countries.<sup>2</sup>

In 2006 Law on International commercial arbitration has been adopted securing that all foreign arbitration decisions are under direct authority of the Arbitrage court. Also the Republic of Macedonia has signed and ratified the New York convention for recognition and execution of foreign arbitration decisions (1958) and Washington convention for solution of investment lawsuits between the states and the citizens of others state (ICSID, 1965). In this field key are: Law on International Commercial Arbitrage (39/2006), Law on Industrial Ownership (47/2002, 42/2003, 9/2004, 39/2006 и 79/2007), Law on Commercial companies (28/2004, 84/05, 25/2007, 87/2008), Criminal law (19/2004, 7/2008) and the Law on Corruption Prevention (28/2002, 126/2006).

In this part laws are also included which cover the inspection, surveillance, the Law on Labor Inspection (35/97), Law on Department of Public Incomes (81/2005), Law on Living Environment (53/2005, 24/2007), Law on Food Safety, Products and Materials that are in contact with the food (54/2002, 84/2007), Law on Market Inspectorate (24/2007), Law on Sanitary and Health Inspection (71/2006), Law on Construction (51/2005, 82/2008).

**Closing of a business** The bankruptcy and the liquidation, the duration and the way of leading of these procedures are of essential importance for the investors and they circle this process. The financial means and the time that is necessary for liquidation or closing of a commercial company mainly represent the essential elements referring to this field. Namely, when talking of the Republic of Macedonia and the procedures for closing of a business, the Law on bankruptcy (34,2006,126/2006 and 84/2007) allows cheaper and faster implementation of the bankruptcy procedures in average of nine months.

#### 4. ECONOMIC PRECONDITIONS FOR THE FDI

Economic performances in the Republic of Macedonia are manifested through the stable growth of GDP which is about 4-5%, the low inflation rate the average of which is 2-3%, the fiscal discipline confirmed by the international financial institutions as well as the coordination between the fiscal and the monetary policy.

Table 1 – Main economic indicators for the R. of Macedonia 2004-2008

	2004	2005	2006	2007	2008
Real growth of GDP (%)	4.1	4.1	4.0	5.9	5.0
Inflation on annual basis (%)	- 0.4	0.5	3.2	2.3	8.3
Central Budget Deficit (as a % of GDP)	0.0	0.2	-0.5	0.6	-1.0
The extent to which the export covers the import (%)	57.2	63.2	63.8	64.2	58.1

Source: State Statistical office and Central Bank of the R. of Macedonia.

With the appropriate legislation, the Republic of Macedonia undertook economic reforms, and by doing so it offered the most attractive tax package in Europe. Namely, the income (profit) tax rates and the personal income tax are 10% (the profit tax was decreased for 15% and the personal income tax was decreased for 15%, 18% and 24%). Regarding the value added tax, the general tax rate is 18% whereas the preferential/privileged tax rate is 5% (including computer software and hardware, food etc.).

The property tax rate amounts 0.1-0.2% and the inheritance tax is in the range between 2-3% for the tax payers that are second in the row of inheritance and 4-5% for the tax payer who is third in the row of inheritance or the one who is not in any relation with the person leaving the inheritance. For the purpose of stimulating additional foreign and domestic investments, the corporate tax on undistributed profit is 0%.

2 Normally these types of contracts are signed in the direction of legal protection of the investments made by the investors of one country on the territory of the other one. In that direction Macedonia and the other countries signatory are obliged that the investments made by the investors by the other contractual side to be able to have treatment which will not be worse than the treatment that is given to the investment of the domestic investors. By this contract normally regulated the way of decision of the eventual made lawsuits between an investor and the contractual side or lawsuits between two contractual sides. The Republic of Macedonia has concluded such types of contracts with the Republic of Croatia (17/95), Republic of Turkey 5/97, Republic of Slovenia 55/96, the former United Republic of Yugoslavia 69/96, FR of Germany 8/97, Switzerland 8/97, Poland 17/97, Italy 34/97, People's Republic of China 49/97, Russian Federation 7/98, Malaysia 7/99, Albania 15/98, Democratic People's Republic of Korea 15/98, France 16/98, Ukraine 21/98, Kingdom of Sweden 31/98, Kingdom of Netherland 13/99, Kingdom of Belgium 23/99, Bulgaria 23/99, Republic of China 44/99, Romania 7/02, Finland 7/02, Bosnia and Herzegovina 7/02, Austria 7/02, Hungary 12/02, Czech Republic 7/02, Kingdom of Spain 110/05.

The introduction of the flat rate tax was made for the purpose of simplifying the tax system which is expected to further stimulate the successful companies to improve their operation and to increase their profitability. The intention is to also make the companies use the money they «saved» from taxes for the purpose of increasing their competitiveness. The flat rate system enables having transparent and efficient administrative procedures, simple calculation and fast filling in of the tax forms.

Special tax relief is offered to companies that operate in technological industrial development zones. This covers relief from both profit tax and personal income tax payment during the first 10 years. Each company is relieved from paying the undistributed profit tax.

Companies can pay tax via Internet, and this saves their time and money.

There are no restrictions on transfer accounts i.e. on the current account payments. The profit and the dividends from the investments can freely be transferred abroad, after the payment of corporate profit tax.

There are no regulatory restrictions for foreign direct investments made by non-residents in the Republic of Macedonia. Credit transactions between residents and non-residents can freely be made as long as they are registered in the Central Bank. Certain legal entities that operate abroad can hold their deposits in foreign banks, only if being given permission for this by the Central Bank. Non-residents are free to open non-resident accounts in Macedonian banks. The Law on foreign exchange operations enables liberal regime regarding capital transactions, to a great extent.

According to legislation, foreign companies and foreign citizens may own construction land in the Republic of Macedonia. Construction site is offered with public tender procedure.<sup>1</sup>

The Republic of Macedonia introduced one-counter system that enables investors to register their business in 4 hours. An individual can register a company by visiting one office, getting information at one place and engaging only one administration officer. This significantly reduces the administrative barriers and the business start-up costs. Decrease was made of the pension and health insurance. According to the above mentioned, and according to the Doing Business Report 2010 of the World Bank, the Republic of Macedonia was ranked third among the ten top reformers for year 2008/2009. In addition, out of 183 economies, Macedonia was ranked as 32<sup>nd</sup> on the list “Ease of Doing Business”.

## 5. FDI IN THE R. OF MACEDONIA FOR THE PERIOD 2003-2008

In this paper, foreign direct investments are investments of legal and physical entities from abroad in business entities in the Republic of Macedonia, which results in establishing mutual long-term interest where the foreign investor owns at least 10% of the total value of the business entity.

Table 2 - FDI according to the economic sectors, 2003-2008, in 000 US\$

Operations/Years	2003	2004	2005	2006	2007	2008
Agriculture, hunting, forestry	1 260	1 559	2 892	900	3 040	4 632
Mine and stone extraction	5	4 401	26 581	20 035	13 272	10 237
Processing industry	35 936	38 586	53 989	50 498	72 982	66 504
Electricity, gas and water supply	3	0	22	225 962	67 870	35 906
Construction	60	6 284	2 413	3 349	16 168	21 405
Wholesale and retail	7 096	13 228	7 967	13 263	14 816	31 048
Hotels and restaurants	21	22	2 763	5 233	11 500	10 130
Traffic, storage and connections	869	65 996	741	4 471	14 675	14 301
Financial mediations	19 180	7 707	12 784	8 140	107 190	146 637
Operations regarding real estate, renting and business activities	13 423	1 531	3 612	14 178	8 051	12 275
Public usage and defense, compulsory social care	0	0	1 905	323	0	0
Education	2 761	3	10	17	21	27
Health and social affairs	0	7	92	1 083	0	11
Other communal, general and personal services	29	136	397	3 213	1 217	3 281
Total	80 643	139 460	116 168	350 665	330 802	356 394

Source: State Statistical office of the R. of Macedonia.

<sup>1</sup> The minimum price offer is determined on the part of the Ministry of Transport and Communications, in compliance with the Construction Land Price Determination Methodology.

According to the business activity (economic sector) the investment was made in, during the analyzed period of time, years 2003-2008, foreign direct investments in the Republic of Macedonia total 1374.1 million US dollars. The most of FDI were made in 2008 being 28.9%, and the least in 2003 being 80.6 million US dollars or 5.8%.

Foreign direct investments in 2008 compared to those in 2007 increased for 25.6 million US dollars. Compared to 2003, FDI in 2008 increased for 275.7 million US dollars which is four times more (441.9%).

In terms of business activities, the greatest value FDI has in processing industry (44.5% of the total FDI), in 2004 in traffic, storage and connections (47.3% of the total FDI), in 2005 again the greatest value FDI has in processing industry (46.4% of the total FDI for that year), and in 2006 it was in the electricity, gas and water supply (64.4% of the total FDI for that year). Over the last years of the analyzed period, 2007 and 2008, and compared with the other business activities, the value of FDI was considerably at its highest in the financial mediations i.e. in 2007 32.4% of the total FDI for that year, and in 2008 41.1%. Compared to 2003, in this business activity FDI increased for 560% in 2007 i.e. 764% in 2008.

Seen per years, FDI in 2004 are higher for 58.8 million dollars than those in 2003, and in 2005 compared to 2004 they are lower for 23.3 million dollars; in 2006 compared to 2005 there was an increase for 235 million dollars and in the period between 2007 and 2006 there was again decrease for 19.9 million dollars. In 2008 there was an increase for 25.6 million dollars compared to 2007.

Table 3 - Financial results from the business running of the companies with FDI according to economic sectors 2003-2008, in millions of denars

Economic sectors	2003	2004	2005	2006	2007	2008
Agriculture, hunting, forestry	- 29	25	36	75	52	53
Mine and stone extraction	231	189	202	218	345	389
Processing industry	- 553	- 331	102	1 570	2 451	3 102
Electricity, gas and water supply	0	0	- 2	-	- 6	11
Construction	231	19	0	36	- 43	- 45
Wholesale and retail	44	512	154	1 027	1 284	1 435
Hotels and restaurants	20	- 70	- 61	- 38	583	641
Traffic, storage and connections	2 604	502	3 418	1 470	5 925	7 586
Financial mediations	173	76	651	5 445	4 196	4 736
Operations regarding real estate, renting and business activities	- 263	458	79	25	250	270
Public usage and defense, compulsory social care	0	0	- 58	0	0	51
Education	0	119	153	206	212	202
Health and social affairs	0	- 1	- 40	- 10	7	5
Other communal, general and personal services	- 3	1	31	4	8	8
Total profit/loss	2 455	1 499	4 665	10 028	15 264	17 844

Source: State Statistical office of the R. of Macedonia.

When it comes to financial results of the business entities operations with FDI, per business activity, for the period 2003-2008, the total of FDI was 51,755 million denars. In 2008, there was a total profit higher for 2,580 million denars compared to year 2007, and when compared to year 2003, the total profit in 2008 was higher for 15,389 million denars i.e. it became seven times bigger (726.8%).

In the period 2003-2008, analyzed by business activity, there are positive financial results in the following activities traffic, storage and connections, financial mediations, processing industry, mine and stone extraction, wholesale and retail, operations regarding real estate, renting and business activities, education, other communal, general and personal services, agriculture, hunting and forestry.

Per years, in 2004, the biggest profit was made in wholesale and retail, and in 2006 in financial mediations. However, the question is to which extent is this fact factual valid to be used for any analysis if it is considered that in year 2006 there is no data about the total profit/loss in the sector of electricity, gas and water supply, although it was then when highest FDI were being made. In the rest of the years (2003, 2005, 2007 и 2008) the biggest profit was made in the sector of traffic, storage and connections which can lead to the conclusion that that business activity shows the highest level

of profit rate for the analyzed period of time.

What is interesting is the analysis of the business sector hotels and restaurants which in 2003 presented a profit of 20 million denars, whereas in 2004, 2005 and 2006 it had a loss. However, beginning from 2007, this business sector makes rapid profit growth. Namely in 2006 the loss was 38 million denars, in 2007 it made a profit of 583 million denars, and in 2008 the profit was 641 million denars.

## 6.CONCLUSION

The so far worldwide experiences have undoubtedly affirmed the fact that FDI is one of the fundamentals that enables and accelerates the economic development of a national economy. Consequently, every national economy must have adequate legislation that will enable smooth attracting of foreign capital.

The analysis of the changes in legislation and their impact on the scope and structure of the FDI in the Republic of Macedonia during the last decade has approved the fact that the legal aspects are of great importance for attracting the FDI. However, to some extent the institutional mechanisms that profiled the framework for doing business are important too.

The results of research done lead to the conclusion that the legal framework, as a significant factor of the business environment in a country, has a very strong influence on the intensity and the structure of the FDI in the Republic of Macedonia. Over the last decade Republic of Macedonia has achieved significant results in this field, but there is a need for further improvement of the relevant legislation yet. What is more important, this fact is more relevant considering the insufficient volume of FDI.

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## FLEXICURITY IN TRANSITION: THE CASE OF COUNTRIES OF FORMER YUGOSLAVIA

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### Abstract

Flexicurity, best described as an attempt to simultaneously combine flexibility and security in the labour market, is today in the core of the European employment agenda. As it aims to increase the adaptability of firms and workers in order to cope with quickly changing economic environment, it has become fundamental for enhancing labour market performance, productivity and competitiveness while reinforcing European social model.

Countries of former Yugoslavia (with exception of Slovenia) are facing several employment challenges, also as a consequence of political and economic developments after the break-up of Yugoslavia. The current labour market situation therefore demands a comprehensive strategy that would enhance labour market performance, however not endanger macroeconomic sustainability. There is a need for flexi-secure labour market policies, which would allow for flexible employment arrangements, however at the same ensure employment security of workers. Slovenia, as a member of the European Union (EU), was already formally invited to design and implement flexicurity strategies. Similar expectations will be put in front of other countries of former Yugoslavia in near future as well. The paper therefore presents a systematic in-depth analysis of the current level of implementation of flexicurity policy components set by the EU – i.e. flexibility of working arrangements, lifelong learning strategies, social security of unemployed and active employment policies – in the countries of former Yugoslavia and by that gives grounds for shaping recommendations about further labour market strategies. Moreover, it examines how ex-Yugoslav countries perform in implementation of these policy components in comparison to new Central and Eastern EU Member States.

The paper finds that ex-Yugoslav countries are, on average, characterized by relatively strict employment protection legislation and low levels of part-time and temporary employment, in spite of significant liberalization measures during the past decade. Majority of countries provide relatively weak social protection of workers in terms of unemployment benefits schemes with extremely low coverage rate. Furthermore, most of the countries face difficulties in the field of design and implementation of active employment policies and lifelong learning programmes. Among ex-Yugoslav countries, the highest progress both in enabling flexibility and security at the labour market is evident in Slovenia.

The implementation of flexicurity policies presents an important tool in improving employment and unemployment situation and by this labour productivity and overall economic performance. Therefore, the countries of former Yugoslavia should more intensely work on the effectiveness of active employment policies and lifelong learning strategies, target them on the most disadvantaged group of unemployed and stimulate them to use these programs. Moreover, they should improve the system of unemployment benefits to better the security of unemployed, however not pulling people out of labour market. At this point it is crucial that each country shapes a comprehensive strategy of further development of labour market, with special attention put on finding such a balance between different flexicurity policy components that best suits specific needs of its labour market.

**Keywords:** Flexicurity; Labour market; Labour market policy; Countries of former Yugoslavia; Empirical analysis.



## 1. INTRODUCTION

The need for flexible and at the same time secure labour markets (i.e. the need for flexicurity) is today in the core of the European employment agenda. Namely, flexicurity presents a response to changes in national economies due to globalization processes, rapid technological development, demographic aging and labour market segmentation. Moreover, it presents a tool for improving labour market outcomes, productivity and competitiveness while reinforcing European social model.

Countries of former Yugoslavia,<sup>2</sup> with exception of Slovenia, face several employment challenges, also as a consequence of political and economic developments after the break-up of Yugoslavia. The current labour market situation demands a comprehensive strategy that would enhance labour market performance, however not endanger macroeconomic sustainability. There is a need for flexi-secure labour market policies, which would allow for flexible employment arrangements, however at the same ensure employment security of workers. Slovenia, as a member of the European Union (EU), was already formally invited to design and implement flexicurity strategies. Nevertheless, similar expectations will be put in front of other countries of former Yugoslavia in near future as well. The research objective of this paper is therefore to assess the current level of implementation of flexicurity policy components in countries of former Yugoslavia and by that to give grounds for shaping recommendations about further labour market strategies. In the analysis we study flexibility of working arrangements, lifelong learning (LLL) strategies, social security of unemployed and active labour market policies (ALMPs) – i.e. flexicurity policy components set by the EU. Moreover, we examine how ex-Yugoslav countries perform in implementation of these policy components in comparison to the new Central and Eastern EU Member States (CEE),<sup>3</sup> which also underwent transition from centrally planned system to market economy.

The analysis, based on descriptive statistics, was performed on the latest available data and included variables chosen from the list of indicators suitable for studying flexicurity prepared by the European Commission (2007). Data were collected from national statistical and employment offices, international databases and official reports of several international organisations (The Organisation for Economic Co-operation and Development (OECD), The World Bank (WB), The International Labour Organisation (ILO), The International Financial Corporation (IFC), The Eurostat, The European Commission and The European Training Foundation (ETF)). At this point we stress that some of the countries of former Yugoslavia did not yet developed a systematic approach to collecting and generating data in certain fields of flexicurity, aggravating qualitative and comprehensive analysis. Nonetheless, this is the first systematic overview of all four flexicurity policy components in all seven countries of former Yugoslavia.

The paper continues with presentation of the flexicurity strategy at the EU level. Section 3 provides a short overview of labour market situation in the ex-Yugoslav countries, followed by an in-depth analysis of the implementation of flexicurity policy components. Last section summarizes major findings and concludes.

### 1. The concept of flexicurity within the European Union

The concept of flexicurity was first employed in the Netherlands in the mid-1990s as a part of labour market reforms; however, today we often link it to the Danish »golden triangle«. The latter presents a prime example of a well-functioning flexicurity arrangement. The model combines a high degree of occupational and geographical job mobility due to low employment protection, comprehensive social security for unemployed and ALMPs aimed at skill improvement and activation of unemployed (OECD, 2004, p. 97).

Pursue for balance between flexibility and security has been present in the EU policy discourse since 1993 and is especially evident within the European Employment Strategy (Tros, 2004, p. 2). As it is stated in the Council Decision (2003/578/EC, p. 13-21) on revision of the Employment Guidelines, *“providing the right balance between flexibility and security will help support the competitiveness of firms, increase quality and productivity at work and facilitate the adaptation of firms and workers to economic change.”* The EU addressed the issue of flexibility and security more explicitly (with the term flexicurity) in 2006 at the Informal Meeting of Ministers for Employment and Social Affairs. Since then it is in the forefront of the European employment agenda.

The European Commission (2007, p. 10) defined flexicurity as *“an integrated strategy to enhance,*

2 Countries of former Yugoslavia are Bosnia and Herzegovina (BiH), Croatia, Macedonia, Montenegro, Kosovo, Serbia and Slovenia.

3 The CEE-10 countries are Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. We study Slovenia as a part of former Yugoslavia and as a part of the CEE group of countries.

at the same time, flexibility and security in the labour market.”<sup>4</sup> The latter should not be perceived as contradictory, but as complementary and mutually supportive. The rationale of flexicurity is therefore to increase the adaptability of firms and workers in order to cope with quickly changing economic environment and to reduce labour market segmentation.

According to the European Commission (2007), flexicurity policies can be designed and implemented across four policy components:

- flexible and reliable contractual arrangements both for employees and employers;
- comprehensive LLL strategies;
- effective ALMPs to cope with rapid economic changes, to reduce unemployment spells and to ease transitions to new jobs; and
- modern social security systems to provide adequate income support, to encourage employment and to facilitate labour market mobility.

Economic analyses confirmed that these four components can be mutually supportive, and improve employment, at-risk-of-poverty rates, and human capital (see European Commission, 2006). However, it should be noted that crucial preconditions for developing flexicurity and making it work are supportive, productive and well-established social dialogue, mutual trust and highly developed industrial relations (see European Expert Group on Flexicurity, 2007).

## 2. BRIEF OVERVIEW OF LABOUR MARKET SITUATION IN COUNTRIES OF FORMER YUGOSLAVIA

The breakup of Yugoslavia, followed by a deep transition crisis deteriorated by armed conflicts and/or high political instability, heavily marked economic development of most of the ex-Yugoslav countries in the 1990s. Due to these specific conditions, economic and labour market recovery of these countries (with exception of Slovenia) has been much slower comparing to other CEE countries (see Gligorov *et al.*, 2008, p. 37). Data on employment growth show that during the transition period most of the ex-Yugoslav countries recorded a strong decline in employment, reflecting job losses because of collapses of larger firms and low level of job creation in mostly smaller firms (see Nešporová *et al.*, 2006, p. 10-11). Employment started gradually to recover in the late 1990s and more intensely after 2004. Nevertheless, employment rates are still low in most of the countries today, especially when compared to Slovenia and other EU countries. For example, in 2009, the employment rate in Kosovo amounted 23.2 %, in BiH 40.1 %, in Macedonia 43.3 % and in Serbia 50.4 %. The employment situation was better in Croatia, as the employment rate in 2009 amounted 56.6 %, whereas in Slovenia 67.5 %. On the other hand, all countries of former Yugoslavia, except Slovenia and Croatia, record enormously high, double-digit unemployment rates, in Kosovo exceeding even 50 %. Most exposed to unemployment are women and young people – the youth unemployment rate is in majority of countries twice as high as the adult unemployment rate or even higher. A serious problem presents also long-term unemployment. The latter has reached especially high levels in BiH, Macedonia, Kosovo and Serbia, where in 2009 more than 75 % of all unemployed were unemployed more than one year. In Croatia and Montenegro the share of long-term unemployed amounted approximately 55 %. For comparison, the share of long-term unemployment in Slovenia amounted 32.8 % in 2009, whereas in EU-27 17.8 %.

One of the key obstacles on the way towards labour market recovery is also extensive informal economy. According to Gligorov *et al.* (2008, p. 49), informal economy produces about one third of GDP in BiH and Serbia (the estimate is even higher for Kosovo and Macedonia) and accounts between 30 and 60 % of total employment. The informal economy does not only present a cost to the national economies due to unpaid tax revenues, but also a risk to workers, as they are not entitled to any kind of labour rights, job security, employment protection and are deprived for professional development (see also Nastav *et al.*, 2007).

<sup>4</sup> As flexicurity is relatively new term, there is no universal definition of it. Nevertheless, we can find several (partially overlapping) definitions. For overview see Madsen (2006).

<sup>5</sup> Kita (2008, p. 5) estimated that only half of the employment in the private sector is reported, whereas the other half is being informal.

### 3. THE ANALYSIS OF IMPLEMENTATION OF FLEXICURITY POLICY COMPONENTS

In the analysis of implementation of flexicurity we focus on four policy components: flexible and reliable contractual arrangements, LLL programmes, ALMPs and social security system for unemployed. The analysis will be based on the variables suitable for studying flexicurity prepared by the European Commission (2007).

#### 3.1. Flexible and reliable contractual arrangements

One of the most commonly used indicators in international comparisons of labour market regulations is Employment Protection Legislation index (EPL), developed by the OECD.<sup>6</sup> Under previous regime, countries of former Yugoslavia had very protective labour legislation. For example, dismissals were not permitted (except out of disciplinary reasons), workers were mostly full-time employed (what provided high security of staying in employment) and were entitled to several employment benefits. However, over the last twenty years all ex-Yugoslav countries adopted profound changes in national labour legislations, which significantly decreased the level of employment protection. For example, EPL index in Slovenia amounted 4.1 in 1991, it declined to 3.0 in 1998 and reached the value 2.5 in 2008. Although some countries already reached the level of employment protection in more developed OECD or EU Member States (see Table 1, data for 2003), differences between them are still high. According to the last available data, the overall EPL index varies from 2.5 in Slovenia and Kosovo to 3.6 in Montenegro,<sup>7</sup> which is above average of the OECD, EU-15 and CEE countries. For comparison, the most flexible CEE countries in 2008 were Slovakia (1.4) and Hungary (1.7), mostly due to increased flexibility in the area of temporary contracts.

As can be seen from the table below, the employment protection in 2003 was rather high in the field of temporary contracts, especially when comparing to the CEE average. Exceptions to high EPL on temporary contracts were Slovenia and Croatia due to legalization of temporary work agencies and legislative changes regarding the duration of temporary contracts. Even stricter were collective dismissal regulations, being especially high in Montenegro, Kosovo and Croatia. In this way countries tried to prevent extensive dismissal of workers through restructuring processes of large companies and by this avoid negative impacts on labour markets and massive quests for social protection. On the other hand, the ex-Yugoslav countries, except Slovenia and Croatia, recorded very flexible regulations in the field of regular employment, being even more flexible than in the CEE-8 and EU-15.

Table 1: Total EPL index and its components, 2003 and 2008

Country	Year	Regular employment	Temporary employment	Collective dismissals	Total EPL index
BiH	2003	1.8	3.1	3.3	2.6
Croatia	2003	2.6	1.9	4.3	2.6
Kosovo	2001	1.3	2.8	4.6	2.5
Macedonia, FYR	2003	2.0	3.1	4.0	2.8
Montenegro	2003	2.2	4.5	4.8	3.6
Serbia	2005	2.0	4.4	3.6	3.3
Slovenia	2003	2.7	2.0	4.8	2.7
	2008	3.2	1.9	2.9	2.5
Ex-Yugoslav countries average <sup>1</sup>	2003	2.1	3.1	4.2	2.1
CEE-8 average <sup>2</sup>	2003	2.6	1.4	3.3	2.2
	2008	2.6	1.6	3.3	2.1
EU-15 average	2003 <sup>3</sup>	2.3	2.1	3.3	2.2
	2008	2.3	2.0	3.2	2.2
OECD average	2003	2.1	1.8	3.0	1.9
	2008	2.1	1.8	3.0	2.1

Note:

<sup>6</sup> EPL index is compiled from 21 items, covering three different aspects of employment protection: (i) individual dismissal of workers with regular contracts; (ii) additional costs for collective dismissals; and (iii) regulation of temporary contracts. Index values are ranging from 0 (least stringent employment legislation) to 6 (most restrictive employment legislation). Data on EPL index for 2008 are in accordance with the OECD methodology version 3. Data for years before 2008 are available only in accordance with the OECD version 2 (see OECD, 2011a; OECD.Stat, 2011).

<sup>7</sup> EPL estimation for Slovenia refers to 2008, whereas for Kosovo to 2001. Data for Montenegro refer to 2003.

<sup>1</sup> Data for Kosovo refer to year 2001, whereas for Serbia to 2005.

<sup>2</sup> The CEE-8 average includes data for Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. Data for Lithuania and Latvia refer to 2004.

<sup>3</sup> The average value does not include data for Luxembourg.

Sources: Gligorov *et al.* (2008); Micevska (2004); Nešporová *et al.* (2006); OECD (2011b); OECD.Stat (2011); Tonin (2009); Vodopivec *et al.* (2007).

Up to today, the value of total EPL index and/or its sub-indices has probably decreased in some of the ex-Yugoslav countries due to changes in labour legislation; however, there is no official data yet available. For example, in 2005 Macedonia reduced maximum severance payments from eight to six months, abolished some restrictions on fixed-term, temporary and part-time contracts and shortened employers' obligation on sick pay from 60 to 21 days (see Feiler *et al.*, 2009). Furthermore, in 2006 it adopted Law on Temporary Work Agencies and by this introduced possibility of hiring agency workers. With the amendments adopted in 2008, the use of fixed-term contracts for permanent task was prolonged from 4 to 5 years. Moreover, in the same year Montenegro allowed fixed-term contracts for permanent task with no duration limitation and eased the notification procedures prior dismissal for employers (see WB, IFC, 2009, 2010a).

As already mentioned, most of the employment protection data presented in the table above are out-dated. In order to obtain a more realistic view on labour arrangements and to broaden the analysis of employment situation in studied countries, we also analysed the rigidity of employment index, developed by the WB.<sup>8</sup> As shown in Table 2, employment in terms of hiring and firing workers and rigidity of working hours are the most flexible in Kosovo.<sup>9</sup> Low employment rigidity is also recorded in Montenegro and Macedonia due to several legislation changes in the past years. For example, both countries eliminated requirements relating to redundancy, eased restrictions on fixed-term contracts and introduced greater flexibility in scheduling of working hours (see Gribben, 2009; Feiler *et al.*, 2009; WB, IFC, 2009).<sup>10</sup> Serbia, on the other hand, adopted legislative measures allowing employers to respond to a decline in work volume by reducing their workers' hours or placing workers on temporary leave with reduced pay (see WB, IFC, 2010c). The employment regulation is, according to the WB's index, the most rigid in Slovenia and Croatia. Rigidity is especially high in the area of hiring workers, as both countries prohibit fixed-term contracts for permanent tasks and limit duration of fixed-term contracts to 24 (Slovenia) or 36 (Croatia) months. Comparing to other countries, they record also high rigidity of working hours due to regulations on annual leave and work on weekly rest day.

**Table 2:** The rigidity of employment index and its components, 2010

Country	Components of the rigidity of employment index (0-100)			Rigidity of employment index (0-100)
	Difficulty of hiring index	Rigidity of hours index	Difficulty of redundancy index	
BiH	56	13	30	33
Croatia	61	40	50	50
Kosovo	0	0	30	10
Macedonia, FYR	11	20	10	14
Montenegro	0	20	20	13
Serbia	78	7	20	35
Slovenia	78	53	30	54
Ex-Yugoslav average	41	22	27	30
CEE-10 average	34	41	24	33
EU-15 average	32	40	32	35

Source: WB, IFC, 2010a.

<sup>8</sup> The rigidity of employment index is a simple average of three indices: difficulty of hiring index, rigidity of hours index and difficulty of firing index. The values of indices are ranging from 0 to 100, by which higher values indicate more rigid regulation (WB, IFC, 2010b).

<sup>9</sup> For example, there is no limit on the length of fixed-term contracts (including renewals), no obligation of notification or approval of a third party in case of dismissal of one or more workers (WB and IFC, 2010a).

<sup>10</sup> In Macedonia, employers are allowed to choose the duration for scheduling and frequency of shift rotation when arranging night's shifts, employer and employees are free to agree on the weekly rest day and on the number of days of paid annual leave beyond the legal minimum of 20 working days. In Montenegro, when employers have to dismiss a worker, they are required to give notice of 15 calendar days only and are no longer obliged to give prior notification to a third party (see WB, IFC, 2009, 2010b).



Although the labour markets of former countries of Yugoslavia became more flexible comparing to a decade ago, the level of part-time employment is rather low. For example, in 2009, the share of part-time employment in total employment amounted approximately 2 % in Croatia, 5.3 % in Macedonia,<sup>11</sup> 10.2 % in BiH, whereas it was the highest in Kosovo (16.3 %). In Slovenia, the share of part-time employment in total employment amounted 9.5 %, which is 5 percentage points below the CEE average. The share of part-time employment in total employment is higher among women and workers employed in agriculture sector. According to Fetsi (2007, p. 116), non-use of part-time employment is associated with the fact that pension regulations make it very difficult for part-time employees in most of the countries to qualify even for the minimum pension.

More common, on the other hand, are temporary employment arrangements. Their share in total employment is increasing in most of the ex-Yugoslav countries, especially among young and lower-skilled people (see Nešporová *et al.*, 2006; Crnković-Pozaić, 2006; Novkowska, 2008). In 2009, the share of temporary employed in total employment amounted 11.6 % in Croatia, 15.5 % in Macedonia and 16.2 % in Slovenia.<sup>12</sup> For comparison, the average value of temporary employed in total employment in NMS amounted 8.0 %, which is 5 percentage points below the EU-15 average. The share of temporary employed in total employment was higher among young people (15-24 years of age): in Macedonia 37.1 %, in Croatia 35.0 %, whereas in Slovenia 66.6 %. For comparison, the CEE average (without Estonia) amounted 21.6 %, which is 18.3 percentage points below the EU-15 average.

### 3.2. Lifelong learning

LLL programmes (i.e. education and training programmes, which are or are not in relation to the current or the future job of participant) are crucial for ensuring long-term employability of workers, especially the most vulnerable. According to the European Commission (2007), high participation in LLL is positively related with high employment and low long-term unemployment. However, it is often the case that firms underinvest in education and training of low-skilled workers, workers on temporary contracts, self-employed and older workers.

During the previous regime, adult population was committed to permanent and functional education. As there were no room for comprehensive LLL strategies, in majority of countries the LLL programmes are today in their early stage of development, what is among others reflected in low participation rates. According to the available data, participation rate of adults (between 25 and 64 years of age) in LLL in Slovenia amounted 14.6 % in 2009, whereas in Macedonia 2.5 % and 2.2 % in Croatia in 2008. Participation rates are probably even lower in other countries of former Yugoslavia.<sup>13</sup> Low participation rates in LLL present also a problem in most of the CEE countries. For example, participation rate in 2009 did not exceed 1.5 % in Romania and Bulgaria and it amounted 2.8 % in Slovakia and Hungary. For comparison, the average in the CEE amounted 5.5 %, whereas in the EU-27 9.7 %. Still, this is way below participation rate in Scandinavian countries (it amounted 31.6 % in Denmark and 22.1 % in Sweden and Finland).

Slovenia already developed a functioning system of LLL, as this is one of the important requirements and expectations of the EU and the Lisbon Strategy. However, in other countries of former Yugoslavia, the importance of LLL is only slowly coming in the forefront of employment agenda.<sup>14</sup> Although these countries, except BiH, adopted strategies or programmes for adult education and LLL in the past years,<sup>15</sup> they face problems of how to insure their implementation. This is additionally hindered by modest public expenditures for adult education and training (especially in rural places) and lack of EU instruments. Some countries receive funding from different international donors, but these funds are mainly project-oriented, short term and unsystematic (see Popovič, 2009). One of the main reasons for low participation in adult education and training is also a lack of motivation (especially by older and unemployed people), related with existential problems, low quality of life and an incorrect perception of LLL as a »shame« (see Župarić, 2009). Likewise employers are not aware of the importance of adult

11 According to the ILO, there is still a strong disincentive in Macedonia against the use of atypical forms of employment due to the high tax wedge at low wage levels (Viertel, 2008, p. 13).

12 Comparing to year 2005, the share of temporary employed in total employment increased only in Macedonia (from 11.8 to 15.5 % in 2009), whereas Slovenia and Croatia recorded a minor decrease (from 17.1 % in Slovenia and from 12.9 % in Croatia).

13 Countries of former Yugoslavia, except Slovenia, do not collect systematic statistical data on participation in LLL. The cited data were obtained from the Eurostat (2011).

14 Progress in national legislation has been especially evident in Croatia and Macedonia, mostly due to obligations in the process of obtaining EU membership. Overview of developments in the field of LLL in mentioned countries is available in Devčić Torbica (2009) and Buova *et al.* (2009).

15 Overview of adopted strategies and laws for adult education in the ex-Yugoslav countries is available in Popovič (2009) and Devčić Torbica (2009).



education and of development of employee. For example, in BiH only a small part of employers, mostly from the private sector, involve their employees in the process of further education, which mostly takes place in foreign countries (Herić *et al.*, 2008, p. 11). This points on the further problem of low quality and inadequate infrastructure for LLL in terms of providers, educational staff and lack of practices and comprehensive guidance system.<sup>16</sup>

### 3.3. Active labour market policies

Several studies pointed on a positive impact of ALMPs on labour market and economic performance (see for example OECD, 2004; Nešporová *et al.*, 2006; Anspal *et al.*, 2007), signifying that expenditures for ALMPs could have an important impact on reducing unemployment and therefore facilitating employment. However, as can be seen from Table 3, expenditures for labour market policies are modest. As the major part of expenditures is devoted to passive employment policies, this leaves an extremely low portion for the ALMPs. Namely, expenditures for the latter vary from 0.04 % of GDP in Croatia to 0.18 % in Slovenia. Low funding is also a reality in the CEE countries, which in 2008 earmarked only 0.23 % of GDP to ALMPs – this is 0.5 percentage points below the EU-15 average and even 1 percentage point below the level in countries with the highest expenditures (Belgium and Denmark).

**Table 3:** Expenditures for active and passive employment policies as % of GDP

Country	Active employment policies, 2008	Passive employment policies, 2006
BiH	0.08	n/a
Croatia	0.04	0.38
Kosovo	n/a	n/a
Macedonia, FYR	0.1 (0.2 in 2009)	n/a
Montenegro	n/a	0.30
Serbia	0.12	0.80
Slovenia	0.18	0.27 <sup>1</sup>
CEE-10 average	0.23	0.27 <sup>1</sup>
EU-15 average	0.74	1.08 <sup>1</sup>

Note:

<sup>1</sup> Data for 2008.

Sources: Centre of Public Employment Services of Southeast European Countries, CPESSEC (2009); Eurostat (2011); Gligorov *et al.* (2008).

Expenditures for ALMPs are in majority of the ex-Yugoslav countries mostly concentrated on wage subsidies for the integration of disabled, job search assistance and support for self-employed and too little on employment incentives, training programs and direct job creation measures.<sup>17</sup> Moreover, ALMPs are not organised on a larger scale and therefore focus only on selected groups of unemployed. Consequently, the coverage rate (i.e. % of unemployed participating in ALMPs) is low. According to the available data, the coverage rate in Croatia in 2009 amounted 2.5 % (WB, 2010b), similar rate was also recorded in Macedonia in 2005 (Cazes *et al.*, 2007a, b).

Majority of the ex-Yugoslav countries adopted employment programs or plans including recommendations and measures on implementation of ALMPs. However, the highest obstacle in implementation of these measures remains lack of funds, which is especially evident in BiH and Kosovo. For example, in BiH there were no ALMPs implemented in 2008, except those funded by the WB programme (Lorencic, 2008, p. 7). Also in Kosovo almost all ALMPs are supported and implemented by the international organisations such as the UNDP, the MLSW and the ILO, by which they mostly focus on youth employment (Kita, 2008, p. 22). Situation regarding funding is at most improving in Montenegro, where the financing of the ALMPs reached approximately 1 % of GDP in 2008 (Gribben, 2008, p. 10).

<sup>16</sup> Educational and LLL challenges in Montenegro, Macedonia and Croatia are also presented in ETF working papers (Gribben, 2008; Feiler *et al.*, 2009; Skjolstrup, 2008).

<sup>17</sup> Overview of development of ALMPs for Montenegro, Macedonia, Croatia and Serbia is available in the reports of the ILO and the Council of Europe (Cazes *et al.* 2007a, b; Rosas *et al.*, 2007; Harasty *et al.*, 2007) and the ETF working papers (Gribben, 2008; Feiler *et al.* 2009; Skjolstrup, 2008).

### 3.4. Social security system

There are significant differences in unemployment benefit (UB) programmes between countries of former Yugoslavia. The most generous UBs can be found in Slovenia, followed by Serbia, whereas in other countries the UBs are really modest. The extremely low UB level was recorded in Montenegro, where UBs present only 60 % of minimum wage (i.e. 55 EUR) in 2008. For comparison, poverty line in Montenegro amounted 119 EUR in 2007, implying that UBs increase the risk of falling into poverty or of resort to the informal economy (see Kaludjerović *et al.*, 2008; Rosas *et al.*, 2007). Moreover, labour legislation in Kosovo provides no UBs - the social safety net provides only basic pensions and limited social assistance (see USAID, 2009).

In majority of studied countries the UBs are mostly limited to 12 months. The duration of benefits is longer only in Federation BiH, Serbia and Slovenia. However, several countries (Croatia, Macedonia and Montenegro) have adopted provisions to allow unlimited duration of UBs for older workers after certain cumulative duration of employment.

As can be seen from Table 4, the share of unemployed who receive UBs is very low. Only exception is Slovenia, where almost one third of unemployed is entitled to UBs. Low coverage rate in other countries is a consequence of the state of labour market and the composition of the unemployment registers, on which the vast majority present labour market entrants and others who had no opportunity of building up the necessary contributions (Fetsi, 2007).

Table 4: Comparison of the UB systems between countries of former Yugoslavia (last available data)

Country	UBs as % of average net wage, 2009	UB duration	% of registered unemployed receiving UBs
BiH	Federation BiH: 40.0 Republika Srpska: 20.0	Federation BiH: 3-24 months Republika Srpska and District Brcko: 3-12 months	2.31 (July 2010)
Croatia	27.8	78-450 days Unlimited duration for persons with 32 years of employment.	24.0 (September 2010)
Kosovo	0.0	no	0.0
Macedonia, FYR	34.0	1-12 months Unlimited duration for persons with more than 15 years of employment and are at most 5 years short to qualify for an old age pension. Duration of benefit is extended for women during pregnancy and for persons on training for the time of its duration.	1.0 <sup>1</sup> (2007)
Montenegro	8.4 <sup>2</sup>	1-12 months Unlimited duration for persons with more than 25 years in employment.	21.2 (2007)
Serbia	60.0-50.0 <sup>3</sup>	3-24 months	9.6 (2008)
Slovenia	63.0 (August 2010)	3-25 months	30.0 (August 2010)

Notes:

<sup>1</sup> By the end of 2007, 24,720 individuals in Macedonia received UBs, of which 21,291 persons received early retirement allowance (until they reach retirement age and are therefore entitled to old-age pension), 3,429 individuals yet received the “regular” UB.

<sup>2</sup> Data for 2008.

<sup>3</sup> In first three months 60 % of previously earned average net wage, thereafter 50 %.

Sources: CPESSEC (2009); Croatian Employment Service (2010a, b); Employment Service of Slovenia (2010); Kaludjerović *et al.* (2008); Labour and Employment Agency of BiH (2010); MISSCEO (2010); Rosas *et al.* (2007); USAID (2009); WB (2008).

#### 4. CONCLUSION

Although countries of former Yugoslavia share a common legacy of centrally planned regime, today they significantly differ in their economic and labour market performance, mostly as a consequence of political and economic developments after the break-up of Yugoslavia. Namely, apart in Slovenia and Croatia, the current labour market situation in the ex-Yugoslav countries is serious. Countries face low employment and labour force participation rates and extremely high unemployment and long-term unemployment rates, which are especially pronounced among women and young people. Among others, high costs to labour markets are also imposed by a large informal economy. The current labour market situation therefore calls on governments to shape comprehensive and suitable strategies or policies to facilitate favourable labour market performance, however not endanger macroeconomic sustainability. One of the answers to the labour market challenges is the approach of flexicurity, promoted by the EU. According to the European Commission (2007) and studies that analysed the impact of one or more flexicurity policy components on labour market outcomes, properly shaped and implemented flexicurity policy components have a positive impact on labour market performance (for brief overview of studies see Laporšek and Dolenc, 2011). This paper therefore analyses the current level of implementation of flexicurity policy components as a policy tool in the countries of former Yugoslavia and by that gives grounds for shaping recommendations about further labour market strategies.

The analysis has shown that countries of former Yugoslavia significantly liberalized employment protection legislation during the past decade, almost reaching the employment protection level of the CEE countries. Despite this, the employment protection is still relatively strict, reflected also in low levels of part-time and temporary employment. Although the liberalization of employment protection on one hand eased hiring and firing procedures for employers, it decreased protection of workers on the other. The loss of workers' security should be compensated by effective social security system and ALMPs. The latter together with LLL programmes are of especial importance as, if designed and implemented properly, can reduce negative labour market outcomes by improving the efficiency of job matching and enhancing the level of human capital (for overview of studies see OECD, 2004; Bassanini and Duval, 2006). However, data show that some governments still underestimate the importance of these policies, as they have not yet established a comprehensive strategy for their development and funding. Some countries also record weak (in Kosovo even no) social protection of workers in terms of UBs.

Except Slovenia, the ex-Yugoslav countries have not yet adopted the concept of flexicurity, however we can expect a gradual transfer of flexicurity policies in their labour markets in near future. This opens the question which flexicurity policy components are the most appropriate for specific labour market situation and how should be designed. Our findings propose that countries should more intensely work on the effectiveness of ALMPs and LLL strategies, target them on the most disadvantaged group of unemployed and stimulate them to use these programs. Moreover, they should enhance the system of UBs to better the security of unemployed. However, on this way towards "flexicure" labour markets, it should be taken into account that each country has to find its own balance between different flexicurity policy components. This will demand better dialogue between social partners, stronger state institutions and higher funding.

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## TRENDS IN ENTREPRENEURIAL ACTIVITY IN CENTRAL AND EAST EUROPEAN TRANSITION ECONOMIES

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### Abstract

After 1989, radical changes in the level of entrepreneurial activity have taken place in the Central and East European (CEE) region countries, transitioning from the communist to a market economy system. These developments have not been properly researched so far, inter alia, due to a lack of reliable empirical data.

In this paper we identify key factors affecting business ownership (BO) rates in the four CEE transition economies, such as: historic and cultural roots, experiences with entrepreneurship under communism, the level of economic development, the growth of GDP during transition, and the speed of market oriented reforms. Using EIM's COMPENDIA data base we test seven hypotheses by conducting comparative analysis of trends in BO rates - both actual levels and dynamics of change- during the period 1989-2008. Five out of seven hypotheses are confirmed while the remaining two hypotheses are partially confirmed.

The current paper makes two contributions. First, we present, for the first time, harmonized business ownership time series during 1989 – 2008, for the new CEE EU member states, which facilitates meaningful comparisons with other OECD countries. Second, we explain the sizable differences in the level and development of business ownership since 1989 among four Central and East European transition economies: Czech Republic, Hungary, Poland, and Slovak Republic. The findings bear important implications for shaping policies aimed at enhancing entrepreneurship in the CEE region.

### 1. INTRODUCTION

This paper explores the different developments of business ownership (BO) rates over the period 1989-2008 in four Central and East European (CEE) countries: the Czech Republic, the Slovak Republic, Hungary and Poland, against similar trends observed in other OECD countries during the same period. Understanding country differences in entrepreneurship is important because entrepreneurship is widely believed to play a key role in economic development (Audretsch and Thurik, 2004, 2010). Such understanding is particularly relevant in countries undergoing systemic transformation from the centrally-planned or communist to a market economy system. The Central European countries under study, immediately after the Second World War, fell under Soviet dominance which lasted until 1989-1990. During 45 years private business ownership was disallowed or barely tolerated as a marginal, unimportant addition to a dominating state-owned sector. Within the official paradigm of the socio-economic development under communism there was no room for entrepreneurship as a potential factor contributing to such development.

The situation has changed dramatically after 1989, when the communist system collapsed. Obviously, entrepreneurs played an important role in this process reflected in the explosion of entrepreneurial initiatives in the CEE region, particularly during the 1990s. These developments have attracted considerable attention among entrepreneurship researchers. The vast majority of this research focused on how individual entrepreneurs cope with the opportunities, threats and challenges within a particular transition context being still affected by the inheritance from the communist past and characterized by mounting barriers and obstacles resulting from a weak institutional base during the early phase of implementing the free market system (Smallbone and Welter, 2001; Peng, 2001; Doern, 2009; Van der Zwan, Verheul and Thurik, 2011). Most recent research acknowledges the heterogeneity of entrepreneurial responses to institutional conditions and the fact that entrepreneurs may also influence change (Welter and Smallbone, 2011). An interesting direction of this debate is related to the "homo sovieticus" mindset developed by several generations of population living under communism (Zinovyev, 1986), which is reflected, inter alia, in the lack of individual initiative, overreliance on the state and passive, obedient acceptance of the rules imposed by the government authorities. The important question is to what extent such mindset affected entrepreneurial attitudes, once the communist-type regimes collapsed and the basic institutions of the free market capitalist system were introduced after 1989 (Shiller, Boycko and Korobov, 1992).

Recent efforts aimed at harmonization of longitudinal data on business ownership (BO) rates and inclusion of four transition economies (Czech Republic, Hungary, Poland and Slovak Republic) in EIM's COMPENDIA data base in the latest edition, paved the way for longitudinal analysis of the BO rates, covering 20 years during the period 1989-2008 (Van Stel, Cieslik and Hartog, 2010). We were able to construct business ownership rates for these countries which are comparable across countries and over time, allowing for comparisons of relevant trends between the selected transition and mature market economies but also among these four transition countries. This was not straightforward as different countries tend to use different business ownership (self-employment) definitions in official OECD statistics (Van Stel, 2005).

The rest of the paper is organized as follows. In the second section we conduct a literature review with the purpose to identify key factors affecting the levels and changes in BO rates of the four countries under study. Based on this review we formulate seven hypotheses for further testing. Next, in the third section, we discuss our data base with harmonized data on the number of business owners across OECD countries over a long range of years. In section four we present business ownership data for OECD member countries with particular focus as how the new CEE countries fit within general patterns of business ownership in the OECD during 1989 – 2008. The results are discussed in the fifth section in the context of seven hypotheses being formulated. In the final section we discuss some policy implications stemming from our research, limitations, as well as directions for future research.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

### 2.1. Scope of literature review

In this section we make an attempt, based on a literature review, to identify key factors affecting the levels and trends in business ownership rates over time in four Central and East European (CEE) transition economies: the Czech Republic, Hungary, Poland and the Slovak Republic. The first group of factors is related to the historic roots and cultural traditions. Over many centuries these four nations have developed strong ties with the Western civilization. In the last 100 years, all of them gained independence after World War I and, after a short period of building the fundamentals of modern states during 1918-1939, fell under Nazi occupation and later Soviet dominance, which ended only in 1989.

The second group of factors relates to the experiences of the four countries under study with respect to the private business sector under communism. Despite the fact that general principles of the command-type economy were quite universal and driven by the ideological motivations, there were notable differences as to the extent the non-state-owned business sector and individual initiatives were tolerated and controlled.

Thirdly we take into consideration the level of economic development and the growth of GDP in the four CEE countries during 1989 – 2008. The relationship between economic development and entrepreneurial activity is vividly discussed in the literature (e.g. Acs, Audretsch and Evans, 1994; Carree et al., 2002, 2007; Wennekers et al., 2010). On the other hand there are sizeable differences in the level of socio-economic development among the four countries under study. Finally, we examine the speed of implementation of market oriented reforms in these countries after 1989, with particular reference to those shaping institutional environment for private business initiatives.

### 2.2. Historic and cultural roots

Within the new institutional economic analytical framework, there are several levels of institutions, the highest of which is that of informal, institutionalized rules shaped over the centuries, including norms, customs, traditions and religions (Williamson, 2000). Winiecki (2004) adapted this framework to the analysis of conditions that affected transition success from the communist to the free market system. According to Winiecki, what played a decisive role in the rapid development of the new private sector under transition was not so much the communist legacy as the pre-communist legacy, which he called "civilization fundamentals." Therefore, it is useful to determine how close the informal rules that existed before communism were to the kind of institutional environment necessary to the efficient functioning of the free market system that emerged after the communist break-up. The informal rules that shape civilization fundamentals include freedom of entrepreneurship, perception of the general need for law and order, and generalized trust. To develop his argument, Winiecki pointed out that practically all successful transition economies in Europe were those that belonged historically to Western Christendom, whereas the "laggards" fell outside the eastern borders of Christianity.

The arguments raised by Winiecki are powerful as they pertain to the differences between Poland and Russia, the example the author used. However, they are of limited use in explaining the differences among the Czech and Slovak Republics, Hungary and Poland because these countries all fall within the historic borders of Western Christendom. Still, by taking into account the variations in their civilization fundamentals, one may point to particular historic institutional traditions that could explain the phenomenon of Czech entrepreneurship revival. Benacek (1995) stressed the role of the Czech Protestant traditions, which date back to the 1780s, and to the proliferation of liberal and cosmopolitan ideas in the 19<sup>th</sup> century. These factors, combined with the very high level of industrial development in the area, provide a fruitful historic base on which Czech entrepreneurship could regain its strength after the 45 “lost” years under Soviet dominance.

A similar argument based on the pre-communist legacy concept can be developed with respect to the formal rules, particularly the legal framework for starting and running a business. Here we may refer to the concept of legal origin developed by La Porta et al. (1999), who distinguished between the traditions of common law and civil law, where common law is typically associated with less government inclination to intervene in the economy and, therefore, greater favorability for entrepreneurship.

The original concept (La Porta et al., 1999) identified within the civil law tradition a socialist legal system that prevailed in the communist economies. However, following widespread criticism, this sub-category was eliminated in the most recent formulation (La Porta, Lopez-de-Silanes and Shleifer, 2008). What seems especially important, however, is the level of pre-communist maturity of the legal system, particularly whether regulations that affect business operations were established before World War II. All four countries under study managed to shape the basics of business law during their short period of independence from 1918 to 1939. Although it does not seem to be useful in explaining differences in the levels of business ownership rates among the four countries, this legal maturity had a practical impact during the early days of transition because the necessary laws could be quickly restored and/or updated. For example, the sophisticated Polish Commercial Code of 1934 was not cancelled under communism, even though most of its regulations were not compatible with the centrally planned system. Under the new circumstances after the fall of communism, the Code was found to be extremely useful, especially for setting up limited liability companies, which became the most popular business vehicles for setting up larger domestic operations and subsidiaries of foreign companies.

Based on the above analysis we may formulate three hypotheses:

H1: As all four countries under study belonged historically to the Western Christendom, this facilitated rapid catching-up of BO rates with those prevailing in the mature market economies while at the same time downplaying the role of communist heritage.

H2: Due to historic and cultural links with some Western European countries, BO rates prevailing in these countries form a “historic benchmark” to which CEE region tended to approximate.

H3: Among the CEE countries under study the historic roots of the Czech Republic provided the most favorable environment for catching up with respect to BO rates.

### **2.3. Experiences with entrepreneurship under communism**

The experiences with entrepreneurship under communism varied significantly among the four countries under study. The private sector was practically liquidated in Czechoslovakia by the mid-1960s, whereas it was allowed to exist as a “marginal addition” to the dominating state-owned sector in Hungary and in Poland. The relevant policies in both countries were implemented in waves, with periods of greater flexibility interspersed with tightened measures aimed at curbing the size and the “excessive richness” of the private business owners. In the case of Poland, an important additional factor was that foreign travel was much less restricted than it was in the other three countries. Therefore, many Poles —particularly the young— had exposure to the free market system from working abroad (often illegally) and (particularly in the 1980s) from the chance to engage in “individual international trade” (Johnson and Loveman, 1995, p. 232).

In view of these developments, one may argue that Hungary and Poland were much better prepared for the “entrepreneurial take-off” in 1989 than the Czech and Slovak Republics were. First, at the verge of the systemic transition, Hungary and Poland had many individuals with at least some experience in starting and running small private business, albeit in the very peculiar and restrictive environment of a centrally planned economy. Second, these businesses were firmly legal with clearly defined rules on registration requirements, tax obligations, restrictions as to the scope of activities, maximum number



of employees, and so on. This observation contradicts the prevailing approach (e.g., Peng 2001), which has pointed to the “gray” underground character of the private sector under communism. While this character may have applied in the former Soviet Union, it definitely did not in Hungary and Poland. Third, some formal regulations designed specifically for the private sector could be easily adapted to the new market-economy environment. For example, the simplified tax scheme for small-scale craft activities currently in use in Poland relies heavily on regulations introduced in the 1980s.

However, there were important negative implications of the “communist embeddedness” of the incumbent private sector in Hungary and Poland, particularly the business skills, attitudes, ethical and moral standards and operating routines developed while conducting business under communism that became obsolete impediments when the rules changed. The lack of customer focus serves as a good example here; under communism, clients were generally not looked after because of the acute shortage of consumer goods and services, so customers waited in lines and got what they got. The major concern of the private business owners operating within the “shortage economy” was getting access, often through informal and/or illegal arrangements, to various production inputs, materials, and components—not customer service. As a result, they were ill-equipped to operate within a market environment where the crucial success factor related to building a strong client base.

Since the communist authorities in Hungary and Poland often switched between flexible policies toward the private sector to tightened measures, the private sector in both countries followed a “low profile” strategy to survive the instability. This strategy was reflected in deliberate avoidance of demonstrations of excessive richness but also in limited market visibility. This strategy obviously contrasts with the proactive, dynamic orientation required when operating within a free-market environment.

While the extant transition literature has focused on the impact of rapidly changing conditions on the survival of the state-owned enterprises, in fact the “transition shock” also brought similar challenges to the incumbent private sector (Winiecki, 2004), as exemplified by the words of an incumbent entrepreneur: *“In 1989 Poland changed to such an extent that, in order to continue my prosperous business, I had to start de novo. The same business, in a different environment, became a new kind of activity”* (Osborn and Slomczynski, 2005, p. 88).

Some empirical data has suggested that the overall balance of already being in business at the time of transition, on the one hand, and “communist embeddedness,” on the other, was not positive for the incumbent private sector and that it was the newly established entrepreneurial firms that were the key driving force of the transition process. For example, Cieslik and Kaciak (2009a) found that the incumbent private sector was only marginally engaged in the advanced forms of entrepreneurship, namely exporting; in 2003, among approximately 50,000 exporters, only 1,200 private firms were established before 1989 and they provided only 4% of the Polish commodity exports. At the same time, 40,500 domestic exporting firms established after 1988 contributed 32% of the export volume (54% of export volume was generated by 7,100 foreign subsidiaries and 10% by 1,200 state-owned enterprises). This paucity of pre-1989 exporters is surprising, given that many Poles were engaged in individual (informal) international trade, particularly in the 1980s, and the income derived from such operations helped to build a capital base for setting up many genuine private businesses after the collapse of the communist system.

The above analysis leads to the following hypothesis:

H4: Experiences with entrepreneurship under the communist regime in Hungary and Poland contributed to the accelerated growth of BO rates after transition. However, this contribution is moderated by the fact that the private sector before 1989 was deeply rooted in the communist environment and consequently the experiences accumulated were not always useful within a market economy system.

#### 2.4. Level of economic development and the growth of GDP after transition

The complex relationship between entrepreneurship and the level of economic development has been subject to considerable debate in the extant literature (for an overview, see Wennekens *et al.*, 2010). For instance, rising per capita income tends to go together with rising real wages (Lucas, 1978), implying increasing opportunity costs of self-employment and hence a negative relation between entrepreneurship and the level of economic development. On the other hand, the importance of services (niche) markets and a higher preference towards autonomy in highly developed economies suggest a positive relation.

Data from the four CEE countries (Figure 1) show considerable differences in their GDP per capita in the early 1990s, when the transition process had just started, particularly between the most



industrialized of the four, the Czech Republic and the least developed Poland (Czech income per capita was almost double that of Poland in 1992). During 1992-2008 all four countries experienced growth in GDP per capita, but the pace of growth was much faster in the countries with a lower base: Poland and Slovakia. In fact, the growth of GDP achieved in Slovakia was remarkable and, as a result, Slovakia surpassed Hungary in GDP per capita in 2007. Consequently, the distance between the highest (Czech Republic) and the lowest (Poland) GDP per capita shrank from 46% in 1992 to 30% in 2008.

At the same time there was a clear trend in narrowing the gap as to the GDP per capita between the four CEE countries under study and the remaining OECD members. Whereas in the early 1990s the average GDP per capita in this region represented only 35 % of the COMPENDIA-23 average, by 2008 this ratio increased to 51% (see Figure 1).<sup>1</sup> This in turn led to gradual transition of this region from the manufacturing-based, efficiency-driven to the innovation-driven development stage. Following the classification of stages of development put forward by the World Economic Forum (Schwab, 2009), both the Czech and Slovak Republics have been categorized as innovation-driven economies, whereas Hungary and Poland have been classified as being in transition from efficiency-driven to innovation-driven. One may reasonably expect that within 10-15 years all four CEE countries will reach the innovation-driven stage, following the path of mature Western economies. While an innovation-driven economy is associated with many entrepreneurs trying to commercialize new innovative ideas in the market, in efficiency-driven economies the exploitation of economies of scale by large firms plays a more dominant role and there is typically less room for small-scaled entrepreneurship.

*Insert Figure 1 about here*

The above literature review and data presented lead to the following hypotheses:

H5: The narrowing gap as to the level of GDP per capita between mature market economies and CEE countries during 1989-2008 contributed to the convergence of BO rates between these two groups of countries.

H6: The relatively high level of economic development in the Czech Republic contributed positively to bridging the gap in BO rates with the mature economies.

## 2.5. The speed of market oriented reforms

The impact of the speed and magnitude of macro-economic reforms can be studied from the perspective of the individual decision to start a business and/or from the perspective of how the reforms affected the growth of the private sector in general. The research conducted by Smallbone and Welter (2001) on a number of transition economies in the 1990s demonstrated that the need for independence and autonomy was by far the most common reason for starting a business in these countries. Clearly, the radically changing external environment, particularly the quick dismantling of the state-owned sector, could prompt such individual decisions. To account for the transition-specific factors in a person's considering entrepreneurship as a life-path option, Cieslik and Kaciak (2009a) adopted Shapero's model of an entrepreneurial event (Shapero and Sokol, 1982). The "systemic displacement" in the model reflects the negative emotions invoked by working in highly bureaucratic state-owned enterprises, government or municipality organizations with very limited opportunities to demonstrate initiative. The model's "between systems" effect encompasses the overall feeling that the communist system has collapsed irreversibly and the new era has begun. At the same time, the numerous businesses being started by former colleagues from work, friends and relatives creates a "positive pull" through demonstration effects, prompting similar decisions to start businesses by people with no previous experience or relevant family backgrounds.

With respect to the magnitude and speed of major macro-economic reforms that paved the way for the market-based economy, Poland emerged as the clear leader among transition economies in the CEE region. As early as 1990, Poland put in force a set of radical regulatory changes that introduced free-market mechanisms and eliminated protective measures for the state-owned sector. In other countries—Hungary and then the Czechoslovak Federated Republic (CSFR)—the respective reforms were introduced more gradually.

The empirical data that demonstrates the significant increase of the new entrepreneurial start-ups in Poland during 1989-1992 seems to support the argument that the "shock therapy" during the initial

<sup>1</sup> The COMPENDIA-23 countries are those originally included in EIM's COMPENDIA data base. The group includes the first 20 countries listed in Table 1 of this paper (i.e. excluding the CEE countries), and Luxembourg, Iceland and Japan (Van Stel, Cieslik and Hartog, 2010).

phase of systemic transition was an important factor in the formation of the new private sector. However, there were similar trends during this period in other CEE countries, particularly the Czech Republic and Slovakia, where the overall pace of systemic transformation was much slower at that time, suggesting that there were other important factors contributing to the expansion of the private sector.

The effectiveness of the “shock therapy” versus that of gradual transition has been the subject of a vivid economic and political debate, particularly in Poland, with strong voices of criticism pointing out the unnecessary hardships of the shock therapy, particularly for the employees of the state-controlled sector (e.g., Kolodko, 2000). Johnson and Loveman (1995) argued that, from the perspective of the new private sector, the overall impact of the shock therapy was positive because it shaped the macro-economic conditions that were necessary for accelerated growth. However, based on the comparative analysis of specific policy measures related to the development of the small business sector in Hungary and Poland, Fogel and Zapalska (2001) found “no evidence on the appropriateness of macro-economic policies to suggest that slower or more gradual policies have overall a greater positive effect on SME development and entrepreneurial growth” (p. 50).

Similarly inconclusive findings result from analyzing the impact of the overall business climate, particularly the impact of ease of doing business on business ownership. Using the aggregated World Bank index as a measure of the ease of doing business in 2009 (World Bank, 2009), at the bottom of the list were both the Czech Republic and Poland, as the most heavily regulated of EU countries, with the exception of Italy and Greece. Slovakia and Hungary, ranked in the middle of the list. Thus, the rankings of the four countries in terms of ease of doing business do not correspond with the rankings based on the level of business ownership. This conclusion does not necessarily reflect transition-specific conditions but reinforces a more general argument raised by Van Stel, Storey and Thurik (2007) regarding the rather insignificant impact of administrative considerations on the level of entrepreneurial activity.

The above literature review leads to the following hypothesis:

H7: The high speed and broad scope of market oriented reforms in Poland contributed positively to bridging the gap in BO rates with the mature economies.

### 3. DATA

In this paper we use business ownership rates for 24 OECD countries, defined as the number of non-agricultural business owners in a country divided by the size of the labour force. Business ownership (self-employment) is defined as the total number of unincorporated and incorporated self-employed outside the agriculture, hunting, forestry and fishing industries, who carry out self-employment as their primary employment activity, see Van Stel (2005, p. 108). Unpaid family workers are excluded. These data are taken from EIM’s COMPENDIA data base (version 2009.1).<sup>2</sup> In this data base, self-employment numbers as published in *OECD Labour Force Statistics* are corrected for measurement differences across countries and over time and thus harmonized. In particular, in OECD Labour Force Statistics owner-managers of incorporated businesses (OMIBs) are counted as self-employed in some countries, and as employees in other countries. Also, the raw OECD data suffer from many trend breaks relating to changes in self-employment definitions over time. EIM has constructed a method to correct for these inconsistencies (see Van Stel, 2005). For an update of the harmonization methods and for detailed information regarding the specifics of the business ownership data for the CEE countries, we refer to Van Stel, Cieslik and Hartog (2010).

2 COMPENDIA is an acronym for COMParative ENTrepreneurship Data for International Analysis. See <http://www.ondernemerschap.nl> for the data and Van Stel (2005) for a justification of the harmonization methods. This database has been used and acknowledged widely (see, among other studies, Armour and Cumming, 2008, Carree et al., 2002, 2007, Davis, 2008 (p. 54), Koellinger and Thurik, 2009, Nyström, 2008, and Parker, Congregado and Golpe, 2011).

## 4. RESULTS

### 4.1. Trends in BO rates 1989-2008 – a comparative analysis

To test our hypotheses we have conducted comparative analysis of trends in BO rates -both actual levels and dynamics of change- during the period 1989-2008. Taking into consideration the above-mentioned mix of economic, institutional and cultural factors affecting the levels and trends in business ownership rates, the countries originally included in the COMPENDIA data base (except for Iceland, Luxembourg and Japan) have been divided into four major country groups (see Wennekers et al., 2010): Mediterranean, Anglo-Saxon, Western European and Scandinavian. The fifth group consists of four Central and Eastern European countries (CEE) which have recently been added to the COMPENDIA data base.

Table 1 demonstrates remarkable developments in business ownership in the four Central and East European (CEE) transition economies (the Czech Republic, Hungary, Poland and Slovak Republic) since 1989. Radical changes in the levels of business ownership during the period under study were combined with diversified patterns, as BO rates evolved over time.

*Insert Table 1 about here*

After 45 years of communist dominance, during which period private business was disallowed or tolerated only as a marginal addition to the state-ownership sector, and subsequently 20 years of transitioning from a centrally-planned to a market economy, the CEE countries were able to catch up with the mature Western economies in terms of the levels of BO rates. While in 1989 the average (weighted) BO rate for the area comprising the four CEE countries was less than one third of the COMPENDIA-23 average, by 2008 this gap had effectively been closed (Table 2; panel 1). At present BO rates in Hungary, Slovak Republic and Poland are quite similar to those of Western European countries, which are geographically and culturally close (Table 2; panel 2). The Czech Republic is a clear exemption; with a very high rate it fits better to the Anglo-Saxon group. Taking into account that very high BO rates in the Mediterranean countries are strongly affected by historic and cultural factors which are specific for this region, we may conclude that nowadays the CEE region as a whole fits very well within a general pattern of business ownership rates in Europe (Figure 2).

*Insert Table 2 about here*

*Insert Figure 2 about here*

The most surprising outcome of the developments taking place in the course of transition from the centrally-planned to a market economy system was that countries that lagged behind in business ownership at the early stage of the transition process, the Czech and Slovak republics, eventually emerged as the leaders in entrepreneurial activity, surpassing Hungary and Poland, which had a more sizeable private sector under communism (Figure 3). As discussed in greater detail in Subsection 2.3. above, due to severe restrictions under communism, at the outbreak of systemic transformation in 1989, the private business sector was practically non-existent in Czech and Slovak republics (then Czechoslovakia). Nowadays (2008), Slovak Republic surpassed United Kingdom as to the level of the BO rate, whereas Czech Republic emerged as a clear leader, lagging only behind two Mediterranean countries traditionally showing exceptionally high business ownership rates, namely Italy and Greece. An additional effect was that the levels of BO rates among CEE countries which were extremely differentiated at the beginning of the transition process, have gradually converged over time (Table 2; panels 3 and 4).

*Insert Figure 3 about here*

### 4.2. Actual vs “equilibrium” business ownership rates in the CEE countries

In the statistical analysis conducted in the previous Sub-section we have investigated the convergence of BO rates in the CEE region with those achieved in other OECD countries during 1989 – 2008. In this section we investigate to what extent the four CEE countries, since 1989, have converged towards business ownership levels which are compatible with their levels of economic development. For each stage or level of economic development one can think of a ‘natural’ rate of business ownership expressing the relative importance of scale economies, the importance of the service sector and several other phenomena influencing the average scale of production (Wennekers et al., 2010).

For this purpose we re-estimate (part of) the model by Carree et al. (2002, 2007). In particular, we re-estimate the ‘equilibrium’ relation between economic development and the business ownership rate. Using this relation we are able to describe the patterns of convergence of the business ownership

rate towards the ‘equilibrium’ business ownership rate for the four CEE countries since 1989. For full details of the econometric analysis we refer to the Appendix to this paper. In this section we will focus on the implications for convergence.

According to our estimation results the ‘equilibrium’ rate of business ownership can be written as

$$E_i^* = 1.381 - 1.333 \frac{YCAP_i}{YCAP_i + 1}, \text{ where } YCAP \text{ is expressed in thousands of US dollars of price level}$$

2000. Using this equilibrium relation, Tables 3a until 3d describe the convergence pattern of the (non-agricultural) business ownership rate for the four CEE countries.

In 1989, at the end of the Communist period, business ownership (self-employment) levels in the four CEE countries were relatively low. In particular, business ownership levels were lower than could be expected on the basis of their level of economic development. From the last columns we can see that convergence has clearly taken place: the difference between the ‘equilibrium’ and actual business ownership rate has decreased since 1992 (and indeed since 1989). In fact, for Czech Republic the business ownership is even higher in 2008 than could be expected based on their per capita income level. Slovak Republic has just recently converged towards the equilibrium rate, while convergence in Hungary and Poland also occurs, but at a slower speed. Figure 4 shows the actual and ‘equilibrium’ business ownership rates for the four CEE countries in 2008. As a point of reference, the United States is also included in the figure.

Insert Table 3 about here

Insert Figure 4 about here

## 5. DISCUSSION

The results of the analysis contained in the preceding Section lead to a general conclusion that the period of 45 years under communist rule, a system which ideologically and practically battled with entrepreneurial initiatives, did not have prolonged negative effect on the private business sector in the CEE region. What mattered most were the institutional and cultural roots or “civilization fundamentals”. Based on those fundamentals, the CEE countries were able, within the relatively short period of transition, to rebuild the entrepreneurial sector.

This is particularly reflected in the gradual approximation of the BO rates in the CEE region with the OECD (COMPENDIA-23) average (Table 2; panel 1): from 32.5% in 1989 to 98.7% in 2008. This confirms Hypothesis 1: *As all four countries under study belonged historically to the Western Christendom, this facilitated rapid catching-up of BO rates with those prevailing in the mature market economies while at the same time downplaying the role of communist heritage.*

In Hypothesis 2 we speculated that: *Due to historic and cultural links with some Western European countries, BO rates prevailing in these countries form a “historic benchmark” to which CEE region tended to approximate.* Such trend is clearly visible for Hungary and Poland (Table 2; panel 2), whereas in the case of the Slovak and Czech republics their “historical benchmark” seem to be the Anglo-Saxon countries. Such developments in the Czech Republic can be explained by the strength of additional factors, namely its most intensive, among CEE countries, historic ties with the Western civilization. In Hypothesis 3 we speculated that such “*historic roots provided most favorable environment for catching up with respect to BO rates*”. Parallel to that was a relative high rate of socio-economic development at the beginning of the transition period (Figure 1), compared to other CEE countries under study which, as expected in Hypothesis 6, also “contributed positively to bridging the gap in BO rates with the mature economies”. Indeed, the speed of catching up was extremely fast. As exemplified by the data contained in Table 2, Czech Republic has surpassed, in terms of BO rate, the COMPENDIA-23 average already in 1996, reaching in 2008 a level 43% higher than the said average.

As to the developments in the Slovak Republic, one shall also bear in mind that Czech and Slovak republics have tradition of functioning as a two-nation state since 1918 and were separated only in 1993. Historically being less advanced, the Slovak Republic could benefit from continuing strong economic, cultural and institutional ties with the Czech Republic, resulting in similar approaches to rebuilding the private business sector after transition to a market economy system. Based on that we consider Hypotheses 2, 3 and 6 as confirmed.



Regarding the impact of past experiences with the private business sector under communism we could distinguish between those countries having sizeable private sector at the outbreak of systemic transition (Hungary and Poland) and countries where the private sector was practically non-existent (Czech Republic and Slovak Republic). In Hypothesis 4 we speculated: *Experiences with entrepreneurship under the communist regime in Hungary and Poland contributed to the accelerated growth of BO rates after transition.* We have pointed out, however, that the positive impact of such experiences can be limited due to the strong embeddedness in the past institutional environment.

The results of empirical analysis presented in the preceding Section (Table 1 and Figure 3) point out to the complex nature of such a relationship. Clearly, the communist past helped in the rapid expansion of the small business sector in Hungary and Poland in the early 1990s. Later on we could note a saturation (Poland) or even decline of BO rates (Hungary). On the one hand this was the result of many of the new business establishments closing after a short period, due to a lack of experience of their owners, inadequate financing, uncertain fiscal regulations, etc. At the same time incumbent private firms could not adjust to the market economy system and ceased operations, despite being successful under communism. Thus our analysis seem to confirm the findings from the extant literature, referred to in sub-section 2.3, that the entrepreneurial experiences accumulated under communism were not much useful for growth of the private business sector after transition to a market economy system. Based on the above we may conclude that Hypothesis 4 was partially confirmed.

Hypothesis 5 read: *The narrowing gap as to the level of GDP per capita between mature market economies and CEE countries during 1989-2008 contributed to the convergence of BO rates between these two groups of countries.* The fast increase in GDP per capita of the CEE countries implied moving from an efficiency-driven type of economy towards an innovation-driven type of economy, where entrepreneurial opportunities are more abundant, especially in a transition context (Stam and Van Stel, 2011). In this sense, the catching-up process in terms of economic development of the CEE countries contributed to a catching-up process also in terms of business ownership.

Moreover, since in the long run countries tend to follow an ‘equilibrium’ rate of business ownership which is declining with economic development,<sup>3</sup> the fast increase in GDP per capita for the CEE countries implied that their equilibrium BO rates were declining, contributing to a convergence process between the actual and the equilibrium BO rates for the CEE countries (see Section 4.2).

We conclude that Hypothesis 5 is confirmed.

With respect to Hypothesis 7, *the high speed and broad scope of market oriented reforms in Poland contributed positively to bridging the gap in BO rates with the mature economies*, the empirical analysis leads to some observations which are similar to those related to Hypothesis 5. The substantial impact of radical economic reforms introduced in Poland on BO rates could be noted during 1989-1991. The “shock therapy” involving major privatizations and closures of many state-owned companies meant the loss of hundreds of thousands of jobs deemed secure under the previous regime. In addition, the “winds of history” spirit (Cieslik and Kaciak, 2009a) inspired many people to start their own business. Later on, the impact of radical reforms seemed to vanish, which strengthens some doubts on this subject, raised in the extant literature and discussed in subsection 2.5 (Fogel and Zapalska, 2001). We may therefore conclude that Hypothesis 7 is partially confirmed.

Summing up the discussion of the results of the empirical analysis in relation to the hypotheses developed in Section 2 we are able to confirm 5 out of 7 hypotheses. Two remaining hypotheses are partially confirmed. It is interesting to note that the two hypotheses being only partially confirmed relate to the developments under communism and during the 20 years of transition. This reinforces the key conclusion derived from our analysis that what mattered most with respect to business ownership rates were the historic economic, institutional and cultural ties with the Western world (the “civilization fundamentals”).

3 Note that, whereas the relation between economic development and business ownership (a measure of *incumbent* entrepreneurship) is mostly found to be L-shaped, the relation between economic development and measures of *new-firm* entrepreneurship such as GEM’s TEA rate, is often found to be U-shaped (see e.g. Kelley, Bosma and Amorós, 2011). The high exit rates in modern economies form the most likely explanation for these different patterns.



## 6. POLICY IMPLICATIONS, LIMITATIONS AND RECOMMENDATIONS FOR FURTHER RESEARCH

### 6.1. Policy implications

As “latecomers”, the CEE countries are in a privileged position as they may study trends in the mature economies and assess the effectiveness of various policy measures aimed at enhancing entrepreneurship. The accumulated body of policy-oriented entrepreneurship research can be helpful in this respect, as well. Since the current entrepreneurship policy debate lacks a sound empirical background, inclusion of these CEE countries in the harmonized COMPENDIA data base is very important as it provides benchmark BO rates, useful for shaping entrepreneurship policies.

Based on the research presented in this paper we point out some conclusions and recommendations.

One of the key policy issues, to be addressed by the CEE policymakers, is whether they shall strive for further increasing the general level of business ownership, which is in fact their most often declared policy statement. Here we shall refer to the concept of the “optimal” business ownership rate (in terms of achieving the highest GDP levels), estimated by Van Praag and Van Stel (2010) as being in the range of 12.5%. Except for the Czech Republic, the remaining CEE countries achieved lower than “optimal” business ownership rates, so far. However, Van Praag and Van Stel find the optimal rate to decrease with higher participation levels in tertiary education.<sup>4</sup> This is generally a strongpoint of the CEE region, particularly of Poland, which scholarization index ranks very high among European countries (Central Statistical Office, 2010, p. 27).

Assuming that the CEE countries are quite close to or above their “optimal” business ownership rates, further increases of the total number of business establishments may not be justified. Alternatively, these countries should rather focus on the ambitious segments of entrepreneurship in view of their potential contribution to the growth of GDP and employment (Stam and Van Stel, 2011). Here we have in mind fast-growing, knowledge-based or innovation-driven firms, creative industries, exporters, etc. In fact, some interesting trends have already become noticeable. We refer to Cieslik and Kaciak (2009b), who demonstrate a significantly higher proportion of high-growth firms and gazelles among Polish manufacturing SMEs, as compared to other OECD member countries (OECD, 2008).

While improving the general conditions for entrepreneurship development, CEE countries should concentrate on the measures that reinforce positive effects of “civilization fundamentals” and downplaying the role of communist heritage. This includes, inter alia, promoting good practices regarding business ethics and corporate social responsibility (CSR). While shaping specific instruments and policy measures, due to historic ties, the accumulated experiences of Western European countries seem to be particularly relevant.

### 6.2. Limitations and future research directions

The inclusion of the four CEE countries in the latest edition of the COMPENDIA data base shall be seen as a first step in the harmonization efforts regarding BO rates in transition economies. In view of the distinct characteristics of their statistical systems, more work is required to make sure that the differences as to the levels of the BO rates are not affected by methodological inconsistencies.

A major limitation of our study stems from the fact that it focused on quantitative aspects of entrepreneurship development. To offer a more meaningful contribution, relevant for entrepreneurs and policymakers, additional research on the qualitative dimensions of entrepreneurship development in transition economies, will be necessary.

More specifically, we need to explore in greater detail the distribution of entrepreneurial activity by major categories: the size of informal versus formal entrepreneurship and the share of marginal-scale entrepreneurial engagements, including those for which the business is a secondary activity, dependent self-employment and those using commission and task contracts without registering the business. The distribution between the solo-entrepreneurs and employers in each country is worth considering as well.

An obvious limitation results from the concentration of our research on four CEE countries with very similar historic and cultural traditions and relatively short (45 years) periods of communist rule. Thus extension of the analysis to other members of the former Soviet Bloc is highly recommended. In the case of such countries like Belarus, Russia and Ukraine we may expect a different picture as the key

<sup>4</sup> Since their education implies a bigger span of control, higher-educated entrepreneurs optimize their profits by running larger firms – implying a lower number of business owners at the macro level.

factors affecting entrepreneurship differ significantly from those observed in the four countries under study: “civilization fundamentals”, experience with entrepreneurship under communism, the level of socio-economic development and the speed of implementation of market-oriented reforms. On top of that, those countries experienced communist rule over 70 years. This can be seen as a minor difference with 45 years experienced by the Czech Republic, Hungary, Poland and Slovak Republic. It meant, however, that three, rather than two generations of people could develop a “homo sovieticus” mindset with potentially negative effects as to the initiatives to start and run own businesses.

Another group of countries worth studying are the Baltic States. Here one can expect similar patterns as to the BO rates, compared to those identified in the four CEE countries under study. In general, broadening the scope by including countries representing different levels of economic and cultural development would greatly enhance the prospects for a quality research on the trends in entrepreneurial activity in a transition environment.

A very promising and largely unexplored research avenue on the former communist countries relates to the historic coincidence of two fundamental developments that took place towards the end of the twentieth century: the collapse of communism and the widespread dissemination of information and communication technologies (ICT). As a general-purpose technology (GPT) that spreads across and has profound effects on all key sectors of economic and social life (Bresnahan and Trajtenberg, 1995), the ICT represents surely one of the “great leaps” in the history of mankind. What is of particular importance in the context of business ownership is that the ICT revolution—particularly Internet technologies—has been extremely favorable to entrepreneurship initiatives because it has reduced the negative effects of the “liability of newness” (Morse, Fowler and Lawrence, 2007). Particular beneficiaries of the ICT revolution are those new business owners in transition economies who have the necessary skills to assimilate these technologies in starting and growing successful businesses within a specific environment of market conditions and physical infrastructure.

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#### Appendix: Re-estimating Carree et al. (2002, 2007)

##### *The model*<sup>5</sup>

The main equation in the model by Carree et al. (2002, 2007) explains changes in the rate of business ownership (self-employment) from an error-correction process towards ‘equilibrium’ or ‘natural’ business ownership rates. A second equation acts as a definition and describes the ‘equilibrium’ rate of business ownership as a function of economic development. Equation (1) relates the change in the rate of business ownership  $E_t$  to the extent in which this rate deviates from the ‘equilibrium’ rate  $E_t^*$ ,

to which the unemployment rate  $U_t$  deviates from the sample average unemployment rate and to which the labour income share  $LIQ_t$  deviates from the sample average income share. Equation (2)

describes the ‘equilibrium’ relationship between business ownership rates and economic development ( $YCAP_t$ ) as either U-shaped (2a) or L-shaped (2b). In the quadratic form, entrepreneurship declines

with per capita income up till a minimum (when  $YCAP_t$  equals  $-\beta/2\gamma$ ) after which entrepreneurship increases with per capita income. In the inverse function, entrepreneurship gradually declines towards an asymptotic minimum value (of  $\alpha - \beta$ ). In the first equation the following notation is used:

$\Delta_4 X_t = X_t - X_{t-4}$ . The model reads as follows:

$$(1) \Delta_4 E_t = b_1(E_{i,t-4}^* - E_{i,t-4}) + b_2(U_{i,t-6} - \bar{U}) + b_3(LIQ_{i,t-6} - \overline{LIQ}) + b_{ITA}D_{ITA} + \varepsilon_{1t} ;$$

$$(2a) E_t^* = \alpha + \beta YCAP_t + \gamma YCAP_t^2 ;$$

$$(2b) E_t^* = \alpha - \beta \frac{YCAP_t}{YCAP_t + 1} ,$$

<sup>5</sup> Apart from some minor adjustments, the description of the model, variables and data sources is taken over from Carree et al. (2007).



where

- $E$ : number of business owners per labour force,  
 $E^*$ : 'equilibrium' number of business owners per labour force,  
 $YCAP$ : per capita GDP in thousands of purchasing power parities per U.S. \$ in 2000 prices,  
 $U, \bar{U}$ : unemployment rate and sample average, respectively,  
 $LIQ, \bar{LIQ}$ : labour income share and sample average, respectively,  
 $D_{ITA}$ : dummy variable with value 1 for Italy, and 0 for other countries,  
 $\varepsilon_1$ : disturbance term  
 $i, t$ : indices for country and year, respectively.

#### *The rationale of the model*

The variable to be explained in equation (1) is the growth in the number of business owners per labour force in a four-year period. The parameter  $b_1$  reflects the speed of an error correction mechanism between the 'equilibrium' and the actual rate of self-employment at the start of the period and is expected to have a positive sign. As control variables, unemployment and the labour income share are included. Unemployment is expected to act as a push factor for self-employment and its expected sign is positive. The labour income share is an (inverse) proxy for business profitability and its expected sign is negative. Finally, we follow Carree et al. (2002) incorporating a dummy for Italy. Italy, and Northern Italy in particular, is exceptional in the sense that a relatively high value of GDP per capita is combined with a high and rising self-employment rate. The model is estimated by substituting the definition (2a) or (2b) into equation (1):

$$(3a) \Delta_4 E_{it} = a_0 - b_1 E_{i,t-4} + b_2 U_{i,t-6} + b_3 LIQ_{i,t-6} + a_4 YCAP_{i,t-4} + a_5 YCAP_{i,t-4}^2 + b_{ITA} D_{ITA} + \varepsilon_{1it}$$

$$(3b) \Delta_4 E_{it} = a_0 - b_1 E_{i,t-4} + b_2 U_{i,t-6} + b_3 LIQ_{i,t-6} + a_4 \frac{YCAP_{i,t-4}}{YCAP_{i,t-4} + 1} + b_{ITA} D_{ITA} + \varepsilon_{1it}.$$

For this paper we are mainly interested in the parameter estimates of  $\alpha$ ,  $\beta$  and  $\gamma$  and these are calculated as a reparametrisation of the parameters in (3a) and (3b):

$$(4a) \hat{\alpha} = (a_0 + b_2 \bar{U} + b_3 \bar{LIQ}) / b_1 \quad \hat{\beta} = a_4 / b_1 \quad \hat{\gamma} = a_5 / b_1,$$

$$(4b) \hat{\alpha} = (a_0 + b_2 \bar{U} + b_3 \bar{LIQ}) / b_1 \quad \hat{\beta} = a_4 (-b_1).$$

Using these parameter estimates, variable  $E^*$  can be computed (see equation 2).

#### *Variables and data sources*

$E$ : Business ownership or self-employment is defined as the number of business owners (in all sectors excluding the agricultural sector), expressed as a fraction of the labour force. Business owners include unincorporated and incorporated self-employed individuals but exclude unpaid family workers. Data on business ownership are taken from EIM's COMPENDIA data base (available through www.eim.net). In COMPENDIA numbers of self-employed reported in *OECD Labour Force Statistics* are harmonized across countries and over time. In the present paper version 2008.1 of the COMPENDIA data base is used. See van Stel (2005) for an account of how an earlier version of this data set is put together. Data on total labour force are from *OECD Labour Force Statistics*;

$YCAP$ : Gross domestic product per capita. The variables gross domestic product and total population are taken from *OECD National Accounts* and *OECD Labour Force Statistics*, respectively. GDP (in thousands of US \$) is measured in constant prices. Furthermore, purchasing power parities of 2000 are used to make the monetary units comparable between countries;

$U$ : Unemployment rate. It is measured as the number of unemployed as a fraction of the total labour force. The labour force consists of employees, self-employed persons, unpaid family workers, people employed by the armed forces and unemployed persons. The main source for this variable is *OECD*



*Main Economic Indicators;*

*LIQ*: Labour income share. It is defined as the share of labour income (including the “calculated” compensation of the self-employed for their labour contribution) in the gross national income. Total compensation of employees is multiplied by (total employment/number of employees) to correct for the imputed wage income for the self-employed persons. Next, the number obtained is divided by total income (compensation of employees plus gross operating surplus and gross mixed income). The data of these variables are from *OECD National Accounts*.

*Estimation results*

Following Carree et al. (2002, 2007) we estimate the model using weighted least squares (with population as the weight factor). Instead of the 23 OECD countries originally used by Carree et al., we now use data of 27 OECD countries to estimate the model, where the four CEE countries have been newly added to the data base.<sup>6</sup> For the 23 original countries we use data for the years 1996, 2000, 2004 and 2008.<sup>7</sup> However, since the early years after the collapse of Communism cannot be considered representative for the relation between economic development and self-employment in the four CEE countries (as self-employment was artificially low), we only use the last two years of data (i.e., 2004 and 2008) for these four countries. Our sample then consists of 100 observations. The results are presented in Table 4.

Table 4: Estimation results

		Quadratic ‘equilibrium rate’: equation (2a)	Inverse ‘equilibrium rate’: equation (2b)
<b>Equations (3a) and (3b), dependent variable: 4-year growth of business ownership rate</b>			
a <sub>0</sub>	autonomous effect	0.057*** (3.6)	0.186** (2.6)
b <sub>1</sub>	error correction	0.118*** (4.1)	0.111*** (3.9)
b <sub>2</sub>	unemployment	0.023 (1.1)	0.027 (1.3)
b <sub>3</sub>	labour income share	-0.060*** (3.6)	-0.052*** (3.3)
a <sub>4</sub>	per capita GDP	-0.000189 (0.3)	-0.148** (2.2)
a <sub>5</sub>	per capita GDP	-2.54 <sup>E</sup> -06 (0.2)	
b <sub>ita</sub>	Italy	0.013*** (3.4)	0.013*** (3.3)
α	2(a) and 2(b)	0.158** (2.3)	1.381*** (9.3)
β	2(a) and 2(b)	-0.0016 (0.3)	1.333** (2.0)
γ	2(a) and 2(b)	-2.15 <sup>E</sup> -5 (0.2)	
minimum		-	
asymptote			0.048
R <sup>2</sup> <sub>adj</sub>		0.232	0.221

Note: Absolute t-values in parentheses. \* Significant at 0.10 level; \*\* Significant at 0.05 level; \*\*\* Significant at 0.01 level. The number of observations is 100.

Since the Inverse model seems to perform somewhat better, we will use this model in the paper. According to our estimation results the ‘equilibrium’ rate of self-employment can then be written as  $E_t^* = 1.381 - 1.333 \frac{YCAP_t}{YCAP_t + 1}$ , where *YCAP* is expressed in thousands of US dollars of price level

2000.

<sup>6</sup> The 23 OECD countries originally used by Carree et al. comprise of the former EU-15, together with Iceland, Norway, Switzerland, the United States, Japan, Canada, Australia and New Zealand.

<sup>7</sup> Due to the four year lag in the model, the ‘equilibrium’ relation between self-employment and economic development is actually estimated using data for the years 1992, 1996, 2000 and 2004.

**List of Tables**

Table 1. Non-agricultural business ownership rates in selected OECD countries, 1989-2008.

Country	1989	1996	2002	2008
Greece	0.188	0.197	0.190	0.198
Italy	0.198	0.208	0.207	0.204
Portugal	0.134	0.167	0.147	0.131
Spain	0.123	0.130	0.127	0.131
Mediterranean countries	0.166	0.177	0.172	0.168
Australia	0.158	0.159	0.158	0.145
Canada	0.105	0.128	0.124	0.120
Ireland	0.102	0.112	0.113	0.116
New Zealand	0.120	0.137	0.135	0.128
United Kingdom	0.113	0.112	0.104	0.115
USA	0.108	0.106	0.098	0.096
Anglo-Saxon countries	0.111	0.111	0.104	0.104
Austria	0.072	0.074	0.087	0.089
Belgium	0.111	0.119	0.115	0.111
France	0.099	0.086	0.079	0.086
Germany	0.071	0.082	0.086	0.097
The Netherlands	0.080	0.098	0.103	0.119
Switzerland	0.069	0.077	0.074	0.068
Western European countries	0.084	0.086	0.086	0.095
Denmark	0.060	0.064	0.067	0.070
Finland	0.081	0.080	0.079	0.088
Norway	0.081	0.071	0.065	0.084
Sweden	0.069	0.081	0.081	0.087
Scandinavian countries	0.071	0.075	0.074	0.083
Czech Republic	0.002	0.112	0.146	0.152
Hungary	0.061	0.120	0.103	0.097
Poland	0.046	0.077	0.077	0.091
Slovak Republic	0.001	0.053	0.065	0.117
Central and Eastern European countries	0.037	0.087	0.092	0.105
COMPENDIA-23	0.113	0.111	0.106	0.107

Source: EIM, COMPENDIA 2009.1 data base.

Note: Business ownership rates for the country groups are weighted averages of the underlying countries.

Table 2. Comparative analysis of trends in BO rates during 1989 – 2008.

No.	Description	1989	1996	2002	2008
1.	Average BO rates in the CEE countries as % of average COMPENDIA-23, of which:	<b>32.5</b>	<b>78.6</b>	<b>86.7</b>	<b>98.7</b>
	- Czech Republic	1.5	100.9	137.7	143.1
	- Hungary	53.8	107.9	96.8	91.0
	- Poland	40.4	69.4	72.8	85.2
	- Slovak Republic	0.7	48.1	61.7	109.5
2.	Average BO rates in the CEE countries as % of average Western European group, of which:	<b>43.8</b>	<b>101.8</b>	<b>106.4</b>	<b>111.2</b>
	- Czech Republic	2.0	130.7	169.0	161.2
	- Hungary	72.6	139.8	118.8	102.5
	- Poland	54.5	89.9	89.4	96.0
	- Slovak Republic	1.0	62.2	75.8	123.4
3.	Lowest BO rate as % of the highest BO rate within the CEE country group	1.3	44.5	44.8	59.6
4.	BO rates in individual CEE countries as % of the average BO rate for the CEE group as a whole				
	- Czech Republic	4.6	128.4	158.8	145.0
	- Hungary	165.6	137.3	111.7	92.2
	- Poland	124.3	88.3	84.0	86.4
	- Slovak Republic	2.2	61.1	71.2	111.0

Source: EIM, COMPENDIA 2009.1 data base.

Note: Business ownership rates for the country groups are weighted averages of the underlying countries (see Table 1).

Table 3a: Actual and 'equilibrium' self-employment rates, Czech Republic

Year	Per capita income in US\$ of 2000	Four-yearly growth of per capita income	'Equilibrium' SE rate (E*)	Actual SE rate (E)	E*-E
1989	N.A.	N.A.	N.A.	0.002	N.A.
1992	12798	N.A.	0.145	0.069	0.076
1996	14429	0.127	0.134	0.112	0.022
2000	14995	0.039	0.131	0.133	-0.002
2004	17054	0.137	0.122	0.151	-0.030
2008	20609	0.208	0.110	0.152	-0.043

Source: EIM, COMPENDIA 2009.1 data base, and own calculations.

Table 3b: Actual and 'equilibrium' self-employment rates, Hungary

Year	Per capita income in US\$ of 2000	Four-yearly growth of per capita income	'Equilibrium' SE rate (E*)	Actual SE rate (E)	E*-E
1989	N.A.	N.A.	N.A.	0.061	N.A.
1992	9477	N.A.	0.175	0.085	0.091
1996	10001	0.055	0.169	0.120	0.049
2000	12114	0.211	0.150	0.110	0.040
2004	14549	0.201	0.134	0.112	0.021
2008	16022	0.101	0.126	0.097	0.029

Source: EIM, COMPENDIA 2009.1 data base, and own calculations.

Table 3c: Actual and 'equilibrium' self-employment rates, Poland

Year	Per capita income in US\$ of 2000	Four-yearly growth of per capita income	'Equilibrium' SE rate (E*)	Actual SE rate (E)	E*-E
1989	N.A.	N.A.	N.A.	0.046	N.A.
1992	6966	N.A.	0.215	0.068	0.148
1996	8619	0.237	0.186	0.077	0.109
2000	10568	0.226	0.163	0.080	0.083
2004	11896	0.126	0.151	0.078	0.073
2008	14706	0.236	0.133	0.091	0.042

Source: EIM, COMPENDIA 2009.1 data base, and own calculations.

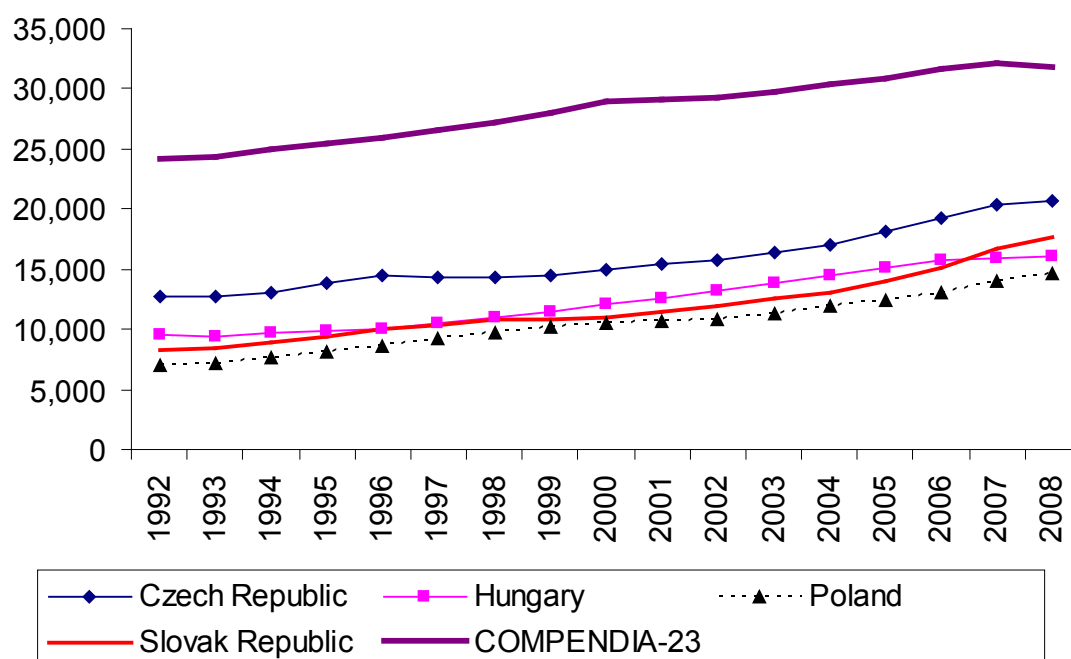
Table 3d: Actual and 'equilibrium' self-employment rates, Slovak Republic

Year	Per capita income in US\$ of 2000	Four-yearly growth of per capita income	'Equilibrium' SE rate (E*)	Actual SE rate (E)	E*-E
1989	N.A.	N.A.	N.A.	0.001	N.A.
1992	8253	N.A.	0.192	0.041	0.151
1996	9984	0.210	0.169	0.053	0.116
2000	10972	0.099	0.159	0.060	0.099
2004	13115	0.195	0.142	0.091	0.051
2008	17721	0.351	0.119	0.117	0.002

Source: EIM, COMPENDIA 2009.1 data base, and own calculations.

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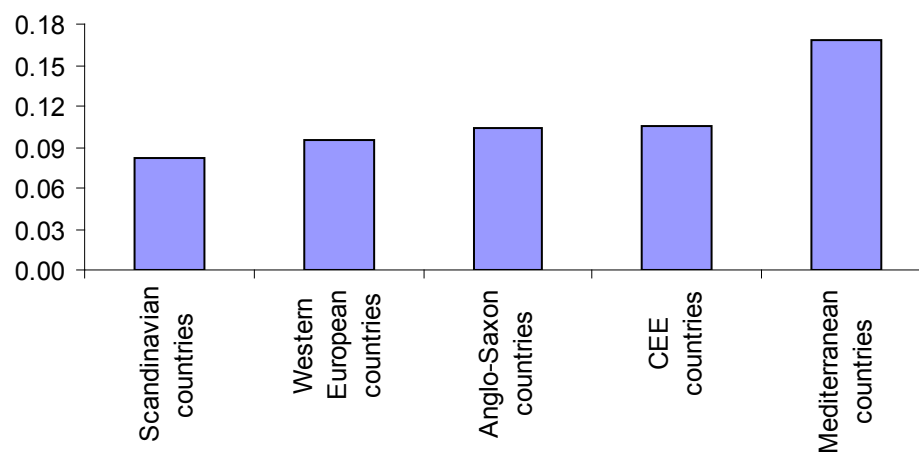
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Source: EIM, COMPENDIA 2009.1 data base, based on OECD National Accounts and OECD Labour Force Statistics.

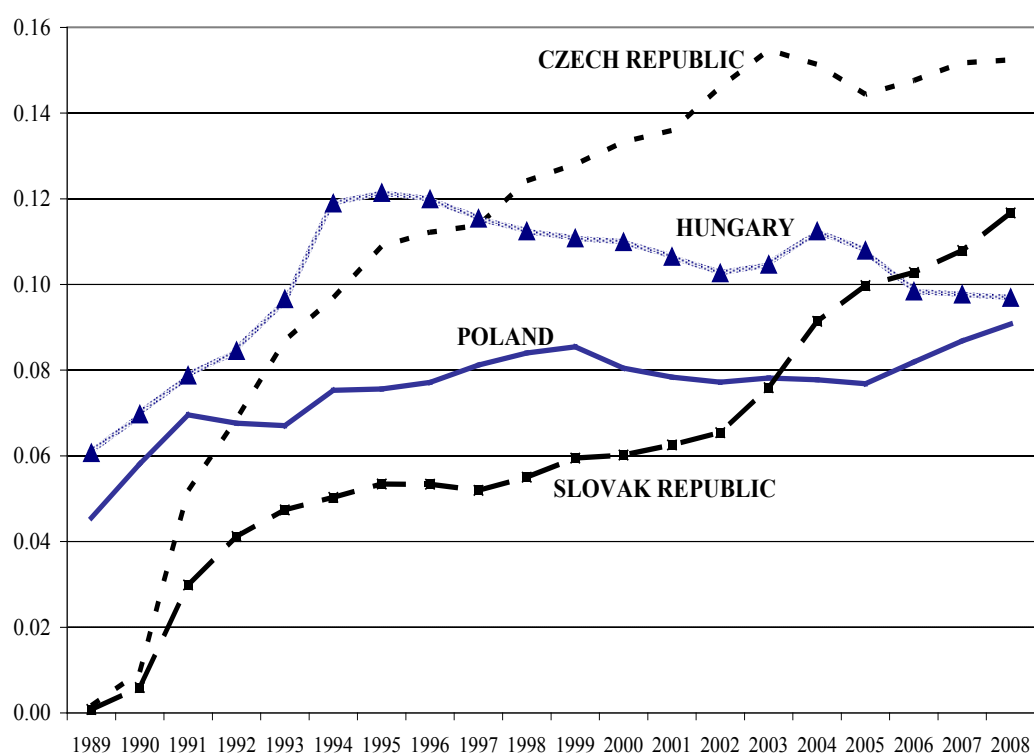
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Source: EIM, COMPENDIA 2009.1 data base.

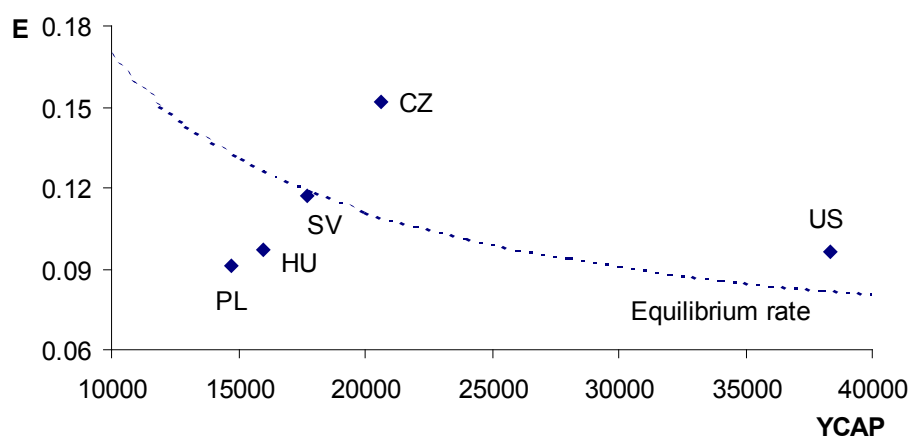
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Source: EIM, COMPENDIA 2009.1 data base, and own calculations.

## WHY 20 YEARS AFTER TRANSITION THERE ARE NO LUXURIOUS GLOBAL BRANDS IN POLAND<sup>1</sup>? COMPARISON WITH EMERGING MARKETS

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### Abstract

Poland 20 years after the transition is fast growing economy. The society is enriching fast and at the same time is eager to surround with luxury. For a long time luxury goods were unavailable for Polish, they didn't even know luxury brands. Then they started to desire them, but didn't have financial resources. Now comes the time when desire to consume match the financial possibilities.

There've been many changes on luxury market recently. Traditionally the most important markets for luxury were supposed to be Western Europe, North America and Japan. In recent times the perspective is changing – customers from emerging markets are becoming more and more important. Brazil, Russia, India and China are playing here special role. China has become the second biggest market for luxury. In the near future emerging economies will contribute to 80% of growth in the luxury goods sector. Also Poland, although not as spectacularly as China, is developing fast.

The aim of this paper is to analyze the economic development and social conditions of Poland, from the point of view of luxury companies. The question is, why 20 years after transition despite dynamic development of country the number of luxury companies is very limited. What are the factors which determine the attractiveness of the market and what are the limits? The characters of Polish market were compared with BRIC markets, which seem to be new capitals of luxury. Polish and BRIC markets were analyzed and compared according to the theory of investment climate. Also conception of conspicuous consumption created by Thorsten Veblen was very crucial.

**Keywords:** Luxury, Poland, emerging markets, BRICs

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<sup>1</sup> It is possible to buy luxury goods in Poland. However the choice is small, prices of products higher than of the same goods in Western Europe. There are only 8 luxury boutiques in Warsaw, 4 in other cities. Luxury companies seem to see Polish market as unattractive, less attractive than markets of Brazil, India, Russia or China.

## 1. INTRODUCTION TO THE TOPIC

The situation on luxury market is changing recently very fast. The luxury is no longer available only for the richest. Global companies started to create cheaper brands whose target is middle class. A lot of not expensive branded accessories are sold (Sikora, 2010). Also the geographical dimensions are changing. Luxury companies have become oriented at emerging economies, especially BRIC countries. Among those new perspective markets Poland should be considered.

The aim of this paper is to analyze economic development and the social conditions of Poland, from the point of view of luxury companies. The question is, why 20 years after transition despite dynamic development of country the number of luxury companies is very limited. What are the factors which determine the attractiveness of the market and what are the limits?

## 2. METHODOLOGICAL NOTE

The paper is based on literature, reports of industry organizations and articles from magazines. A very crucial source was KPMG report about luxury in Poland, the first such complex analysis. The company conducted research as well among consumers of luxury as owners of luxury companies. Financial information in the report was based on data from Ministry of Finance. Due to that fact author relies on the report a lot. The topic is quite complex, existing literature resources are not enough to answer the question with 100% certainty. The conclusions should be treated as author hypotheses, opened to the discussion and further research.

The structure of the article consist of four parts. Firstly the characters of Polish market will be listed. In second part theoretical framework will be presented. Then changes on the global luxury market will be described, Polish market compared with BRICs markets. Finally the conclusions will be drived and the title question answered.

Treating Brazil, Russia, India and China (BRIC countries) as one group of countries cause among many researchers doubts. However BRIC countries have a lot in common. What link them are fast economic development, enriching of society, rising consumption aspirations and lack of market saturation. There is one more factor: the belief of western companies that they will bring profits to them. However it can't be forgotten that they are still emerging countries with turbulent economic environment and huge social stratification. They are treated as new markets for luxury: full of risks but with perspectives of high profits. Entering Poland also brings perspective of high profits and lower risks at the same time. It also could be new market for luxury. Author decided to compare those countries with Poland because it is surprising, why global luxury companies see such potential in BRIC countries and are not interested in better developed Poland. Basing on this comparison author considers what makes market attractive for luxury.

For purpose of this article author defines luxury brand as a brand which is selective, exclusive, contributes emotional and creative value to the consumer. Moreover it needs to have an artistic dimension, to be result of craftsmanship and to be international (Chevalier and Mazzalovo, 2008). Other definition stress factors that must be included to qualify a product as a luxury. Firstly, in order to fulfill holistic experience an extravagant service is required. Luxury product should represent a dream: functionality is one dimension but it is the dream which satisfies all senses. Finally luxury product must stay current and be timeless by design and materials that age well (Kapferer and Bastien 2009).

Polish and BRIC markets will be analysed and compared according to the theory of investment climate. Also conception of conspicuous consumption created by Thorsten Veblen was very crucial. Finally concept of luxury spread in society will be shortly described. It helps to understand consumer behavior, illustrates dependence between consumer taste and customs, economic development and political system as well. It shows how consumption of luxury is becoming part of everyday life on different markets. Despite those advantages it has many inaccuracies and because of that author resigned from applying it in the article.

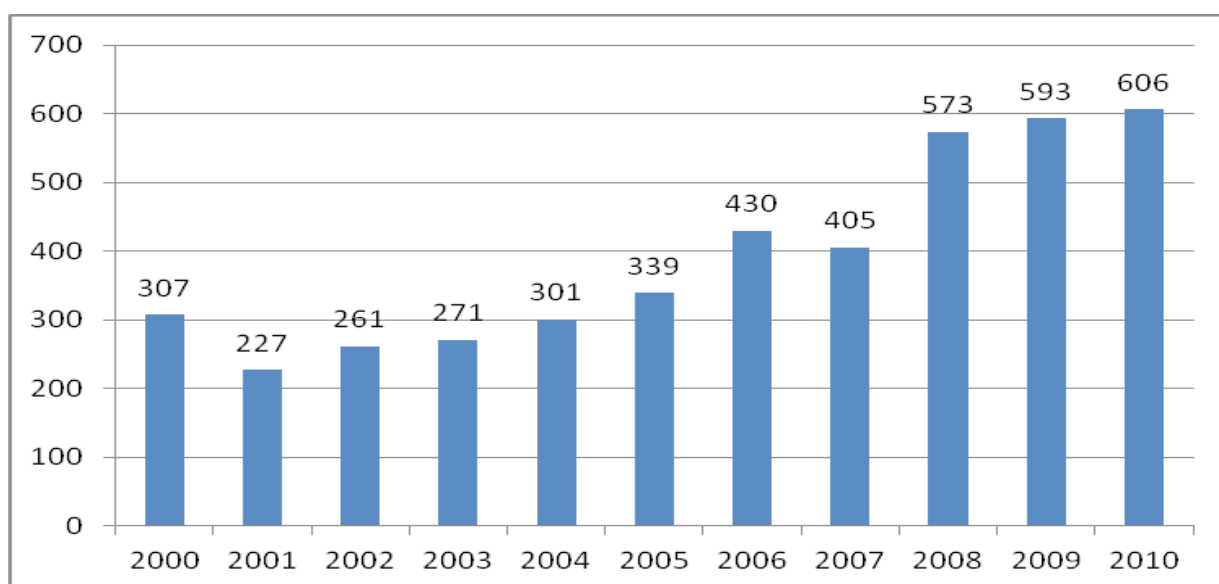
### 3. LUXURY ON POLISH MARKET

There are three main factors determining demand for luxury goods. They are: number of people with high income, the level of their income and eagerness to spend money on luxury goods. The other determinant is supply of luxury brands on the market. Poland will be analyzed according to those factors.

For purpose of this article consumers of luxury in Poland were divided because of the level of their monthly income. The division was prepared in accordance with tax threshold. The first group earns between 920 – 1 800 euro/month, the second 1 800 – 5 000 euro/month, the third over 5 000 euro/month. Luxury is also bought by people with lower income, but because of the marginal size of their spending, they weren't taken into account (KPMG report, 2010, pp. 23-25). The analyze doesn't take into account the earnings of people active in shadow economy, which according to World Bank amounts to almost 30 % of GDP<sub>2</sub>.

The level of earnings of Polish is growing – Poland in years 2006 – 2008 noticed the highest in Europe, amounting to 33%, growth of number of richest people, so called HNWI (high net worth individuals)<sub>3</sub>. During last 10 years the number of people earning more than 1 800 euro by month (gross) almost tripled. Their income level increased by 30%. It is estimated that in 2010 there was 606 thousands of them, their average income amounted to 3 750 euro. 50 000 of them have income amounting to over 50 000 euro (KPMG report, 2010, p.23).

Figure 5: Number of people earning over 1800 euro/month in Poland (thousands)



Source: own scheme based on KPMG report 2011

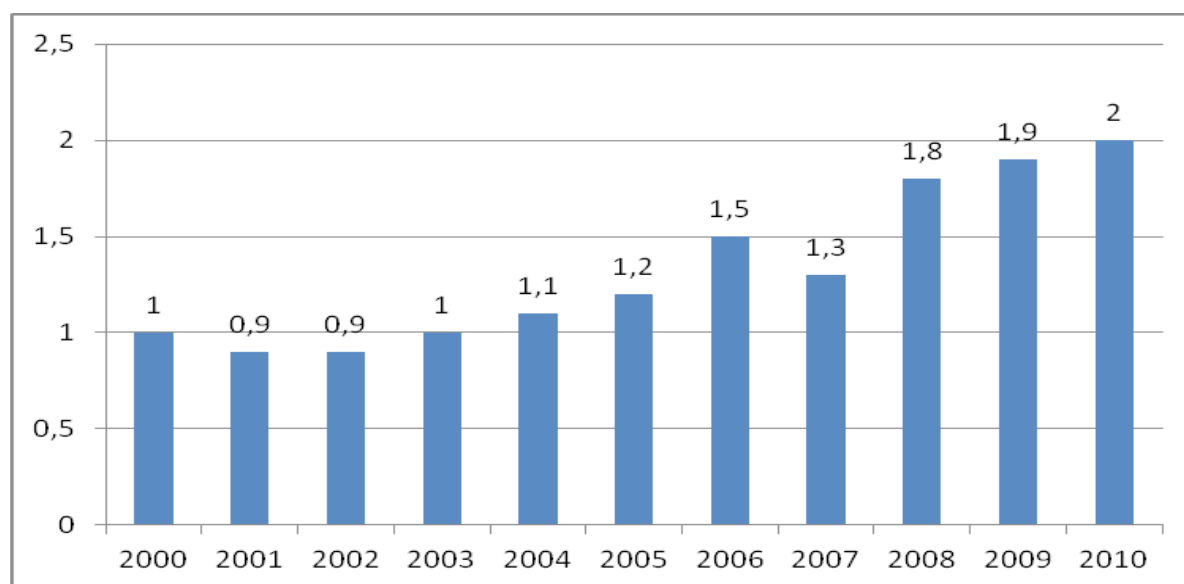
What's worth mentioning is the fast growth of number of rich, after the decrease due to financial crisis in year 2009.

About 40% of spending for luxury in Poland belongs to people who earn less than 1800 euro/month. There are 2 million people belonging to this group, their number doubled during last 10 years (KPMG report, 2010, p.23).

<sup>2</sup> <http://bezrobocie.org.pl/wiadomosc/594405.html>

<sup>3</sup> KPMG report, pp. 7, HNWI earn at least 50 000 euro and has liquid assets with a value of 1 million dollars

Figure 6: Number of people earning between 920 – 1800 euro/month in Poland (in millions)



Source: own evaluation based on KPMG report 2011

Consumers of luxury in Poland spend for luxury goods from 9% to 18% of their income. The first group spends around 9%, the second –15%, the richest spend even 18%. It's estimated that during next two years the average spending for luxury can increase by 50% and arise to the level of 19% of income of consumers (KPMG report, 2010, p. 25).

The economic crisis in year 2009 influenced the level of spending for luxury of half of consumers. The need for savings hit mainly the first group, they reduced their spending by 30% comparing with previous year (KPMG report, 2010, pp.7-8).

Table 1: Consumers of luxury in Poland

group number	monthly gross income (euro)	number of people in 2009	number of people in 2010	declared spending on luxury goods (% of income)	other
1	920 – 1 800	1 945 000	2 000 000	9%	From year 2000 the number of people in this group doubled. Their income level rose by 50%.
2	1 800 – 5 000	543 000	555 000 – 556 000	15%	Between year 2000 and 2010 the number of people in this group doubled. Their income level rose by 40%.
3	over 5 000, fluid assets with value of 1 million dollars	50 000	50 000 – 51 000	18%	From year 2006 till 2008 the number of people in this group was arising at 10% level. In 2009 it slowed a little

Source: KPMG report 2010, 2011

Polish society is enriching dynamically. After over 40 years of communist leadership, and after hard time of transition they desire to spend money, make their life comfortable, surround with beautiful objects, use expensive and luxurious products. People want to live as elites in Western Europe do. The demand of society to consume luxury is very high.

If it comes to availability of global luxurious brands in Poland only 53% of them<sup>4</sup> are present (KPMG

<sup>4</sup> Out of 200 best known global luxurious brands which has been distinguished



report, 2010, p.34). By presence author means either brand salon or multi branded store. Most brands are cooperating with local partners and are being sold in their branded salons. Luxury can be divided into three groups: cars, watches, clothes&accessories, the presence differs between each of them.

The presence in automobile industry is very high – it amounts to 88% attendance rate. Almost all brands have its representatives: Porsche, Bentley, Maybach, Jaguar, Aston Martin or Ferrari (KPMG report, 2010, p. 35). If it comes to jewelry and watches 65% of the most famous brands can be bought in Poland. Most of them have an official representative in Poland, only a few have its own brand shops. Only 30% of clothes brands can be bought in Poland. They are sold in stores located in big cities, mainly in Warsaw (KPMG report, 2010, pp. 37-47).

Luxury companies claim that there is a big problem with finding appropriate place to locate boutique in Poland. They don't want to be present in commercial centers or on shopping streets near popular, cheaper brands.. A few "luxury basins" exist in Poland, for example Three Crosses Square or opened in November 2011 vitkAC shopping center in Warsaw. However because of high demand the renting prices are very high there, even for luxury companies (KPMG report, 2010, pp. 33-48). Some new luxury shopping centers are being built. Klif center is planning to develop shopping malls dedicated only for luxury (connected with entrance of Chloe, Dior, DKNy, Givenchy).

Only 30 % of luxury consumers live in mazowiecki region, where capital is located (KPMG report, 2011, p.5). Over half of them live in middle sized cities, only 31 % live in bigger towns (KPMG report, 2010, pp. 56-57). The author opinion is that this lack of concentration can be seen as main obstacle when analyzing attractiveness of Polish luxury market. That situation makes building brand awareness difficult and expensive. Many "would be consumers" don't recognize the global brands and have no opportunity to see them in luxury boutiques. Due to the lack of brand awareness many people doesn't see the need to buy expensive, unknown brands, even when they see them in shops in Warsaw. The other result of this situation is proportionately lower revenues brought by each boutique. One shop in a city meets demand only of a small part of potential customers. This situation makes costs of activity higher than they are in countries with big territorial concentration of customers.

Luxury clothes brands are represented by Polish company – Paradise Group. There are 12 luxurious boutiques in Poland (<http://www.paradisegroup.pl>), 8 of them in Warsaw. It's worth considering that in such business and touristic places as Krakow and Wroclaw there are no luxury stores. Tourists often buy luxury as souvenirs, also local businessmen would buy some luxury products, if they have such possibility. While almost all of luxury stores are located in Warsaw only 30% of all potential consumers of luxury have the possibility to visit them frequently.

Lack of competition makes luxury goods in Poland much more expensive, sometimes even twice more expensive than the same goods abroad. Goods that are sold in Poland as luxury, are considered abroad as popular and from lower shelf, offer in Poland is very limited. That encourages some Polish to buy luxury abroad. Lowering the prices to European standards and widening offer would encourage many new customers for shopping.

Lack of global brands on Polish market strengthens the local companies. The best known Polish brand is Wittchen, who produce leather goods and accessories, Kruk – third best known among worldwide jewelry brands, vodka Belvedere, sport cars- Leopard or Zaremba –company sewing suits on measure for men. Wittchen company is planning to develop Polish luxury brands capital group. It will specialize in leather goods and luxury accessories. At the moment there is Wittchen and Vip Collection in this group, the president of the group is planning new acquisitions (Property News, 2011). Creating a luxury group can strengthen the potential of companies and make them more successful in future.

#### **4. INVESTMENT CLIMATE, CONSPICUOUS CONSUMPTION AND CONCEPTION OF LUXURY SPREAD IN SOCIETY**

Factors which make luxury companies eager to start activity on new market are not so clear. However author decided that theory of good investment climate explains the subject fully (Stepniak, Umiński, 1993, p. 61). The theory presents motives of companies to invest on foreign markets. Factors creating good investment climate can be divided into: economical, social, administrative and political groups (Stepniak, Umiński, 1993, p. 61). Economical climate is created by present economic situation, by forecasts for the future and by condition of infrastructure. Social climate is made by situation on the labour market, welfare of society, customers group size, culture, shopping customs (for example conspicuous consumption habit), brands knowledge. Administrative climate consists of tax politic, control over transfers of income and law regulating entrepreneurship. Political conditions consist of political stability, privileges granted for foreign investors, protection of intellectual property. Good

investment climate determines if the market is seen as attractive for investors or not. Polish and BRIC markets will be analyzed according to those determinants.

When talking about luxury concept of conspicuous consumption is particularly important. According to Veblen people consume not only to maximize individual satisfaction but also to build its position in society. Preferences are determined socially in relation to position in social hierarchy (Trigg 2001, p. 99). There are two ways in which person can display its wealth: through leisure activities and through high expenditures on consumption and services. The common feature of those activities is fact of wasting – time and money. By taking part in such activities the leisure class show its status and wealth. Spending money on consumption due to indicate somebody's wealth to other members of society is called by Veblen conspicuous consumption. It's claimed that this type of consumption is the most important factor determining consumers' behavior. Veblen claims that it's shaping behavior as well of the rich as the other social classes. Each social class tries to emulate the consumption behavior of the class above it, even the poorest are under the pressure to consume for show. The search for status never ends. In order to distinguish from others people always try to own more (Trigg 2001, p. 101). The necessity to consume conspicuously is often the main reason of buying luxury products.

Conspicuous consumption is tightly connected to the scheme of luxury spread in society. The process is divided into five phases. In each of them luxury is becoming more familiar to the society. The theory assume that in first stage of development the society is poor, ruled by the authoritarian regime, basic goods are missing. In second phase socio-political changes take place. They allow dynamic economic growth and thus enrichment of a wide part of society. The middle class is growing, the wealthier elites start to buy some luxury products. In next phase conspicuous consumption takes place. Wealthy elites are purchasing a lot of luxury goods and consuming it ostentatiously. Social discrepancies are growing. In the next phase society is getting used to luxury, elites don't demonstrate the fact of owning so much. However, possessing luxury goods is still indicator of status. The final phase begins when people are used to luxury and consume it discretely, for their own pleasure. Elites appreciate the high quality and original design, they are no longer satisfied with other goods than luxury ones (Chadha and Husband, 2007, pp.43-47).

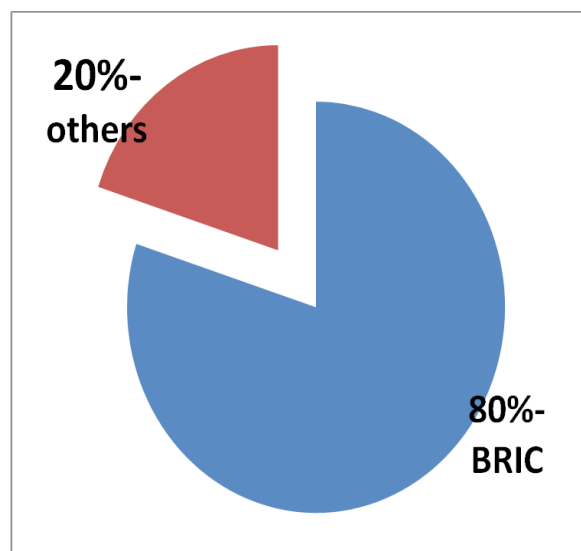
Its very difficult to decide in which phase Poland or BRIC countries are. The societies in those countries are enriching fast- because of that some groups of people are in first phase, and the other even in fourth. The process is in fact very fluent and for sure further, detail research is needed to decide which country is in which stage of development. Because of that this model will not be used in further parts of article.

## 5. SITUATION ON GLOBAL LUXURY MARKET

Traditionally the most important markets for luxury were supposed to be Western Europe, North America and Japan. However in recent times the perspective is changing – customers from emerging markets are becoming more and more important. Brazil, Russia, India and China are playing here special role. According to forecast of Goldman Sachs the GDP of above mentioned countries in year 2040 will be higher than GDP of actually leading countries: USA, Japan, Great Britain, Germany, France and Italy (Wilson, 2003). Emerging economies will contribute in the near future to 80% of growth in the luxury goods sector (Curtin, 2009).

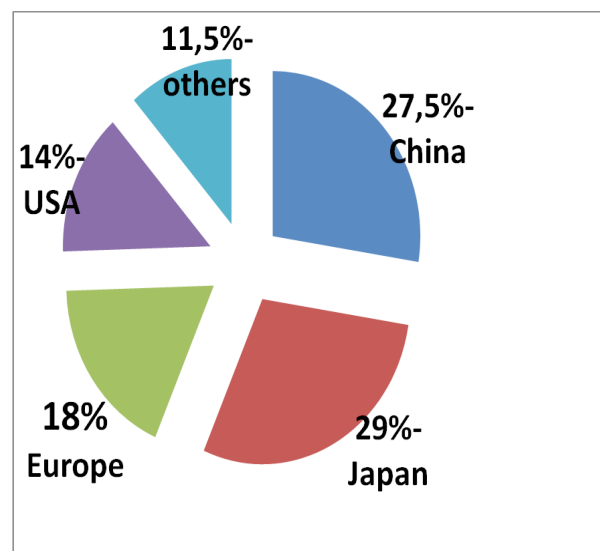
The most perspective market is China. According to the World Luxury Association in 2009 Chinese have "consumed" 27.5% of luxury goods sold around the world, which gave a value of 9.4 billion dollars. It places China as second, after Japan (share of 29%), biggest market for luxury. At the same time Europe amounted to 18% of share, United States – 14%. The Association estimates that in year 2012 Chinese will spend for luxury 14, 5 billion dollars (without luxury cars, yachts and planes), which will place them at first place in global ranking (Yang, 2010).

Figure 1: Consumers of luxury in 2040



Source: own scheme based on Goldman Sachs forecast

Figure 2: Consumers of luxury in 2009



Source: own scheme based on World Luxury Association data

## 6. POLAND AND BRICS MARKETS – COMPARISON OF FACTORS DETERMINING SUCCESS OF LUXURY BRANDS

Poland and BRIC countries have a lot in common: as well advantages as barriers. In this part author will compare characteristics of those markets. The comparison will show the reason why BRIC countries are seen as more attractive to invest than Poland is.

There are many factors attracting foreign companies to BRIC countries. One of them can be number of residents in those countries. Compared with 1, 3 billion inhabitants in China, 1, 15 billion in India, 193 million in Brazil or 141 million in Russia, Poland with its 40 million society seems to be very small market (World Bank, 2009).

What links together societies of Russia, India and China is conspicuous consumption. Possession of branded products has become an alternative system of prestige. Social status is achieved largely through consumption on the show (Chevalier and Xiao Lu, 2009). In Brazil this phenomenon is not so popular, in Poland such behavior is seen as a bad taste. Polish consume rather discretely, at home, for their own pleasure. What's more Polish society is far more egalitarian than societies of BRIC countries. Surprisingly for luxury companies it's not advantage. The bigger the social stratification, the more visible the richness of the financial elites is. Social stratification links with conspicuous consumption – the bigger social differences, the more intensive conspicuous consumption. Author opinion is that this is important reason why each of BRIC countries is seen as more attractive than Polish market is. Lets describe those markets.

The luxury goods market in Brazil is limited appropriately to Sao Paolo, where 50% of all luxury consumers in the country live (Rumsey, 2009). The population of billionaires amount for 30 people (Forbes, 2011). The middle class is still small, so does its consumption-needs. Brazilians don't know global brands and don't see the necessity to buy them (Rumsey, 2009). High import tariffs double the price of luxury products in Brazil. However, due to visa and huge distances within the Brazil, Brazilians rarely go abroad. On the one hand it increases the demand for products sold in the country, on the other lack of traveling contribute to the ignorance of brands knowledge and lack of motives to encourage their purchase (CPP Management Consultants, 2009).

Russian financial elites spend large sums quite spontaneously. Many Russians make purchases abroad but the vast majority still uses the Moscow boutiques. In Moscow live 79 billionaires, it is the biggest such cluster of wealthy people in the world (Forbes, 2011). The disadvantage of Russian wealth, however, is its instability. Since their origin is most often associated with natural resources, fluctuations in world markets results in regular changes in their properties. Hence, the fast rotation on the list of Russian millionaires. The middle class is growing fast, so does its consumption necessities (The luxury goods market in Russia, 2007).

In India live 50 billionaires (Forbes, 2011). Middle class is numerous and their number is growing

fast. So does its consumption needs. Due to high prices and relatively small choice of luxury goods in India the richest customers make shopping abroad (Seidel, 2010). However middle class and businessmen still buy in country. Because of lack of territorial concentration of customers in India it's hard to reach all of them. Due to that more and more companies are opening Internet shops.

In China live 115 billionaires (Forbes, 2011). Comparing to 2009 the number increased more than four times – in that year China was inhabited by 28 billionaires (Forbes, 2010). However the average luxury consumer is not so rich. It is a person between 20-40 years old, earning between 732 – 7320 dollars (Yang, 2010), often spending family savings.<sup>5</sup> Even if the average spending of each consumer in China is not high, a large number of buyers make huge profits of the company. Chinese buy many goods abroad, during the trips – in previous year they spend for luxury in Europe 50 billion dollars (Rzeczpospolita, 2011).

Another important factor contributing to market attractiveness is law transparency. Transparent law makes it easier and safer to invest on the market. The situation is good in Poland, India and Brazil, the law is unclear in Russia and China. The big impediment of being present on China market is lack of respect for intellectual values, rampant piracy and unclear rules of competition. Also counterfeiting lowers the benefits of companies and destroys the brand image. Fake products are more and more similar to original ones which make fighting with them even more difficult. Russian market is also hard to predict – the company can not be sure how the law will be interpreted (Chevalier and Xiao Lu, 2009). Due to the instability of Russian market, international companies were present there for a long time only through local distributors. Nowadays more and more of them decide to be present directly (Report Russia, 2007).

Very crucial element creating demand for luxury is level of duties imposed on import of products of higher order. In India and Brazil it's very high, sometimes can reach even 60% of value of the object (Rumsey, 2009). It lowers the demand and encourages to make shopping abroad. In other BRIC countries it's moderate and doesn't influence demand so much. If it comes to costs implied by state China has to be mentioned. Functioning on this attractive market further facilitates the favor of the authorities who are reducing entrance barriers and are ensuring a privileged position. Also the owners of prestigious shopping centers due to attract foreign brands offer very favorable terms. Shopping places are rented on very low prices, the renovation and decoration costs are often financed by shop owners (Jing Daily, 2010). The situation looks totally different in India. Lack of proper infrastructure has been the main problem that foreign companies met when entering the market. Shopping malls and streets didn't exist there, all trade took place on markets. Companies at the beginning were opening boutiques in exclusive hotels. A few exclusive locations have been recently opened but the renting prices are much more expensive than in Europe (Ridge, 2010, p.12). Also in Poland infrastructure is often said to be main obstacle preventing luxury companies from entering the market. In Russia exist a lot of exclusive boutiques, also in Brazil the infrastructure is well developed.

Table 3: Factors determining attractiveness of market

	total number of inhabitants (World Bank 2009)	number of billionaires (2011)	presence of middle class	territorial concentration of rich people
Brazil	193 million	30	small, growing	50% living in Sao Paulo
Russia	141 million	101	numerous, growing	Moscow
India	1,15 billion	50	numerous, growing	lack of concentration
China	1,3 billion	115	numerous, growing	lack of concentration

<sup>5</sup> This assumption is confirmed by the report of the World Luxury Association according to which 60% of luxury consumers in China don't use the money earned by themselves



Poland	38 milion	10	numerous, growing	30% living in mazowiecki region
	knowledge of global luxurious brands	custom of abroad shopping	level of duties on luxury	law transparency
Brazil	lack of knowledge	unpopular	high	good
Russia	good	popular	normal	weak
India	good	popular	high	good
China	good	very popular	normal	weak
Poland	quite good	not so popular	normal	good
	influence of financial crisis on economy	forecast of growth dynamics	infrastructure development	market saturation
Brazil	weak	dynamic	weak	weak
Russia	huge	moderate	good	high in Moscow
India	weak	dynamic	weak	weak
China	big	moderate	good	high
Poland	weak	moderate	weak	very weak

Source: own scheme

Access to the markets of China and Russia is becoming increasingly difficult, it is slowly getting saturated. Those two markets, especially Russia, were heavily influenced by financial crises. On the other hand the Brazilian, Indian and Polish markets are still not saturated. Because they are not related so much with other markets the influence of financial crisis wasn't for them so hard.

Luxury companies traditionally have attributed the greatest prospects to China. However it's Brazil where dynamic growth over the next five years is predicted (Rumsey, 2009). Luxury tourism industry will quickly develop there. It is fueled by low prices and attractive natural conditions, inhibited by the lack of adequate infrastructure (Rumsey, 2009). Also the Indian market is forecasted to develop dynamically and to surpass China in the future. However the Brazilian market is valued higher than the Indian. The interest of luxury companies with the Polish market is growing. According to Polish consulting companies the request to research Polish market has grown by 20% comparing with previous year. The global luxury companies are considering entrance into Poland more often than in the past (KPMG report, 2010).

## 7. CONCLUSIONS

To answer the question why 20 years after transition there are no global luxury brands in Poland strong points as well as barriers of Polish market must be noticed.

What's most important is the fact that after 20 years of facing "after transition problems" Polish desire to surround with luxury. This demand has matched with financial possibilities of quickly enriching society. Moreover luxury market in Poland is still not saturated. It creates very attractive situation for entering companies. Another very crucial advantage for investors in Poland is its politic and economic stability. The political system is stable and guarantees enforcement of transparent law. Also the financial crisis didn't influence Poland in significant way.

At the same time there are three major factors of underestimating Poland by foreign luxury investors.



First of all Polish society is quite egalitarian. The material differences between people are not so visible as in emerging countries. Those who are rich are consuming luxury discretely, not for show. Possessing branded products is not a determinant of social status as for example in China or India. Because of that for foreign investors it wasn't easy to notice the moment when society became rich. Due to such consumption model Polish don't spend so much money only to rise their social status, they don't buy as much as they could. Consumers in Poland rather prefer to hide their financial status, they don't want their neighbors or press to know and talk about it.

The other very crucial problem is lack of territorial concentration of luxury consumers. It increases costs of getting to customer and lowers the brand awareness. People living in small cities have limited opportunities to buy luxury, they also don't see the need to do so.

Moreover, Poland in comparison with BRIC societies can simply be seen as a very small market. 40 million inhabitants compared with 1, 3 billion people in China seem to be really little. In context of the larger markets with polarized society, potential of Poland could have been not noticed.

Another problem is that Poland is often treated as a part of poor Eastern Europe region. When investors think about it, they think about problems, economy and society of whole region. It's often forgotten that Poland is leader of this part of Europe and is better developed than other countries there. The image created in 90., the image of Poland as a poor country with many economical problems is still alive.

The lack of proper infrastructure is often said to be the major barrier when entering Poland. However it can be said that if there are no luxury companies interested in entering Poland, nobody will build exclusive commercial centers. Klif or vitkAC center are the best proofs that this problem can be solved. Author claims that it's the smallest obstacle.

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**TWO WAYS OF TRANSITION – COMPARISON OF THE ECONOMIC RESULTS ACHIEVED IN POLAND AND IN FORMER GERMAN DEMOCRATIC REPUBLIC****Konrad Poplawski**

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E-mail: [konrad.poplawski@wp.pl](mailto:konrad.poplawski@wp.pl)**Abstract**

In this article the author would like to conduct a comparative analysis of the processes that were observed throughout the last 20 years of transition of Poland and Eastern part of Germany. The author defines the process of transition as an economic, judicial and institutional change from the artificial socialistic economy to free market economy. However, the author in this article focuses on the economic aspects of this process. The joint characteristics, which are similar for both countries, are parallel preconditions for reforms due to socialistic circumstances, which had been affecting those economies over 40 years. Both regions had suffered from Soviet way of economic management and had many similar problems and inequalities after the years of socialism. However, both countries have been affected by different instruments during the process of transition. Whereas German Democratic Republic was absorbed by the Federal Republic of Germany and at once it started to be westernized to introduce the basic structures of west Germany. Eastern Lander ha at once access to great capita resources enabling to introduce rapidly the process of building infrastructure. However, Poland went different way and with help of different international organizations tried to approach economic patterns of western Europe its own way. The quite radical program of reforms named from one of the author Balcerowicz plan led first to great slump and soon afterwards to fast revival of Polish economy, although Poland had rather small access to capital funds and even had a burden of debts from socialistic times to pay back. The author's intention is to try different method of assessment of success or failure of transition in both regions. The GDR development level is very often compared to the level of development of west Germany and Poland is often set together with other Central Europe countries. Though, also comparison of situation and development of basic economic indicators can give interesting observations and conclusions.

**Keywords:** transition, GDR, Poland, Costs, Growth**1. INTRODUCTION TO THE TOPIC**

In this article the author would like to conduct a comparative analysis of the processes that were observed throughout the last 20 years of transition in economies of Poland and Eastern parts of Germany. The common quality, which is similar for both countries, is parallel starting point to reforms. Both regions had suffered from Soviet way of economic management and had many similar problems, misbalances and inequalities after the years of socialism. However, both countries have been affected by different instruments during the process of transition. Whereas German Democratic Republic was absorbed by the Federal Republic of Germany and at once it started to be westernized to introduce the basic institutions of West Germany. Former GDR obtained at once access to great capital resources enabling to introduce smoothly the process of building infrastructure and renewal of manufacturing base. However, Poland chose different way and with help of different international organizations tried to approach economic patterns of western Europe on its own way. The quite radical program of reforms named from one of the authors – the plan of Balcerowicz led first to great GDP slump and soon afterwards to dynamic revival of Polish economy, although Poland had rather small access to capital funds and had to cope with the burden of debts.

The author's intention is to use different method of assessment of success or failure of transition in both regions than it is commonly used. The GDR development level is very often compared to the level of development of western Lander of Germany and Poland is often set together with other Central Europe countries, although both countries had similar structural problems such as obsolete manufacturing assets, technological gap or hidden unemployment to overcome. Though, also comparison of situation and development of basic economic indicators in both regions can give interesting observations and conclusions.

## 2. METHODOLOGICAL NOTE

In this article different sources of scientific data were used. The author used various expertises of German and Polish research institutes, scientific books, newspaper articles and Internet sources. The statistical data were withdrawn from national statistic offices of Poland and Germany and from websites of international organizations concerned with economics. The author is conscious that such a comparison of data concerning German and Polish economies can be sometimes difficult to standardize due to methodological issues of different sources, however such an approach lets observe trends occurring in both regions and also draw some general conclusions concerning paths of transition and growth taken by both countries.

The structure of the article consists of three parts. Firstly, the author will describe the starting point of both countries and choices that were made according to way of development. Then the author will describe the instruments that were used and programs which were accessible for both regions. Finally the author will describe the results achieved and try to show conclusions comparing inputs and outputs of both countries.

For the purpose of the article the author defines the process of transition as an economic, judicial and institutional change from the artificial socialistic economy to free market economy. However, the author in this article focuses on the economic aspects of this process.

## 3. TRANSITION IN FORMER GDR

In Germany quite a common opinion prevails that it was impossible for GDR to be integrated into West Germany similarly to what occurred in Central Europe as the situation was very different. Proponents of such a point of view think that close cultural proximity, small distance and lack of excise duty zone between both German states after the unification were arguments in favor of migration. According to those thesis there was a choice either to extend the West Germany or to rebuild the East Germany (Paque 2009, p. 16-19). First solution assumed rapid migration from the East to the West and inflow of migrants from GDR looking for some job and better living standards in the West. The second solution was chosen from the beginning to omit the consequences of vast wave of GDR migrants coming to the West. The federal government took into account also the experiences of the migration of the Germans moved from the areas of Central and Eastern Europe after the World War II. At that time due to those processes the population of Germans increased by 20%, whereas in 1990 the population growth equaled about 25%, so the comparison seemed justified (Paque 2009, p. 21).

From the beginning it was also obvious that the GDR would be integrated into the Federal Republic of Germany and the parties were not equal. Such an approach offered pros and cons for both sides. First of all the Eastern Lander got an access to great resources of capital, investments and knowledge transferred from the West into the East. The federal government made sure to send best experts to the East to lead the changes and to transform the eastern regions towards western pattern not always taking into account the assets already existing in the East. The model of West Germany was imposed to the eastern parts without analyzing of that model indeed fits the best the manufacturing base and the expectation of inhabitants of eastern part of Germany.

Already before the unification of the two countries the economy of the GDR had been quite dependent on exports to West Germany, what was crucial to keep serving the debt of the East Germany. In the period from 1980 to 1989 the share of its exports to the Federal Republic of Germany in the total exports had increased from 30% to 49% (Roesler 2002, p. 64). Those efforts in the framework of exports at all cost was economically justified and let the GDR to limit its foreign debt and increase efficiency of the economy in general. However, those slight improvements built on deliveries of cheaper than in the world oil from the USSR could not restrain the consequences of the oil shock from 1985, when the oil prices plummeted after 12 years of peaking (Roesler 2002, p. 65) and the economy started to fall into debts again.

The process of unification became possible due to several political and socio-economic factors. First of all the world order changed since the USSR had been not able to keep control over its satellite countries. Apart from that the economic problems of GDR also intensified, because the uncompetitive economy could not develop under the policy of exporting at all cost. Besides social attitude to the unification in East Germany was also positive, as the citizens of that country no longer wanted to restrain their personal needs in inefficient economic system (von Prollius 2006, p. 247). In the moment, the process of unification of Germany began, the Eastern-German industry had been already obsolete and there was no capital to renew the manufacturing base necessary for keeping the production at high level. The politicians of the Federal Republic of Germany knew, therefore, that high capital



outlays will be needed to get rid of this gap.

However, the first problem to deal with, was the unification of currency systems. In the centre of West-German plans was to satisfy the GDR citizens and to show them that the whole process of westernization is beneficial to them. Thus, it was decided to convert the currency of East Germany into D-Mark at the relation of 1 to 1, which was eligible to salaries and wages, pensions and in limited amount savings (up to 6000 DM per person). The whole process was helpful in reduction of debts as companies debts were converted in the relation 1 DM to 2 units the currency of East Germany. Other solutions such as state control of currency conversion or free floating of East-German currency have not been seriously considered, as they would undermine the standard of living of GDR inhabitants making them dissatisfied with the reforms and led to massive migrations (Paque 2009, pp. 30-34). An important part of the transition accounted also for privatization. The federal government created a special institution, which task was to conduct this process and get rid of state ownership in the East Germany. The institution had to take control over 8500 companies employing about 4 million people (Jahresbericht der Bundesregierung zum Stand der Deutschen Einheit 2010, p. 74). Until 2000 the eastern regions of Germany were going still through the transition period to fit the model of West Germany. Therefore, the public sector and excessive construction sector had to be diminished and manufacturing industry started to expand. The German economists assess that only after 2000 the eastern regions were advanced enough to start the process of long-standing and more stable growth.

In practice such a construction of the transitions meant that over the night the salaries and wages of East Germans increased by 100% from 1/6 of West level to 1/3 of West level (von Prollius 2006, p. 251). It helped also to decrease the level of debt of East Germany. The reform was favorable also for GDR pensioners, who gained the same level of pensions as in the West Germany. Nevertheless, such a focus on keeping incomes in GDR high meant the slump in competitiveness of enterprises in East Germany, what consequently could only have led to intensification of social transfers from the West to the East. Some critics also stressed that such an approach takes risk of awakening great expectations of rapid improvement of life standard in the society not in line with productivity growth, what can result in great disappointment afterwards. It can be summed up that the politicians of the Federal Republic of Germany chose to improve the life standard of inhabitants at costs of enterprises, which from the beginning were condemned to losses as they could not maintain the competitiveness towards the western companies, as they lose the cost advantage and had no protection period, which would have helped them to get accustomed to new economic order. The western concepts of restoration were taking into account this problem, however, it was assessed that in about 4 years the investments would allow the economy of eastern lander to revive and whole production equipment would also be massively improved, though those forecasts turned out to be dramatically overoptimistic (von Prollius 2006, pp. 257-259). However, it is also important to notice that an approach taken led to smoothly deal with the problem of inflation, because GDR quite fast could have taken over the reputation of the Bundesbank, what let the prices to keep more stable than in other countries of Central and Eastern Europe.

#### 4. TRANSITION IN POLAND

The situation of Poland in 1990 was very different from the GDR conditions, although both countries had lived over 40 years under the economic order of socialism. Poland entered the transition having to challenge much worse economic circumstances, as throughout 1980s the Polish economy was constantly in recession after the introduction of the martial law in 1981 and because of vast debts inherited as a result of the credits taken by socialistic regime in 1970s. Differently than in the GDR the members of Polish regime started to take over the state ownership to anticipate the soon breakup of the economic system (Małecki-Tepicht 2010, pp. 277-279). It was also obvious that Poland would also have to face the dramatic level of inflation, as throughout whole socialism the socialistic government very often decided to inject into the economy empty money and in consequence already in 1989 the rate of inflation amounted to about 700% (Małecki-Tepicht 2010, p. 278) and 585% in the following year (Malinowski 2010, p. 295), what meant in practice that the real demand largely exceeded real supply. Analyzing these precondition must lead to a conclusion that Poland had more difficult problems to deal with at the beginning of transition.

First stage of transition in Polish economy was conducted according to recommendations of such institutions as World Bank, International Monetary Fund, London Club and Paris Club, which were in favor of neoliberalism prescriptions. This approach to transformation was based on the privatization, liberalization, restriction of state influence and ownership and attempts to achieve monetary and fiscal equilibrium (Czyżewski, Grzelak 2005, p. 17). Although the whole process of transition in Poland

officially began in 1990, important reforms had been made already 2 years before this date. For the economic situation of Poland the decisions made in 1988 had great meaning, when the new bill concerning economic activity was established giving more freedom in founding of enterprises. The act was created to let the representative of the ruling party to take over part of national property, though it was also a breakup for the ordinary entrepreneurs, who wanted to found their own business. According to some rough assessments this regulation let the spirit of entrepreneurship revive in Poland, what proves some assessments that only in 1989 about 400 thousands companies were founded, whereas in the period of 1990-1992 on average 250-300 thousands enterprises were emerging annually (Woźniak 2009, p. 3). In 1990 the package of reforms named from one of its main authors the Balcerowicz plan started to be introduced in Poland. The program of reforms, which was consulted with international institutions consisted of 6 chapters, which were showing its economic aims. The package targeted at stabilizing the economy, changes of the economic system, changes of the social policy, achieving the international support, setting conditions, which aimed at achieving sociopolitical support and inflow of foreign capital (Żukrowska 2010, p. 776). In the first stage of implementation assumed the transition of institutions, political system and judicial infrastructure. The second embraced reforms of financial and bank sector and changes in tax system, introduction of currency exchange and liquidation of state monopolies. The third part covered re-privatization of state companies and rebuilding of capital market, what will resulted in creation of spirit of free entrepreneurship.

All those measures similarly to GDR were introduced quite rapidly, so the process adopted the form of shock therapy, which was assumed to painful for the society in the short-run. Such a remedy for the problems of the Polish economy matched with diagnosis of the preconditions and was better tailored to the real needs of Poland than it occurred in the GDR. The authors of the program were convinced that main difficulties inherited by socialism are such qualities of the economy as excessive equality of incomes in the society, disproportionate state control (Mączyńska 2000, p. 273). Equally as in the case of GDR the costs of transition in Poland were largely underestimated. The plan assumed the decrease of industrial production by 5% and the amount of unemployed people equaling 400 thousands over the short time. However, already in the first year of transition – 1990, the unemployment rose to around one million (6,1% of the labor force) and to 2 million in the next year (11,8%) and constantly rising in the next 2 years. The industrial production slumped already in 1990 by 21% (Zagóra-Jonszta 1999, p. 5). The state also could not take control of inflation over the next 9 years after introduction of the program.

Later on criticism of the plan of Balcerowicz emerged among the economists, who assessed the costs of transition as high unemployment, slow income growth and too rapid privatization of enterprises at low price as too high (Zagóra-Jonszta 1999, p. 7). Balcerowicz, on the other hand, stressed that the quite stringent process of transition let the state to create good conditions for liberalization of trade and export growth and entrepreneurship.

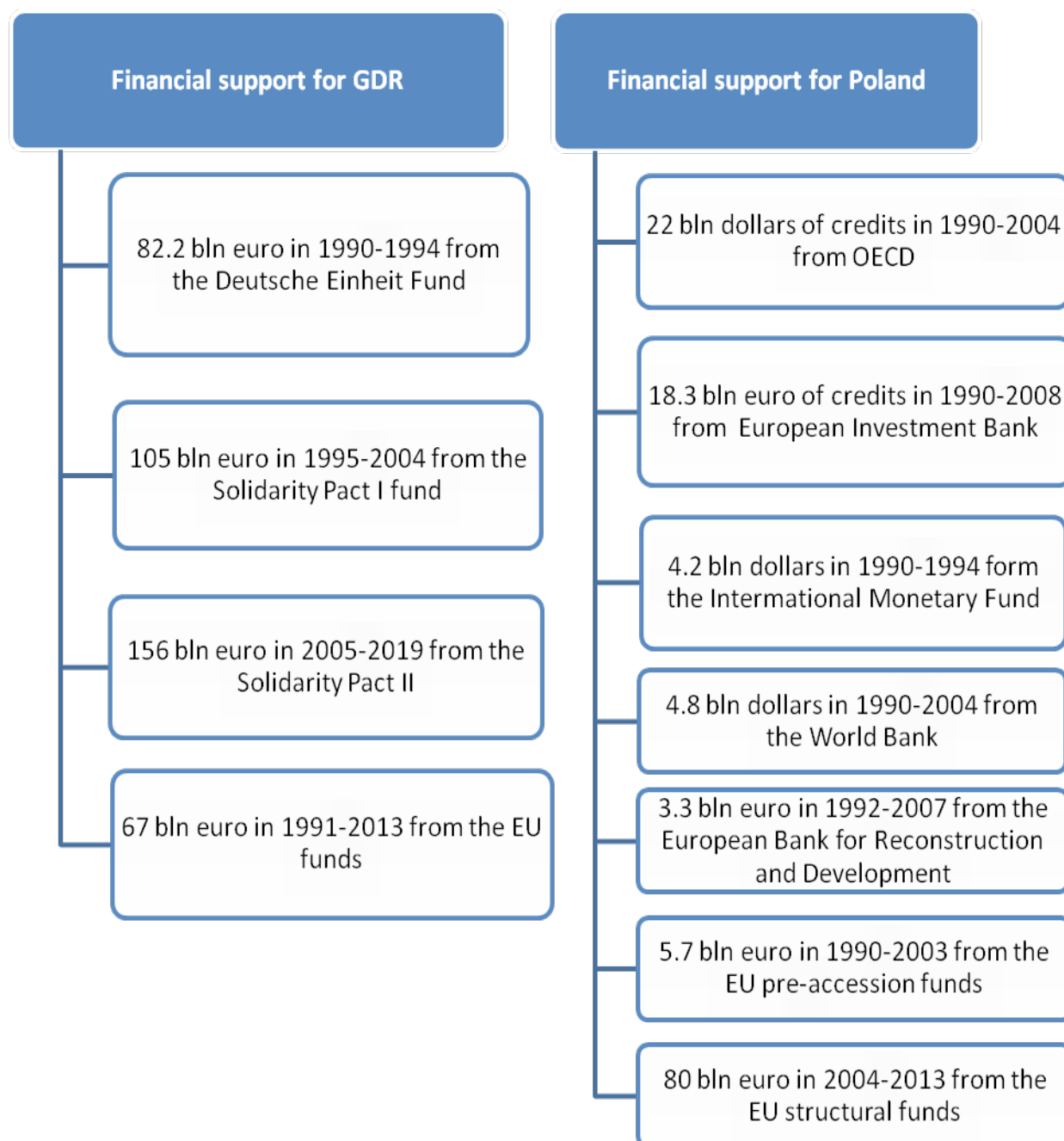
However his main criticizers underlined that especially in the first stage of “shock therapy applied in Poland means were confused with targets, so the low inflation, stable exchange rate or accessing the European institutions became more important than growth itself and the reforms turned out to be too costly (Kołodko 2004, pp. 8-9).

The situation of Poland started to improve only in 1994, when the inflation and unemployment started to decrease and GDP started to rise in more stable way. Especially the period between 1994 and 2000 let the Polish economy to return to equilibrium thanks to various structural reforms. The effects of this could have been perceived by the society as good and real incomes started to increase and the inequalities in goods distribution to diminish thanks to what Poland could start to pay back its debts inherited after the era of socialism (Grzega 2009, p. 3).

## 5. COMPARISON OF FINANCIAL SUPPORT DURING THE TRANSITION

The beginning of transition meant something very different for the GDR and Poland. Although both regions until that time had been affected by similar means, during the transition using the same instruments was impossible, as the GDR gained the access to vast sources of irreclaimable capital, whereas Poland had to use credits and loans offered by various international institutions, which mostly had to be returned after an investment was finished. That different circumstances implied that Poland could not start with rapid improvement of infrastructure, as it was too costly for the country, which was already highly indebted and had to negotiate with its creditors facilitation of credit conditions. At the same time west Germany was already investing huge amounts of money in the infrastructure of the GDR starting the complex program of reconstruction of GDR economy.

Picture 1: Comparison of capital sources accessible for both countries In the transition period



Source: Own calculations on the data accessible on the websites of IMF, EIB, World Bank, EBRD and Polish and German government

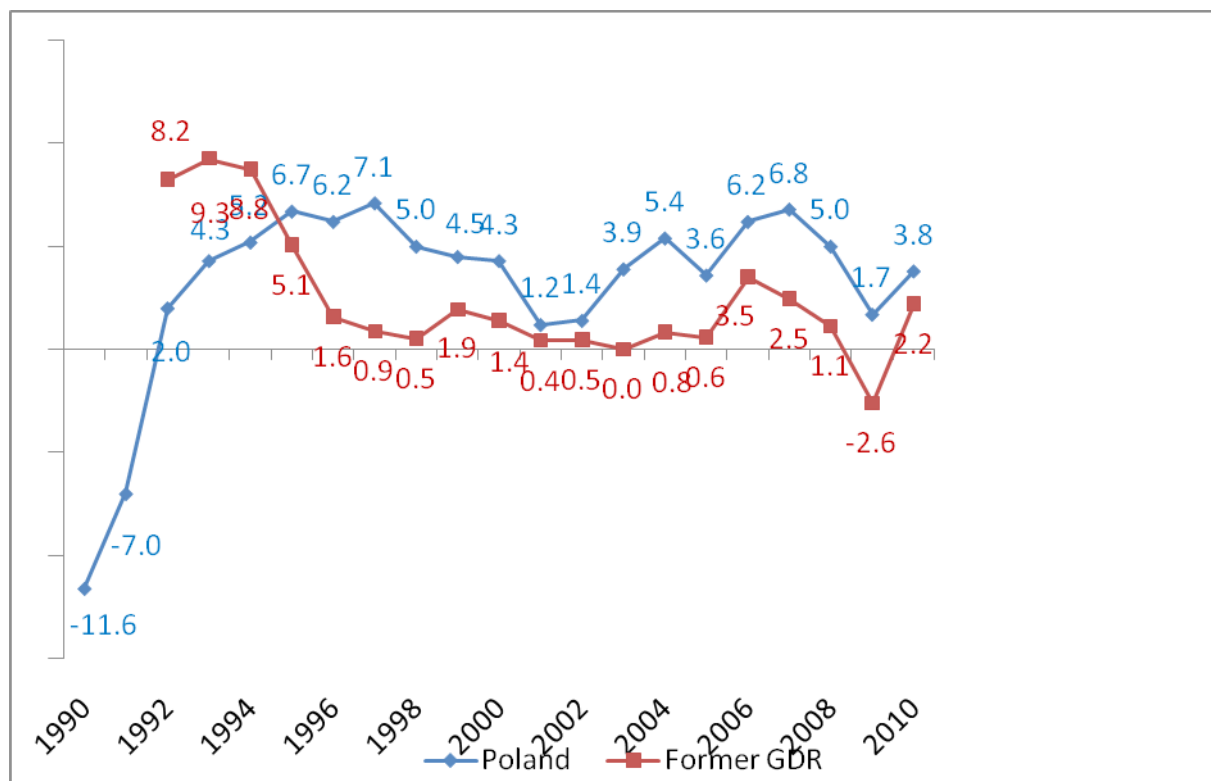
The above summary shows how generous were programs aimed at reconstruction of the GDR, whereas more than twice bigger Poland could have counted only on support of various international organizations, which rather offered cheap credits, which could be used for very specific aims and were not complex solutions for the obsolete manufacturing facilities of Polish economy. GDR had an access to vast capital resources throughout whole 20 years of the transition period and even after 2011 can count on further prolonging of some programs, though in smaller scale than so far. Poland, on the other hand, obtained better access to free capital resources only after entering the EU. It is right now difficult to forecast, but after 2013 already in the next long-term budget of the EU, Poland has chances to negotiate the next big inflow of EU money, whereas the EU funds for east Germany are supposed to be decreased.

It is important to notice that Poland could not assign all the credits it became for investments as some part of them as for example the help from the International Monetary Fund was allocated for the refinancing of the credits already taken during the socialistic times. Only the agreements signed firstly with Paris and then with London Club, allowed the country to restructure its debt level.

## 6. ECONOMIC RESULTS OF TRANSITION MODELS OF POLAND AND FORMER GDR

The comparison of results achieved by both countries especially taking into account capital resources accessible by both regions and somehow concerns the debate between the proponents of gradualism in transition and economists in favor of shock therapy. Although Poland could not count on such generous investment program as in case of former GDR, the economic effects of its economic way of transition turned out to bring much better economic results almost in all aspects.

Graph 1: Comparison of GDP rates (in constant prices) in Poland and former GDR (in per cents)

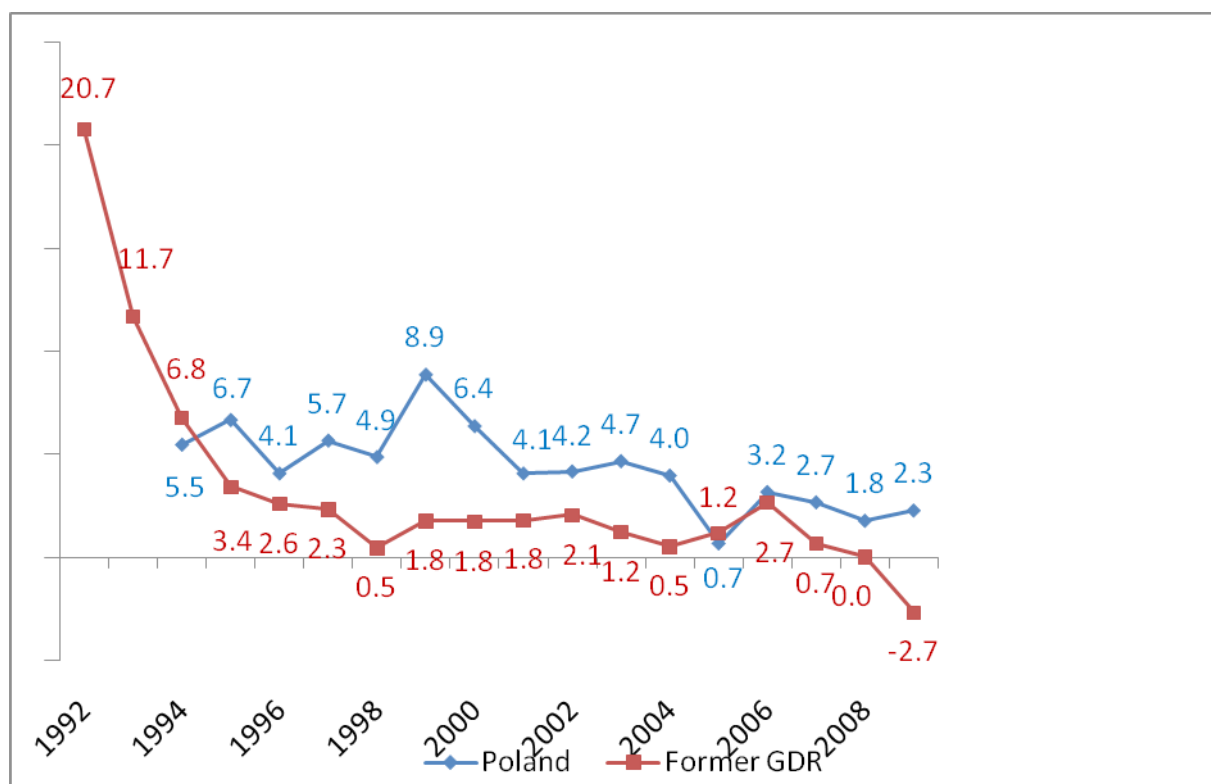


Source: Eurostat, Federal Statistical Office of Germany

The development of GDP was very different in both regions and it is the most visible indicator of different paths of transition taken by former GDR and Poland. In the period of 1992-1995 the economy of GDR recorded high level of GDP growth thanks to beneficial exchange ratio of eastern and western German currencies and transfers in the form of investment programs. However, later on the growth started to weaken and in the next 10 years it did not exceed the pace of 1%. Only in the period of 2006-2008 the GDP growth was higher than 1%. Interesting was also the situation of former GDR during the global financial crisis. The eastern regions of Germany has been affected by the consequences of the crisis to the lesser extent, what may be an implication of its smaller dependence on export in the opposition to western Germany. The recession was slighter as the GDP fell by 2,6%, whereas in Germany as a whole the decrease was sharper and amounted to 5%.

On the other hand, in Poland the development path was quite conversed as the economy at the beginning was growing at quite slow pace and in the years 1990-1991 the country was hit by a very severe recession due to the shock therapy applied. However, the revival came quite quickly and in the period of 1993-2000 quite high growth of an average 5,5% per annum occurred. Later on during the period of 2001-2002 the mild GDP stagnation was recorded, which was though quite painful for the society. Since 2003 the period of quite stable growth was recorded and surprisingly the Polish economy managed so far to overcome the crisis without being hit by the recession.

Graph 2: Productivity growth In Poland and former GDR (in per cents)

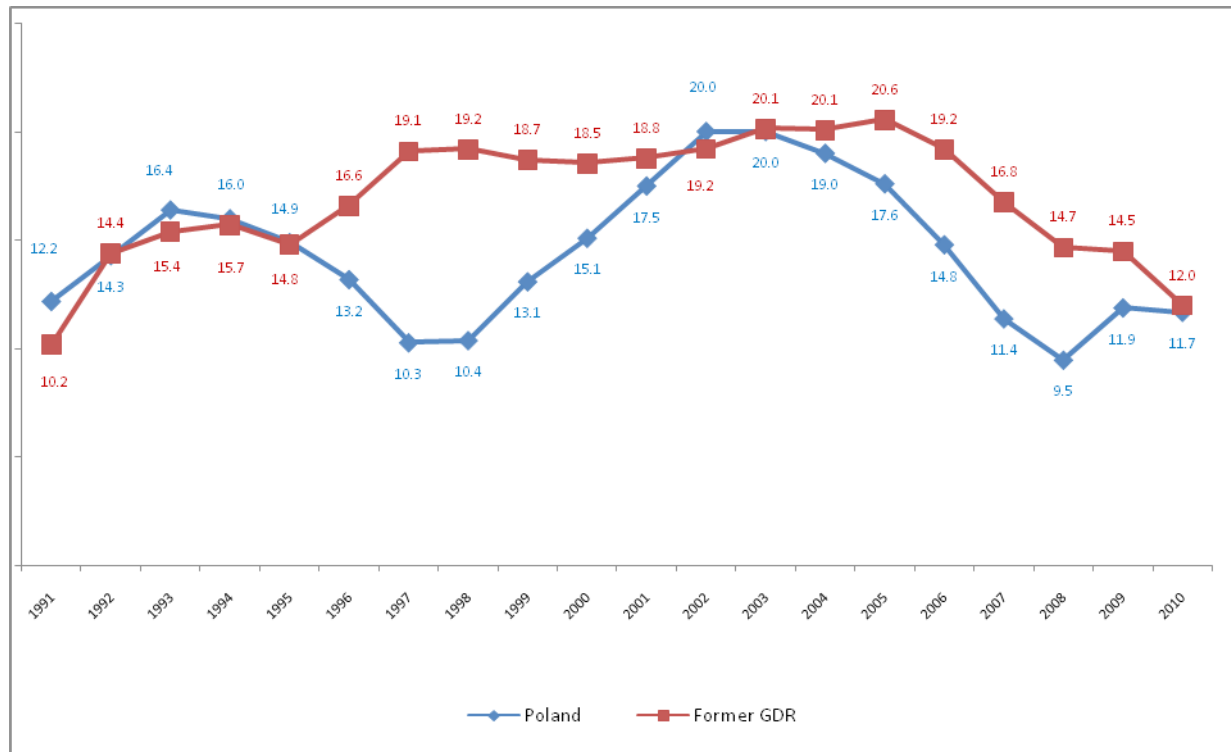


Source: OECD and Federal Statistical Office of Germany

The development of GDP in both regions is confirmed by the productivity changes. In former GDR between 1992 and 1994 the stage of incredibly high productivity growth occurred as very fast the processes of privatization were conducted which resulted in rapid surge of unemployment. For the next 11 years between 1995 and 2006 the productivity maintained the relatively stable pace, though much slower than before and much slower as compared to Poland. Since 2005 the weakening of productivity growth has been recorded and in 2009 it decreased by 3,1%. In Poland the productivity through the whole period of transition has been relatively stable, although since 2003 slower pace of its growth have been noted.



Graph 3: Comparison of unemployment rates In Poland and former GDR



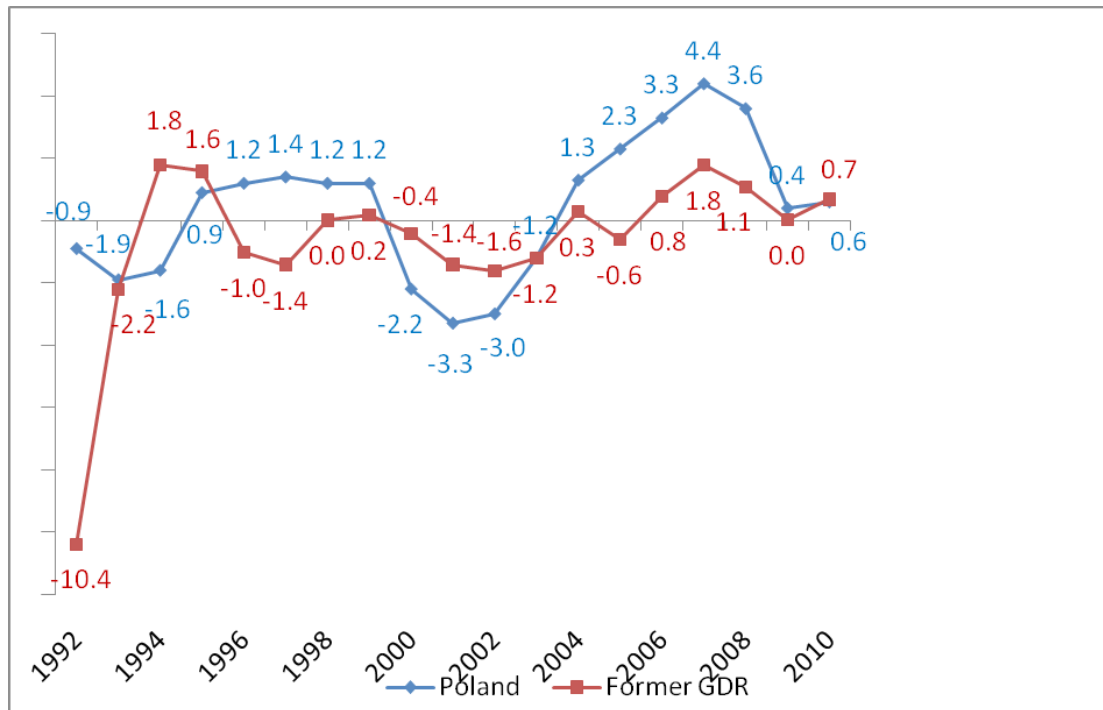
Source: IMF, Federal Statistical Office of Germany

Very interesting is analysis of unemployment rates in both countries during the recession. The main observation leads to conclusion that the business cycles were affecting the labor market in very different way. In the former GDR the unemployment started to grow from the very beginning of the transition as the leading politicians of west Germany were insisting on fast introduction of reforms of changes. However, such an approach made unemployment achieve very high level of about 15% in the period of 1992-1996. However, then unemployment instead of lowering started to increase even further to 19% in 1998 and maintained this level through the next 8 years and only after 2005 it started to decrease sharply.

In Poland the changes in unemployment have been more dynamic. In the first years of transition the Polish economy was behaving in similar way, what proves almost the same unemployment rates in the period of 1991-1996. However, later on the unemployment started to decrease to about 10% in 1997 and 1998 and then rise again for the next 5 consecutive years achieving its transition peaks in the period of 2002-2003. From that time, it was decreasing until the relative stable level 10-12% in the years 2007-2010.

The unemployment statistics show that in case of Poland employers was sometimes overreacting with layoffs of workers as it was the case in the beginning of this century. In case of GDR the changes were often restricted by the state, which was offering programs of co-financing workers posts. On the other hand, the policy to Germany seemed to fail to enough stimulate employees to look for some job, offering them very generous social protections. Good example to prove this thesis was the package of reforms Agenda 2010 introduced by chancellor Schröder in 2005, which decreased the levels of unemployment reliefs and limited the period of obtaining it. From that moment the unemployment especially in the former GDR started to decrease very rapidly.

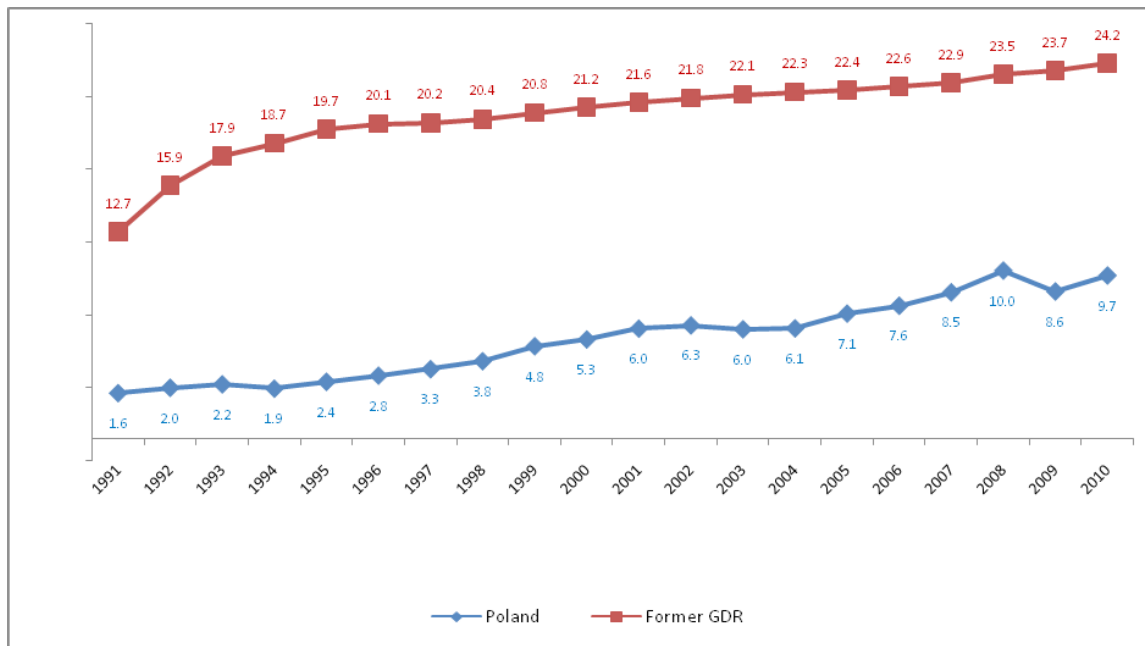
Graph 4: Comparison of changes in employment In Poland and former GDR (in per cents)



Source: OECD, Federal Statistical Office of Germany

The development of employment also shows completely different trends on the labor markets of both regions caused by different ways of transition. Especially in the GDR the beginning of transition was very painful for the society as the employment fell very sharply and except for a few years the losses in employment have not been regained until now. One of the reasons behind better unemployment indicators was migration of the employees from eastern to western Germany, what proves that during the 20 years period the population of eastern regions decreased by about 1 million. On the contrary in Poland, where privatization was conducted at much slower pace and where competition of companies was not affected by unfavorable exchange rate as in case of Germany, the employment was rising except for periods of 1990-1994 and 2000-2003.

Graph 5: Comparison of average yearly gross salaries In Poland and former GDR (in thousands euro)



Source: Own calculations based on the data from the Federal Statistical Office of Germany and Statistical Office of Poland

It is also interesting to illustrate changes in salaries and wages in Poland and former GDR. In 1991 the difference was really huge and an average employee in eastern regions of Germany was earning almost 8 times higher than in Poland. The reason of that was the conversion rate of eastern Germany currency into German mark and generally better economic situation of eastern Germany at the end of socialism. The spread between the salaries was expanding for the next few years and as a consequence in 1994 the yearly salary was almost 10 times higher. However, at the later stage the salaries of Polish workers have been regaining the distance towards the level prevailing in eastern Germany and 2010 the relation was 1 to 2,5.

## 7. CONCLUSIONS

Assessment of the GDR advances especially counted towards the level of economic indicators in west Germany seems to prove the success of transition in former GDR as most indicators such as GDP per capita or salaries achieved 70-80% of the level of West Germany. However, the picture becomes more complicated when GDR indicators are compared with other post-socialistic countries, especially if the scale of investments is taken into account. Looking from that perspective it seems that some reforms have been introduced in GDR too fast and the shocking changes they brought especially in case of employment brought negative implications for economic growth prospects. The focus on rebuilding of infrastructure turned out to be too narrow and too few supply side reforms have been offered for eastern part of Germany to balance the losses for companies due to unfavorable for them exchange rate damaging their competitiveness. The assumption of German politicians and economists from the beginning of transition seemed correct that some improvement of life quality should be fast and visible to bring hope for the inhabitants of former GDR and discourage them from moving to western countries. On the other hand, the question emerges that as over 1 million of people decided to leave for West Germany, so if the program of vast investments and improvements which as a side effect undermined the competition of German companies brought positive results in limiting inflow of people from former GDR. Maybe the migration of people was impossible to avoid, so it should not have been at the centre of attention.

From today perspective it seems that the trials to make former GDR as similar as possible to western Germany in a very short time was a mistake. The institutions that conducted the process of privatization so quickly had nothing to offer for the workers who were made redundant except for offering generous social reliefs and discouraging the unemployed from looking for a new job. In Poland employees were not guaranteed so generous social protection schemes, so they had to react to economic situation changes faster and in more flexible way. Therefore, after the period of stagnation the unemployment in Poland was decreasing quite quickly and productivity growths remained stable, whereas in the former GDR it was staying at the same high level, even when the market situation improved.

Looking at the general statistics can be also deceiving as even in the former GDR there are regions as for example Saxony, which well used their chances to invest in new technologies and educations and its prospects of growth are rather good. Poland could not take a challenge with east part of Germany on the example of infrastructure, which nowadays is even more modern than in west Germany. However, even today it is visible that the programs for the former GDR were too much oriented in reconstruction of production capacity and too few was invested in people and stimulation of entrepreneurship.

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## (Footnotes)

- <sup>1</sup> The data for year 2007 has not been obtained from the DF Program, but from the report on internet [http://www.vibilia.rs/srpski/izvestaj/0508/Start%20ap\\_110308.pdf](http://www.vibilia.rs/srpski/izvestaj/0508/Start%20ap_110308.pdf)

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