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Abstract

Free 'Entry' and free 'Exit' are fundamental mechanisms of the competitive market economy operation. Free entry ensures that potential entrepreneurs will take advantage of profitable opportunities and enter profitable segments of the market, increasing competitive pressure on the incumbent firms, lowering output prices and improving the overall allocation of resources. Both free entry and free exit guarantee that more efficient firms and those producing in accordance with the market demand, survive and prosper while inefficient units and those whose production is not geared to the market will contract and eventually embark on exit. Barriers to entry and exit influence the development of competitive conditions in established market economies, however, for economies in transition the freedom of entry and exit has an even more significant dimension. The reason for that are particular 'initial conditions' which the economies inherited from their communist past: massive distortions of the economic structure, highly monopolistic and oligopolistic markets, and a large average firm size. With a collapse of the old regime, transformation of the old economic structure had to take place through the entry of new, market-oriented firms particularly in the undeveloped sectors of the economy and the exit of inefficient and uncompetitive enterprises especially from the over-grown industrial sector.

This report presents some outputs of the research project 'The Impact of Barriers to Entry on the Speed of Transition: A Comparative Study of Countries in Different Stages of Transition' (PHARE ACE project No. P95-2047-R), coordinated by Leszek Balcerowicz and done by an international team which included: Ewa Balcerowicz (Poland), Andrzej Bratkowski, (Poland); Irena Grosfeld (France); Iraj Hashi (U.K); Jan Mladek (the Czech Republic); Gediminas Rainys (Lithuania); Jacek Rostowski (Hungary); Miklos Szanyi (Hungary); and Lindita Xhillari (Albania). The main aim of the project was to investigate nature and impact of barriers to entry in five countries at different stages of transition with various development backgrounds and traditions. The study has been based on the experience of new firms in Poland, Hungary, the Czech Republic, Lithuania and Albania – the first three having reached an advanced stage of transition and the latter two having embarked on the transition process later, thus lagging behind the front-runners. The study has focussed on the legal, fiscal and institutional factors which impede new entries and slow down the expansion of new firms in each country.

The report consists of two parts. In Part I, Chapter 2 we discuss the interaction between the government's regulatory activity and the entry of new firms into the formal or informal sectors of the economy. Here we highlight the necessity of this important function of the government as well as its undesirable implications such as rent seeking and corruption. In Chapter 3 we consider a framework for the analysis of barriers to entry and growth of new firms, highlighting the main constraints to entry and growth considered by this report. Chapter 4 is devoted to the review of an actual pattern of new firms' entry in the early transition period in the five countries under consideration. Part II reports on the results of our enterprise survey; it is a detailed study of 400 firms in five transition economies. Here we first discuss (Chapter 5) the composition of the sample on which the study is based and then (Chapters 6,7,8,9 and 10) summarize main findings of the study in terms of the relative importance of different barriers facing new firms in each country. Chapter 11 discusses the main policy recommendations of this study.

Ewa Balcerowicz, Leszek Balcerowicz and Iraj Hashi

Part I
Constraints to Entry and Development of New Firms in Transition Economies and the Role of Government

1. Introduction

The main aim of the present study is to investigate the nature and impact of barriers to entry in five countries at different stages of transition with differing development backgrounds and traditions. The study is based on the experience of new firms in Poland, Hungary, the Czech Republic, Lithuania and Albania – the first three having reached an advanced stage of transition and the latter two having embarked on the transition process later thus lagging behind the front-runners. The study focuses on the legal, fiscal and institutional factors, which impede new entries and slow down the expansion of new firms in each country. This report presents some outputs of the research project 'The Impact of Barriers to Entry on the Speed of Transition: A Comparative Study of Countries in Different Stages of Transition' (PHARE ACE project No. P95-2047-R). The research was co-ordinated by Leszek Balcerowicz and done by the international team, which included the following partners and associates: Ewa Balcerowicz, Center for Social and Economic Research – CASE Foundation, Poland; Andrzej Bratkowski, Center for Social and Economic Research – CASE Foundation and Bank Handlowy, Poland; Irena Grosfeld, DELTA, France; Iraj Hashi, Staffordshire University, U.K.; Jan Mladek, The Czech Institute of Applied Economics, The Czech Republic; Gediminas Rainys, Economic Research Centre, Lithuania; Jacek Rostowski, Central European University, Hungary; Miklos Szanyi, Institute of World Economy of the Hungarian Academy of Sciences, Hungary; Lindita Xhillari, National Agency for privatization, Albania.

Free 'Entry' and free 'Exit' are the fundamental mechanisms of the operation of a competitive market economy. They will guarantee that the more efficient firms and those producing in accordance with the market demand, survive and prosper while the inefficient units and those whose production is not geared to the market will contract and eventually embark on exit. Free entry will ensure that potential entrepreneurs will take advantage of profitable opportunities and enter the profitable segments of the market, increasing the competitive pressure on the incumbent firms, lowering output prices and improving the overall allocation of resources. In the absence of free entry, imperfect market structures will survive, inefficient firms will be able to maintain their prices and profit margins, and there will be no incentive to reduce costs.

Recent developments in the 'industrial organization' theory, particularly the work on the 'contestable market' theory by Baumol and his associates, have clearly established that the existence of free entry and exit conditions, which will make a market 'contestable', ensures an improvement in the allocation of resources and the overall welfare. These authors have shown that the presence of potential entry, in contestable markets, will impose a discipline on incumbent firms and force them to behave 'as if' these rivals have already entered the market. The focal point of this literature is that conditions of entry are the main determinants of the performance and structure of an industry.

Of course, it is not only the contestable market theorists who have highlighted the importance of entry conditions for industrial structure and performance. Years earlier, Bain (1968), Stigler (1968), Von Weizsacker (1980), Demsetz (1982), and many others had elaborated on the impact of barriers to entry on technical and allocative efficiency and consumer welfare.

Barriers to entry and exit influence the development of competitive conditions in established market economies as well as in transition economies [1]. The literature on barriers to entry is almost completely based on the experience of developed market economies. However, for economies in

[1] Although the present study will focus on barriers to 'entry', the conditions of 'exit' are equally important for the development of a competitive economy. The nature and intensity of the exit processes during the transition to a market economy was the subject of another research project financed by the ACE programme. See Balcerowicz, et.al. (1998) for a detail investigation of types of exit, the legal and institutional framework for different exit processes, and government policies influencing the pace of exit in each country.

transition the freedom of entry and exit condition assumes an even more significant dimension than in the already-established market economies. This is because of the particular 'initial conditions', which they inherited from their communist past: massive distortions of the economic structure, highly monopolistic and oligopolistic markets, and a large average firm size. With the collapse of the old regime, the transformation of the old economic structure had to take place through the entry of new, market-oriented firms particularly in the undeveloped sectors of the economy and the exit of inefficient and uncompetitive enterprises especially from the over-grown industrial sector [2]. These initial conditions meant that, in the early stages of transition, the volume of entries and exits will be, by necessity, very high - reflecting the large scale changes that had to take place before these economies attain a macroeconomic structure consistent with their level of development and with the needs of a market-based economy open to international competition.

One of the main elements of the reform programme in all economies in transition was the liberalization of entry conditions. Along with the liberalization of prices and foreign trade, appropriate measures facilitating the establishment of new enterprises were approved in the very early phase of reforms in all of these countries. The effectiveness of liberalized entry conditions, of course, depends on the presence of appropriate legal and institutional framework in which new firms will operate. The establishment of a conducive, legal and institutional environment, however, takes much longer. In practice, new firms come into existence before the *rules of the game* are properly established. These *rules* develop gradually and are not always, and everywhere, consistent with the aim of liberalizing the entry conditions. The conditions facing new firms, therefore, have fluctuated in some countries in accordance with changes in the political environment and in line with the strength of different lobbies and interest groups [3]. Furthermore, given that the composition of the bureaucracy has changed slowly, and to varying degrees in different countries, the old prejudices against private entrepreneurship has not always disappeared quickly in all transition economies [4]. Consequently, in some countries, although the measures aiming at the liberalization of entry conditions have been on the statute books for some time, the actual conditions regulating the entry of new firms are still far from 'accommodating' and 'facilitating'.

As a result of the liberalization of entry conditions, there was an explosion of new firm entry in every transition economy across Central and Eastern Europe. Even so, entry has not been uniform across sectors and size groups [5]. The great majority of the new entries have been very small firms concentrated in sectors such as trade and services. Some of these activities, such as banking and financial services, were highly undeveloped while others, such as marketing and advertising were almost non-existent in the former economic system. Here, new entries filled a gap in the market. In other areas, such as distribution, the former networks were both insufficient in meeting the market demand and inefficient in their operations, offering profitable opportunities to new entries. Entry to other sectors of the economy, however, has not been as numerous as that in trade and service activities.

Despite the large scale liberalization of entry conditions, the number and size distribution of firms in many branches of economic activity remains skewed. Many activities, especially in the industries, are still dominated by a small number of large firms. Medium and large size new firms in industrial and commercial activities are rather rare. The underlying reason for these features is the fact that barriers to entry have not been completely eradicated and conditions facing new enterprises, when they do enter a market, are not always conducive to stability and expansion.

The improvement of conditions of entry and the consequent development of new private firms also has another, and more crucial, dimension in the course of transition. New firms constitute the most dynamic part, or the engine of growth, in transition economies (see Blanchard 1997). They are not constrained by traditional ownership relations or the incentive system, which dominate the state-owned or privatized sector of the economy. They recognize the promising segment of the market to enter and respond quickly to changes in demand and cost conditions. Evidence is gradually emerging (see for example Belka, et.al. 1995) that although 'privatized' firms perform better than firms which are still state-owned, there is a significant difference the performance of newly set-up private firms and 'privatized' firms. The removal of entry barriers, therefore, is important for transition economies as it can have a major influence on their growth performance.

With the exception of the very early stages of transition, when small entrepreneurs took over pavements and empty spaces in city centres all across Eastern Europe and embarked on business activities without any rules or restrictions, the liberalization of entry conditions did not, of course, mean a complete abolition of all regulations affecting the establishment of new businesses. New laws were quickly promulgated to oversee and regulate the entry of new firms – specifically requiring them to register with municipal or higher authorities, tax offices, social insurance offices, and in some or all cases obtain a license or permit from the competent state authorities. While there is no doubt that new firms have to be subject to certain

[2] For a detailed analysis of the nature and magnitude of exit process in the Czech Republic, Hungary and Poland, see Balcerowicz, Gray and Hoshi (1998), Chapter 4.

[3] For a discussion of the views of leading reformers in early transition, see Balcerowicz (1995) and Blejer and Coricelli (1995).

[4] See Shleifer (1997) for an interesting discussion of the speed of changes in bureaucracy in Poland and Russia and its implication for small businesses.

[5] For a detailed data for Poland, see Chmiel (1998).

laws and be governed by regulations designed to protect the citizens, these laws and regulations provide the arena for the state (and state officials) to exercise an effective influence over private sector development. They fall in the category of 'government erected barriers' with two important implications. Firstly, state-sponsored rules and regulations create the opportunity for rent seeking activities by government officials and bureaucrats, i.e., bribery and corruption. During the transition period, governments often comply with the demands of various interest groups and may even turn a blind eye to rent seeking activities.

Secondly, these rules and regulations may push the entrepreneurs to the informal sector of the economy. With undeveloped rules of the game and under non-conducive environment, all economic agents, new firms in particular have to decide whether – and to what extent – they wish to operate in the formal economy. This decision is based on the incentive system generated by the legal and institutional mechanisms operating in different countries. New entrepreneurs have to assess and weigh the opportunity costs of entering a new business. They will have to compare the gains from entering the official economy with, firstly, the gains from operating in the unofficial or shadow economy and, secondly, with what they can earn in employment or even unemployment. In many cases, the legal and institutional structures and a wide variety of rules and regulations provide sufficient incentive for new firms (or existing firms) to operate outside the formal economy. It is therefore not accidental that a significant shadow economy has emerged in all transition economies – with a severe impact on state finances, resource allocation and the establishment of a competitive market economy.

Finally, in addition to the regulatory and fiscal barriers, private sector development may be further constrained by the continued dominance of some economic activities by large state-owned or privatized enterprises and their entry deterring behaviour. Some of these enterprises are, to varying degrees, still subject to semi-soft budget constraints and have close contact and relationship with banks (which are also still to a large extent state-owned). Some authors have expressed a concern that these firms, at least in some countries, may exercise a strong influence on prices and output levels in their product and input markets. The dominant firms also enjoy lower cost of credit compared to new entrants and can potentially 'crowd out' new entrants in the credit and raw material markets (Hussain 1994 and OECD 1996).

This study aims at investigating the impact of above factors in five countries at different stages of transformation with a view to identifying those barriers that still impede the establishment of new firms and their early growth. It is divided into two parts. In Part I, Chapter 2 we discuss the interaction between the government's regulatory activity and the entry of new firms into the formal or informal sectors of the economy. Here we shall highlight the necessity of this important function of the government as well as its undesirable implications such as rent seeking and corruption. In Chapter 3 we consider a framework for the analysis of barriers to entry and growth of new firms, highlighting the main constraints to entry and growth considered by this report. Chapter 4 is devoted to the review of the actual pattern of new firm entry in the early transition period in the five countries under consideration. Part II reports on the results of our enterprise survey, a detailed study of 400 firms in five transition economies. Here we shall first discuss (Chapter 5) the composition of the sample on which the study is based and then (Chapters 6,7,8,9 and 10) summarize the main findings of the study in terms of the relative importance of different barriers facing new firms in each country. Chapter 11 discusses the main policy recommendations of this study.

2. Government and Transition

The massive deregulation of economic activities was a fundamental feature of transformation in all Central and East European countries. The all-pervasive system of state control established under socialism was inappropriate for these transforming economies and had to be replaced by a completely different set of rules and regulations designed to facilitate the establishment of a market economy. While the vast machinery of the former system was being dismantled, the state had to assume new functions and formulate the 'rules of the game' appropriate for the operation of the new system. Given the legacy of the old system and the manner of its disintegration, new rules had to be devised at the same time as the new system was taking shape. It was therefore inevitable that the new regulatory framework would develop unevenly in different countries and that some countries would suffer from a 'regulatory vacuum', a near-total-absence of an appropriate regulatory framework for the protection of citizens' economic interests [6]. In other countries, many of the old rules and regulations were retained until new ones could be promulgated – a policy broadly aimed at preventing opportunism.

The newly elected governments had to design new rules and regulations for various aspects of economic activity, including the conditions of entry and operation of new firms. The

[6] The attitude of the ruling parties in some countries (Albania and the Czech Republic, e.g.) was that all economic activities were legal as long as they were not explicitly forbidden by law - an attitude which resulted, for example, in financial scandals such as the formation of pyramid schemes in the former and the 'tunnelling' of privatization investment funds by their main shareholders and managers in the latter. Similarly, almost all transition economies suffered from environmental damage caused by the massive, uncontrolled and wholesale import of second hand cars from Western Europe, many of which were not road-worthy.

process was by definition time consuming since changes in regulations also required various legal changes which could not be brought in immediately. New regulations ranged from those dealing with the registration and licensing of new firms; to fiscal regulations governing taxes, social and health insurance and other contributions, accounting and financial rules covering book keeping, expenses, depreciation, and banking, labour code governing conditions of work, minimum wage, dismissals, etc.; real estate regulations dealing with conditions of lease or sale of commercial property; and many others.

The aims of government regulations in transition countries are not always explicit. Sometimes they are expressed in terms of correcting market failures arising from externalities or asymmetric information (establishing minimum standards in the interest of consumers, and licensing of certain activities and professions); at other times in terms of promoting public welfare and protecting citizens against scrupulous businessmen (employment laws, tenancy laws, etc.). Mostly, however, they are designed to facilitate the identification of economic units for tax purposes (tax base) and to ensure that the state treasury receives its dues [7].

But these rules and regulations, useful as they may be, play an additional, rather negative, role too. Regulations affecting entry and survival of firms put politicians and bureaucrats at different levels of government in a strong position to exercise influence over new firms. They provide the politicians with legitimate means to pursue their own objectives – which may range from extracting a rent, to using subsidies to create employment in friendly companies and areas, favouring their political allies and penalizing their opponents. Taxes, subsidies and various contributions may also be used to achieve the same objectives. The success of transition policies is closely bound with the way governments and politicians use their newly acquired (or retained) powers to control the entry and operation of new private firms (see Frydman and Rapaczynski 1991, Boycko, Shleifer and Vishny 1996, Shleifer and Vishny 1993 and 1994 for a discussion of the role of government and the relevant empirical evidence).

The establishment of new firms and the growth of this sector are closely influenced by the type of regulatory policy referred to above and the consequent exercise of discretion by politicians. The politicians' attitudes have a crucial impact on the entrepreneurs' decision on whether or not to enter a market. In some transition economies, such as Russia, many old style politicians hostile to the market system retained power and have engaged in 'predatory' actions against new firms. In other countries such as Poland, on the other hand, politicians responsive to the needs of the newly emerging market economy have facilitated the growth of registered new businesses. For example during 1995, the number of businesses slightly surpassed 2 million in Poland and reached only one million in Russia (with a population four times larger) (see Chmiel 1998 and Shleifer 1997). In effect, politicians exercise control rights over firms through a variety of regulations including the registration and licensing requirements, sale or lease of real estate, the level and type of taxes and contributions, and rules governing exports and imports. Furthermore, in addition to central authorities, regional, municipal and local governments too devise their own rules and regulations – to pursue their own objectives – which erect further obstacles for the newly established firms.

There is no hard and fast rule about the optimum level of regulation – a level that has to be worked out for each country or industry separately. On the one hand, of course, the establishment of a market economy requires the abolition of the system of rules and regulations, which was in force under socialism. On the other hand, the new system requires its own new 'rules of the game' aimed at creating a level playing field for all participants. While governments should provide sufficient 'space' for entrepreneurs to engage in lawful economic activities, it should also ensure that no one's rights (including the citizens' and the state's) are violated by the emerging entrepreneurs. In some areas such as environmental protection or the financial system, many countries still do not have sufficient rules to protect their natural environment or their citizens' financial interests against new firms and their self-seeking managers [8].

In areas such as taxation, on the other hand, the legacy of the socialist system (with its massive state sector and high levels of expenditure) led to the imposition of very high levels of taxes and contributions and to too many complicated and constantly changing rules. Expenditure on the 'safety net' (e.g. unemployment and other social benefits) was often misused because of the absence of an appropriate monitoring system and suitable rules. It is clear that if the government does not take a conscious and clear view of the appropriate level of regulation, it will either not be able to resist the pressures for 'excessive' regulation from different levels of bureaucracy or it will not bring in the basic regulations which are necessary for the development of a market economy.

The impediments to private sector development also play an important role in pushing certain entrepreneurial activities

[7] As Friedman has pointed out the licensing of professionals (doctors and nurses for example) is a mechanism by which the state provides relatively low cost information about the qualification of these professionals for consumers. At the same time, as a barrier to entry of new economic units, this is not an excessively costly barrier. See Friedman's discussion of occupational licensing in Friedman (1962), pp.137-160.

[8] On the question of environmental protection, the Hungarian law was passed only in 1996 while in Albania there is still no law regulating the impact of economic units on the natural environment. On financial issues, it is interesting to note that when some of the culprits of the disastrous pyramid schemes in Albania were tried and convicted, it was realised that the existing rules could only impose a maximum of 3 years imprisonment on them, i.e., the country lacked proper rules of the game to hand them punishments in proportion to their crimes. Similarly, in the Czech Republic, the culprits of the tunnelling of investment funds and many other financial irregularities have gone unpunished because of the lack of appropriate rules.

Table 1. Taxes and Contributions[a] in Five Transition Economies, 1998

Category	Czech Rep	Hungary	Poland	Albania	Lithuania	U.K.	EU average
Personal Income tax (%) (low/high brackets)	15-40	20-42	19-40	5 -20	33[b]	23-40	20-55
Threshold of highest bracket (in USD)	21000	5500	12700	4800	700	43360	
Company tax (on profits) (%)	35	18-23[c]	36	30	29	31	31-40
Social security, health, pension and unemployment contributions (%)							
Employer	35.0	43.2	47.18[d]	34.2	30	15.5	
Employee	12.5	11.5	0	11.7	1	14.4	
Total	47.5	54.7	47.18	45.9	31	29.9[e]	20-37

Notes:
[a] With the exception of income tax, all other taxes and contributions refer to legal persons. All figures are based on exchange rates in May 1998.
[b] Only one rate.
[c] A company's taxable income is taxed at 18 percent. Furthermore, if a part of profits is distributed to shareholders, an additional tax of 23 percent is levied on dividend payout. If all profits were reinvested, the tax rate would be just 18 percent.
[d] 2 percent of this is unemployment tax and 0.18 percent special labour tax.
[e] These figures apply when employees are in an occupational pension scheme; otherwise the contribution is 10 percent for employers and 10 percent for employees (20 percent in total).
Source: Complied from country studies prepared for the project 'The Impact of Barriers to Entry on the Speed of Transition: A Comparative Study of Countries in Different Stages of Transition', CASE, Warsaw 1998. EU averages are from Borish and Noel (1996).

into the shadow economy. Naturally, many new businesses wish to evade what they consider 'excessive' levels of taxes and 'troublesome' rules and regulations if at all possible. To this end they may try to conduct some or all of their business outside the formal sector. This will have a distorting effect on the development of the private sector as well as major implications for government finances. A shortfall in government revenue will reduce its ability to provide the normal services expected of a government in a market economy – including policing of the informal sector. This will create incentive for more entrepreneurs to try to shift some of their activities into the shadow economy, reducing government's revenues and its normal expenditure programme further. The available evidence from transition economies shows that the size of the shadow economy is related to the level of 'legal protection' and 'legal effectiveness' provided by the government. These services, in turn, are dependent on government's revenues and its taxation policies (see Johnson, et.al. 1997, Kaufmann and Kaliberda 1995).

Irrespective of the height of entry barriers and the role of fiscal, regulatory and institutional constraints, some firms will always carry out a part or all of their activities in the informal sector. Most of these, by nature, are small owner-managed units. What is more significant (and serious) is the fact that many formally established firms, even some large ones, do not report a proportion of their sales and expenditure and pay some of their employees in cash (over and above their declared wages) and suppliers in cash or kind. In this way, they reduce their own (and their employees' or suppliers') tax and contribution obligations. For many years now, economists have argued that high rates of taxation is a major factor in pushing employers and employees into tax evasion and underground activity. In their study of the impact of government taxation policies in 15 transition economies, Johnson, et. al (1997, p.20) show that the size of unofficial economy in transition economies is significantly correlated with the effective tax rate (or tax burden) [9].

In order to understand one of the main complaints of the management of new firms in transition economies, it is useful to compare the overall tax burden in these countries with those in established market economies. This is done in the table 1, which shows the levels of actual taxes, and contributions paid by employers and employees in the five transition economies under consideration, the U.K. and EU countries.

With the exception of Hungary, personal income tax rates are slightly lower than those in the EU countries are, though the thresholds for the application of the higher tax bracket are generally smaller. Company taxes are about the same as those in the EU countries, with the rates in Poland and the Czech Republic similar to the upper range of EU countries rates. The striking point of this table, however is that, compared to West-

[9] See also Kaufmann (1995) for a framework for the measurement and analysis of the informal sector.

Table 2. Share of Shadow Economy in GDP in the Czech Republic, Hungary, Lithuania and Poland, 1989-1995 (in percent)

	1989	1990	1991	1992	1993	1994	1995
Czech Republic	6.0	6.7	12.9	16.9	16.9	17.6	11.3
Hungary	27.0	28.0	32.9	30.6	28.5	27.7	29.0
Lithuania	12.0	11.3	21.8	39.2	31.7	28.7	21.6
Poland	15.7	19.6	23.5	19.7	18.5	15.2	12.6

Source: EBRD (1997), p. 75.

ern market economies, the level of social security, health and unemployment contributions in four of our five countries (particularly in Hungary), is much higher. This observation clearly supports the claim that high levels of contributions forces many entrepreneurs (and employees) to operate outside the formal economy.

There is no general agreement on the method of estimation of the size of the informal sector or the factors influencing it. While the size of shadow economy may depend on a variety of economic, social, cultural and institutional factors in each country, the high rate of obligations is undoubtedly a major factor in the partial reporting of sales and costs (especially labour costs) in these economies. Table 2 is an indication of the estimated size of the informal sector in the four countries under consideration.

3. A Framework for the Analysis of Barriers to Entry

New firm entries in transition economies are generally small and medium sized, with larger firms, which are often set up by foreign investors being exceptions. The obstacles impeding the entry of domestic firms and those discouraging joint ventures and foreign investment are the major impediments to private sector development and their identification and eradication must be of prime concern for policy makers.

At the start, we must distinguish between two types of new entries: those entering the market for the first time (start-ups) and those that have their origins in older established firms but have been separated in the privatization process and have become new legal entities (spin-offs). As we have already pointed out, start-ups or de nuovo firms play a particularly important role in the early transition process and therefore this study will concentrate on the specific obstacles facing them. The problems facing the second group, spin-offs, are discussed at length in the privatization literature.

New firms have to pass through two stages before being established on the market: the initial creation and the early development. New entries not only face a number of important and relatively severe barriers to entry, they face continued difficulties even when they have succeeded in overcome the early barriers. In each stage they face a number of problems and impediments specific to that stage. New firms need a conducive environment and a supportive institutional framework for one to two years before they can spread roots and develop their own relationships with customers and suppliers. Nurturing and support is not, of course, achieved by subsidization but by the creation of level playing field (especially in comparison to the shadow economy), the provision of information, and minimizing the unnecessary restrictions in procedures.

Table 3 summarizes the main constraints faced by new entrants in the two stages of development.

The present study will therefore consider the impact of four specific areas on the establishment and growth of new firms in five countries. These are: regulatory barriers including the legal, institutional and fiscal environment; financial constraints influencing the availability of initial capital and investment resources; informational barriers including the knowledge of the available support programmes; and the competitive environment, particularly the role of existing state-owned firms and that of the informal economy.

4. New Firm Entries

We can now consider the actual picture of new firm entries in the five countries under consideration in the early transition period and note the changes in new firm entries in the course of transformation. One of our aims was to collect data on the number of new companies (which we call 'entrants') according to the following criteria: according to sectors, legal form and size. We wanted to gather information from the whole transformation period in order to identify trends over time. This part of the project turned out to be a very difficult task. Causes are numerous, let us enumerate only some of them.

It should be emphasized here that statistical agencies in the five countries do not publish regular, comparable and reliable data on new entries and, for example, in Poland this data is not published at all [10], while in Hungary it was published only

[10] In order to have access to this data, one has to place an order with the Central Statistical Office and that is very expensive. Furthermore, the obtained data is not of good quality. For explanation, see Chmiel (1998), pp.4-6.

Table 3. Types of Constraints to Entry and Development of New Firms

Constraints	Initial Creation 1st stage	Early Development 2nd stage
Government Sponsored Constraints	Registration and Licensing Length and number of stages in the process, costs, minimum capital requirement Fiscal Levels of taxes and contributions, compliance cost	Renewal of Licenses Fiscal Same
Input Constraints (Capital)	Source of Initial Capital Own, family, banking system, special facilities, informal market Cost and Availability of Credit Criteria for obtaining a loan (track record, collateral), high risk-weighted interest rates	Source of Capital for Investment Same Cost of Credit Interest rates
Information Constraints	Support Programmes Governmental, NGO and other programmes to support new firm entries	Support Programmes Programmes to support existing SMEs
Environmental Constraints	Behaviour of Existing Firms Impact on availability and price of inputs, conditions of product market and sales outlets	Same
Informal Sector	Competitors in Shadow Economy Impact of the informal sector on input and output prices and conditions of competition	Same

until 1994. The information on new firms is not kept centrally in any of the five countries. The data is kept separately in different regions and in different institutions depending on a variety of factors. Moreover, the quality of what is published varies considerably across different countries. For example in most countries the data does not identify the number of active firms, as opposed to the dormant ones or those that have ceased operation altogether. In theory it is of course possible to identify active firms if tax returns are used as the basis for the identification of economic units. This, however, is not the practice in most countries. Therefore, the number of entries in most cases overstates the effective entry. Another problem is the change of the statistical classification from the one typical of communist economies to NACE. In Poland this resulted in incomparability of sectoral data classified until 1992 with those collected since 1994. For the Czech Republic data for 1990 and 1991 are not available, because in that period the data covered the whole of former Czechoslovakia.

The tables 4-6 illustrate the scale of new firm entries in the five transition economies.

All the five transition economies witnessed an enormous wave of new enterprise entries, which resulted in a rapid increase in the number of registered private firms (see Tables 4 and 5). The most dramatic increase in the number of private companies took place in Albania and this process continued for quite a long period (1991–1994). Albania began practically at

Table 4. Number of Registered Firms [a]

	1990	1991	1992	1993	1994	1995	1996
Albania [b]	37	2,336	6,640	11,556	19,967	9,960	7,892
Czech Republic [c]	-	-	1,050,278	1,158,902	1,018,404	1,207,905	1,347,992
Hungary	446,861	603,910	733,410	857,899	969,534	1,011,945	-
Lithuania	8,991	40,841	61,923	80,606	103,360	116,600	121,437
Poland	-	-	-	1,772,186	1,884,784	1,863,867	2,098,294

Notes:
[a] All sectors except for agriculture, state enterprises excluded.
[b] Data for Albania includes only limited liability companies and natural person businesses.
[c] For 1990-1991 – before Czechoslovakia's split no separate data is available for the Czech Republic.
Source: Data delivered by co-researchers in their papers on statistics of entry for individual countries, available at CASE.

Table 5. Net Entry [a]

	1990	1991	1992	1993	1994	1995	1996
Albania	-	2,299	4,304	4,916	8,411	-10,007	-2,068
Czech Republic	-	-	-	108,624	-140,498	189,501	140,087
Hungary	-	157,049	129,500	124,489	111,635	42,411	-
Lithuania	-	31,850	21,082	18,683	22,754	13,240	4,837
Poland	-	-	-	-	112,598	-20,917	234,427

Note: [a] Increase in the number of firms (year to year).
Source: Calculations based on data presented in Table 4.

Table 6. Net Rate of Entry (in percent) [a]

	1990	1991	1992	1993	1994	1995	1996
Albania	-	6,213.5	184.2	74.0	72.8	-50.1	-20.8
Czech Republic	-	-	-	10.3	-12.1	18.6	11.6
Hungary	-	35.1	21.4	17.0	13.0	4.4	-
Lithuania	-	354.2	51.6	30.2	28.2	12.8	4.1
Poland	-	-	-	-	6.4	-1.1	12.6

Source: Calculations based on data presented in Table 4.
Notes: [a] The net rate of entry is the ratio of the difference between the number of economic entities at the end of the year (*t*) and (*t-1*) to their number at the end of the year (*t-1*) In other words, the net rate of entry is an increase of number of registered firm in the year (*t*) in relation to the stock of firms in (*t-1*).

the zero starting point. Therefore, the net rate of entry (for a definition see the note to Table 6) was very high, ranging from 6212.5percent (!) in 1991 to 72.8 percent in 1994. Lithuania came second, with the net rate of entry amounting to 354.2 percent in the peak year of 1991 (see Table 6). In the years 1992–1996 the increase in the number of private firms was slowing down (with the exception of 1994), consequently, also a net rate of entry was slowing down (from 51.6 percent in 1992 to 4.1 percent in 1996).

With respect to the Czech Republic and Poland, we miss comparable data for the first years of transition [11], which were the most important years as far as the growth of the private sector is concerned. The tables show a much slower net rate of entry in later years.

Hungary is a country with a steady growth in the number of private firms and with a steady decline of the rate of entry. It needs to be emphasized that both Poland and Hungary had a much better starting point than Lithuania and Albania. In the former two countries the private sector started to grow slowly as early as in the second half of the 1980s due to relaxation of economic policies at that time.

Out of the five investigated transition economies Albania witnessed the most dramatic pace of the growth of the private sector. It was also Albania, which demonstrated a dramatic decrease in a number of companies (by 50.1 percent in 1995 and 20.8 percent in 1996). This tremendous drop is the indication of a dramatic impact on the economy by financial pyramid schemes that developed in Albania in the 1990s.

In other four countries the private sector has been steadily growing and strengthening. A sudden decrease in the number of private companies in Poland, observed by statistics in 1995 (see Tables 5 and 6), was not a sign of a crisis in the private sector. Contrary to what one may expect, this was caused by the change of a regulation on the statistical register, which forced many owners of dormant companies to delete them from the register. As a consequence, the register's contents were changed, whereas nothing was changed in real terms. It is yet one more example of the caution and care needed to deal with statistical data in transition economies.

[11] This is due to reasons explained earlier on in the text.

Part II
Barriers to Entry and Growth of New Firms: Results of the Enterprise Survey

To study the constraints to entry and growth of new firms a special questionnaire has been prepared in order to make a detailed study of a group of firms in five transition economies. The questionnaire was addressed to owners of the sample firms or general directors employed in a company long enough to know its whole history.

5. The Survey Sample

Iraj Hashi and Jan Mladek

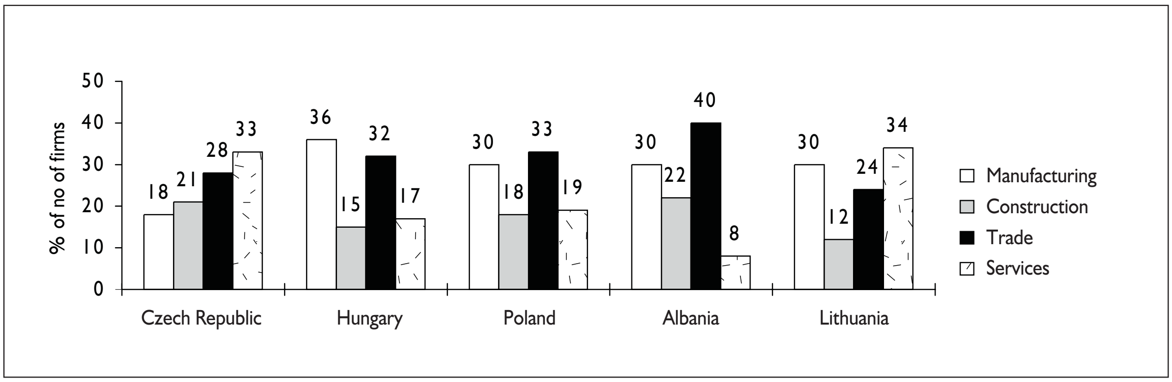
The sample consists of 396 newly established enterprises, one hundred each in the Czech Republic and Hungary, ninety six in Poland, and fifty each in Albania and Lithuania. Individual proprietorships and businesses run by physical persons were excluded. The reasoning behind this was that these economic entities are not obliged to do the accounts, contrary to companies (limited liability companies, joint stock companies, partnerships and co-operatives), thus the available data have to be limited. Similarly, other regulatory and fiscal constraints are smaller than for co-operatives and commercial code companies. Moreover, a legal form of a natural person business has its shortcomings in a sense that it is suitable for small firms owned by one person only and once they grow they usually change their legal status [12]. All these characteristics were not with line of the research aim that is to study barriers to entry and growth of companies in mature legal forms enabling fast development.

Enterprises were selected from the Company Registers kept at courts, statistical agencies or other state institutions, associations of entrepreneurs and employers' organizations in different countries. The sample in each country, however, had to conform to certain rules regarding the firms' activity, size and location.

Activity

Only four branches of economic activity (as specified in NACE classification) were chosen for this study: manufacturing, construction, trade and services. The primary criterion for

Figure 1. The Main Activity of Sample Firms in Five Countries



[12] And this is why in the sample we have actually captured a number of firms that had been initially created as natural person businesses, and only after some time they changed into a limited liability company or a partnership.

Figure 2. The Date of Establishment of Sample Firms

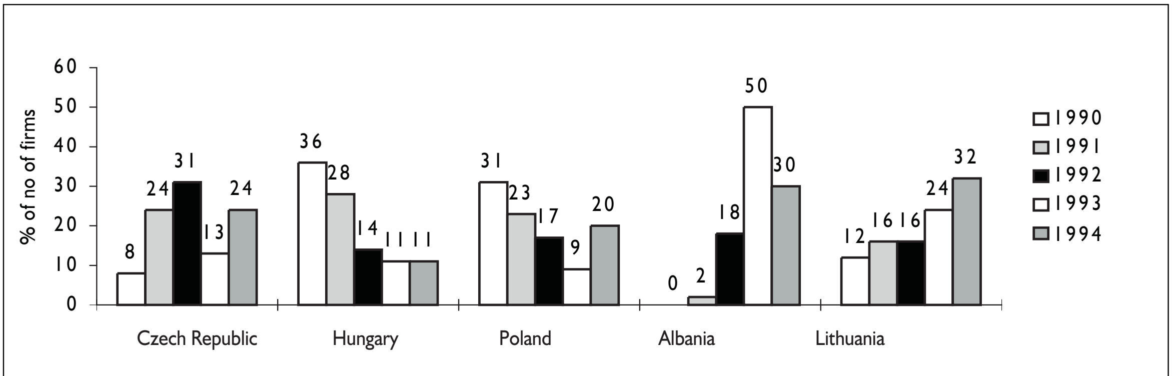
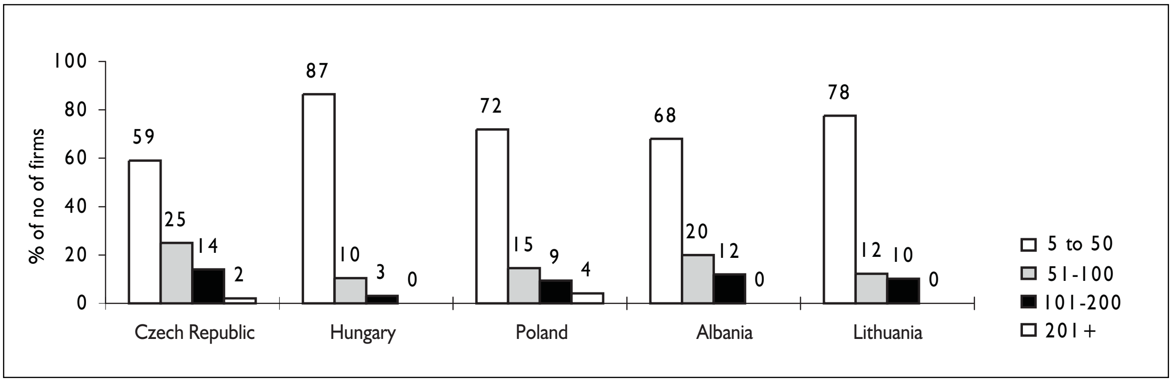


Figure 3. Distribution of Sample Firms According to Their Size (by 1995 Employment)



the selection of the sample was that it should reflect the share of these four sectors in the national economy (by employment). Of course other criteria such as size, regional location and the legal form were also applied in sample selection. Therefore, in the end, the sample did not precisely reflect the sectoral composition of national economies. Figure 1 represent the sectoral make up of the sample in five countries.

Date of Establishment

All enterprises in the sample were new private firms, established in the early transition period, 1990–1994. As such they would have faced, and overcome, a variety of impediments to their establishment and early growth which are of interest to this paper. Figure 2 represents the distribution of the sample according to their year of establishment.

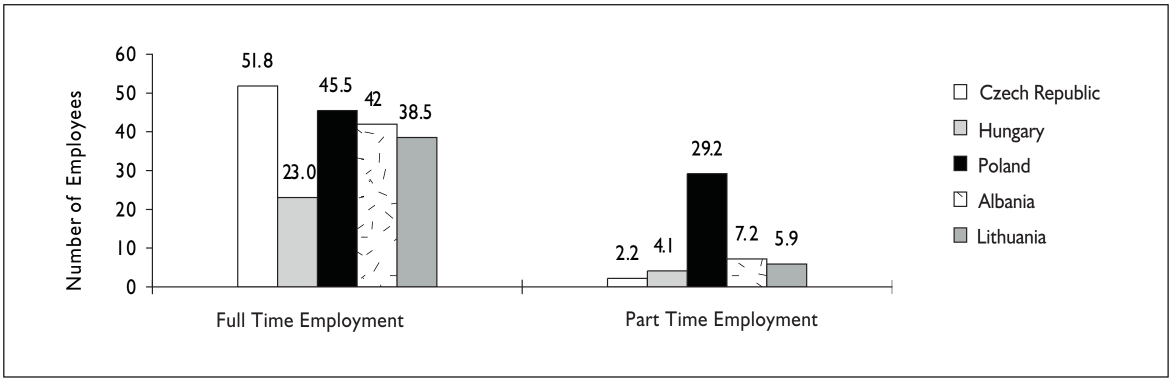
Size

Given that newly established firms are invariably of small and medium size, the sample concentrated on firms with a full time employment of less than 200 in mid-1997 when the interviews were conducted. Figure 3 shows the size distribution of sample firms in each country.

As the table shows, smaller firms, employing 5–50 people (full time) constituted between 59 percent and 82 percent of the sample. This reflects both the nature of new entries under conditions of transition and the size distribution of private firms in the economy as a whole (where larger firms are less common) [13]. Firms in transition economies usually employ many part time or 'free-lance' workers – for the latter group they do not often pay social and health insurance contributions. The following diagram shows the average number of full time and part time employees (in 1995) in the five samples.

[13] As the table shows, some country samples included a few firms, employing more than 200 in 1995. These firms were selected for the sample because at the time of interviews their employment levels were below 200. Only in the course of the interview it was noticed that in 1995 they had higher levels of employment. Given that these were successful firms that had expanded very rapidly in the early transition period it was thought that their experience was relevant to the project and that they should be included.

Figure 4. Average Number of Employees in Sample Firms in 1995



Legal Form

In general in transition economies, most new firms are small and the 'limited liability' is the dominant legal form. Partnerships and 'Joint Stock' companies (and co-operatives) are rather rare. The high level of initial capital required to establish a join stock company (see Table 7 below) is one of the main reasons for this pattern. Figure 5 shows the legal form of companies in the sample.

Location

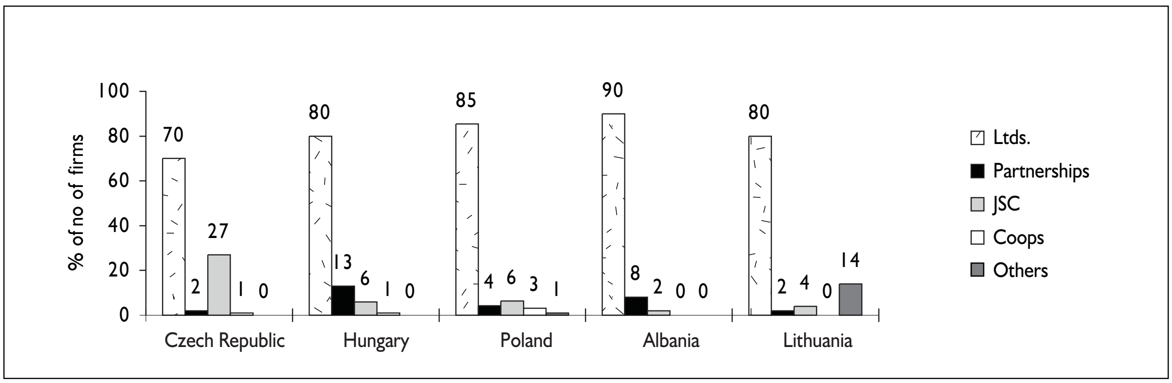
In order to widen the geographic base of the sample and to mitigate the bias towards the capital cities (which face very specific conditions in terms of demand, costs, input markets and exposure to information as well as technology), a proportion of the sample (ranging from one quarter to one third) was selected from a less developed region of each country: the districts of Prostejov and Olomouc in Central Moravia in the Czech Republic; the Hajdu-Bihar district in Hungary; the districts of Koszalin and Łomża in Poland; the city of Elbassan in Albania, and the city of Kaunas in Lithuania.

Table 7. Initial Capital Requirement for two Main Legal Forms of Business (in USD, at May 1998 exchange rates)

	Albania	Czech Rep	Hungary	Lithuania	Poland
Limited liability company	700	3000	5000	2500	1200
Joint stock company	70,000[a]	30,000	50,000[b]	25,000	29,000
% to be paid in cash		50[c]	30	25	25[d]

Notes:
[a] For joint stock companies without a public offer, this figure is $14000.
[b] Will be doubled next year
[c] In cash or kind
[d] 100% for payment in kind

Figure 5. The legal Form of Sample Firms



Time and expense constraints meant that it was not possible to have a sample with a wider regional distribution but given that a large proportion of new firms have been set up in or around the capital cities, we believe that the sample will provide a fairly representative picture of the problems faced by new firms in the early transition.

Foreign Companies

Finally, the sample in each country had to include a group of foreign companies, preferably 15 firms [14]. Companies established by multinationals or huge foreign corporations were excluded from the sample under the assumption that their entry to the new market (in any of the transition economies) can be facilitated (sometimes even to a great extent) by the mother company. One of the aims of the survey was to examine what are (if there are any) similarities and differences between domestic firms and companies established by foreign investors [15].

6. Barriers to Entry and Growth of New Firms in Poland

Ewa Balcerowicz

6.1. Introduction

The key element of the transition from a so-called centrally planned economy to a market economy is to search for and to create a new owner: a private one. There are two ways to make this change happen:

• the first one is a replacement of the state in its function of an owner; this can be achieved through privatization of state-owned enterprises inherited from the old ('socialist') system;

• the second one is a spontaneous creation of new private companies, which results in the growth of the private sector and the increase of its share in the economy.

Privatization of state-owned enterprises turned out to be a difficult task in every country in transition. As a result, progress in privatization has appeared to be generally slower than expected and needed. The case of the Polish privatization is a good example here.

In Poland privatization was one of the key elements of a reform program worked out in the end of 1989 and started in January 1990. The first program of privatization (of November 1990) was quite optimistic and envisaged privatization of 50 percent of state assets in the first 3 years of the reform [see- Blaszczyk, 1997a]. In seven years (1990–1996) 5,592 (that is 66.2 percent) out of 8,441 state-owned enterprises (as of the end of 1989) initiated the transformation processes, however, only 1,898 (i.e. 22.4 percent) firms had completed the process and were privatized [Blaszczyk, 1997b]. By the end of the year 1996 there were still 3,847 state-owned enterprises (see GUS 1997) of which 410 were huge companies, mostly of heavy industry and infrastructure [Blaszczyk, 1997a]. Until autumn 1997 some sectors (energy, gas, water, transportation, and telecommunication) had been totally excluded from privatization programmes [16]. Poland – a leader in reforms in 1990 has lost its position in this respect: the Czech Republic, Albania, Hungary, Estonia and Lithuania are ahead of Poland in privatization. In Poland 40 percent of GDP is still generated in public sector, while in above-mentioned countries the numbers are 30–35 percent [see EBRD, 1997].

In the case of Poland, a start-up of new private companies has appeared to be a more important process for creation and growth of private sector than the privatization of state-owned enterprises. The so-called 'greenfield' privatization has been the most dynamic phenomenon in the ownership transformation of the Polish economy.

The number of one-man businesses had increased from 813,145 in 1989 to 1,949,986 in 1996 (240 percent increase, see Chmiel 1998, table 5). The number of commercial code companies had grown dramatically (21.6 times) from about 15,700 in 1989 to 340,090 in 1996 [GUS, 1997]. In the years 1992–1996 the number of companies with foreign capital had tripled: from 10,010 in the end of 1992 to 28,622 in 1996 [see Chmiel, 1998, p. 7]. The new (greenfield) private sector had the most dynamic development with respect to production, sales and investment.

The growth of the private sector is the main factor that explains the growth of the Polish economy. GDP started to grow as early as in 1992 and this trend continues. In a group of 24 economies in transition, Poland is the only country with real GDP in 1996 that surpassed the level of pre-transition year of 1989 [EBRD, 1997].

Yet, there has been a close connection between the growth of the greenfield private sector and the privatization of state-owned enterprises. The new private sector has absorbed much of the assets and labour released from the state sector. Capital and human resources came either from liquidated and bankrupt state enterprises or from state enterprises restructuring their activities under pressure of new economic environment and thus releasing resources onto the market. The investigation of 200 largest state-owned manufacturing enterprises showed that the total employment in a

[14] The standard definition was used here: over 50 percent of foreign participation in a company's capital.

[15] Results of this investigation are presented in a comparative paper by Miklos Szanyi [1998].

[16] Since October 1997, when the change of the government took place, TP SA - telecommunication company has been put on the privatization track and initial preparatory steps started for another huge company PLL LOT.

200-firm sample had decreased by 35.6 percent in the years 1989–1994, from 884,000 in 1989 to 569,000 in 1994 [Balcerowicz, 1996]. It can be assumed that the majority of released labour force was absorbed by the private sector, since in that period the decrease in employment in the entire economy was only 8 percent.

In last three years number of entries (i.e., new firms) has been growing in a slower pace than in the period of 1990–93. There are two possible factors explaining this fact:

- either the Polish market has become more competitive and bigger capital is necessary to start-up business; or
- other conditions for doing business in Poland have worsened.

This chapter presents the conditions for starting and doing business in Poland in 1990s. What follows are results of the detailed survey done in 96 domestic and foreign new companies established in Poland in the first 5 years of transition period.

As it was presented in chapter 3 there are four types of constraints on the start-up and development of new private companies:

- regulatory constraints;
- information;
- financial constraints, and
- the environment for business and competitive conditions.

All of them were subject to investigation and results of the survey are presented below.

6.2. Regulatory Constraints

Regulatory constraints include both rules (laws) and institutions responsible for executing laws. They can be divided into constraints in:

- registration and licensing (i.e. at a start-up of a company);
- regulation of real estate, labour, taxes and other contribution, exports and imports which all influence the activity and growth of new firms.

6.2.1. Registration and Licensing

Seven stages of the registration process were examined to evaluate how difficult and/or time consuming each of the stages is for investigated companies (for the results see Table 8). The conclusion is that the registration process in Poland was generally perceived as easy.

Obtaining of an activity-specific license (on average 3.59 points; for the explanation of the scale of evaluation see Table 8) was the only difficult phase. However, only 22 companies out of 96 examined had to apply for the license, thus the majority of companies (77 percent) did not have to face this stage at all. This result gives an idea of a level of economic freedom on the Polish market: it may be considered as quite high, yet, as proved by a separate study of regulatory constraints [see Balcerowicz, 1998], it has been gradually limited by the introduction of licensing to another spheres of economic activity.

The sectoral analysis reveals that obtaining a license was regarded as the most difficult stage by companies active in services (4.33 vis-a-vis 3.57 average for the total sample). Foreign firms found this stage of registration more difficult than Polish companies did, but the subsample was very small in this case – only 5 companies.

In order to speed up the registration process new companies used services of outside consultants: lawyers and other professionals. High share (63 percent) of those who relied on help of specialists can be used as a proxy for complexity and length of the registration procedure. This is also proved by analysis of rules governing the registration procedures [see Balcerowic,z 1998, Part I]. The court has as much time as 90 days to deal with an application. Only after registration in court, a company can apply for registration in the statistical office (which can take up to 2 weeks). And without the statistical

Table 8. Poland: Evaluation* of Registration Process

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Court registration	1	5	2.33	2	2	1.07	94
2.	Tax Office registration	1	5	1.93	2	2	0.85	95
3.	Registration for social insurance and health	1	4	1.83	2	2	0.80	95
4.	Registration with the Statistical Office	1	5	2.14	2	2	1.01	95
5.	Obtaining criminal record	1	5	2.14	2	2	0.97	29
6.	Opening a bank account	1	5	1.95	1	2	1.12	94
7.	Obtaining activity-specific license	1	5	3.59	4	4	1.23	22
8.	Renewal of license	1	4	2.44	1	3	1.17	9
9.	Others	1	5	4.09	5	4	1.16	11

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – very easy; 2 – easy; 3 – moderate; 4 – difficult; 5 – very difficult.

identification number a new company cannot legally start its activity or open a bank account.

This shows that every stage takes some time and one stage determines the possibility of another to the extent that at least four out of six stages (namely: the court registration, obtaining a license, the statistical registration and opening a bank account) cannot be pursued parallel to each other.

Taking all these factors into consideration one may be struck by the fact that the enterprise survey in Poland produced results much better than expected. The whole registration process took on average 2.75 months, that is less than the maximum official time limit for the court registration alone. However, it has to be acknowledged that there were big differences within the surveyed companies: with a minimum of 2 weeks and a maximum of 20 (!) months.

Apart from the use of external consultants, bribes could be another explanation of a relatively short length of time for completion of the registration procedure. The question on bribes was not asked straightforward for obvious reasons, therefore, we had to draw conclusions from answers to an indirect question [17].

It is quite interesting that over the half of owners and managers (54 percent) did not believe that bribes are used to speed-up the registration process. Nevertheless, more than one fourth of the surveyed (29 percent) answered that bribes are common. The remaining 17 percent of respondents did not reveal their opinion.

Another significant revelation is that, contrary to what one may expect, the highest percentage of those who do not think that bribes are widely used is among companies located out of Warsaw (83 percent). It can be explained by the fact that these companies are located in less-developed regions with high unemployment rate. Courts and other registration offices in such regions are less occupied and can process applications in shorter time. Another reason can be a positive attitude of local authorities and administration towards new private entrepreneurs as job creators. We mustn't forget that local authorities are elective and in order to get re-elected they have to satisfy needs of their electorate. Effective local administration is one of them.

The survey results for the capital city firms give quite an opposite picture. 37 percent of companies believe that bribes are commonly used (vis-a-vis 4 percent of regional companies), 45 percent do not. Here we can use the similar type of reasoning as for regional firms; we only need to reverse it. The capital city administration is heavily occupied because mostly Warsaw attracts private investment, whereas the administrative capacity is not growing accordingly to the growth of private business. These two factors put together seem to explain the increased ratio of positive answers to the question about bribes asked to companies in Warsaw.

6.2.2. Regulation on Real Estate

Only one third (exactly 35 percent) of companies in the Polish sample use their own premises for business; the other two thirds of the firms fully or partially rent the buildings or business space. For companies that rent premises the most common problems are the following facts:

• a rent can be increased at a short notice (48 percent of responses); and

• rents are high and this is due to high monopolization of the real estate market (38 percent of responses).

In general, the regulations on real estate are not considered a barrier. Managers and directors perceived these regulations as having a minor effect on the establishment and growth of companies (an average of 2.41 points on the scale of 1 to 5; see Table 9 in the text).

6.2.3. Labour Regulation

Labour laws are causing problems to the vast majority (83 percent) of the sample firms. The main ones are:

• too high social insurance contributions (for 82 percent of all the sample companies and 99 percent (!) of those who complain of labour and employment laws;

Table 9. Poland: Evaluation* of Effect of Regulations on the Establishment and Growth of the Companies

		minimum	maximum	mean	modal	median	standard deviation	number of responses	no response
1.	Renting or purchasing of premises	1	5	2.41	1	2	1.39	93	3
2.	Registration and licensing	1	5	2.70	2	2	1.45	84	12
3.	Tax and contributions	1	5	4.16	5	4	0.97	96	0
4.	Exports and imports	1	5	2.93	1	3	1.48	73	23
5.	Health and safety	1	5	2.74	3	3	1.15	95	1
6.	Labour laws	1	5	3.28	3	3	1.12	96	0

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – no effect at all; 2 – minor effect; 3 – moderate effect; 4 – severe effect; 5 – very severe effect.

[17] The question was: 'Do you believe that bribes are commonly used to speed up the registration process?'

• the law on dismissal being too protective of employees (43 percent of the sample enterprises).

It is interesting to observe that only four Polish companies mentioned activity of a trade union in a firm as an unfavourable factor for the business development. An evident explanation is a non-existence of trade unions in new private enterprises.

Another observation is that private entrepreneurs did not raise an issue of the minimum wage. It seems that a fixed (in the course of three-party one-year negotiations) level of the minimum wage is not yet a problem for private companies in Poland.

Labour laws are ranked second out of six types of regulations, as far as their negative effects on the establishment and growth of the companies are concerned (see Table 9).

6.2.4. Regulation on Taxes and other Contributions

Laws on taxes and other contributions have the strongest effect on the establishment and growth of new private companies in Poland. Managers and owners described their effect as a 'severe one' (on average 4.16 points with the modal of 5, see Table 9).

One of the tasks of the project team was to find trends in the period of 1990–1997. As far as regulations on tax and other contributions in Poland are concerned, the results are as follows:

• the majority of companies (73 percent) stated that their tax and social insurance contributions as a percentage of their revenues had increased since their establishment; the conclusion is that the increasing burden put on the private companies in Poland has resulted in an increase of costs and a decrease of profits and consequently – in a decrease of investment;

• according to owners and managers of private firms, the regulations on taxes and other contributions had been changed many times (67 percent of responses);

• furthermore, these regulations had become more complicated in time (80 percent of responses);

The last two unfavourable changes made the majority of firms (75 percent) spend more time on dealing with taxes as compared to the first year of the establishment. They also made companies use services of persons from outside of a firm, namely tax advisors. 40 percent of surveyed companies used the services sometimes, the other 19 percent often.

6.3. Support for the SME Sector

There is a common belief shared by many economists and policy makers that small and medium-size companies should be supported by special governmental policies. This approach is advocated also in transition economies where, on the one hand, there is much room for the growth of the private sector, but on the other hand, there is a common need to learn how to establish and run business and to have access to capital.

In the survey questionnaire there was a separate section devoted to problems of an access to programmes or agencies established to provide assistance for new businesses or small and medium-size companies and about the nature of these support schemes. The results of the investigation have showed that the information about the existing programmes is very poor: only seven firms received a support from special schemes or agencies. Not a single company had obtained a special loan (a guaranteed one or one at low interest.

6.4. Financial Constraints

All domestic entrepreneurs surveyed in Poland, except for one, had used their own savings to start-up a business. This important finding has to be supplemented with the information that in the majority of cases, own savings were the only source of initial capital of the company. They constituted on average 74.24 percent of initial capital in the subsample of domestic companies. Other sources (like loans from friends, loans from informal capital market, restitution) were of minor importance. The bank loan had been used only in eight cases and its share in financing of initial capital (average of the total domestic subsample) was 3.75 percent.

Obviously, for a small group of domestic companies that obtained a bank loan at the start-up its share in initial capital was much higher. Those eight cases of bank loans seem to contradict a widely held view that new domestic companies do not have any chance to obtain a bank credit at a start-up, as they do not have a track record, therefore are not trustworthy.

As compared with domestic companies, foreign firms relied at a start-up mostly on foreign partner's contribution, leasing arrangements and prepayments for the contracts. These three sources accounted for as much as 51 percent of initial capital. Nevertheless, their own savings also played an important role (on average 46 percent of initial capital).

The important issue to examine was the access to and use of bank loans by new small and medium-size private companies in Poland. The common opinion is that in transition economies small and medium-size companies have a very poor access to bank loans. The conclusion drawn from the belief is that the lack of external sources of finance hinders the development of new private firms and apparently, halts the growth of private sector. Findings of the survey jeopardize these common opinions.

First of all, an important fact is that only 62 percent of the sample firms had ever received a bank loan. The other 34 percent of companies had not ever tried to get a bank loan. We need to remember that the sample consists of private companies established after 1989 and before 1995, that is businesses with a history record of at least 3 up to 7 years. Therefore, we may assume that the percentage of those who had ever got a credit should be bigger than 62 percent.

Rather surprisingly, only in four cases applications for credit were rejected. In order to explain such a small number of rejected cases it would be logical to assume that, firstly, companies applied for a loan only if they were positive about their chances to get a credit, and, secondly, their applications were well prepared. It is proved by the fact that not a single company complained about the lack of experience and knowledge of procedures of applying for a bank loan. Two of the four rejected companies were refused a credit because of the lack of collateral.

The companies that had never applied for a bank credit explained this fact by two reasons:

• too high costs of a credit (the most common answer);

• there was no need to apply for it (very common answer).

Another striking finding was that the majority of firms (73 percent) which had received a bank loan were satisfied with its amount. They did not wish to alter their loans because they generally regarded them as adequate for needs of their companies. Only 10 percent of companies found their loan largely insufficient, while 15 percent stated that they could do with a slightly bigger amount of it. What immediately comes to mind here, is that the survey results do not support a widely held opinion that in transition economies it is the lack of bank credits for new private business that hinders the growth of the private sector.

Companies' satisfaction with the amount of a received credit does not imply that new private companies are likewise contented with banks' credit services.

When asked about the main obstacles to obtain a loan from banks the respondents chosen four factors (see Table 10)

• the cost of a loan was stated as the most important one: high interest rates were regarded as a severe problem (3.99 points) [18].

• complex procedures for application (3.78 points, that is close to a severe problem);

• the collateral requirement (3.66 points); and

• the obligation to have a track record, however, this is was a moderate problem (3.17 points).

When asked about investments, two thirds of companies declared that they had had a major investment since their establishment. Slightly more than half of the firms found their investments adequate, the remaining 44 percent regarded them to be too small. What is interesting, only one company responded that the investments were too large

Retained profits were the main source of finance for investments: 76 percent of responses. For the total sample 44.27 percent of investments were financed by retained profits [19]. Loans from domestic banks ranked second (on average 19 percent), which is again a surprising finding. Other sources, i.e. loans from foreign banks, loans from family and friends, loans from informal market, leasing agreements or credits from domestic and foreign suppliers played a minor role. The final point is that own savings had 8.30 percent share in financing of companies' growth.

Another widely held conviction is that because of the lack of external financing, new small and medium-size companies cannot afford modern equipment etc. In general the owners and managers of the sample companies had a very positive assessment of the capital stock of their company. 64.5 percent of respondents stated that their stock capital in compar-

Table 10. Poland: Evaluation* of Obstacles to Obtain Finance from Banks

		minimum	maximum	mean	modal	median	standard deviation	number of responses	no response
1.	Cost of loans (interest rate)	1	5	3.99	5	4	1.07	89	7
2.	Complex procedures for application	1	5	3.78	5	4	1.06	89	7
3.	Collateral requirement	1	5	3.63	4	4	1.21	88	8
4.	Connections with bank managers	1	5	2.40	1	2	1.27	80	16
5.	The need to have a track record	1	5	3.17	3	3	1.31	81	15
6.	Long delays in processing loan application	1	5	2.84	4	3	1.30	82	14

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

[18] For the evaluation scale see note to Table 10.

[19] Exactly for 64 companies, because respondents from such a portion of the sample gave complete data for several questions that referred to the issue of sources of finance for investment.

ison with the capital stock in the country is either much younger (38.5 percent) or slightly younger (26 percent). The other 30 percent of respondents assessed that their capital stock is of about the same age as the country average in their sector.

At the same time salaries of both non-managerial staff and managerial staff were considered to be much higher or higher than the country average in a given sector (64.5 percent and 52.1 percent respectively). Only 5 percent and 20 percent of respondents were of the opinion that salaries of non-managerial and managerial staff respectively are lower or much lower than average in their sectors.

6.5. What Hinders the Growth of a Company?

The bulk majority (91 percent) of owners and managers wanted their companies to expand. Only 9 percent were satisfied with the current volume of activity.

The companies were asked to specify what hinders the increase of their production. This question enabled to settle a rank of different constraints earlier examined separately in the survey, and of some other constraints mostly of physical nature (see the specification in Table 11).

The following three factors turned out to be the most severe barriers:

• high burden of taxes and other contributions came up as the most important one (and was on average regarded as a severe problem – 4 points on 1 to 5 scale, see the note to Table 11).

• problems related to regulations (3.85 points), and

• insufficient finance for expansion (3.18 points), which is on average a 'moderate problem'.

Other factors, e.g. insufficient demand, shortage of qualified workers, limitations in physical capacity or regulations on working conditions were regarded on average as a minor problem.

Analysis of subsamples according to ownership discloses a few differences between domestic and foreign companies.

Domestic companies find tax burden to be a slightly more severe factor hindering their growth than foreign companies do (4.03 points for domestic, 3.87 points for foreign companies). The proportions are reverse as far as the importance of regulations is concerned (3.81 points for domestic vis-a-vis 4.00 points for foreign). Domestic companies consider the shortage of finance for expansion as a slightly more severe burden than foreign companies do (3.22 points and 3.00 points respectively). One can observe that although shortage of inputs and insufficient demand is regarded to be only a minor problem, still in the scale of burdens foreign companies rank the shortage of all kinds of inputs lower than domestic ones.

6.6. Environment and Competitive Conditions

The overall environment for the development of private business in Poland was evaluated as 'satisfactory' (see Table 12). Opinions ranged from 'poor' (2 points on the scale of 1–5) to 'very good' (5 points), however, the modal judgement was 'satisfactory'.

Table 11. Poland: Evaluation* of Obstacles to Increasing Company's Production

		minimum	maximum	mean	modal	median	standard deviation	number of responses	no response
1.	Insufficient demand	1	5	2.57	3	3	1.23	83	4
2.	Shortage of qualified workers	1	5	2.74	3	3	1.30	86	1
3.	Shortage of high quality management personnel	1	5	2.75	1	3	1.41	85	2
4.	Shortage of other inputs	1	5	1.95	1	1.5	1.11	64	23
5.	Limitations of physical capacity	1	5	2.09	1	2	1.22	70	17
6.	Insufficient finance for expansion	1	5	3.18	3	3	1.32	83	4
7.	High burden of taxes / contributions	1	5	4.00	4	4	1.08	87	0
8.	Problem related to regulations	1	5	3.85	5	4	1.17	39	48
9.	High redundancy payment associated with dismissals	1	5	2.12	1	2	1.23	83	4
10.	Regulations on working conditions	1	5	2.33	1	2	1.22	86	1
11.	Uncertain political / economic conditions	1	5	2.70	3	3	1.19	82	5
12.	Others	1	5	3.67	5	4	1.49	15	72

Note: *The same scale used as in table 10.

Table 12. Poland: The Overall Environment for Development of Private Business in Poland*

		mean	modal	median	number of responses
1.	The overall environment for development of private business	3.08	3.00	3.00	95

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – very poor; 2 – poor; 3 – satisfactory; 4 – good; 5 –very good.

Table 13. Poland: Evaluation* of Obstacles Affecting the Business of a Company

		mean	modal	median	number of responses
1.	Political instability	2.43	3	2	87
2.	Inflationary conditions	3.72	4	4	95
3.	Frequent changes in government	2.40	2	2	87
4.	Frequent changes in laws and regulations	3.88	4	4	95
5.	Non-transparency of laws and regulations	3.90	4	4	96
6.	Operation of commercial law	2.84	3	3	90
7.	Operation of the banking system	2.95	3	3	92
8.	Inadequate measures against crime / corruption	3.18	4	3	85
9.	Continued government intervention in the economy	3.07	3	3	85

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

There are three factors regarded as having the strongest negative effect on business of new small and medium-size companies:

• frequent changes of laws and regulations (3.88 points in the 1–5 scale);

• non-transparency of laws and regulations (3.90 points), and

• inflation (3.72 points).

All three are regarded as 'severe' problems for companies in Poland. 'Moderate' implications are brought by inadequate measures against crime and corruption (3.18 points), continuing governmental intervention in the economy (3.07 points) and in operation of the banking system (2.95 points). The remaining three examined factors turned out to be less than moderate problem (see Table 13).

For the majority of new companies examined in Poland the main competitors are other domestic small and medium-size firms and foreign firms or joint ventures established in Poland (see Table 14). The strongest competitive power is exercised by foreign firms or joint ventures; their power is regarded as slightly more than 'moderate' (3.20 points on a scale of 1 to 5). The most frequent answer was that foreign firms (or joint ventures) are very strong competitors (modal of 5). It is surprising that state-owned enterprises and large privatized firms are on average regarded as weak competitors, and the majority of enterprises do not regard them as competitors (modal 1, see Table 14).

The survey data give some idea about the volume of the grey economy. The two thirds of new small private companies face a competition from firms acting in grey economy. However, their competitive power is on average regarded as less than moderate (2.57 points); at the same time unregistered firms seem to be strong in some sectors only, as the dominant answers was '1' ('not a competitor', see Table 14).

6.7. Foreign Companies

A small part of the questionnaire was addressed only to foreign companies. The idea behind it was to find out, on the one

Table 14. Poland: Main Competitors and their Competitive Power*

		mean	modal	median	number of responses
1.	Domestic SMEs producing similar goods / services	2.84	4	3	92
2.	SOEs or large privatized firms	2.08	1	1	84
3.	Foreign firms or joint ventures established here	3.20	5	3	86
4.	Firms in the informal sector of economy	2.57	1	3	68
5.	Importers selling new products	2.42	1	2	50
6.	Importers selling second hand products	1.58	1	1	36

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a competitor; 2 – a weak competitor; 3 – a moderate competitor; 4 – a strong competitor; 5 – a very strong competitor.

Table 15. Poland: Evaluation* of Obstacles to Foreign Companies

		mean	modal	median	standard deviation	number of responses
1.	Obtaining the relevant permits and licenses by foreign firms	2.13	1	2	1.20	15
2.	Inadequate legal protection for foreign investors	2.07	1	2	1.12	15
3.	Difficulties faced by foreign firms in buying land and real estate	3.36	5	4	1.43	11
4.	Negative attitude of government officials (from tax offices, etc.)	2.14	1	1.5	1.36	14
5.	Negative attitude of suppliers and customers towards f. i.	1.53	1	1	0.96	15
6.	Negative attitude of population in general towards f. i.	1.40	1	1	0.80	15

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 16. Poland: Evaluation* of Factors Facilitating for Foreign Firms

		mean	modal	median	standard deviation	number of responses
1.	Laws facilitating foreign investment	2.00	1	1	1.26	15
2.	Cheaper skilled labour	3.14	4	3.5	1.36	14
3.	Size of the market	3.67	4	4	0.79	15
4.	Access to other countries of the region	3.07	4	3	1.44	14
5.	Liberalized foreign trade	2.93	3	3	1.34	15

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a factor at all; 2 – minor factor; 3 – a factor of some importance; 4 – an important factor; 5 – a very important factor.

hand, what are the obstacles to foreign companies established in Poland, on the other hand, what factors are regarded as facilitating. Results of the investigation are presented in Tables 15 and 16.

The subsample of foreign companies was small (15 companies), therefore we must be careful not to jump to conclusions. Rather surprisingly, apart from difficulties with buying land and real estate for business in Poland (in this particular area foreign investors are evidently discriminated in comparison with domestic businesspersons [20]), all other factors most likely to be perceived as barriers, were regarded by sample respondents as a 'minor problem', or close to 'not a problem at all' (see Table 15). Limitations in land and real estate purchase were on average considered to be slightly more than a 'moderate problem' (3.36 points), with the modal of 5 (a 'very severe problem') in our evaluating scale of 1 to 5 (see the note to Table 15).

The size of the market ranked first on the scale of six facilitating factors. With an average rank of 3.67 and a modal of 4, it was regarded by the sample foreign companies as an 'important factor' (see Table 16 and the note to it). Cheaper skilled labour in Poland, access to other countries of the region and liberalized foreign trade were perceived as factors 'of some importance' (3.14 points, 3.07 and 2.93 respectively).

Table 17. Poland: Evaluation * of Overall Environment for Foreign Investment in Poland as Compared to:

		mean	modal	median	standard deviation	number of responses
1.	Albania	1.17	1	1	0.37	6
2.	The Czech Republic	3.60	3	3.5	0.92	10
3.	Hungary	3.70	4	4	0.78	10
4.	Lithuania	2.57	3	3	0.49	7
5.	Poland	3.40	4	4	1.08	15

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – very poor; 2 – poor; 3 – satisfactory; 4 – good; 5 – very good.

[20] For a detailed description of this discrimination see Balcerowicz (1998), Part III, section 4.

Low rank of special laws facilitating FDI (2.00 points only) supports opinion of many economists that it is not special facilitating laws that attract much of foreign investment; more deciding are overall business conditions together with economic and political standing of the country of a would-be-investment.

Foreign companies were asked too evaluate the overall environment for FDI in Poland in comparison to the other four transition economies analyzed by the project (for results see Table 17). In the Polish sample Poland came third, after the Czech Republic and Hungary, with an average of 3.40 points, which means that the environment for foreign investment is regarded as slightly more than 'satisfactory' (3 points) but less than 'good' (4 points). It would be advisable to examine the bases of the ranking, i.e. to check whether respondents as investors have a first hand knowledge of the Czech Republic and Hungary or just repeated common views present in Poland spread by newspapers in the country and abroad in the first few years of transition period.

6.8. Conclusions

The establishment of a new company had not been a problem in Poland in the early transition period of 1990–1994. The registration process is generally perceived as an easy one. A lack of capital at the start-up has not been a problem for new entrepreneurs either. The only real complains are made by those who had to apply for a license, however, licensing has been limited to some specific activities.

Nevertheless, regulations are a real problem. The analysis of the survey results shows that regulations hinder the growth of firms, impose high costs on small companies and create uncertainty for them. There are two spheres where regulations are particularly unfavourable: the labour code and taxes. The labour code is too protective of employees and imposes too much rigidity on contracts between employers and employees. The tax system is too complex and is getting more complicated over time. It has been changed very often in recent years, and these changes have resulted in making managers spend more time on tax related issues. A severe problem for entrepreneurs is also the non-transparency of regulations. Taxes and contribution for social insurance are regarded as very high and they strongly influence the activity and growth of companies.

The survey results did not support the widely held view that growth of private sector is hindered by a lack of bank credit. The vast majority of enterprises in our study have experienced growth since their establishment and the majority of them succeeded in obtaining bank credit. Their expansion was achieved by utilizing their retained profits first and then by using bank credit. Nearly all of those firms that applied for loan were successful with their application and regarded the amount of credit as adequate for their needs. It does not mean that private companies were satisfied with the quality of bank services. The main problems were the cost of loans, complex procedures for application and collateral requirements.

Very few firms in our sample had received information and support from the national or international schemes which have been set up to help and support the small and medium-sized enterprise sector.

7. Barriers to Entry and Growth of New Firms in Hungary

Miklos Szanyi

7.1. Introduction

Hungary was regarded as the communist country which experimented most with a reform of its centrally planned economy. The introduction of a series of measures was aimed at following a few market economic functions. The major goal was to ensure a proper interest of citizens as well as of economic organizations in order to increase performance and launch bottom-up initiatives and inventions. The logic of this line of the reform led straightforwardly to changes in ownership patterns of the economy. This significantly influenced the establishment of small businesses already during the 1980s. Although the state property was not privatized, it was allowed to be used by private persons for moonlighting. Setting up of small businesses was permitted, however, the upper limit of employment was fixed: private ventures were not allowed to grow into medium size brackets. The development of private business was hampered also by tax regulations and by bureaucracy.

This mixture of private and public within the centrally planned economy carried out mixed influence on private entrepreneurs. On the one hand, they were allowed to take responsibility for their decisions and also to earn benefits. On the other hand, doing business was more a matter of finding and targeting weak points of the centrally planned economy, both structurally and functionally. Private ventures were set up in branches where state-owned firms (SOEs) were especially weak, and their performance was dependent very much on the relationship to the state (sometimes the party) bureaucrats. Consequently, private business could not develop regardless of the overwhelming net of paternalistic linkages, which was so characteristic in all centrally planned economies.

Thus, the early development of the private sector in Hungary did not mark a breakthrough in the economic system. Entrepreneurs collected useful experiences and practices, but many of them did not have an opportunity to learn some of the basic market economy lessons. For example, many private firms (some of them quite big) which grew up during the 1980s, went bankrupt during the early 1990s. Many of them lost their convenient market niches of the shortage economy. Others failed because of false management practices, e.g. because of a too rapid credit-financed company growth.

By the end of the 1990s entrepreneurs learned their lessons. Bankruptcies and liquidations are still quite frequent, but now different reasons stand behind them. Many failures are deliberate and are in fact close to a fraud. In other cases, small ventures exit from the official economy only to reappear in the unregistered or grey economy. The estimated share of the grey-black economy in Hungary is some one third of total GDP. The share is also pushed up by relatively high tax rates and social security contributions. This is especially true for the small business, since tax evasion is the easiest and most frequent in this segment of the economy. It seems that negative effects of the government's income centralization can not be compensated by the currently carried out small business promotion system.

The establishment of small businesses is enhanced by a variety of means.

Perhaps the most important ones were:

• the tax holiday for companies which were established and registered by the end of 1992

• different preferential credit lines (among them the ones which were provided for privatization purchases)

• some sort of assistance and consulting services.

Still, behind the massive increase in the number of private entrepreneurs and new business ventures at least two more important factors can be identified. The first one relates to the organizational break-up of once big SOEs. During the period 1988–92 a large number of SOEs established new ventures by the dozens partly in order to siphon state property out of SOEs, partly because the formerly integrate network of industrial companies needed reorganization and the establishment of independently functioning units.

The other important process, which increased a number of small businesses, was the forced entrepreneurship. Private persons who actually took up a job as employees had to establish a new business entity in order to get the job. Hiring another business entity is significantly cheaper for companies than to employ private persons on regular bases. Moreover, employees are more flexible this way. In other cases employees themselves decided to be contracted as a business entity rather than as a regular employee in order to spare on taxes. The large number of forced entrepreneurs would skip back to regular employment as soon as financial conditions allowed them to do so.

Because of a rather complicated structure of the group of small businesses and difficulties in interpreting the statistical figures it is crucial to obtain more information from empirical surveys. This paper contains the main results of such a survey, which was carried out in Hungary in the years 1996–1997.

7.2. Regulatory Barriers to Entry

Similarly to Poland, the registration in Hungary did not present serious problems for entrants. The registration was usually facilitated by outside experts such as e.g. lawyers. Owners and managers did not bother much about it (85 cases out of 100). Only 14 companies reported that their registration process took over 12 months, with the longest period of 36 months. In the case of the remaining 86 companies, however, we should not consider the registration process to be completely finished, rather, we should think that necessary permits for starting operation were obtained.

A court decree about registration is not necessary in Hungary to start up the economic activity, yet, there are a few maneuvers which require court registration. Banks, for example, do not usually extend loans to firms which have no valid court registration.

Owners and managers perceived the registration process as an act of preparation of necessary supplements, registering at the tax, health and statistical offices and opening a bank account. Accordingly, the highest rank as 'barrier' was only 2.7 on the 5-degree scale for the court registration and for the obtaining of activity-specific certificates and licenses (see Table

Table 18. Hungary: Evaluation* of Registration Process

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Court registration	1	5	2.7	3	3	1.3	98
2.	Tax Office registration	1	5	2.0	1	2	1.0	98
3.	Registration for social insurance and health	1	4	2.0	2	2	0.9	98
4.	Registration with the Statistical Office	1	5	1.9	1	2	0.9	96
5.	Obtaining criminal record	1	4	1.6	1	1	0.7	75
6.	Opening a bank account	1	4	1.8	1	2	0.9	99
7.	Obtaining activity-specific license	1	5	2.7	3	3	1.4	67
8.	Renewal of license	1	4	2.4	1	2.5	1.2	26
9.	Others	1	5	4.7	5	5	0.6	3

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – very easy; 2 – easy; 3 – moderate; 4 – difficult; 5 – very difficult.

18). Those few who needed specific certificates ranked this as a very serious problem (18 cases of 67 companies gave the problem 4 or 5 points). Court registration scored 28 "fours" or "fives" out of 98 firms. Only 19 firms mentioned bribes as a usual practice for accelerating registration procedures. Bribes are more likely to be used by those who need quick court registration in order to receive a bank credit or special licenses. This practice was not necessary for most companies.

In order to have a closer look we further divided different groups of companies within the sample. Beside branch affiliation big companies, we distinguished foreign firms and companies located in the countryside were separated. Deviations from the sample averages were usually only minor. Big companies used to have more difficulties with licensing. Court registration was ranked 3.3, which indicates the existence of difficulties. Manufacturing firms ranked the same question 3.0; big firms tended to pursue manufacturing activity. Foreign companies complained on difficulties with the acquisition of activity-specific licenses (3.1). Construction firms (usually the smallest in the sample) had the least difficulty with registration. Their scores were predominantly below average. Registration was the quickest for firms engaged in services, the slowest for trade companies. Registration was completed quicker in the countryside than in the capital city. On average, foreign firms needed 7.9 months to complete registration, big firms – 5.5 months.

Real estate market conditions and regulations constitute a problem for many entrants, since most of them do not own a company seat, and many of them strive to purchase one. 60 companies hired facilities and 40 operated from their own. The majority of the 60 companies were not satisfied with the conditions: 30 of them blamed monopolistic positions and high rental fees, 16 – a sudden and drastic increase of prices. There were few companies which complained on the lack of flexibility in renting contracts. Quite interestingly, they considered the period needed to break the contract to be too long, and thought that contracts are signed for too long periods.

Problems with premises were the same for the sub-groups of the sample, however, construction firms tended to suffer more because slightly more of them operated from hired premises. On the other hand, more services firms owned their premises.

As far as labor regulations are concerned, it is the high health contribution that was most criticized (87 cases). The negative impact of high social security contributions was emphasized univocally. Interestingly, the dismissal was apparently not a problem at all. The issue appeared immediately in 19 of the 68 firms reporting the occurrence of the dismissal. One-week period was reported in 10 cases, 2 weeks in 8 cases.

Most employees were reported to receive the relatively low legal minimal salary, but actually obtain much higher incomes. This practice effectively facilitates quick dismissals and helps employers to pay smaller social security contributions.

As far as employment regulations are concerned, big manufacturing companies had again most difficulties.

In the opinion of 71 interviewed managers, high social security costs as a percentage of their revenues have even increased since the establishment of their companies. 81 of them thought that tax and social security regulations changed very frequently. In fact, they changed every year, in many cases even several times within a year. 70 managers stated that they spent more time on tax and payment matters than in the year of the establishment. Therefore, many of them hired tax experts regularly (27 cases) or even employed one on a permanent basis (34 cases).

There was an interesting split among firms concerning changes in eligible expenses.

35 percent of respondents stated that they increased and 44 percent that they decreased. Eligible expenses of especially trade and service firms were reported to decrease, whereas manufacturing and construction firms' expenses increased. Foreign and big companies mentioned a decreasing level of eligible expenses, while many of the countryside ventures – an increase. We did not find a solid explanation for the scattered pattern of answers to this question.

Foreign trade regulation caused significant problems for half of those who were involved in such an activity (79!). The other half did not blame the regulations. Beside bureaucratic procedures of tariff payments, it was the import surcharge, introduced in 1995 and banned in 1997, that was mentioned as a barrier. But the surcharge can be considered a barrier of business in general, not a specific entry barrier.

Table 19. Hungary: Evaluation* of Effect of Regulations on the Establishment and Growth of the Companies

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Renting or purchasing of premises	1	5	3.0	3	3	1.3	90
2.	Registration and licensing	1	5	1.8	1	2	1.0	93
3.	Tax and contributions	1	5	3.9	4	4	1.0	98
4.	Exports and imports	1	5	3.0	2	3	1.3	71
5.	Health and safety	1	5	2.8	3	3	1.2	73
6.	Labor laws	1	5	2.6	3	3	1.1	84

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – no effect at all; 2 – minor effect; 3 – moderate effect; 4 – severe effect; 5 – very severe effect.

In the opinion of the interviewed managers, tax regulations and other contributions had the single most important effect on entry and development of small business (on average 3.9 points with the modal of 4, see Table 19). Both the excessive level of the contributions and frequent changes in the regulations were blamed. Other areas of regulation did not on average receive rankings over 3.0 points meaning "moderate effect" (see Table 19).

7.3. Support for Small Business

Very few sample companies received support of any kind in their development (17). In the 11 cases the support was provided by central government agencies (small business support institutions, the privatization agency or ministries), in 4 cases – by chambers of commerce and trade, 2 cases of foreign support were registered and one company received support from the local government.

6 support schemes were targeted at domestic or foreign marketing actions, 4 at obtaining finance for technological development (ISO certificates, and one R and D project in the laser development). Companies reported preferential credits only in three cases.

7.4. Financial Constraints

Since the Hungarian sample contained more small businesses than medium sized ones, their registered capital was consequently rather low, 1.05 mn USD on average. There were 30 companies which registered with the official minimum capital for a limited liability company, namely with 1 mn HUF (the equivalent of 5,000 USD at the May 1998 exchange rate). Because there is no capital limit for partnerships, 14 out of the 16 partnerships registered with even smaller capital. On the other hand, there were companies with capital exceeding 10 mn. USD. As we can observe, the sample companies differed significantly at this respect.

Trading companies showed a definitely high capital need with an average of 2.8 mn USD. The second scoring manufacturing companies applied only 0.28 mn USD or one tenth of the average of trade companies.

Interestingly enough, difference between big and small firms' averages was just in the opposite direction: big firms scored below average: 0.5 mn. USD. This can be explained by the fact that size measured by employment did not correlate positively with the amount of the initial capital.

Most companies' capital needs were covered from their own savings, in the case of 75 companies – to 100 percent. In a further 6 cases mother companies provided the base capital to 100 percent. Family and bank loans together with SME development funds hardly played any role (2 companies mentioned them). 69 companies regarded their registered capital as sufficient, 22 as too small. The latter were probably those who were able to develop their business quicker than they had originally expected. Quite interestingly, foreign companies did not involve more outside finance than domestic ones. Countryside companies tended to finance initial capital from their own savings to a significantly higher extent than firms in the capital city (97.3 percent for 25 firms out of 30). 'Other' sources were used primarily by manufacturing firms.

Bank credits were received by 40 companies, 51 never tried to obtain them and 9 companies were met with refusal. On average, banks loaned the amount of 0.34 mn. USD, with the exception of few considerably higher credits, and the rest being rather limited. There was a company which received 600 mn HUF, another one 100 mn HUF , and there were three cases of credits amounting to 70 mn. HUF. If we exclude these 5 cases, an average amount of a credit provided by banks goes down to 0.15 mn. USD.

Manufacturing firms had little difficulty with obtaining bank credits. 53 percent of them received bank loans, and their average amount was much higher than that of other companies (0.57 mn. USD vis-a-vis 0.16 mn. USD of trade companies second in this ranking). Big companies received bank loans more frequently (14 out of 16), but the sums were usually below average (0.22 mn. USD). This implies that small firms received higher amounts! Foreign companies did not usually try to get a bank loan (11 out of 17). 21 out of 30 regional firms received loans, but again, the received amounts were much below average (0.14 mn. USD).

Thus, the conclusion is that small manufacturing firms in the capital city received most bank loans.

Obviously, both short and long term credits were mentioned. Several firms mentioned a continuous short term financing (to the tune of up to 30 mn HUF of permanent credit stock in one case). As far as long-term and medium-term credits are concerned, at least 29 companies received them (15 with a deadline of 12 months, 4 of 24 months, 4 of 36 months, 2 of 48 months, 2 of 60 months, 1 of 72 months and one with a 120-month deadline).

Thus, one could not conclude that Hungarian companies were devoid of bank credits. It was reflected in the question about intended changes in the level of bank borrowing: 24 out of 47 firms did not want to change the current level. Among those 11 who wanted to reduce indebtedness drastically, high costs of a credit were mentioned as the primary reason (see Table 21). Those who wished to broaden credits needed fresh money for further expansion. In all cases, sufficient collateral had to be provided for bank loans, in the form of real estates, equipment and stocks, in many cases a combination of these three elements.

Among companies which did not apply for bank credits, predominated those, which did not need them (especially foreign firms), or those which could not afford high interest charges (38 cases). 13 companies did not believe they would obtain a credit. Among those firms whose applications were

Table 20. Hungary: The Main Sources of Finance for [A] Working Capital Needs; [B] Investment (number of mentionings)

		[A]	[B]
1.	Own personal savings	32	13
2.	Retained profits (operating revenues)	84	43
3.	Loan from family and friends	12	4
4.	Loan from domestic bank	16	13
5.	Loan from foreign banks	2	0
6.	Loan from special programmes set up to aid SME's	0	0
7.	Loan from informal capital market	1	0
8.	Credit from domestic suppliers	24	2
9.	Credit from foreign suppliers	14	5
10.	Late payment of taxes and contributions	9	0
11.	Others	5	5
12.	Leasing	-	5

rejected by banks, 4 could not provide the necessary collateral; another 6 were regarded as too risky.

Working capital needs of firms were financed primarily from sales revenues and personal savings (see Table 20, part A). Out of 84 firms which mentioned sales revenues, 33 declared them to be the only source of working capital (100 percent), and another 17 firms estimated the share of revenues being between 75 and 99 percent. In the case of personal savings, 4 out of 34 firms declare the share of this source to be 100 percent. The two thirds of the companies named several sources, among them different kinds of credits and delayed payments, as it is shown in Table 20[A].

The analysis of Hungarian firms' working capital financing revealed the fact that in the case of regional companies, supply of the capital was not sufficient. Most bank loans were used to finance the companies' working capital needs (10 cases, with the share in total finance above average). Domestic suppliers' credits also played an important role in the case of regional firms (further 10 companies with the share in total finance above average). Almost all foreign and big firms reported a high share of retained profits in financing of working capital needs.

61 companies out of 100 were involved in investments. Manufacturing and construction firms were prevailing among investors. They also invested more. The average amount was 0.33 mn. USD but again, there were big differences among companies regarding the invested amounts. Companies in the countryside carried out smaller investments. The structure of investments' financial sources was quite similar to that of the financing of working capital needs. The majority of companies financed investments with profits (revenues), or with personal savings (see Table 20[B]). Out of 43 firms mentioning operating revenues, 28 stated that over 75 percent of costs were covered from this source. Out of 13 companies which mentioned their own savings, 7 financed over 75 percent of costs from this source. Domestic bank credits also played an important role here, and in the category 'others', 5 companies mentioned a capital increase.

Out of only 20 managers who offered personal property as collateral in bank credit applications, 12 worked in the countryside. 58 respondents, primarily those who did not apply, stated that there was no need to offer personal property. Some of the respondents did not want to risk their personal wealth, others put all their assets in the venture, and there were also managers who did not possess valuable personal property. As a rule, many of the applicants had to offer their personal properties as collateral in an application for a bank loan.

Those, who had applied, usually stated that they would consider applying again, whereas those who had not felt it necessary to apply said that they did not intend to apply in the future, either. Those who wanted to apply usually expected that they would obtain the required credit from the bank (32 out of 37). Not surprisingly, there were especially many potential applicants in the countryside. Many big firms reported their intention to apply for bank loans. Other sub-samples reported figures below average.

As far as barriers of borrowing from banks are concerned, the two most significant ones were: high interest rates and the excessive level of collateral required by banks (see Table 21).

A complex application procedure which ranked third, was not so much a problem for big companies (3.1 points), as it was for smaller ones.

Regional firms regarded necessary connections with bank management an important barrier (3.4 points on the 1 to 5 scale). The same obstacle was brought up by services firms (3.5 points). Slow processing was observed in the case of construction firms (3.9 points). Other factors were regarded to be far less important, but it is worth mentioning one of them: inefficient working of commercial banks was perceived negatively.

Despite the widespread belief of bad business climate in Hungary, companies came up with modest profits in every single year. This is an interesting finding because the country underwent an economic shock. We should not forget that the recession which hit the Hungarian economy during the 6 inves-

Table 21. Hungary: Evaluation* of Obstacles to Obtain Finance from Banks

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Cost of loans (interest rate)	1	5	4.3	5	5	1.0	94
2.	Complex procedures for application	1	5	3.5	5	4	1.3	91
3.	Collateral requirement	1	5	4.3	5	5	1.1	94
4.	Connections with bank managers	1	5	2.8	1	3	1.4	75
5.	The need to have a track record	1	5	2.1	1	2	1.3	77
6.	Long delays in processing loan application	1	5	3.3	3	3	1.3	79

Note: *The following scale1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5– a very severe problem.

tigated years was the worst the country had met in the modern times! In spite of the recession, new entrants (at least those who survived to provide us with information for the questionnaire) produced profits during the whole period, as it is shown in Table 22. The other remarkable finding is that the level of profits did not change much, at least on this rather unimpressive scale.

Table 22. Hungary: Statement on Profit and Loss of a Firm in Subsequent Years since Establishment *

		average ranking	number of responses
1.	1990	3.6	36
2.	1991	3.5	55
3.	1992	3.5	75
4.	1993	3.6	88
5.	1994	3.6	96
6.	1995	3.8	99

Note: * The following scale 1 to 5 has been used for the evaluation:
1 – heavy loss; 2 – moderate loss; 3 – breakeven; 4 – moderate profit; 5 – substantial profit.

Big firms as well as regional ones reported modest decline in profitability, and yet, they maintained averages over 3.0. The foreign firms' profitability had begun to improve since 1993, but kept on lingering below average. The profitability of construction companies was high in the early 1990s and had declined far below average by 1995. Similarly, a declining trend had been present in trade firms, at least until 1993. This was probably a result of fierce competition in trade. Services companies, on the other hand, improved performance from below average to an average level.

Business success can also be detected in the growth of corporate assets. 86 companies reported a total asset value of 14.6 mn USD at the end of one year of their establishment. This amount increased to 34.0 mn USD at the end of 1995. In comparison, 100 reporting companies had a stock of debt worth HUF 1457 mn at the end of 1995. This debt was accumulated by 40 firms, 50 reported no debt at all (10 companies did not provide data). Only 9 firms reported debt to the state, 32 to suppliers, 23 had bank debts.

7.5. Company Growth

Entrepreneurs (at least those who have employees) are usually expected by sociologists to strive for development and growth of their businesses. Hungarian entrepreneurs are not different in this respect. 84 managers wanted to expand, whereas only 16 thought the current size of their company to be adequate. Those wishing to expand were also asked about the barriers of growth (for the results see Table 23).

The strongest, and perhaps the only generally important barrier is the high level of contributions (taxes and social security contributions received a 5-point score in 35 cases, while, for example, the inadequate demand was given 5 points in only 21 cases). The inadequate demand was a problem mainly for regional firms (3.8). The lack of necessary capital was perceived by big companies to be a particularly serious problem (3.6), regional firms found the economic uncertainty to be such a problem (3.5). Branch-specific features were not mentioned in this context.

The fact that entrepreneurs saw relatively little difficulty in a business growth, and that the most serious barrier was high burden of taxes and contributions, is also reflected in their employment figures. Employment as a proxy for the size of a business had been growing steadily throughout the period. This development is shown in Table 24.

This table corroborates much better with the macrostatistical figures of the Hungarian economy. A stagnation can be observed in 1990–1991, and then a modest recovery in 1994 and 1995. The 1994–95 figures were examined in order to check whether the increase had been brought about by some big companies which had entered the sample in those years.

Two of the companies which entered the sample in 1994 had the employment level significantly above average (150 and 116 people). The exclusion of these companies brought down the regular employment from 21.66 to 19.32 in 1994 and from

Table 23. Hungary: Evaluation* of Obstacles to Increasing Company's Production

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Insufficient demand	1	5	3.2	3	3	1.4	80
2.	Shortage of qualified workers	1	5	2.0	1	2	1.1	71
3.	Shortage of high quality management personnel	1	5	1.7	1	1	1.1	66
4.	Shortage of other inputs	1	5	1.6	1	1	1.0	58
5.	Limitations of physical capacity	1	5	1.9	1	1	1.3	65
6.	Insufficient finance for expansion	1	5	3.1	3	3	1.3	78
7.	High burden of taxes / contributions	1	5	3.9	5	4	1.2	83
8.	Problem related to regulations	1	5	2.7	1	3	1.5	44
9.	High redundancy payment associated with dismissals	1	5	1.6	1	1	0.9	59
10.	Regulations on working conditions	1	5	1.8	1	1	1.1	59
11.	Uncertain political / economic conditions	1	5	3.1	5	3	1.5	64
12.	Others	1	5	3.6	5	4.5	1.7	10

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 24. Hungary: End-of-year Employment Level in a Company since its Establishment

		mean	median	number of responses
Regular, full time employees in:				
1.	1990	12.50	7	36
2.	1991	13.49	7	59
3.	1992	16.55	8	76
4.	1993	17.34	10	88
5.	1994	21.66	12	97
6.	1995	23.02	12	100
Part time, free lancers and independent entrepreneurs in:				
1.	1990	2.89	0	36
2.	1991	2.29	0	59
3.	1992	2.29	0	76
4.	1993	2.82	1.5	88
5.	1994	3.34	2	97
6.	1995	4.12	2	100
Total employment in:				
1.	1990	15.39	8.5	36
2.	1991	15.78	8	59
3.	1992	18.84	10.5	76
4.	1993	20.16	13.5	88
5.	1994	25.00	15	97
6.	1995	27.14	16	100

23.02 to 20.83 in 1995; still, not a significant change in the trend.

As it is shown in Table 24, every 1 of 7 employed is a free lancer. These figures have to be explained by relatively high wage costs and also by seasonality, especially in the construction business. 12 employers mentioned higher costs of regular employees as a reason for employing free lancers, 26 emphasized an increased flexibility in employment as a reason for employing people on part time terms (which also means that they are employed only temporarily). There was a handsome of firms which employed solely free lancers.

Not surprisingly, big firms employed more people on average, among them less free lancers. Employment of free lancers was curiously widespread among foreign firms. Regional companies employed on average slightly more people than firms in the capital city. Trade and construction companies employed fewer people, and among them less free lancers, than the other two branches.

7.6. Environment and Competitive Conditions

Conditions of the private business development were on average considered by 95 respondents to be closer to "bad" than to "satisfactory". The average on the five-degree scale was 2.4 and this was much worse than for Poland (3.08 points, see section 6.6). Interestingly, foreign firms provided slightly higher rankings (2.6 on average). There were many areas identified as a significant barrier to entry and development of a company. In consistency with previous questions, highest ranking was given to frequent changes in regulation and the lack of transparency of regulation (3.8) (see Table 25). An almost equally important factor was high inflation. But such basic conditions of business activity as political stability or operation of the banking sector were not considered a barrier. It is worth noticing that the evaluation of obstacles by Hungarian companies was very similar to that made by Polish new private firms (see Table 13).

Barriers to growth affected particular groups of companies to various extents. The inflation was regarded as the most severe obstacle by firms in the countryside (4.2 points), but also big firms and manufacturing branch felt badly affected by it (4.0). Contrary, small companies and those of the capital city were relatively little disturbed by the inflation. Foreign companies evaluated frequent changes in regulations as a minor barrier. Instead, they considered the low level of banking services as particularly disturbing (3.6). This explains their cautious behavior concerning bank loans. Construction companies mostly complained on banking services (4.0), but they also found corruption to be a significant problem. The direct government intervention in the economy was regarded a serious problem by companies in the countryside (3.8), perhaps because entrepreneurs of crisis ridden regions expected more government support than what was actually provided.

Entrepreneurs considered either similar small and medium-sized companies or foreign companies (joint ventures) their most serious competitors. State-owned companies, imports and the shadow economy were not considered as major competitors, although for a few companies their competition was a significant factor. Competition was perceived stronger in the countryside than in the capital, especially from the side of domestic SMEs (3.9 points). The informal sector played different roles in particular branches. Its influence was the strongest in the construction (3.6), the lowest in the manufacturing (2.3).

Table 25. Hungary: Evaluation* of Obstacles Affecting the Business of a Company

		mean	modal	median	quantity
1.	Political instability	2.3	1	2	86
2.	Inflationary conditions	3.7	5	4	98
3.	Frequent changes in government	2.7	1	3	84
4.	Frequent changes in laws and regulations	3.8	5	4	98
5.	Non-transparency of laws and regulations	3.8	5	4	95
6.	Operation of commercial law	3.3	3	3	81
7.	Operation of the banking system	3.0	3	3	93
8.	Inadequate measures against crime / corruption	3.5	3	3	88
9.	Continued government intervention in the economy	3.4	5	4	59

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 26. Hungary: Main Competitors and their Competitive Power*

		mean	modal	median	quantity
1.	Domestic SMEs producing similar goods / services	3.6	5	4	95
2.	SOEs or large privatized firms	2.1	1	1.5	70
3.	Foreign firms or joint ventures established here	3.5	4	4	77
4.	Firms in the informal sector of economy	2.7	1	2	73
5.	Importers selling new products	2.7	1	3	63
6.	Importers selling second hand products	1.6	1	1	49

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a competitor; 2 – a weak competitor; 3 – a moderate competitor; 4 – a strong competitor; 5 – a very strong competitor.

Table 27. Hungary: Evaluation* of Obstacles to Foreign Companies

		mean	modal	median	standard deviation	number of responses
1.	Obtaining the relevant permits and licenses by foreign firms	1.6	1	1	1.1	17
2.	Inadequate legal protection for foreign investors	1.7	1	1	1.0	17
3.	Difficulties faced by foreign firms in buying land and real estate	1.6	1	1	0.8	13
4.	Negative attitude of government officials (from tax offices etc.)	1.8	1	1	1.2	15
5.	Negative attitude of suppliers and customers towards f. i.	1.7	1	1	1.2	14
6.	Negative attitude of population in general towards f. i.	1.4	1	1	0.5	14
7.	Possibility of exporting toneighbouring markets	1.6	1	1	0.7	12

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 28. Hungary: Evaluation of Factors Facilitating for Foreign Firms*

		mean	modal	median	standard deviation	number of responses
1.	Laws facilitating foreign investment	3.1	2	3	1.1	17
2.	Cheaper skilled labour	3.1	1	3.5	1.6	16
3.	Size of the market	2.7	3	3	1.3	16
4.	Access to other countries of the region	2.7	3	3	1.1	15
5.	Liberalized foreign trade	3.3	4	4	1.4	16

Note: *The following scale 1 to 5 has been used for the evaluation:
1 –not a factor at all; 2 – minor factor; 3 – a factor of some importance; 4 – an important factor; 5 – a very important factor.

Competitors were usually criticized for using unfair practices in competition (62 out of 100 companies examined). The most frequently mentioned means of unfair competition were delayed payments or total omission of taxes and contributions (24) and misuse of connections with bank or government officials (22). Many managers mentioned corruption in central or local governments' tenders (17), which was, in our opinion, classified in some cases as 'open or hidden subsidization of a competitor' (17 references). Among larger competitors' practices the price manipulation was mentioned most frequently (16). According to estimates, on average 34 percent of output prices and 26 percent of input prices were manipulated. Input or output channel control was not considered important, perhaps due to the fact that small enterprises work on different markets than large companies, or in small market niches.

Quite interestingly, the shadow economy was not referred to as frequently as the government's corruption was. 43 respondents estimated on average that a 16.6 percent share of sales markets is occupied by the shadow economy, although obviously there were large differences among sectors. Further 9 interviewees said it was a high percentage, but were not able to make an estimation. 29 managers thought that the penetration of the shadow economy was rather small and 12 did not want to provide an answer.

7.7. Foreign Companies

Only 4 companies were in search of a foreign investor, and 17 had been already working with foreign capital involvement. 17 companies wished to establish close business links with foreign partners. Their most important motivation was access to foreign markets (14 out of 17 companies), but an access to additional capital and technology was also a significant element (7-7 mentioning).

The establishment of a joint venture or an affiliate in Hungary does not seem to require excessive efforts due to liberal regulation of foreign capital activity. All types of potential barriers constituted hardly any problems for respondents (see Table 27).

Only 2 entrepreneurs mentioned some types of discrimination against foreign capital. The average rankings settled in the range between 1.6 and 1.8 for all types of special barriers. Moreover, there was a unanimous moderate appreciation of factors supporting foreign investments among companies (see Table 28).

Finally, foreign investors expressed their opinion that foreign investments could be enhanced if inflation was pushed down, and economic regulation became more stable.

7.8. Conclusions

Registration and licensing does not create an important barrier to entry. Court registration is typically slow, but firms can start operation prior to a valid court decree. Registration is a condition of obtaining a bank credit, yet, application for bank loans is not very frequent, except for longer established and bigger firms. Some ventures reported difficulties in obtaining special licenses; a problem which seriously limited their activity.

Almost all entrepreneurs considered social security contributions very high. They did not had a paralyzing effect though, since many managers hired free-lancers and for regular employees they provided unregistered payments which escaped taxation and other contributions.

Tax and social security regulations change very frequently and their rules are not transparent to an average entrepreneur. Managers spend an increasing amount of time on the mentioned regulations, and have to use services of outside experts, or hire one continuously.

Small business support schemes played a very limited role in the establishment of new ventures. Due to high interest rates and a conservative banking behaviour, an outside financing does not play an important role in small companies. It is usually the more established and bigger companies that get access to a bank credit. They can afford high interest rates if necessary. Most successful and fastest growing companies needed 4–6 years until they could meet bank requirements. Banks were also criticized for a conservative lending policy and slowness. Firms with a foreign ownership were usually financed by their owner.

The greater number of the sample companies were growing. Interviewed companies had been profitable throughout the period, invested, and increased employment and value of their assets. This seems to be in contraction to their overall negative perception of a business climate in the country. The growth of companies seems to follow basic macroeconomic trends: there was a sluggish movement in 1990–1991 and a slow growth in 1994 and 1995. Growth seemed to accelerate in 1995 despite a restrictive monetary and fiscal policy of the government in that year (the so-called Bokros-package). Austerity measures seemed to improve a business climate and expectations. They also counterweighted restrictions in the domestic demand.

The single most important barrier to company growth was high taxes and social security contributions. The problem was even aggravated by continuous changes in regulations, which required from entrepreneurs a serious amount of time and money to cope with. Competition was not considered extremely strong. Nevertheless, unfair practices annoyed managers, especially in the case of corruption in the governments' procurement tenders. The corruption was perceived more negatively than the existence of the shadow economy. Foreign companies did not see any special difficulty in the establishment and growth in Hungary.

8. Barriers to Entry and Development of Czech New Private Firms

Jan Mladek

8.1. Introduction

After the 'Velvet Revolution' in 1989, economic reformers in Czechoslovakia faced a market dominated by large state monopolies (which were created and maintained by administrative action rather than by economic determination), and almost completely lacking the private sector, even when compared to Hungary or Poland. Small craftsmen who remained in the private sector, were tightly regulated, highly taxed, and always subject to capricious local officials.

In the framework of the economic reform implemented in Czechoslovakia since 1990, the re-establishment of the private sector had been understood as a key element. The role of small and medium-sized enterprises is crucial due to their ability to increase competitiveness of production and, consequently, the export performance, to adopt new technologies, to modernize economic structure and to create new employment opportunities. At the same time, it is obvious that the role of SMEs in solving huge economic problems of the country cannot be overvalued.

The Entrepreneurial Law of April 1990 legalized the establishment of private companies and permitted them to employ unlimited numbers of workers and produce a full range of goods. Step by step, a number of new laws and regulations concerning private enterprise took effect.

The general policy towards SMEs was to remove all obstacles to creation and growth of enterprises assuming that once entering business is possible, private initiative will appear automatically. The state was supposed to guarantee only the removal of barriers to entry and growth and to create a stable macroeconomic environment, that is, to keep inflation low and to maintain an exchange rate to hard currencies at a fixed level. This was supplemented by privatization, which was supposed to speed up the growth of already existing companies compared to pure start-ups. Restitution and the so-called "small privatization" were the most important privatization methods for the SME sector.

Under the restitution program, the property nationalized after February 1948 (the date of the communist coup), was returned to original owners or their heirs. The former Czech Minister of Privatization, Mr. Tomas Jezek, estimated the amount of restitution at 100 000 ? , 80 000 of which being real estates.

The so-called small privatization program was developed in the first half of 1990 and put into action in 1990–93. Altogether, 22 345 units were sold in public auctions (Earle, et. al. 1995).

Restitution and the small privatization significantly contributed to the creation of the private sector in the retail trade, wholesale trade, services, and also small manufacturing industries.

The philosophy assuming that the creation of a business-friendly environment and removing obstacles is a sufficient policy of the government, had been modified slowly by slowly. The law on the state support to SMEs, which came into practice in the first half of 1992, had become a fundamental systemic measure in regard to SMEs. It deals with the following forms of the state assistance for firms with less than 500 employees (later 250):

- providing capital
- providing training
- providing consulting
- providing information.

It is obvious that providing necessary assistance requires a functioning infrastructure in the form of specialized banks, assurance agencies, consulting centres, information networks, etc. One of the first steps was setting up the Ceskomoravska Zarucni a Rozvojova Banka (CMZRB) – a bank providing guarantees and financing development of SMEs. This joint stock company with a strong influence of the state was designed on the basis of West European experience.

The research carried out in Czech firms and undertaken within the international project on 'Barriers to Entry', can be understood as examining the hypothesis that the Czech government is conducting its original SME policy of removing barriers to entry and growth and supporting firms by special programs.

8.2. Impediments to Creation of Firms

There is a common perception in the Czech Republic that registration and licensing are the principal barriers to the creation of SMEs. Hence, the interviewed companies were asked to evaluate eight stages of registration process using a scale from 1 to 5, where 1 is a very easy and 5 is a very difficult and time consuming stage (see the note to Table 29).

The survey has shown that the registration with the statistical office and the opening of a bank account constitute hardly any problems. The most difficult steps are the court registration (3.38 points, which is one percentage point more than in Poland, and 0.68 more than in Hungary) and the obtaining an activity-specific license. The median of these two procedures equals 3, while for all others equals 2 (see Table 29). It is interesting that the court registration is regarded as the most difficult stage of establishing a company in the Czech Republic, while the obtaining activity-specific license ranks only second. This outcome is contrary to Polish results (see section 6.2.1). In Hungary these two procedures were regarded to be of the same difficulty (2.7 points both).

The situation at registration courts seems to be alarming. To the sensitive question whether respondents believe that bribes are commonly used to speed up the registration process 77 percent answered YES, 12 percent were not capable to answer and only 11 percent did not believe that bribes were used. In Prague, only 4.7 percent of interviewed managers did not believe that bribes were used in order to register a firm, while in Central Moravia this figure was much higher: 22.2 percent. Thus, the court registration in Prague is perceived as a significantly bigger problem than in the countryside. The average time for obtaining all necessary permits was 3.84 months, while in individual cases it ranged from one month to two years.

Regulation of real estate rental can be viewed as another barrier. 33 percent of the sample companies own real estates used for business, while the remaining 67 percent operate in fully or partially rented premises. 4 companies complained about short tenancy terms, 10 were concerned about a highly monopolized real estate market and 22 were afraid of rent increases which could be made at a short notice.

The labour code was another potential obstacle examined by the survey. Out of 74 respondents who found it problemat-

Table 29. The Czech Republic: Evaluation* of Registration Process

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Court registration	1	5	3.38	3	3	1.05	97
2.	Tax Office registration	1	5	2.00	2	2	0.98	97
3.	Registration for social insurance and health	1	5	2.10	2	2	1.00	96
4.	Registration with the Statistical Office	1	5	1.77	1	2	0.76	93
5.	Obtaining criminal record	1	5	2.58	2	2	1.21	97
6.	Opening a bank account	1	5	1.93	1	2	1.00	97
7.	Obtaining activity-specific license	1	5	2.60	3	3	1.04	95
8.	Renewal of license	1	5	2.46	3	2	1.01	65
9.	Others	2	5	4.50	5	5	1.00	8

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – very easy; 2 – easy; 3 – moderate; 4 – difficult; 5 – very difficult.

ic, 1 entrepreneur complained that the minimum wage was too high, while 51 (69 percent) cited high contributions to social and health insurance and laws regulating dismissals as main problems. Trade union activities were troublesome only for 4 firms.

Some 84 percent of respondents had some experience with dismissing employees. The average time between the announcement and the employee's actual departure was 6.69 weeks. This is rather surprising, as the labour code stipulates that a two-month (nine-week) notice should be given for dismissals with legal reasons and three-month for dismissals without a stated reason. However, there is always an option of an agreement which can be made immediately, sometimes under pressure. The 'under pressure agreement' was suggested by several respondents as a quick way of getting rid of unwanted employees. By examining foreign firms separately, we will discover that they are following the law with 13 weeks needed for dismissal of an employee, twice as long period as compared to 6.43 weeks in the case of domestic firms. Also medium-size firms are more law-obedient with 7.19 weeks needed for dismissal compared to 6.61 weeks for small firms.

Respondents were asked whether their tax as a percentage of their income had increased, decreased or remained the same: 43 percent of the respondents said it had increased, 30 percent thought it had decreased and 27 percent believed it had not changed. At the same time, firms have improved in 'creating costs' on the balance sheet in order to decrease their tax base: 61 percent have become better and only 10 percent have worsened their abilities to create costs.

When asked about how the regulations have changed in three specified areas since the establishment of their company, entrepreneurs gave evaluations, which are presented in Figure 6.

Taxes and other contributions were perceived as becoming more complicated over time, while real estate and employment rules were considered not to change much. The presumption that things had become less complicated was rather rare (see Figure 6).

Firms were asked to evaluate an effect of rules and regulations on various aspects of establishment and growth of business. For results see Table 30. As it might have been expected, the strongest effect was assigned to regulations on taxes and other contributions. In this respect, the Czech Republic did not differ from both Poland and Hungary. However, with 3.16 points taxes and contributions in general affected new private Czech firms less than they did Polish (4.16 points) and Hungarian companies (3.9 points). A little surprisingly, problems with renting or purchase of premises ranked the second.

Taxes and contributions were a less significant problem for foreign firms than for domestic ones. Construction and services firms ranked problems with taxes above average.

Figure 6. The Czech Republic: Nature of Changes in Regulations on Real Estate, Taxes and Contributions, Employment

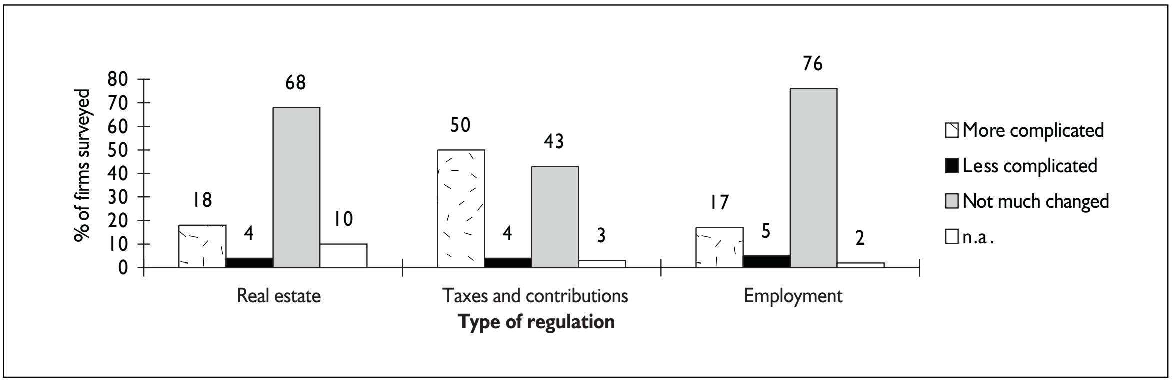


Table 30. The Czech Republic: Evaluation* of Effect of Regulations on the Establishment and Growth of the Companies

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Renting or purchasing of premises	1	5	2.71	2	3	1.32	96
2.	Registration and licensing	1	5	2.36	2	2	1.18	99
3.	Tax and contributions	1	5	3.16	3	3	1.05	100
4.	Exports and imports	1	5	2.45	1	2	1.31	74
5.	Health and safety	1	5	2.49	2	2	1.08	96
6.	Labour laws	1	5	2.64	2	2	1.15	99

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – no effect at all; 2 – minor effect; 3 – moderate effect; 4 – severe effect; 5 – very severe effect.

8.3. Assistance to the SME Sector

Out of 100 sample firms, 16 had received some kind of support aimed at the development of SME sector. These programs were mainly organized by the central government (9 mentionings) and rarely by international agencies (3) or a local government (1).

In 2 cases a credit guarantee was provided and in 3 cases subsidies of the interest rate were offered. The number of firms which were assisted, can be considered substantial, given the fact that the main part of the research was done in Prague, where firms are not eligible for the majority of programs. Out of 16 supported companies, 8 were from Prague and 8 from Central Moravia.

8.4. Finance

Financial constraints are probably the major obstacle to new firms' development. Therefore, the research team investigated sources of the starting, working and investment capital of new private companies in five transition economies. Results of the Czech sample are presented in Table 31. Personal savings and loans from families and friends were crucial for starting business – together these two sources constituted 64.5 percent of the initial capital of new companies. Bank loans represented only one tenth of the starting capital and they were granted preferentially to Prague medium domestic firms in the manufacturing and trade sectors. Retained profits followed by bank loans were the main sources of the working capital. Bank loans for the working capital were given mainly to Prague medium firms in the manufacturing sector. Two major sources were used for financing investment: banks loans together with leasing (in total 37.9 percent) and retained profits (39.3 percent). Bank loans for investment were preferentially given to Prague small domestic firms in manufacturing, trade and services.

49 companies used bank loans as a source of finance, 14 applied for them but did not succeed and 37 did not apply at all. The average amount of a received bank loan was 480,000 USD (40 mentions). Time of repayment was 32.4 months on average.

A collateral was required as a rule. Out of 49 firms which obtained a bank credit, 47 were required to have a collateral. Real estate belonging to the company was used as collateral in 29 cases, real estate belonging to the owner or their family in 13 cases, and 11 companies had other collateral. Surprisingly, a collateral was a bigger problem for foreign firms than for domestic ones.

Out of 37 firms which did not apply for a bank loan, 8 were convinced that they would not obtain it and 27 had other reasons.

54 companies intended to apply for a bank credit in the near future, while 46 had no such intention. Those firms which planed to obtain a bank loan needed it in most cases either for fixed assets (41 percent of companies) or for the working capital (41 percent as well). 40 out of 52 entrepreneurs expected that their application would be successful.

Table 32 presents the evaluation of factors which are generally regarded as typical obstacles to obtaining finance from banks. The collateral requirement with an average rank of 4.21 ('a severe problem') seems to be the highest burden for Czech SMEs. The median of 5 indicates that the majority of examined entrepreneurs recognized the collateral requirement as a 'very severe obstacle'. It is worth mentioning that the median reached 5 only in the case of the collateral. The

Table 31. The Czech Republic: The Main Sources of Finance for [A] the Starting Capital; [B] the Working Capital; [C] Investment (in percent)

		[A]	[B]	[C]
1.	Own personal savings	58.1	12.6	2.0
2.	Retained profits (operating revenues)	-	51.3	39.3
3.	Loan from family and friends	8.4	1.8	2.6
4.	Loan from bank	10.6	18.4[a]	31.6[b]
5.	Restitution	3.1	-	-
6.	Loan from special programmes set up to aidSMEs	0.2	0.1	0.0
7.	Loan from informal capital market	0.0	0.1	0.4
8.	Credit from domestic suppliers	-	4.3	0.0
9.	Credit from foreign suppliers	-	2.1	1.4
10.	Late payment of taxes and contributions	-	0.6	2.2
11.	Others	19.6	8.7	14.2
12.	Leasing	-	-	6.3
13.	**Total**	100	100	100

Notes:
[a] Out of which 17.6 percent are loans from domestic banks and 0.8 percent are loans from foreign banks.
[b] Out of which 29.1 percent are loans from domestic banks and 2.5 percent are loans from foreign banks.

Table 32. The Czech Republic: Evaluation* of Obstacles to Obtain Finance from Banks

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Cost of loans (interest rate)	1	5	3.97	5	4	1.09	86
2.	Complex procedures for application	1	5	3.27	3	3	1.15	83
3.	Collateral requirement	1	5	4.21	5	5	1.09	85
4.	Connections with bank managers	1	5	2.43	2	2	1.23	80
5.	The need to have a track record	1	5	2.73	3	3	1.38	82
6.	Long delays in processing loan application	1	5	3.30	3	3	1.27	80

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

costs of loans ranked second. At the end of the list there are the connections with bank managers; they do not seem to be a problem for small and medium entrepreneurs (2.43 points on average).

Liabilities of Czech SMEs to banks amount to 700.2 thousand USD. Liabilities toward the state are very low, 23.1 thousand USD on average. 16.3 thousand USD out of this sum are mainly unfinished payments for privatization, so the net average liability to the state is 6.8 thousand USD. Median figures show that the majority of firms does not have any liability to the state. Unpaid taxes constitute a problem for 10 firms out of 57. Unpaid taxes and contributions are much higher in Prague than in the Moravia region, higher in manufacturing and services than in trade and construction. Foreign firms were generally reluctant to answer this question, therefore, their position vis-a-vis the fiscal authorities is not clear.

8.5. Company Growth

Owners and managers of new private companies in the Czech Republic generally want their businesses to grow and expand. The survey brought a very strong evidence for this fact. 96 out of 100 managers were not satisfied with their firms' current size and they intended to expand.

11 potential barriers to an increase of production were evaluated on the 1–5 scale (see Table 33). Not surprisingly, the tax burden and the lack of capital were considered the most serious hurdles to expansion. Interestingly enough, the shortage of qualified workers and managers was perceived as a 'moderate problem' (3.21 and 2.96 points respectively). On the other hand, SMEs consider redundancy payments associated with dismissals and regulations on working conditions as minor problems only.

Table 33. The Czech Republic: Evaluation* of Obstacles to Increasing Company's Production

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Insufficient demand	1	5	2.69	2	3	1.22	94
2.	Shortage of qualified workers	1	5	3.21	4	3	1.31	96
3.	Shortage of high quality management personnel	1	5	2.96	4	3	1.36	91
4.	Shortage of other inputs	1	5	2.19	1	2	1.11	90
5.	Limitations of physical capacity	1	5	2.19	1	2	1.08	94
6.	Insufficient finance for expansion	1	5	3.34	4	4	1.19	94
7.	High burden of taxes / contributions	1	5	3.37	4	4	1.07	94
8.	Problem related to regulations	1	5	1.87	1	1	1.15	78
9.	High redundancy payment associated with dismissals	1	5	2.13	1	2	1.31	94
10.	Regulations on working conditions	1	5	1.96	2	2	0.90	93
11.	Uncertain political / economic conditions	1	5	2.42	1	2	1.35	93
12.	Others	1	5	4.60	5	5	0.94	25

Note: *The same scale used as in Table 32.

Table 34. The Czech Republic: Evaluation* of Obstacles Affecting the Business of a Company

		mean	modal	median	quantity
1.	Political instability	2.26	1	2	98
2.	Inflationary conditions	3.14	3	3	100
3.	Frequent changes in government	1.83	1	1.5	96
4.	Frequent changes in laws and regulations	3.05	4	3	99
5.	Non-transparency of laws and regulations	3.64	4	4	100
6.	Operation of commercial law	3.5	2	3	100
7.	Operation of the banking system	3.03	3	3	100
8.	Inadequate measures against crime / corruption	3.49	5	4	99
9.	Continued government intervention in the economy	2.70	2	2.5	96

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 35. The Czech Republic: Main Competitors and their Competitive Power*

		mean	modal	median	quantity
1.	Political instability	2.26	1	2	98
2.	Inflationary conditions	3.14	3	3	100
3.	Frequent changes in government	1.83	1	1.5	96
4.	Frequent changes in laws and regulations	3.05	4	3	99
5.	Non-transparency of laws and regulations	3.64	4	4	100
6.	Operation of commercial law	3.5	2	3	100
7.	Operation of the banking system	3.03	3	3	100
8.	Inadequate measures against crime / corruption	3.49	5	4	99
9.	Continued government intervention in the economy	2.70	2	2.5	96

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a competitor; 2 – a weak competitor; 3 – a moderate competitor; 4 – a strong competitor; 5 – a very strong competitor.

8.6. Environment and Competitive Conditions

The overall environment for development of private business in the Czech Republic was evaluated as closer to poor than satisfactory. The average (on the 1–5 scale) was 2.31 only, and that is much lower than in the case of the Polish sample (an average of 3.0 points) and a little less than in Hungary (2.4) (see Sections 6.5 and 7.5). Opinions of Czech respondents ranged from 'very poor' (1 point) to 'very good' (5 points), however, the modal judgement was that the overall environment for business is poor (2 points).

When asked about obstacles hampering the functioning and growth of their companies, entrepreneurs expressed their strong dissatisfaction with a non-transparency of laws and regulations and with inadequate measures against corruption and crime. Both of the barriers reached the median of 4 (on 1–5 scale) which stands for a 'severe problem' (see data in Table 34 and the note about the scale).

Frequent changes in the government, political instability and the continued government intervention in the economy were considered to be the least important problems out of the 9 examined obstacles. However, it should be stressed that the research had been done before the end of 1997 when open political crises started. Surprisingly enough, foreign firms were generally optimistic about all nine factors affecting the business of a company in the Czech economy with the exception of banking system operation and frequent changes in the government. Construction firms were particularly concerned with inadequate measures against corruption. This is not surprising, since public tenders common in this sector are generally perceived as unfair.

For the majority of new companies surveyed in the Czech Republic main competitors are: (1) foreign firms and joint ventures established in the Czech Republic and (2) domestic SMEs producing similar goods and services (see Table 35). These two groups of competitors exercise slightly more than 'moderate' power (3.11 and 3.10 points respectively on a scale of 1–5).

The comparison of the current situation with the early 1990s shows growing competition within the SME sector and decreasing competition from state enterprises exploiting advantages of economies of scale. In the survey SOEs and large privatized firms came fifth, with an average of 2.41 points only. A sectoral analysis revealed that manufacturers had to cope with the highest competition from imports (both new and second-hand products) and from firms operating in the shadow economy.

8.7. Conclusions

Surveys and interviews conducted among SMEs at early stages of the Czech economic transformation and before the introduction of the state support program in 1992 (see Bohata 1993) had identified the following problems as major barriers in this sector:

- excessive taxes,
- delayed payments,
- high interest rates.

On the basis of their short experience, SMEs representatives formulated recommendations for governmental policy stressing the need for accelerated privatization, improvement and clarification of laws and regulations and accessible credits with lower interest rates and fewer collateral requirements. Looking at the current situation, we may state that the first recommendation was realized (fast privatization had been on the agenda of the Czech government anyway), however, many problems with respect to laws, regulations and credit policy of the banking sector still remain unsolved.

The 1997 survey revealed that the main problems affecting Czech SMEs at present, are as follows:

1. Court registration – a difficult and time consuming process;

2. High level of taxation (including social security and health insurance contributions);

3. Poor access to credits caused by collateral requirement and high interest rates – the main barrier to investment expansion,

4. Insufficient protection of ownership rights in a broad sense (an inadequate enforcement of law, crime, corruption);

5. Lack of qualified workers and managers.

Beside such SMEs' problems as the tax burden and access to cheap credits, which are common in other countries as well, Czech entrepreneurs face a specific problem: a badly functioning state. This fact was also stressed by the EU administration when evaluating the preparedness of the country for its future EU membership. A remedy of this situation could be the recommendation for the main policy based on the presented research.

The comparison of the current situation with the early 1990s shows a positive and fast development of competition within the SME sector and its growth. At present, the main competitors of interviewed SMEs are foreign firms and joint ventures established in the country, followed by domestic SMEs producing similar goods or services. While until recently, SMEs had faced a stronger competition from state enterprises exploiting advantages of economies of scale and, to a much lesser extent, competition from new entrants taking advantages of low entry costs.

9. Barriers to Entry and Growth of New Firms in Albania

Lindita Xhillari

9.1. Introduction

The political change of 1990 in Albania came in conditions of a deep economic crisis, manifested in all dimensions at the beginning of 1980. Roots of the crisis can be found in 50 years of the centrally planned economy. The Albanian economy of 1990 was dominated by state property in all sectors including trade, industry, construction and food processing. At the beginning of 1990 the Albanian industrial sector comprised approximately 400 state-owned enterprises. They accounted for approximately 45percent of net employment and for about 23 percent of the working population. Agriculture was a base sector for the Albanian economy providing almost 50 percent of the labour force. From a size point of view, enterprises were organized as large vertical integrated units or so-called "kombinats" with thousands of employees operating in different sectors, while small enterprises were mostly present in trade, catering, restaurants and grocery stores, handcrafts etc. As in most ex-socialist countries, Albanian enterprises were not companies in a market economy sense. There did not exist any corporate laws and SOE were essentially production units with extreme restrictions in a financial and managerial autonomy. Most means of production, including land, were under the state ownership. Not owning any means of production Albanian citizens could not engage in any significant economic activity.

Until 1990, the state budget had been based on three main revenue sources: the turnover tax, enterprise profits transfers and social security contributions all paid by enterprises.

The State Bank of Albania was in charge of both central banking and commercial banking functions. In the situation of this extreme centralization the role of the State Bank in monetary interventions had been diminished for many years. In 1991 only 3 banks were operating in Albania, while in some of Eastern European countries their number had increased substantially. Due to a low economic development level during socialist era, the legacy in the field of financial institutions was very poor and their establishment took place later than in other European and Balkan countries. Until the beginning of 1990 the financial sector like all the other sectors of the Albanian economy had operated in the framework of an extreme centralization. The comprehensive economic reform program which began at the beginning of Albanian transformation, alongside with reforming other sectors of economy, also aimed at the setting up of a new financial system.

Imposed by the above-mentioned initial conditions, macroeconomic stabilization was the first step of the Albanian economic reform. The economic reform was directed towards: decreasing budget deficit, monitoring inflation, solving the foreign debt problem, introducing a floating exchange regime, keeping a domestic convertibility of the national currency – Lek, creating a two tier banking system and a system of non-bank institutions, initiating a modern legal framework for a financial system.

An informal financial sector emerged and developed as a phenomenon accompanying deep economic changes in the ongoing economic transition towards the market economy. The establishment of the informal market and its development as a reaction towards difficulties of transition period, filled in the vacuum of non-existent market institutions and this led to an overall financial crisis. The Albanian experience of the 1990s proves that building strong institutions seems to be indispensable for a successful reform.

The economic reform of 1991 was aimed at overcoming the very difficult challenge of adoption and transition from socialist economic structures to a well-developed market system. The assumption had been made that creation of the private sector will pave way to the growth of the economy and the alleviation of the 1980s crisis. This was to be achieved through privatization of state enterprises, the establishment of the legal framework and the creation of the favourable environment for private business.

Governments which took office after the collapse of the communist regime, had made their best to take institutional, economic and legal measures in support of economic reform in all dimensions. They wanted to contribute to the establishment of the necessary environment for a new private sector development. In August 1991 the Law on Sanctioning and Protection of Private Property, Free Initiative of Independent Private Activities and Privatization was adopted, thus opening the way to privatization of the state property as well as the establishment of new private entities. In a short time period, a legal framework had been established for promoting private businesses, supporting labour market, the protection of private economic rights and implementation of a fast privatization process of state-owned enterprises. It should be stressed that as a result, the Albanian private sector has impressively grown since the collapse of the communist regime.

The year 1991 marked the beginning of the privatization of small units like shops, restaurants, and minor manufacturing companies. It was then followed by a rapid privatization of small and medium size enterprises. The economic reform within the financial sector started with the decentralization of the mono bank system and its change to a two-tier bank system. The Bank of Albania performed traditional functions of a central bank, while commercial banks lent money to commercial clients and received deposits. The foreign trade and price liberalization in the middle of 1992 paved the way to a significant growth of the private sector, mainly the trade sector. It enabled creating new workplaces. As a result of the above-described economic policy in 1995, 60 percent of GDP was generated (up to 55 percent in 1994) and 75 percent of the workplaces were offered by the private sector. Since then the economic situation has undergone some important changes. The crisis caused by pyramid schemes and the second one caused by Serbia's and Albania's dispute over Kosovo affected the private sector development in general and had a terrible impact on SME formation and survival. There was a decline in GDP in 1997 and an accompanying rise in unemployment up to 17percent (an official figure). This period observed the growth of an informal economy. Many fiscal changes were introduced which directly or indirectly affected SMEs. Despite the fact that credit lines were increased in both number and available funds, the credit reimbursement is still very low.

In the following sections of this chapter, I will examine different groups of factors and their impact on the development of the private sector in Albania in the early transition period. These groups of factors include regulatory framework, fiscal constraints, credit policies and availability and cost of other sources of financing the establishment, functioning and growth of a private company. The impact of these factors and potential barriers they create was highlighted in the course of a survey done in 50 newly established companies in two regions of Albania. One was the capital city of Tirana where 30 companies were interviewed; the other city was Elbasan, 50 km away from the capital. The survey was assisted by the Albanian Institute of Statistics INSTAT and originally, it was to cover the region of Pogradec which is one of less developed areas of the country. However, due to a dramatic financial crisis (breakdown of financial pyramids) which brought about political unrest at the beginning of 1997, it was shifted to the Elbasan region, which is also considered to be a less developed area. Most of the surveyed firms were very small. It was hard to find new private firms having over 50 employees, especially in Elbasan.

As it was already mentioned above, the transition had started in Albania later than in other Central and Eastern European countries, therefore the sample does not contain any companies established in 1990. Among interviewed firms there was 1 company registered in 1991, 9 companies registered in 1992, 25 companies registered in 1993 and 15 companies registered in 1994 [ ]. Interviewees were supposed to be owners or co-owners of the firms, general directors or other directors and managers. In fact, in the majority of cases (64percent of the sample) owners preferred to answer questions themselves.

9.2. Regulatory Constraints

When asked to evaluate subsequent stages of the registration process and license obtaining Albanian entrepreneurs on average did not considered registration and licensing as difficult, costly or time consuming processes. Almost all the proce-

[21] For more details about the Albanian sample - see chapter 5.

Table 36. Albania: Evaluation* of Registration Process

		minimum	maximum	mean	modal	median	number of responses
1.	Court registration	1	5	3.28	4	3	50
2.	Tax Office registration	1	5	3.30	4	3	50
3.	Registration for social insurance and health	1	3	1.96	2	2	27
4.	Registration with the Statistical Office	-	-	-	-	-	0
5.	Obtaining criminal record	1	5	2.77	3	3	48
6.	Opening a bank account	1	4	2.00	2	2	50
7.	Obtaining activity-specific license	2	5	3.67	3	4	48
8.	Renewal of license	2	5	3.44	4	3.5	50
9.	Others	3	5	4.00	3 and 5	4	2

Note: *The following scale 1 to 5 has been used for the evaluation:
1– very easy; 2– easy; 3– moderate; 4– difficult; 5– very difficult.

dures were regarded moderate or less than moderate in a one to five scale extending from very easy (1), easy (2), moderate (3), difficult (4) to very difficult (5) (see Table 36). The value of a modal indicates that four out of seven stages of registration were considered difficult by a significant number of companies (4 points). These are: court registration, tax office registration, obtaining and renewal of a license.

For companies established in the countryside each stage of the registration process was more difficult than for capital city businesses. One reason may be the fact that the business register for all companies is located in the Court of Tirana. Under these conditions, difficulties could be reduced by hiring consultants for the registration process. However, only half of the surveyed regional entrepreneurs used consultants for such purposes.

Quite interestingly, the registration process was more difficult for foreign companies than for domestic ones. The difference in evaluation was the biggest in the case of court registration. Foreign firms considered this stage as difficult (3.9 points on a 1–5 scale), while domestic companies found it slightly more than moderate (3.2 points). The only stage of registration process which was easier for foreigners than for domestic entrepreneurs, was opening of a bank account.

Registration procedures are not only difficult but also time consuming. Therefore 52percent of interviewed companies hired consultants of different professions. The average time needed for registration was 1,93 month, although there were a few cases of the registration process taking 4–6 months. Highest averages were observed in construction and in manufacturing sectors where over 2 months were needed for registration. The reason behind this is the necessity to obtain a license in order to run activities in manufacturing or construction. Obtaining a license is time consuming and relatively more difficult than other registration procedures. In order to obtain a license, companies in the Elbasan region had to spend 82 percent more time than those in the capital, while foreign firms spent 37 percent more time than domestic companies.

Half of the companies considered bribes as a factor speeding up the registration process, whereas 26percent of interviewees denied this fact. This finding may prove that the opinion about widespread corruption in Albania is well justified. The problem of corruption will be touched upon later on in this chapter.

Regulations on real estate, labour, exports and imports do not create any serious barriers for private entrepreneurs. Activities and businesses are run rather in self-owned premises than in rented ones. In Elbasan 70percent of the surveyed companies used their own premises and for Tirana the percentage was smaller – 33percent. It is mainly due to the fact that rents can be increased at a short notice (69.2percent of the companies had had such a problem). Big companies tend to have their own premises more than small ones. The simplest explanation is that a small company can easier move to another premises. Rental contracts are mostly realized in foreign currencies (usually in USA dollars), which is risk-free for owners of premises.

The main problem regarding labour is a high burden of social and health contributions: 27 out of 50 businesses were concerned with this matter, while as many as 44 companies agreed that these contributions had increased since the establishment of a company. Only 3 days are needed to dismiss an employee. Regulations on a dismissal of employees were not considered a problem at all in Albania. This is due to the fact that most employees do not have labour contracts protecting them from being dismissed. The new Labour Code went through the Parliament no sooner than at the end of 1995 and at the time of the enterprise survey labour provisions were widely disregarded. Another reason for the employees' weak position vis-a-vis employers is the fact that employees hardly ever belong to unions through which they can protect their rights. Such unions formally exist, however, they are too small and do not function well, so they do not have enough power to enforce employers to negotiate with them.

Albanian new businesses considered the high level of taxation and other contributions major barriers to business development. The social security, health, pension and unemploy-

Table 37. Albania: Evaluation* of Effect of Regulations on the Establishment and Growth of the Companies

		mean	modal	median	number of responses
1.	Renting or purchasing of premises	3.4	4	4	47
2.	Registration and licensing	3.4	3	3	50
3.	Tax and contributions	3.8	4	4	50
4.	Exports and imports	3.3	4	4	38
5.	Health and safety	2.3	2	2	50
6.	Labour laws	2.4	1	2	49

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – no effect at all; 2 – minor effect; 3 – moderate effect; 4 – severe effect; 5 – very severe effect.

ment contributions account for 45,9 percent of wages, which is a very high ratio as compared to the EU ratio (see Table 1). It is not only that taxes were high, they were also subject to frequent changes, making it difficult for companies to familiarize with new regulations. This is the opinion of both foreign and domestic entrepreneurs, in and out of the capital city. Furthermore, the majority (74percent) of companies thought that regulations on taxes and contributions had been getting more complicated over time. Even so, tax advisers are not commonly used by companies: 40 percent had never used them, while only 16percent had often hired them.

Firms evaluated effects of different regulations on the establishment and growth of a company by a one to five scale, from no effect (1) to a very severe effect (5). Regulations on taxes and contributions ranked first with 3.8 points, meaning that regulations in this field have a "severe effect" on business (see Table 37). Regulations on three other spheres: registration and licensing, renting and purchasing of premises and on exports and imports came second.

9.3. Support for the SME Sector

The survey revealed the fact that private firms are not adequately supported in Albania. Only 8 (i.e. 16percent) of the companies had received some support. In 5 cases support was provided by the central government, 2 schemes were organized by the Chamber of Commerce and one by an international agency.

9.4. Financial Constraints

Let us begin with an issue of the initial capital for newly established companies in Albania in the first half of the 90s. 43 out of 50 companies answered the question on the initial capital, while 7 firms preferred not to give any figures claiming them as confidential.

The average initial capital for the survey sample was 73,243 USD. This figure is distorted by data for one of the trade sector firms which had started with a very high initial capital, exceeding one million USD. If this distortion is excluded, the average value of the initial capital decreases to 48,534 USD. Foreign companies declared on average to have the initial capital 4 times bigger than that of domestic firms. The highest figures for the initial capital are those of trade and construction, whereas the manufacturing and services stay behind.

Entrepreneurs listed two main sources of the initial capital: their own savings and other sources formed in almost all cases by accumulated profits from a business activity in the past (see Table 38[A]). This is understandable since at the beginning of the transition most of new private entrepreneurs involved in trade. The shift from trade to manufacturing can be considered a positive tendency.

Loans from banks came as the third source of finance for the initial capital. However, in specific Albanian conditions both loans from the informal market and loans from family and friends are very important since they make for more than 19percent of the initial capital (see Table 38). Loans from family and the friends are rarely granted without any interest or with bank interest rates. In most cases interest rates of these loans were comparable to the informal market interest rates. Although the time of the pyramid schemes seems to be gone, it may be of interest to do a short comment on the shadow economy which was extremely large in the years 1993–1996. During that period and especially in 1995–1996, households' savings were deposited in banks for short periods of time and in small amounts. Most money was involved in the shadow economy which offered high interest rates associated with a very high risk. According to a poll carried out by the Albanian Centre for Economic Research, regarding financial sources at the start of the business, most Albanian businessmen felt allergic to banks. About 90percent of them said that they were ready to choose a less secure but simpler and less bureaucratic way of financing. That is another explanation for the figures of our survey.

When analysing data on the initial capital according to the ownership and place of activity, we found out that for companies placed in Tirana personal savings were of the same importance as for foreign companies. The informal market played a significant role as a source of financing for firms established out of the capital city.

Table 38. Albania: The Main Sources of Finance for [A] the Starting Capital; [B] the Working Capital; [C] Investment (in percent)

		[A]	[B]	[C]
1.	Own personal savings	32.4	18.7	13.5
2.	Retained profits (operating revenues)	-	44.2	43.0
3.	Loan from family and friends	9.9	6.5	4.6
4.	Loan from bank	12.2	6.1[a]	7.4[a]
5.	Restitution	2.6	-	-
6.	Loan from special programmes set up to aid SMEs	0.0	0.0	0.0
7.	Loan from informal capital market	9.8	2.8	9.0
8.	Credit from domestic suppliers	-	3.8	0.2
9.	Credit from foreign suppliers	-	6.0	5.5
10.	Late payment of taxes and contributions	-	0.8	0.1
11.	Others	33.1	11.1	12.4
12.	Leasing	-	-	4.3
13.	**Total**	100	100	100

Notes:
[a] All of them are loans from domestic banks.

The next important investigated issue was the source of the working capital needs. Findings are presented in the Table 38 [B].

The main source of finance for the working capital of Albanian new private companies were: on the first position – retained profits (operating revenues) which covered on average 44.2percent of the needs, and on the second place – personal savings. Loans from banks played a very modest role in financing the working capital (6.1percent on average), whereas they covered 12.2percent of the initial capital. Bank loans were less important for entrants than loans from family and friends and loans from the informal market summed up (see Table 38 [B]). Results were identical for the financing of investments. Retained profits were the most important source of finance, while personal savings plus other sources (profits from past activities and other businesses) covered on average 25.9percent of investment needs. Once again, bank loans did not play a significant role here (only 7.4percent).

As we discuss now the investments of new companies established in the first half of the 90s, it is worth noticing that 36 firms had had major investment since their establishment. An extensive part of the questionnaire was devoted to external financing of the new private sector emerging in the Albanian economy since the beginning of the transition. As it was already discussed, the bank loans' share in financing the working capital and investment needs of new companies was rather insignificant. The same conclusion was obtained from the examination of banks' activity.

Firstly, only 13 surveyed companies had ever received a bank credit, 8 firms tried but their applications were rejected and 29 firms did not try at all. The 13 companies made only 26 percent of the sample, and such a percentage of credit-takers seems to be very low as compared to other surveyed countries. For Poland, Hungary and the Czech Republic this share was much higher and accounted for 62, 40 and 49percent respectively of the country's sample. Secondly, as much as 58percent of the surveyed companies had not ever applied for a bank credit, which is a strong evidence of a poor performance of the banking sector in Albania. Again, this is a much higher ratio than in the three advanced transitional economies (see Sections 6.4, 7.4 and 8.4).

The companies that succeeded in getting a bank loan received an average of 21,420 USD. A credit was provided to a firm on average 1.18 time and the average repayment period

Table 39. Albania: Evaluation* of Obstacles to Obtain Finance from Banks

		minimum	maximum	mean	modal	median	number of responses
1.	Cost of loans (interest rate)	2	5	4.33	5	5	49
2.	Complex procedures for application	2	5	4.06	4	4	49
3.	Collateral requirement	1	5	3.15	4	3	48
4.	Connections with bank managers	1	5	3.40	5	3	47
5.	The need to have a track record	1	5	1.77	1	2	48
6.	Long delays in processing loan application	2	5	4.28	4	4	46

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

of a loan was 4.6 years. The repayment period was shorter for services and manufacturing companies and longer for construction firms. Out of 13 companies that succeeded in obtaining a credit, 2 firms would considerably increase the amount of a loan, 4 would slightly increase it, while the remaining 7 firms were satisfied with credits they had obtained. Collateral was a necessary condition to obtain a bank loan. It was either real estate belonging to the owner or his family (9 cases) or real estate belonging to the company (7 cases).

Albanian new private companies not only hardly relied on bank loans, they also did not count much on bank credits for the future. Only 16 out of 50 companies (i.e. 32percent of the sample) declared their intention to apply for a bank loan in the future. 9 entrepreneurs would use a loan to finance the working capital, 4 – fixed assets and 5 – investments. 14 out of the 16 firms which were going to apply for a loan expected to get it. The annual rate of interest which most firms were able to pay, was usually 18percent and only one firm stated it could afford 30percent of loan interest. The inflation rate at the time of the survey was 12.7percent.

Companies were asked about obstacles to obtaining finance from banks. The results are presented in Table 39.

Cost of a loan, complex procedures for application and long delays in processing loan applications are the main barriers to getting a bank loan. All three elements are considered to be "a severe problem". A more detailed analysis reveals that out of the capital city these obstacles are considered to be more severe than in the capital. Quite interestingly, there is no need in Albania to have a track record to make bank procedures easier and quicker. This requirement is not considered a problem by any firms: either big or small established in or out of the capital city. However, not only domestic but also foreign firms complained about long delays in processing a bank loan application and about complex procedures, although dissatisfaction with the latter is smaller. The survey proves the thesis that the financial sector and banks especially are weak in Albania and their support in financing development of the private sector is inadequate.

It is worth underlining that Albanian new private companies declared to have made moderate profits in all the observed years (see table 40). The financial situation of surveyed companies was good and stable throughout the whole period. For 1995 profits were even half way between "moderate" and "substantial" (see the note to Table 40). Only one company out of those that disclosed data on their profits and losses evidenced loss (in one year only), and only a few companies were at a breakeven point. The majority declared their profits as moderate, some – as substantial.

Table 40. Albania: Statement on Profit and Loss of a Firm in Subsequent Years since Establishment *

		average ranking	number of responses
1.	1990	-	0
2.	1991	-	0
3.	1992	4.1	9
4.	1993	4.1	36
5.	1994	4.2	50
6.	1995	4.4	49

Note: * The following scale 1 to 5 has been used for the evaluation:
1 – heavy loss; 2 – moderate loss; 3 – breakeven; 4 – moderate profit;
5 – substantial profit.

Privatization played quite a significant role for the interviewed firms. 28 firms purchased assets in the privatization process: 22 bought buildings and others purchased machinery, equipment and transport vehicles.

The value of purchased assets was estimated at 2,146,100 USD, which constituted about 66percent of the initial capital of companies involved in the privatization process. Contrary to privatization, the restitution did not play a substantial role in starting a business (2.6percent of the initial capital, see Table 39).

It may seem quite surprising that financial outcomes of newly established private companies in Albania soon after the collapse of the communist economic regime should be so positive. The most important reason was a large demand for products which had not been available on the domestic market before the transition started. The second reason may have been the lack of competition at the early stage of transition. The third reason – the quality of production factors which were partly examined in the survey. Owners and managers of entrants were asked about an age of their capital stock. Only a few declared that their capital stock is slightly older than the average for a country in a respective branch; the strong majority (59.9percent) of managers regarded their machinery and equipment as either slightly younger or much younger from the country's average (see Table 41).

Firms located in the capital city have younger capital stock than those situated out of the capital. The optimistic assessments made by managers and exhibited in Table 41 might be based on a very obsolete technology and machinery characteristic for Albania under the previous economic and political regime and inherited by the emerging market economy of the country.

Wages were the final examined element. Managers declared that their wages are either the same or higher than the national average for managerial staff, (48percent of

Table 41. Albania: The Age of Company's Capital Stock in Comparison with the Age of Capital Stock in the Country

		average ranking	number of responses
1.	Much younger	10	21.2
2.	Slightly younger	18	38.3
3.	About the same	13	27.7
4.	Slightly older	6	12.8
5.	Much older	0	0

Table 42. Albania: The Wages of [A] Managers; [B] Employees as Compared with the National Average

Payment		[A]		[B]	
		number of responses	percent of responses	number of responses	percent of responses
1.	Much higher	2	4	1	2
2.	Higher	24	48	21	42
3.	About the same as average	24	48	27	54
4.	Lower	0	0	0	0
5.	Much lower	0	0	0	0
6.	No answer	0	0	1	2

answers, see Table 42). Similar results appeared for employees' wages. It needs to be stressed that the country's average is low. In terms of a location, wages approximating the national average salary were rather paid by firms located out of the capital city than those in the capital. Wages higher than the country's average were paid by 53percent of companies located in the capital city compared to 26percent firms out of the capital. The main reasons behind that were a lower living standard as well as cheaper labour force in the countryside.

9.5. Growth of a Private Firm

It is a positive sign that the majority of companies (i.e. 37 out of 50) intended to expand. The remaining 13 firms (i.e. 26percent) considered the current size of their production as satisfactory. There was a sectoral difference: 87percent of manufacturing firms compared to only 50percent of firms in the service sector had plans to increase their production. Those wishing to expand were asked about barriers to their growth. For the results see Table 43.

The survey revealed that insufficient finance is the main barrier for the business expansion (4.2 points). A high burden of taxes and contributions came second. Both obstacles were evaluated as severe problems. The crisis that burst after March 1997 aggravated the situation even more, as it added uncertainty of political and economic conditions to already existing problems. During the 1997 revolts which started due to the failure of the pyramid schemes, many investors, especially foreigners, left the country. The new government in collaboration with the World Bank initiated a project for protecting investments from a political risk. A special agency connected with the Ministry of Finance had been established for this purpose.

At the time of the survey (1997) respondents mentioned also an insufficient demand as a barrier to an increase of production (3.0 points, which means a "moderate problem"). To understand this obstacle we have to take into consideration a high level of unemployment in Albania resulting in a low purchasing power of the population. Two additional reasons are: an

Table 43. Albania: Evaluation* of Obstacles to Increasing Company's Production

		minimum	maximum	mean	modal	median	number of responses
1.	Insufficient demand	1	5	3.0	4	3	29
2.	Shortage of qualified workers	1	4	1.8	1	1	28
3.	Shortage of high quality managemen personnel	1	5	2.2	1	2	26
4.	Shortage of other inputs	1	4	2.6	2	2	19
5.	Limitations of physical capacity	1	5	3.0	1	3	22
6.	Insufficient finance for expansion	1	5	4.2	5	4	36
7.	High burden of taxes / contributions	1	5	3.6	4	4	36
8.	Problem related to regulations	1	5	3.0	4	3.5	22
9.	High redundancy payment associated wit dismissals	1	4	2.2	2	2	32
10.	Regulations on working conditions	1	5	2.5	1	2	33
11.	Uncertain political / economic conditions	1	4	2.6	3	3	33
12.	Others	3	5	4.0	3 and 5	4	2

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 44. Albania: End-of-year Employment Level in a Company since its Establishment

		mean	median	number of responses
Regular, full time employees in:				
1.	1990	-	-	-
2.	1991	24.0	24.00	1
3.	1992	30.1	20.50	8
4.	1993	32.8	17.00	35
5.	1994	37.6	18.00	49
6.	1995	42.0	21.50	50
Part time, free lancers and independent entrepreneurs in:				
1.	1990	-	-	-
2.	1991	0.0	0.00	1
3.	1992	0.4	0.00	8
4.	1993	2.3	0.00	35
5.	1994	3.0	0.00	49
6.	1995	3.6	1.00	50
Total employment in:				
1.	1990	-	-	-
2.	1991	24.0	24	1
3.	1992	30.5	21	8
4.	1993	35.1	17	35
5.	1994	40.6	22	49
6.	1995	45.6	27	50

unfair competition of foreign products and a small size of the domestic market.

Quite surprisingly, despite all the barriers hindering expansion of a company in Albania, private firms had grown very steadily throughout the whole examined period. By taking employment [22] as a proxy for the size of a business, we will observe that on average a company had grown by almost 80percent in a 5-year period (1991–1995), (see Table 44) Even if we exclude the first two years due to a limited number of observations made in 1991 and 1992, we will still come up with an increase in employment amounting to 30percent in a 3-year period, which is also a good result.

Albanian new private companies employ regular employees as well as part-time workers and free lancers. The share of two latter in the total employment had varied from 9percent (in 1992) to 19percent (in 1993). The main reason behind employing free lancers was a lack of obligation to give a dismissal notice and to pay insurance contributions, which, consequently, made free lancers cheaper workers.

9.6. Environment and Competitive Conditions

An overall environment for the development of private business in Albania was evaluated as satisfactory. An average of 3.1 points placed the evaluation of the private business in the middle of the scale (of 1–5).

Surveyed companies were asked to evaluate barriers to their functioning and growth. Interestingly enough, contrary to what was found out in the three most advanced transition economies, the strongest obstacles in Albania were evaluated as "moderate problems" only (see Table 45). The inflationary condition, frequent changes in laws and regulations, operation of the commercial law received on average slightly more than 3 points, and these three barriers are at the top of a list. Inflationary conditions became a problem as the economic crisis in 1997 caused a continuous depreciation of the domestic currency, low production level, high level of inflation, etc. The other six factors were considered to have a minor effect (see Table 45).

Main competitors for new private firms are SOEs or large privatized firms, foreign firms or joint ventures established in the country and firms in the informal sector of the economy. Their competitive power was evaluated at slightly more than 3 points on a 1–5 scale (see Table 46). Firms located in the countryside seemed to compete with many actors present on the market; for smaller firms the competition was stronger than for bigger ones. Foreign firms did not have any major competitors, whereas domestic ones faced a relatively high competition, mainly from SOEs or large privatized firms.

[22] We take into consideration permanent, full-time employees.

Table 45. Albania: Evaluation* of Obstacles Affecting the Business of a Company

		mean	modal	median	number of responses
1.	Political instability	2.6	3	3	50
2.	Inflationary conditions	3.3	3	3	50
3.	Frequent changes in government	2.2	2	2	41
4.	Frequent changes in laws and regulations	3.1	3	3	48
5.	Non-transparency of laws and regulations	2.7	3	3	35
6.	Operation of commercial law	3.1	3	3	48
7.	Operation of the banking system	2.5	2	2	48
8.	Inadequate measures against crime / corruption	2.4	2	2	45
9.	Continued government intervention in the economy	2.5	3	3	22

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 46. Albania: Main Competitors and their Competitive Power*

		mean	modal	median	number of responses
1.	Domestic SMEs producing similar goods / services	3.3	3	3	14
2.	SOEs or large privatized firms	3.1	3	3	40
3.	Foreign firms or joint ventures established here	3.1	3	3	32
4.	Firms in the informal sector of economy	2.7	3	3	35
5.	Importers selling new products	2.6	3	3	25
6.	Importers selling second hand products	2.2	2	2	21

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a competitor; 2 – a weak competitor; 3 – a moderate competitor; 4 – a strong competitor; 5 – a very strong competitor.

45 percent of the sample companies had to confront unfair competition in such forms as: a subsidy (1 case), control of inputs by established large firms or importers (4 cases), control of distributors by established large firms (5 cases), manipulation of prices by established large firms (11 cases). Finally, the most frequent form of unfair competition was a partial evasion of paying taxes and other contributions (17 cases, i.e. 75percent of answers). A sectoral analysis revealed that manipulation of prices by large firms and non payment of taxes and contributions constitute a bigger problem for trade companies than for construction and manufacturing ones.

The share of the informal economy in particular sectors was estimated to be 16.5percent. The data should be treated with caution, since only 4 companies made this evaluation. Other 14 firms believed that the share of the informal economy in their sector is large but were not able to estimate its size. 13 firms expressed a different opinion, they thought that the percentage of the grey economy is small. As many as 19 companies (38percent of the sample) did not have any opinion on that matter or preferred not to disclose it.

Only one respondent was looking for a potential investor to sell the company, while other respondents were satisfied with the present situation. 8 firms were looking for foreign investors to join business.

9.7. Foreign Companies

The subsample of foreign firms was rather small – it contained 7 companies. Tables 47 and 48 presents results of the examination of obstacles and factors facilitating foreign investment in Albania. As far as obstacles are concerned, obtaining licenses and relevant permits was regarded as a major obstacle. However, an average of 3.1 identified the barrier only as: "a moderate problem". All other obstacles, except for one, were evaluated as minor problems. It is worth underlining that foreign investors did not perceive the attitude of Albanian population to foreign investors as a negative one.

As far as facilitating factors are concerned, respondents pointed out two elements: laws facilitating foreign investment and cheaper skilled labour. The two factors gained respectively 4.3 and 3.9 with the modal of 5 and 4 (see Table 48).

9.8. Conclusions

The existence and development of the informal financial sector, high tax evasion and a large informal labour market are specific phenomena of the Albanian transition period. These features are listed first in view of their scale and impact on the economic development of the country. The main negative

Table 47. Albania: Evaluation* of Obstacles to Foreign Companies

		mean	modal	median	number of responses
1.	Obtaining the relevant permits and licenses by foreign firms	3.1	5	3	7
2.	Inadequate legal protection for foreign investors	2.3	1	1	7
3.	Difficulties faced by foreign firms in buying land and real estate	2.0	1	2	7
4.	Negative attitude of government officials (from tax offices, etc.)	2.4	4	2	7
5.	Negative attitude of suppliers and customers towards f. i.	1.8	1	1.5	6
6.	Negative attitude of population in general towards f. i.	1.2	1	1	6

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 48. Albania: Evaluation* of Factors Facilitating for Foreign Firms

		mean	modal	median	number of responses
1.	Laws facilitating foreign investment	4.3	5	4	7
2.	Cheaper skilled labour	3.9	4	4	7
3.	Size of the market	2.6	3	3	7
4.	Access to other countries of the region	2.0	1,2 and 3	2	3
5.	Liberalized foreign trade	2.5	3	3	4

Note: *The following scale 1 to 5 has been used for the evaluation:
1 –not a factor at all; 2 – minor factor; 3 – a factor of some importance; 4 – an important factor; 5 – a very important factor.

effects of the large informal economy in Albania were: a high credit risk, growing budget deficit due to a massive tax evasion, growing inflation rate, stimulation of a mentality of laziness and the illusion of an easy welfare society etc. This situation created serious barriers to a new firms' entry to the fragile Albanian market. Certain steps should be undertaken to improve the situation. An up-to-date banking infrastructure has to be established in order to improve the performance of the banking system. It should promote competition in the financial market, especially through strengthening the private sector and putting control over the monetary flow outside banks. An appropriate legal and institutional framework has to be established and links between different aspects of the economic reform need to be built to assure a sustainable development of the private sector.

The registration and licensing process is neither difficult nor time and money consuming. Although foreign companies find these processes more difficult than domestic ones, there are not any barriers for new firms to enter the market.

The high burden of social and health contributions and their long-term increase is a concern to all companies. On the other hand, dismissal of an employee does not constitute any problem for an employer. Taxes and contributions are very important to the growth of companies. Albania has a good legal taxation framework which is comparable to those of many developed European countries. However, poor law enforcement causes problems from both businessmen' and macroeconomic points of view. Taxes are quite high and subject to frequent changes, which is considered as a serious barrier to a business's growth. The discrimination among firms in paying custom duties or other taxes and the manipulation of prices leads to unfair competition.

There is not any discrimination of foreign firms vis-a-vis domestic ones. Laws facilitating investments and cheaper skilled labour in Albania are highly estimated by foreign investors.

The firm's capital is financed mainly from personal savings and accumulated profits out of a business activity in the past. Bank loans did not play a significant role in financing the initial capital or working capital. Insufficient finance is considered as the main barrier to expansion of a company. The privatization process did not play a significant role in obtaining assets for the company.

The survey results proved that the poor credit system made it difficult for businessmen to start a company and later on, to finance its growth and, consequently, to face competition and survive in the market. The credit market is extremely restricted. A high collateral requirement constitutes a serious barrier for newly established businesses. At a very high credit risk banks (especially foreign ones) do not provide credits to Albanian clients willingly. In order to diminish their risks, banks apart from credits offer to their clients also different bank services. Loan cost, complicated application procedures and long delays in processing them are the main barriers to getting a bank loan. For companies located out of Tirana those obstacles are even more troublesome than for firms operating in the capital city.

10. Barriers to Entry and Growth of Private Companies in Lithuania

Gedyminas Rainys

10.1. Regulatory Constraints

The aim of the survey was to identify factors which limit new business development in Lithuania. Entrepreneurs and senior managers of 50 small and medium size new private companies established in the first half of the 90s [23] were asked to judge severity of different constraints to entrants.

The first set of questions regarded a start-up of a company, and more closely – the registration process. The survey revealed that Lithuanian enterprises do not regard registration as a barrier impeding business development (see table 49). Out of 8 registration stages only two: obtaining a license as well as renewal of it, were slightly more complicated processes (3.45 and 3.17 respectively). Licensing as the main problem of a registration process was indicated by enterprises in the trade sector. At the same time renewal of a license was the main problem for services companies. Although the listed stages of a registration and licensing process are not considered to cause problems, every two out of three enterprises hired outside consultants to help with the registration.

The survey provided evidence that a size of a company has only slight correlation with difficulties appearing in the registration process. Firms with employment over 50 people estimated problems of registration as "easy-difficult", while enterprises employing a smaller number of employees as "easy-moderate". A company's location (territorial aspect) appeared not to have any impact on evaluation of a registration process. The same conclusion holds for all other parts of the questionnaire.

According to interviewed companies, a registration process takes on average 2 months, and in individual cases longer but does not exceed 10 months. An average time for obtaining all necessary permits has decreased over the past three years (before it had taken 5 months on average or even more). However, there is a concern about the overall regulatory environment: frequent changes in rules, instability and uneven law enforcement. According to the survey, 36 percent of respondents believed that bribery is used to speed up the process of registration and licensing.

One of the problems faced by new entrants is regulation on real estate market. 40percent of the sample companies owned their premises, the remaining 60percent rented facilities, which caused some problems. Among the most frequently mentioned problems were high rents and their increases at a short notice.

80 percent of interviewed firms regarded labour and employment laws as problematic and unfavourable to employers. Respondents were complaining about too high social insurance contributions and overprotective laws on dismissals, whereas only few of them considered the minimum wage and activities of trade unions to be a problem.

A dismissal of an employee had occurred in 43 companies out of 50, and the process took 2.4 weeks on average. It is important to add here that the Lithuanian laws on employment foresee 2 weeks as the minimum period necessary to dismiss an employee. Only one respondent reported that a dismissal process takes 6–12 months. Such situation usually happens when there are not any legal reasons for a dismissal and employers are reluctant to pay high severance payments required in this case by law.

Among constraints limiting operation and growth of firms in Lithuania, the highest rank was given to a level of taxes. Over 50 percent of respondents declared that their tax burden including social and health insurance contributions had increased during the last years; one third of respondents stated

Table 49. Lithuania: Evaluation* of Registration Process

		minimum	maximum	mean	modal	median	standard deviation	number of responses
1.	Court registration	-	-	-	-	-	-	-
2.	Tax Office registration	1	4	2.3	3	2	0.82	45
3.	Registration for social insurance and health	1	4	2.2	2	2	0.85	45
4.	Registration with the Statistical Office	1	3	2	2	2	0.74	30
5.	Obtaining criminal record	1	4	2.6	3	3	1.07	10
6.	Opening a bank account	1	5	1.87	2	2	0.91	46
7.	Obtaining activity-specific license	1	5	3.45	5	3	1.39	20
8.	Renewal of license	1	5	3.17	5	3	1.64	12
9.	Others	2	4	3.33	4	4	1.15	3

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – very easy; 2 – easy; 3 – moderate; 4 – difficult; 5 – very difficult.

[23] For information about the sample see Chapter 5.

Table 50. Lithuania: Evaluation* of Effect of Regulations on the Establishment and Growth of the Companies

		minimum	maximum	mean	modal	median	standard deviation	number of responses	no response
1.	Renting or purchasing of premises	1	5	2.63	2	3	1	38	12
2.	Registration and licensing	1	5	2.66	2	2.5	1.1	32	18
3.	Tax and contributions	1	5	2.7	3	3	1.21	41	9
4.	Exports and imports	1	5	2.8	2	3	1.33	36	14
5.	Health and safety	1	5	2.5	3	2	1.34	41	9
6.	Labour laws	1	5	2.6	3	3	1.16	42	8

Note: *The following scale 1 to 5 has been used for the evaluation:
1 - no effect at all; 2 - minor effect; 3 - moderate effect; 4 - severe effect; 5 - very severe effect.

that there were not any changes since the establishment of their company; and only 10percent thought that tax and social insurance contributions as a percentage of their total revenue had decreased.

It should be noted that, in the area of labour regulations, which are regarded by respondents as becoming more complicated over time, the payroll tax and related regulations are considered a major constraint.

Tax level in Lithuania is not only perceived as high, it also involves time and money consuming compliance work. As many as 80 percent of respondents said that they spent more time on tax and regulatory compliance activities than in the first year of a firm's establishment, the remaining 20percent did not notice a significant change in time spent on tax-related problems.

Furthermore, the majority of firms hired outside specialists to deal with taxes and contributions-related matters. Only a few firms relied on their own accountants or lawyers. And the problem lies not only in routine tax compliance, but also in constant changes in regulations concerning taxes and contributions (90 percent of respondents described the Lithuanian tax system as unstable).

Another regulatory constraint of a moderate importance is customs and trade regulations. 28 out of 37 companies to which this problem is relevant, had problems connected with exports and imports. The main complaint was against the Customs Department and its discretionary application of customs regulations and corruption. High duty rates and frequent changes in customs regulations were also mentioned as obstacles.

Thus, tax-related regulations as well as customs and foreign trade regulations are viewed as a constraint having a moderate effect on the establishment and growth of new business in Lithuania. Other rules and regulations (registration and licensing, regulations on real estate market, etc.) are slightly less important.

10.2. Assistance for New Business

Only three companies out of 50 had ever received support for business development. Assistance programs were organized by the Chamber of Industry and Commerce (1), international agencies (3) or private consulting firms (1).

Firms were provided with advice on preparation of a business plan, some legal issues, financing, marketing and suppliers. Two companies were supported with low interest loans (300,000 USD each). Interest subsidization was offered some years ago when inflation and interest rates reached 30 percent and more. In recent years, interest rates on loans aimed at small business financing have reached the level of the average interest rates charged by commercial banks, therefore the importance and volume of special financing programs has decreased.

10.3. Financial Constraints

40 entrepreneurs provided information about the initial capital; the remaining 10 considered this information confidential. According to the survey results, the average size of the initial capital was 104,000 USD; however, this figure has little practical significance for the analysis. Frequent changes of exchange rates make it difficult to compare figures provided by companies. Figures calculated in US dollars may seem impossible (e.g. in one extreme case it was 36 USD), yet, they are real. At the time of hyperinflation, and still having the rouble as a local currency (the litas was introduced in 1993), an exchange rate was such that a small amount of US dollars was enough to fulfil registration requirements. Moreover, it should be mentioned that companies usually register the minimum required capital which according to the current legislation is 2,500 USD.

The most common way to cover the initial capital needs was to use personal savings: as many as 72 percent of respondents mentioned this source of financing (see Table 51, column A). The second most frequently used source were loans from family and friends (10 mentionings, i.e. 20percent of respondents). Market loans i.e. bank loan and loans from the informal market played a minor role here. It is however important to notice that in the case of 4 companies bank credits were available at the earliest stage, that is at a start-up of a company. Spe-

Table 51. Lithuania: The Main Sources of Finance for [A] the Starting Capital; [B] the Working Capital; [C] Investment (number of mentionings)

		[A]	[B]	[C]
1.	Own personal savings	36	17	9
2.	Retained profits (operating revenues)	-	36	8
3.	Loan from family and friends	10	3	1
4.	Loan from bank	4	11[a]	6[b]
5.	Restitution	0	-	-
6.	Loan from special programmes set up to aidSME's	0	0	0
7.	Loan from informal capital market	3	1	1
8.	Credit from domestic suppliers	-	13	1
9.	Credit from foreign suppliers	-	12	2
10.	Late payment of taxes and contributions	-	6	0
11.	Others	9	6	3
12.	Leasing	-	-	1

Notes:

[a] Out of which in 8 cases the loans came from domestic banks and in 3 cases the loans came from foreign banks.

[b] Out of which in 3 cases the loans came from domestic banks and in 3 cases the loans came from foreign banks.

cial programs for small business development did not play any role in financing the initial capital of companies.

In the short run firms were self-sufficient. The main source of the working capital finance were internal funds of a company – retained profits were mentioned by 72percent of respondents (see Table 51, column B). Only a small part of financing came from suppliers and banks.

When asked about their investment, 38 percent of companies replied that it was not satisfying and 48 percent thought it adequate. 48 percent of the sample firms had been carrying out investments since their establishment. The average amount was about 338,000 USD (ranging from 1,000 USD up to 2,250,000 USD).

Sources of financing investment were similar to those used for financing the working capital. Companies relied mostly on personal savings and retained profits. Only 6 respondents (12percent) obtained bank credits for investments (see Table 51, column C).

A large part of the questionnaire was devoted to the external finance. One of the examined issues was the role of bank credits in the establishment and growth of new private companies in transition economies. Some of the findings have just been presented. The general conclusion is that in the case of new private companies the access to credits is not as limited as many economists focussing on transition economies suppose, and that the external finance plays a fairly important role in the development of the private sector. 21 (42percent) out of 50 Lithuanian new companies established in the 90s received bank loans. Out of all companies which applied for a bank loan only 7 (14percent) were refused, which can be considered as a small number.

The average loan was around 215,000 USD. In general, loans provided to companies were rather small.

Short-term credits were predominant, although long-term ones were also provided to companies. The average repayment period for a loan was 17.4 months, but there were several cases when firms received loans for 3–5 years. Continuous financing (opening of a credit line) was mentioned only once.

Collateral was required from 80 percent of firms which received a bank credit. Real estate was the most common form of collateral. In some cases companies' owners used their personal or family's property as a source of collateral. It is worth adding that the main reason for a bank's refusal to give a credit was a lack of collateral (7 rejected sample companies). This proves that rejections were rationally justified decisions of banks tending to diminish their risk.

It seems that Lithuanian entrepreneurs could do with more external financing since some of those that had received bank loans stated that they would wish to increase their debt level if they could alter the amount of a loan.

Although, as presented above, banks fairly frequently provide financing to new private companies in Lithuania, as many as 22 surveyed firms (44percent of the sample) had never applied for a bank credit. This finding needs to be explained. The survey revealed that in some cases there was not any need for it, and some companies were discouraged by high interest rates. 4 firms questioned a chance to obtain a credit from a bank. Some firms did not have resources that could be used as collateral. Moreover, the registration of collateral and legal procedures enforcing this mechanism are weak.

42 percent of companies intended to apply for a loan in the near future, and as much as 52 percent did not (!). New credits would be used for fixed assets and the working capital financing. Almost all (19 out of 21) entrepreneurs who wish to apply believed that there would not be any problems to obtain the credit. These firms were ready to pay on average a 12 percent interest rate (it was in 1997 when Lithuania approached 8.6 percent inflation rate).

Table 52. Lithuania: Evaluation* of Obstacles to Obtain Finance from Banks

		minimum	maximum	mean	modal	median	standard deviation	number of responses	no response
1.	Cost of loans (interest rate)	3	5	4.39	5	5	0.69	43	7
2.	Complex procedures for application	1	5	3.58	4	4	1.14	41	9
3.	Collateral requirement	1	5	3.9	5	4	1.14	44	6
4.	Connections with bank managers	1	5	2.73	3	3	1.98	38	12
5.	The need to have a track record	1	4	2.15	2	2	0.96	39	11
6.	Long delays in processing loan application	1	5	3.32	3	3	1.08	37	13

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Companies were asked to evaluate obstacles to obtaining finance from banks. Results are exhibited in Table 52. High interest rates received the highest score – 4.39 meaning more than a severe problem.

All companies, irrespectively of their sphere of activity, location and a country of origin (domestic – vis-a-vis – foreign companies), regarded a level of interest rates as the most severe obstacle.

Collateral requirement ranked second, it was regarded as a "severe problem" (3.9 points). For domestic companies the collateral requirement was a bigger problem than for foreign enterprises. Respondents were also complaining about complex application procedures and delays in processing loan applications (see Table 52).

When asked to evaluate profitability of their company, respondents on average indicated modest profits in every year since 1990 up to 1995. Although an economic recession in Lithuania began in 1990 and many enterprises were operating at a loss, it seems that newly established small and medium-size companies were able to earn profits even in the time difficult for economy as a whole. Better performance of newly established firms may be partially explained by a higher quality of their capital stock and human resources. As compared with the country as a whole, capital stock owned by these companies was younger. The firms use new production and services technologies.

Only 14 sample companies purchased assets in the process of privatization, mostly in the form of buildings, machinery and equipment. The average value of acquired assets was 134,000 USD. None of respondents participated in the restitution process. This can be explained by the fact that the restitution program in Lithuania covers mostly land, housing and church property.

The survey showed that new private firms pay higher wages to their non-managerial employees, while managerial staff receives about the same or slightly higher salaries than the national average.

10.4. What Hinders the Growth of a Company?

Lithuanian sample companies established in the first half of the 90s have been growing steadily. Data on average total employment as a proxy for the growth of a firm shows a slow increase in the years 1990–92, then a sharp increase in 1993, and again a steady growth in the next years (see Table 54).

When asked about future developments, almost all respondents (48 out of 50) declared their willingness to expand. Obstacles affecting growth of companies are presented in Table 53. The main barrier to expansion of a new private business is a high burden of taxes, which is "a severe problem" (3.97 points on a 1–5 scale, see the note to Table 53). Insufficient finance for expansion was ranked second and it was also regarded a severe obstacle. Moreover, respondent frequently expressed their concerns about an unstable political and economic situation in the country. A shortage of qualified workers and high quality managers was regarded as a moderate problem and this obstacle came forth in the ranking. Newly established firms ranked an insufficient demand as a moderate problem, yet, for large privatized enterprises it is a major obstacle.

A negative impact of the burden of taxes and contributions to companies' growth was mentioned by each of the 4 examined sectors.

At the same time, intensity of other problems varied from one sector to another. The main constrains for manufacturing companies were insufficient finance for expansion and high redundancy payment associated with dismissals of workers. Enterprises in the construction sector most frequently indicated to uncertain political and economic conditions, problems related to regulations and insufficient finance for expansion. The service sector complained most on a shortage of qualified workers, insufficient finance for expansion and a shortage of high quality managerial staff. Foreign companies pointed out to a shortage of qualified workers and high quality managerial staff as well as shortage of other inputs. The main problems for domestic companies (owned by domestic entrepreneurs) were insufficient finance for growth, uncertain political and

Table 53. Lithuania: Evaluation* of Obstacles to Increasing Company's Production

		minimum	maximum	mean	modal	median	standard deviation	number of responses	no response
1.	Insufficient demand	1	5	2.85	3	3	1.3	42	8
2.	Shortage of qualified workers	1	5	2.9	4	3	1.24	41	9
3.	Shortage of high quality management personnel	1	5	2.88	4	3	1.35	42	8
4.	Shortage of other inputs	1	5	2.94	3	3	1.35	37	3
5.	Limitations of physical capacity	1	5	2.5	2	2	1.23	36	4
6.	Insufficient finance for expansion	1	5	3.7	4	4	1.14	40	10
7.	High burden of taxes / contributions	1	5	3.97	5	4	1.11	41	9
8.	Problem related to regulations	1	5	2.52	2	2	1.31	23	27
9.	High redundancy payment associated with dismissals	1	5	2.28	1	2	1.36	39	11
10.	Regulations on working conditions	1	5	2.15	1	2	1.2	38	12
11.	Uncertain political / economic conditions	1	5	3.12	3	3	1.42	41	9
12.	Others	3	5	4	-	4	1.41	2	48

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 54. Lithuania: End-of-year Employment Level in a Company since its Establishment

		mean	median	number of responses
Regular, full time employees in:				
1.	1990	8.8	3	5
2.	1991	8.7	6.5	14
3.	1992	12.0	8.5	22
4.	1993	27.4	13.5	34
5.	1994	32.4	14	49
6.	1995	38.5	16	49
Part time, free lancers and independent entrepreneurs in:				
1.	1990	1.2	0	5
2.	1991	1.7	0	14
3.	1992	1.4	0	22
4.	1993	1.4	0	34
5.	1994	1.8	0	49
6.	1995	2.2	0	49
Total employment in:				
1.	1990	10.0	7	5
2.	1991	10.4	6.5	14
3.	1992	13.4	8.5	22
4.	1993	28.9	13.5	34
5.	1994	34.2	15	49
6.	1995	40.7	20	49

economic conditions and insufficient demand. For bigger companies (over 50 employees) most serious problems were: limitations of physical capacity and insufficient finance for expansion, while smaller companies were more concerned with uncertain political and economic conditions.

Social security and health contributions are matters of serious concern for Lithuanian companies. Expensiveness of regular full-time employees (both wages as well as social and health insurance contributions are taken into account) results in employing cheaper free lancers (see Table 54). It is easier to dismiss them and companies have a possibility to by-pass employment laws and labour code.

10.5. Environment and Competitive Conditions

The overall environment for private business development in Lithuania was considered as "satisfactory"(3 points) by 47 percent and as "poor" (2 points) by 40 percent of respondents. The average grade for the sample was 2.65 on a 1 to 5 scale. The question should be posed about reasons for such poor assessments of the business climate. Managers and owners were asked to specify and evaluate the main factors negatively affecting the business of their companies. Findings are presented in Table 55.

Non transparent laws and regulations as well as their frequent changes had the most severe effect on the business of private companies in Lithuania. These barriers are considered to impede the private sector growth to the utmost degree.

The informal sector and corruption ranked second in this list. The weak banking sector and constant government interventions were also perceived as serious obstacles. Other constraints were less important.

Interviewed entrepreneurs considered both the informal economy and foreign firms or joint ventures operating in Lithuania as their main competitors. Other mentioned competitors, although less important, were domestic small and medium-size enterprises producing similar products and services as well as importers of these products. A size of a company did not play a significant role in defining main competitors.

For manufacturing companies main competitors were foreign firms or joint ventures established in Lithuania, importers selling new products and firms in the informal sector of the economy. However, they evaluated their competition as week and between week and moderate. Not surprisingly, construction enterprises met the strongest competition from firms in the grey economy (evaluated as strong competitors), and domestic SMEs producing similar services (moderate competitors). The same is relevant to trade companies, which consider importers selling new products to be moderate competitors. The main competitors for the service sector companies are foreign firms or joint ventures established in Lithuania and domestic SMEs producing similar goods and services.

There is a strong difference in perception of main competitors between domestic firms (companies established and owned by Lithuanian entrepreneurs) and foreign firms (established in Lithuania with the bulk of foreign capital). The former regarded firms in the informal sector of the economy and foreign firms or joint ventures established in the country as their

Table 55. Lithuania: Evaluation* of Obstacles Affecting the Business of a Company

		mean	modal	median	number of responses
1.	Political instability	2.42	1	2	45
2.	Inflationary conditions	3.00	3	3	44
3.	Frequent changes in government	2.63	2	2	43
4.	Frequent changes in laws and regulations	4.11	5	4	45
5.	Non-transparency of laws and regulations	4.23	4	4	44
6.	Operation of commercial law	3.06	3	3	33
7.	Operation of the banking system	3.44	4	4	41
8.	Inadequate measures against crime / corruption	3.72	5	4	39
9.	Continued government intervention in the economy	3.40	5	4	35

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 56. Lithuania: Main Competitors and their Competitive Power*

		mean	modal	median	number of responses
1.	Domestic SMEs producing similar goods / services	2.56	1	2	36
2.	SOEs or large privatized firms	2.06	1	1	36
3.	Foreign firms or joint ventures established here	3.00	3	3	37
4.	Firms in the informal sector of economy	3.14	4	4	35
5.	Importers selling new products	2.43	1	2	30
6.	Importers selling second hand products	2.04	1	2	28

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a competitor; 2 – a weak competitor; 3 – a moderate competitor; 4 – a strong competitor; 5 – a very strong competitor.

main competitors. Foreign companies usually compete among themselves.

62 percent of respondents accused their competitors of unfair practices in competition. The most popular means of unfair competition are tax evasion (18 cases) and close relationships with bank managers as well as government officials (16 mentionings). The last finding is understandable once you relate it to the fact that 43.8 percent of sales revenues of the investigated companies comes from the public sector. Thus, the grey economy and corruption are among main factors impeding the private sector development and discouraging new entries. However, when asked to evaluate the size of the informal sector in their industry, 52 percent of respondents hesitated to give an approximate estimate. Others believed that, on average, the informal economy amounted to 44 percent, which is an outstanding figure. Very often newly established companies faced unfair competition through open or hidden subsidies to other firms (11 mentionings) and price manipulation by larger competitors. Less common practices of unfair competition were the control of distribution channels and smuggling. Taking into account importance of the public sector as the buyer of products and services of the surveyed companies, one may understand the reason for so much complaints about corruption.

4 companies out of 50 were actively looking for an investor to buy their companies. All of them preferred foreign investors to domestic ones. Many more firms (14) would like to find a foreign investor to establish a joint venture. Companies were looking mostly for additional capital (13 cases), new technologies (8) or an access to export markets (4).

10.6. Foreign Companies

The sample of 50 small and medium enterprises included 10 foreign firms (foreign capital companies as well as joint ventures) operating mostly in the service (4) and production (3) sectors. These companies were asked several questions in order to identify constraints specific to foreign investment in Lithuania. The results are presented in Table 57.

According to foreign investors most serious problems their companies had to confront were: negative attitude of governmental officials, difficulties in buying land and real estate as well as inadequate protection of foreign investors. As far as the process of registration is concerned foreign entrepreneurs faced some problems while getting permits and licenses. The negative attitude of population, suppliers and customers was considered only a minor problem.

Only 3 respondents believed that foreign companies and joint ventures operating in Lithuania faced discrimination or unfair competition from domestic firms in the form of subsidization of domestic producers, specific trade regulation and output market control.

Foreign investors believed that Lithuania has the potential to attract foreign investments. First of all, they valued high-skilled and still low-paid labour force and a good geographical location of the country. Foreign companies agreed that legal framework is also favourable. The size of the market (for obvious reasons) and liberalized trade regime were of less importance in making decisions to start business in Lithuania (see Table 58).

The overall climate for foreign investment in Lithuania was rated between satisfactory and good. The Czech Republic was evaluated as the best country for foreign investment (average rank 4.29), Lithuania was given the second rank (3.44) and Hungary and Poland took the third position (3.40). It has to be stressed that some of the respondents' judgements were based on widespread opinions about an economic juncture of a particular country and not on their own experience. Growing imports of Czech origin to Lithuania (Skoda cars, Karosa busses, etc) may have formed a good image of the Czech Republic for foreign investors.

Table 57. Lithuania: Evaluation* of Obstacles to Foreign Companies

		mean	modal	median	standard deviation	number of responses
1.	Obtaining the relevant permits and licenses by foreign firms	2.18	2	2	0.75	11
2.	Inadequate legal protection for foreign investors	2.87	3	4	1.13	8
3.	Difficulties faced by foreign firms in buying land and real estate	3.14	3	3	1.68	7
4.	Negative attitude of government officials (from tax offices etc.)	3.2	3.5	5	1.62	10
5.	Negative attitude of suppliers and customers towards f. i.	2.09	2	1	1.3	11
6.	Negative attitude of population in general towards f. i.	2.1	1.5	1	1.29	10

Note: *The following scale 1 to 5 has been used for the evaluation:
1 – not a problem at all; 2 – a minor problem; 3 – a moderate problem; 4 – a severe problem; 5 – a very severe problem.

Table 58. Lithuania: Evaluation* of Factors Facilitating for Foreign Firms

		mean	modal	median	standard deviation	number of responses
1.	Laws facilitating foreign investment	2.90	3	3	1.29	10
2.	Cheaper skilled labour	3.90	4	4	0.57	10
3.	Size of the market	2.77	3	3	0.97	9
4.	Access to other countries of the region	3.00	4	3	1.41	9
5.	Liberalized foreign trade	1.75	1	1.5	0.96	4

Note: *The following scale 1 to 5 has been used for the evaluation:
1–not a factor at all; 2– minor factor; 3– a factor of some importance; 4– an important factor; 5– a very important factor.

10.7. Conclusions

The overall environment for the private business development in Lithuania was considered as close to satisfactory. However, companies did perceive some obstacles for functioning and development of business, particularly in the areas of taxes, finance and regulations.

Lithuanian enterprises did not regard registration as impeding business development. What they complained about was a high level of taxes as well as the tax system itself – its non-transparency and changeability in general. Weaknesses of the tax system are also a general problem of the whole regulatory system. It is perceived unfair, non-transparent, unstable, unfair and unevenly enforced.

The most common source of finance for the starting capital were personal savings. Loans from family and friends were the second source. As far as financing both the working capital and investments is concerned, new private companies relied mostly on retained profits supported in many cases by own personal savings. Bank loans were seldom used. Lithuanian companies perceived external financing as costly, taking into account high interest rates as well as collateral requirement.

Only 3 companies out of 50 received support for business development. In recent years, interest rates on loans aimed at small business financing have reached the level of the average interest rates charged by commercial banks, therefore, the importance and volume of special financing programs has decreased.

Lithuanian companies declared that they wished to expand their production, however they faced obstacles affecting their growth. The most severe problem was the heavy burden of taxes and tax-like obligatory payments (i.e. social security, health, pension and unemployment contributions), which limit companies' own capacity to invest. The second most important barrier was insufficient finance for investments. This obstacle is closely related to the first obstacle (strictly speaking it stems from the restrictive tax system) and to a comprehensible reluctance to use bank loans.

Finally, the issue of vast corruption and a large size of the grey economy was raised by Lithuanian new companies. The two phenomena distort competition, impose extra costs on legal business and impede the growth of formal business activities of companies.

11. Conclusions and Policy Recommendation

Leszek Balcerowicz and Iraj Hashi

New firms face a number of barriers to entry and impediments to early growth that have been identified in this study through a survey of enterprises that have overcome these barriers. Those entrepreneurs who could not overcome the entry barriers or the problems of initial stages of operation have either transferred their activities to the shadow economy or left the market altogether. Of course, as in many countries, the early transition period is characterised by a high rate of entry and exit – and this is a natural feature of an emerging competitive economy. This research has been concerned with identification of those barriers which may be eased or removed in order to enhance the state of competition and create a level playing field for new and existing firms. New small and medium-sized firms are recognised as a most dynamic element of the emerging market system and with a significant contribution to the development of transition economies. It is therefore important that the government facilitates the formation of these firms and creates an appropriate macroeconomic and institutional framework for their operation. Given the types of barriers identified in the respective country papers and cross-country comparative studies, the following policy recommendations are:

1. Registration of new firms and issuing of activity-specific licenses need to be reviewed in all countries. New firms should be able to complete all registration requirements in one place or institution in each region (regional courts, e.g.) – in a 'one-stop' centre. Instead of the present arrangement where new entrepreneurs have to visit several institutions (courts, tax offices, social security offices, statistical agencies, etc.) to register with each of them separately, the 'one-stop' registration centre should inform all these institutions directly. The establishment of such a centre will also facilitate the access to information for business partners, the general public and government. It will improve transparency and reduce the possibility of fraud.

The obtaining of activity specific licenses and permits as well as their renewal pose a major problem in all countries. Over the years, the number of activities requiring licenses or permits have increased – to a large extent by pressure from interest groups such as the incumbent firms or their representatives. A distinction must be made between a need for professional licensing (providing the public with information about the quality of service they can expect e.g. in the fields of medical care and public health), and licensing which is aimed at controlling a number of competitors and protecting an interest group. The latter type serves no economic purpose and should be removed. Moreover, as some country studies indicate, the issuing of permits by government departments provides ample opportunities for corruption and rent seeking by officials at various levels. The removal of this barrier will also help to reduce the scope for corruption.

2. The majority of firms in our study do not own their property and have to lease their premises, often from municipalities or other state institutions. The shortage of commercial real estate and the possibility of owners to raise rents at short notice are identified as the main impediments in this area. Given the nature of ownership of real estate, the government can improve the situation by speeding up the privatization of publicly owned real estate. Of course, this will have a major effect on the income of local governments (who stand to loose a permanent, reliable and increasing source of income) and alternative sources must be found for this purpose.

3. Taxes and contributions are by far the most important impediment to the early growth of new firms in all five countries. Taxes in transition economies are high because of the particular structure of public finance, including a large state sector, continued subsidization of certain industries, and the prevalence of the informal economy. Only with the reform of public finances can the government begin to reduce the rate or level of taxation. This is exactly what has been happening in the Czech Republic, Hungary and Poland.

The social and health insurance contributions are a more complicated issue and rich with serious social and political implications. In four of the five countries under consideration (except Lithuania, and yet, Lithuanian entrepreneurs complained about these contributions as entrepreneurs in other countries did), contribution rates are far higher than those of, for example, the U.K. and most EU countries. At present, these contributions are paid into special funds, which, together with funds from the budget, support the provision of health, pensions, social insurance, unemployment, disability and other benefits. The level of contributions are high because this was the only way that a welfare system largely left over from the old days (except for the unemployment benefit, which is relatively new) could be maintained. A reduction in contributions, therefore, has to await an urgently needed reform of the welfare system. In some countries (like e.g. Poland), this is now at the top of the government's agenda. Other countries will have to embark on a fundamental reform of the pension system and health service urgently if they wish to be in a position to reduce the burden of these contributions on their employers and employees.

In addition to the level of taxes and contributions, it is generally agreed that new firms in their early growth have to deal with regularly changing fiscal rules and regulations. These changes create a high degree of uncertainty and impose compliance costs on entrants at a time in their life cycle when they can least afford it. It diverts resources and management time away from the firm and into professional advisors.

4. Very few firms in our sample had received information and support from national or international schemes which had been set up to help and support the small and medium-sized enterprise sector. Of course, there is a wide-ranging debate amongst economists as to whether small and medium sized firms should be given special support. Without entering this debate, it is important that the government aims at creating a level playing field in which new firms can compete with established firms on equal terms. Furthermore, it is essential to increase the level of information available to potential and actual new firms about the wide-ranging SME support programmes.

5. Enterprise surveys in all five countries point to a number of other common issues which concern the great majority of entrepreneurs. These are: the macroeconomic environment and institutions, frequency of changing laws and regulations and their non-transparency. Making regulations transparent and reducing uncertainty by avoiding frequent changes in regulations are feasible and practical measures that can be taken by the governments.

6. There is a generally held view that financial constraints, particularly a new firms' access to bank credits, act as a major barrier to entry – and therefore the government is expected to step in to support new enterprises. Our study does not support this view. Given a small size of companies in samples, particularly in the Hungarian one, it has to be admitted that companies generally had better access to credit than it had been initially expected. A bank credit was the second most important source of finance for investment in Poland, Hungary and the Czech Republic, and the third in Lithuania (Albania was an exception here). The majority of firms received a bank credit (however small) and furthermore, in each of the five countries (including Albania) there was a group of companies which obtained bank loans even at the time of establishment. Banks seem to have been 'rational' in supplying credits and enterprises in applying for them. Our study of finance and investment in sample enterprises has found no traces of adverse selection – which leads to credit rationing. Obviously, a word of caution is necessary here. Our sample consisted of firms that have actually entered their market and survived their initial phase. Entrepreneurs who did not survive for a variety of reasons, including lack of access to bank credit, were by definition excluded.

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