By law and by custom: Factors affecting small and medium-sized enterprises during the transition in Lithuania
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Chapter 9: Policy recommendations

9.1 Introduction

_If the only tool you have is a hammer, you treat everything like a nail._
_A. Maslow_

The purpose of this final chapter is to explore the necessary policy tools for SME development in Lithuania. The need for policies to support SME development in Lithuania can be justified from both an economic and socio-political perspective. From an economic perspective, SMEs are important for both their innovative potentials and for job creation. Further SMEs provide an important part of the infrastructure on which competitiveness of the economy depends (Smallbone & Piasecki 1995). From a socio-political perspective, the development of an entrepreneurial class in the form of SMEs facilitates the development of a market-oriented economy at the grassroots level (Smallbone & Piasecki 1995; Roberts & Tholen 1998) and the political base for a market economy. Evidence from developed western economies shows that SMEs face certain disadvantages due to their ‘smallness’ in competing with larger firms and this justifies policy intervention on the basis of the longer-term potential contribution of the SME sector (Smallbone & Piasecki 1995).

New start-ups can contribute innovation, jobs, and act as a positive competitive force in the economy. But existing SMEs are especially important since they have demonstrated the ability to survive the difficult start-up period and may have potential for further growth. In that sense, existing SMEs are the most likely to generate additional jobs, and add value to local, regional and national economies through external sales. For this reason, providing policy support for such enterprises offers potential public as well as private benefits (Smallbone & Piasecki 1995:16). Given our focus on existing SMEs, proactive policy recommendations are presented that focus on existing SMEs but may also be applicable for start-ups.
The central premise of this thesis is based on the Baumolian perspective that entrepreneurs are present in any given context but it is the external environment that shapes their manifestation. Like a seed, entrepreneurship has the potential for growth wherever the opportunity arises. Though the government is not the only factor that influences the manifestation of entrepreneurship, governmental policies can both create a conducive environment for productive entrepreneurship to grow or can interfere with SME development and create conditions for unproductive or even destructive entrepreneurship to prosper. In this sense public policy plays a crucial role in determining not just the quantity of entrepreneurial development but also the quality of entrepreneurship. The process of entrepreneurial self-selection can be adversely affected by external barriers such as governmental constraints. Given the restricted conditions, the most capable entrepreneurs may choose against starting their own businesses; but those individuals who are most able to get along with bureaucrats and politicians, have the right connections and the greatest capability to bribe are the most likely to start up private businesses (Chilosí 2001:343). Altering the risk-reward profile of the entrepreneur can affect the quality of entrepreneurs that undertake business start-ups. In the following sections, we will present some possible strategies to further promote the growth of productive entrepreneurship.

9.2 Current Governmental initiatives and programs

The creation of an appropriate legal and institutional framework within which SMEs can develop is one of the most difficult tasks of the transition period yet one which is critical to the development of the SME sector… (Smallbone & Piasecki 1995:19).

Though little was being done to promote SME development at the beginning of transition, the Lithuanian government is currently undertaking a number of measures to promote SME development. In 1996, the Lithuanian government created the Lithuanian Development Agency for Small and Medium Sized Enterprises (SMEDA). The five main aims of the SMEDA are (1) to stimulate the development of new SMEs, (2) to increase the competitiveness of SMEs, (3) to promote the creation of new jobs, (4) to increase the
survival rate of SMEs, and (5) to increase information technology (IT) literacy of SMEs. Furthermore, SMEDA is responsible for analyzing the economic and legal environment for SME development, updating and disseminating information about financing possibilities for SMEs and providing publications on SMEs. Also SMEDA is involved with initiating and administering the provision of subsidized consulting services for SMEs and participation in international SME programs and projects. SMEDA currently subsidizes business advice and consultancy at various business centers throughout Lithuania. Also SMEDA has created government supported guarantor funds to assist SMEs in receiving bank loans.

In July 2002, the SME development agency received a government subsidy in order to implement a project that provides support for starters. As a part of this project, subsidized consulting services will be provided to starters in six regions of Lithuania. The services are intended to be accessible by both rural and urban starters. Special attention will be paid to female starters and young starters (ages 20 – 29). In addition, SMEDA already supports the development of business incubators in seven Lithuanian cities.

Furthermore, the improvement of statistical data is also important for developing appropriate policies. The Lithuanian Ministry of Economics is working together with the Lithuanian Chamber of Commerce, Industry and Crafts (LCCIC) to develop a business database. In addition to governmental activities, there are currently an estimated 5 000 NGOs related to SME development in Lithuania. These organizations range in size and scope. Some organizations such as the Kaunas Regional Association of Small and Medium-sized Business have a local focus while organizations such as the LCCIC have a national focus.

A 61-page report containing policy guidelines and recommendations for SME development in the Baltic countries produced by the OECD is used as a reference for Lithuanian SME policy. This comprehensive document provides extensive and practical measures for issues related to SMEs such as regulation reform, taxation reform, financing, business consultations, regional policy, capacity building and fostering
entrepreneurial spirit (see appendix 9.1 for list). This information is available on the SMEDA website\(^1\), however it is only available in English with no Lithuanian translation. This is striking. Lithuanian SMEs can only access this document if they read English. This example illustrates the existing gap between intentions and practical applications.

It is not the aim of this thesis to reproduce all the suggestions contained in the OECD report, rather, a specific number of issues will be addressed, grouped in four main strategies: reform, proactive policy, legitimacy through visibility, interactive approach and alliance building. Though presented in separate sections, these policy recommendations can be implemented simultaneously. Also, attention is paid to issues largely absent in the OECD report such as the need for external monitoring, differentiation of existing SME needs and the role of informal institutions. In addition, the barriers to SME operations raised in the previous chapters of this thesis are also discussed.

### 9.3 Reform

As the name suggests, the reform approach focuses on simplifying existing governmental policies and reducing transaction costs (both direct costs and indirect, compliance costs) that seem to interfere with the development of a thriving SME sector. These include reducing both direct costs such as taxation and indirect costs such as adhering to legislative requirements and frequency of inspections. Formal barriers such as the frequent changes to tax policies and tax level were identified as some of the main barriers by existing SME owners in Chapter 6.

In terms of direct costs, reducing the overall tax rate and providing a tax break for start-ups (up to three years) would promote the allocation of entrepreneurship to productive uses. There is a need for laws and regulations to be as simple as possible, transparent and neutral in order to minimize the degree of discretion available to the bureaucracy in their application. Official interpretations published in an accessible form of existing legislation may be a useful means to reduce corruption.
Reforming business regulations can also be an effective means to help eliminate corruption. An analysis of the regulation of entry in eighty-five countries shows that heavier regulation of entry is generally associated with greater corruption and a larger unofficial economy, but not with measures of better quality or private or public goods (Djankov et al. 2002). It is therefore advisable to reduce taxation and legislative barriers, keep the level of new legislation low and make sure new legislation is clear and simple to interpret. Indirect costs form a considerable barrier to existing SME owners in terms of compliance costs. By diminishing the number of regulations and reducing the number of inspections, compliance costs could be significantly decreased.

9.4 Proactive policy

In supporting existing SMEs, it is important to differentiate between types of SMEs, in terms of growth levels and target groups. The needs for business services and financial schemes will differ. High growth SMEs in general will be in need of greater and more complex financial resources (including venture capital) and managerial skills. Slower growth SMEs will also need access to financial resources but on a different level and based on credit and small loan schemes at reasonable interest rates. Furthermore specific groups based on sex, ethnicity and region may require specific attention. Public policy needs to be designed and targeted to particular subgroups in mind since SME characteristics are often influenced by gender and ethnic effects. For example special funding for high-growth companies could inadvertently discriminate against female business owners in Lithuania who tend to have smaller businesses that seem to grow at a slower rate. For women and ethnic minorities, an emphasis on integration into and the development of new business-related networks may be an important strategy to overcome their disadvantaged position.

Furthermore, there should be a distinction made between the different economic and social functions performed by different types of SMEs in the transitional setting. High growth SMEs may be important for their innovative and employment contributions. But only a very small proportion of SMEs are high growth and they tend to be the exception to the rule. Most SMEs stay small but their economic and social contribution should not
be underestimated. Slow growth or no-growth SMEs (such as OAM traders) can provide stable employment for the business owner and a small group of staff and this in itself is an important contribution to alleviating the chronically high unemployment/underemployment rate in transition countries such as Lithuania.

SMEs can also provide a means for earning a decent livelihood for groups which experience a disadvantage on the formal labor market due to their sex, language ability, ethnicity, age and location. On a regional level, private business initiatives can help stimulate further economic development in more economically depressed areas. Given scarce resources, the reduction in bureaucratic obstacles at the local level especially in rural areas, can be an efficient and effective way of assisting the development of small enterprises (Smallbone et al. 2001b:271).

Traders, using a renewable trading license, form the most basic type of Lithuanian SMEs. As described in chapter 4, license-holding traders provide both employment opportunities to those disadvantaged on the formal labor market and provide price sensitive households with a selection of inexpensive durable goods. Recognition of the economic contribution these traders, seems to be an important first step towards improving their situation.

With regard to compulsory business membership of a Chamber of Commerce or other business institutions, it may be more appropriate to improve current statistical data collected by the Lithuanian statistical office than to require businesses to join an independent Chamber of Commerce unless there was some sort of guarantee that the interests of smaller businesses would be equally represented. Current statistical data should also be expanded to track businesses that are re-registered but engaging in the same business activity under a different name.

The effectiveness of SME policy also depends on the nature of the institutions involved and the quality of the individuals responsible for delivering support programs (Smallbone & Piasecki 1995:16). In essence it is just as important to select qualified individuals to devise and implement SME related projects as it is to create new projects in the first
place. Personnel with previous SME experience in Lithuania and exposure to Western methods (through visits and consultations) are essential. Further developing the means to attract and retain qualified governmental staff should also be combined with competitive salaries.

**Outside monitoring.** At the moment, SMEDA, a governmental organization, is responsible for implementation of SME policy. No independent monitoring body exists. An independent monitoring body consisting of NGO representatives and SME business owners should be created to evaluate existing policy and to provide recommendations for policy alterations and/or changes. An independent monitoring body may help safeguard against projects being only partially implemented or implemented on paper only.

**9.5 Legitimacy through visibility**

In chapters 4, 5 and 7, the issue of legitimacy of SME activities was raised. The open-air market traders in Chapter 4 identified the negative public attitude towards their trading activities as forming a barrier to their business activities. In Chapter 5 SME owners commented that the both negative public attitude as well as the lack of legitimacy of their activities in the eyes of governmental officials formed a barrier to their business operations. Chapter 7 indicates that lack of legitimacy and visibility of female SME owners may create additional difficulties for female SME owners.

An often-neglected area of policy is the need to increase the positive image of SME owners and entrepreneurs in the popular media and in available literature. This is especially crucial in Lithuania as in other post-socialist countries where entrepreneurs were associated with a negative, even criminal image of capitalism and where the most celebrated high profile entrepreneurs were directly connected to criminal or Mafia activities. The government can play an important role in the process of shaping a positive image of entrepreneurs, as can NGOs and entrepreneurship organizations. Interviews with SME owners and reports illustrating the positive economic and social impact of productive entrepreneurship could be widely disseminated. Further the establishment of positive role models for potential entrepreneurs and mentorship programs for existing
entrepreneurs could improve the capabilities of SME owners and survival rate for existing SMEs.

This is especially true for groups who have generally received less media exposure as SME owners such as women, ethnic minorities and senior citizens. Past research has indicated that the lack of visibility of female entrepreneurs results in a lack of legitimacy for women as 'successful entrepreneurs' (Baker et al. 1997). As a result, women have to work harder to gain access to resources, convince resource suppliers and corporate customers that they are as competent as men (Brush 1997).

9.6 Interactive approach

*Building bridges between existing formal and informal institutions is an effective means of enhancing the success of formal institutions* (World Bank 2002:178).

As our results suggest in Chapter 6, business barriers are interrelated for existing SME owners. Therefore, we cannot talk simply of changes to the formal rules without addressing supportive changes to informal institutions. Informal institutions are especially important because they form the values that guide the behavior of individuals, families and local communities as well as governments. Together these groups shape and underpin the workings of all institutions (UNEC 2001).

In the absence of functioning formal rules and institutions, informal institutions fill the gap to facilitate exchange between actors i.e. to lower transaction as well as interaction costs. But as the informal networks lower transaction costs for some, they exclude other potential actors. Therefore it is of utmost importance to create a functioning formal environment which ensures a level playing field for all potential actors.

To be effective, it is important to stimulate informal institutional support for new formal institutions. One way of gaining support of informal institutions for new formal rules is by connecting citizens (i.e. the broad public) to the process of change. This is perhaps the
greatest challenge to the post-socialist society, creating a sense of societal engagement as stakeholders in relation to formal rules. Individual citizens can obtain a sense of connectedness and commitment if they are consulted and incorporated in the decision-making process. Democratic voting is one formal role but more must be done to create a feeling of engaged democratic leadership. Town meeting type assemblies to discuss possible policies and to voice opinions in a public forum are needed. Positive ideas from these forums could be implemented and the practices made visible in order to develop a sense of inclusion for creating new policies. Though this process necessitates commitment of both time and energy, its results could help increase the effectiveness of formal rules that are more closely embedded in informal institutions.

9.7 Alliance building
A spirit of cooperation is largely missing amongst the population in Lithuania. This is not surprising since it was discouraged during Soviet rule. As a result there is little experience with forming alliances or coalitions around collective interests. In fact there seems to be a blatant absence of cooperation between NGOs, SME owners and governmental officials. Lack of cooperation ultimately leads to only the most influential voice being heard as can be argued is the case in Lithuania with the interests of large enterprises. The main strategy to address this imbalance is by forming alliances based on mutual interests and needs. SME groups formed based on business sector or industry may be the most efficient unit at the grassroots level. These groups can then form alliances either amongst themselves or with larger NGOs in order to get their interests heard.

This process will necessitate an attitude change both among SME owners who tend to be individualistic and existing NGOs that tend to suffer from competition and rivalry. In the end it is only through cooperation that both SME owners and NGOs can learn from one another and improve the situation for all actors themselves. Finally, as both Douglass North and Justinas Zubrickas have indicated, in order to achieve sustained change, these processes necessarily take time.
POLICY GUIDELINES AND RECOMMENDATIONS ON
INSTITUTIONALISATION OF SME POLICY AND SME REPRESENTATION

1. Ensure that the policies and strategies to encourage entrepreneurship and enterprise development are stated and seen as a central aim of national development policies.

2. Determine policy priorities for the small and medium-sized business sector and ensure that performance of implementation is monitored.

3. Encourage actions and initiatives that will build a positive image of entrepreneurship across the whole of society and that will help to improve attitudes to new enterprise.

4. Designate clear institutional responsibility for small and medium-sized business policy at national, regional and local levels.

5. Ensure that the reasons for intervention by government and agencies are stated in SME policy, as well as the directions on how support should be provided and delivered to the small and medium-sized business sector.

6. Assign the responsibility and resources to local and regional government to promote and develop small and medium-sized enterprises.

7. Establish procedures for a regular dialogue with small and medium-sized business representatives and seek to develop joint initiatives that will build public/private partnership in supporting SMEs.

8. Develop policies and support programmes that address the needs expressed by SMEs and prepare them for increased global competition and opportunities and EU accession.

9. Monitor the structure, performance and the changing needs of the small and medium sized business sector.

10. Provide training and guidance on customer service to personnel in ministries and agencies.

POLICY GUIDELINES AND RECOMMENDATIONS ON
RULE OF LAW AND REGULATION, INFORMAL ECONOMY

1. Improve the legal and regulatory environment for small and medium-sized businesses by focusing awareness and action on improvements in the key areas where the State has direct responsibility.
2. Implement measures to improve small business registration, licensing and administrative procedures where the existing procedures are identified as unduly bureaucratic and as obstacles to entrepreneurship.

3. Seek a change of attitudes by the bureaucracy in dealing with small and medium-sized businesses through specific actions such as demonstrated high standards at government level and by training public officials.

4. Provide small and medium-sized business representatives with an opportunity to express their views on relevant draft legislation and regulations.

5. Distinguish between broad segments of the informal economy (ranging from businesses in breach of minor misdemeanours to businesses involved in serious criminal offences) when designing policies and programmes for small and medium sized businesses.

6. Instigate and develop a systematic and continuing programme to deal with all forms of corruption, especially, in its impact on small and medium-sized businesses.

**POLICY GUIDELINES AND RECOMMENDATIONS ON TAX POLICY FOR SMALL BUSINESS**

1. Recognise the crucial role that tax policy plays in influencing and shaping the environment for small business growth.

2. Design tax policies with the twin objectives of increasing tax revenues and promoting the emergence and growth of enterprise.

3. Create a clear definition of small and medium-sized businesses for tax and other purposes.

4. Reduce the number and frequency of changes in the tax system.

5. Simplify the rules applied and thereby reduce the compliance burden for small and medium-sized businesses.

6. Ensure that the tax laws and rules are transparent and easily accessible by the small and medium-sized business sector.

7. Focus on practical steps to develop administrative rules to achieve a simple and transparent tax regime for small and medium-sized businesses.

8. Interact and communicate regularly with the small and medium-sized business sector in the development and implementation of tax rules.
9. Encourage and support the SME sector to present its viewpoint on policies and facilitate its participation in the government’s consultative process on tax legislation on a regular basis.

10. Review tax incentives to ensure each incentive is cost-effective, fair, and properly targeted.

11. Consider the need for special measures to support micro and small enterprises and the possible use of presumptive taxation (tax base inferred from simple indicators) for the smallest businesses.

12. Develop comprehensive training for tax policy-makers and administrators that will prepare them to take a constructive attitude to small and medium-sized businesses and will equip them to advise businesses on the tax rules and interpretation of such rules.

13. Develop a system to monitor the implementation of recommendations.

POLICY GUIDELINES AND RECOMMENDATIONS ON FINANCIAL INSTRUMENTS FOR START-UPS AND SMEs

1. Seek to strengthen the banking and financial system in parallel with efforts to improve the availability of funding for SMEs.

2. Provide selected financial services through public policies where the private sector fails to meet the needs of SMEs.

3. Focus on measures that will improve access to finance by SMEs and encourage the provision of a broad range of financial instruments (e.g. leasing, loan guarantees for fixed asset investment and working capital, venture capital, interest subsidies, factoring).

4. Develop loan guarantee schemes and institutions to improve the access to finance and encourage commercial banks to provide loans to selected SMEs.

5. Seek to foster new attitude to SMEs among banks and link this initiative with the provision of new funding mechanisms.

6. Ensure that good business practice is followed when using public funds.

7. Provide training and advice for entrepreneurs and staff in small and medium-sized businesses in dealing with financial institutions and loan applications.

8. Ensure that access to finance is improved on the regional and local level.
POLICY GUIDELINES AND RECOMMENDATIONS ON ADVISORY SERVICES FOR NEW AND SMALL BUSINESSES

1. Build policy for business advisory services with a clear vision of what small businesses really need.

2. Create a policy framework for the provision of advisory services, based on a coherent analysis of where market gaps exist and reasoning why government intervention is appropriate in closing in these market gaps.

3. Manage and operate business advisory service programmes and institutions like commercial entities.

4. Involve the private sector, as early as possible, in the provision of business advisory services and recognise that in the long run the private sector will need to become the prime supplier of business advisory services.

5. Aim for sustainability in the design and organisational structure of business advisory service programmes and delivery institutions and seek to diversify funding sources.

6. Invest particularly in the selection, training and ongoing supervision of staff delivering business advisory services. Recognise that the promotion of business advisory services is another important form of human capacity building in the overall economy, which is crucial for successful long-term development of the whole economy.

POLICY GUIDELINES AND RECOMMENDATIONS ON REGIONAL AND LOCAL ENTERPRISE PROMOTION

1. Formulate and implement a coherent regional development strategy.

2. Research and assess the specific local and regional environment in advance in order to inform and guide the preparation of regional policy.

3. Promote the entrepreneurial climate at the local level.

4. Promote capacity building of institutions and agencies dealing with regional policy at the local level.

5. Facilitate and support the emergence of financial institutions at the local level.

6. Maximise the role that Business Incubators can play in the promotion of local entrepreneurship and in assisting start-up ventures.

7. Be cautious about the use of free economic zones as a tool of local entrepreneurship promotion and evaluate the full costs and benefits of any such proposals.
8. Promote appropriate use of evaluation methods for local entrepreneurship promotion projects.

Chapter 9 notes

1 Http://www.svv.lt. On the SMEDA website, the OECD policy document is listed under 'policy' in the English language version, but on the Lithuanian language version this section is missing.

2 Shane et al. (1991) discuss this issue in terms of gender and nationality differences.