

## SMES – THE FUTURE OF CEE?

Small and Medium-sized Enterprises (SMEs) account for 99% of entrepreneurial entities in the CEE and employ some 70% of labour in the region (EBRD Transition Report 2017). In some respects, SMEs are already “the present” of the economic activity in the CEE, and are recognised as a vehicle driving economic expansion, social development, innovation and poverty reduction mainly due to their capacity to create jobs (World Economic Forum 2010, p. 491). The Focus Group discussion recognised this capacity and focused on several key aspects for SME’s performance:

- ▶ SMEs variety matters: SME’s capacity to advance economic growth depends on various factors, in an interplay that determines different impacts across countries. If SMEs are generally recognised to be more agile and flexible than large firms in facing market challenges and technological change, they are also recognised for shorter-time orientation and more financial limitations. Different business needs, challenges and behaviour can be distinguished, subject to the company’s activity sector (e.g. agriculture, manufacturing, constructions, trade, services, etc.), development stage (e.g. emerging/start-up or mature business), form of ownership (domestic or foreign), connections with large firms and positions within broader value chains. All these elements in turn influence a variety of micro-economic factors (corporate strategies, business plans, capital investments, access to customers, finance and markets, availability of skilled staff or experienced managers, production and labour costs, etc.) that combine with macroeconomic factors (inflation, unemployment, economic crises, GDP changes) and factors related to the risk of doing business, such as cyberattacks, rising housing prices and interest rates, interstate conflicts, energy price shocks, failures of national governance and continued unstable governments in office (World Economic Forum, 20192).
- ▶ SME’s innovation and technology capacity is essential for maximising growth opportunities: SMEs increasingly adopt (open) innovation in shifting their business to more promising high-tech areas and adopt product and technology innovations more than services and business-model innovations, a recent study shows (Hossain and Kauranen, 20163). SMEs also significantly increase their share of new products considering IP protection, and typically are very selective in that process, patenting innovations that have strong market potentials, in contrast to large firms that patent innovations routinely and sometimes in order to exchange, share and cross-license. However, building innovation and technology capacity in SMEs

is a long and cumulative process that requires financial and human capital investments, and favourable regulatory frameworks. Strategic options, such as the “smart use of ICT” both in manufacturing and in services, to allow companies to interact electronically and seamlessly and enter new markets in global digital supply chains, as well as the uptake of Key Enabling Technologies (KETs)4 that have applications in multiple industries and provide the basis for innovation in a range of products across all industrial sectors, are essential for upgrading SMEs’ innovation and technology capacity.

- ▶ Small is not always beautiful: The productivity gap between average micro and large companies in CEE is 70% (compared to 40% in other EU countries)5. Small firms in CEE tend to be much more varied than their Western European counterparts, with a much higher percentage of low productivity, “zombie firms”, but also a strong group of highly productive stars, which should ideally be able to expand rapidly, drawing not only on their own retained earnings, but also external funding to finance R&D, take-overs, and global expansion. This landscape creates a dilemma for policy-makers. While size-dependent preferential tax treatment, labour or accounting rules may answer specific needs of such firms, it can also discourage growth and expansion, cement inefficiencies and result in more zombie firms holding on to labour that could earn more and produce more elsewhere.

- **Key challenges faced by SMEs (especially in the CEE countries):**

### 1. HUMAN CAPITAL AND AVAILABILITY OF SKILLED WORKFORCE

This is a complex challenge with many roots. On the one hand, there are significant educational system deficiencies that are not satisfactorily addressed (obsolete curricula that are not correlated with labour market needs, or more broadly, societal needs, limited availability of entrepreneurial education in schools and universities, weak mechanisms for technology transfer and commercialization of research results). Consequently, a large share of graduates who come out from the university bench and start their professional career in the private sector often need significant in-house training in company-specific operations, or start their own business with very low levels of management or entrepreneurial skills.

On the other hand, the shortage, or in some cases, the sheer lack of skilled workforce, are also felt at the higher company echelons, or in many family businesses that face the closing

1 World Economic Forum (2010), [The Financial Development Report 2010](#)

2 World Economic Forum (2019), [Regional Risks for Doing Business 2019](#)

3 Hossain, M. and I. Kauranen (2016), Open innovation in SMEs: a systematic literature review, *Journal of Strategy and Management* 9 (1): 58-73

4 A group of six technologies: micro and nanoelectronics, nanotechnology, industrial biotechnology, advanced materials, photonics, and advanced manufacturing technologies.

5 EBRD Transition Report 2017-18

down perspective because there are no successors to take over. This is an effect of the large numbers of both “blue collars” and “white collars” that CEE countries have lost through extensive brain-drain and other forms of economic migration over the last three decades. Outward migration flows have been typically fed by the low salaries that were claimed to maintain a competitive advantage of the region, when in fact their main effect proved to be a continued lock-in into low- and medium-tech specialisation patterns and further widening of development and productivity gaps between the CEE and the West.

Imports of labour force from outside the EU (e.g. Ukraine, Serbia, Vietnam, the Philippines, etc.) may, in some cases, offer a solution to the workforce shortages, but in most cases, the lack of adequate qualifications of such workers, language issues and cultural differences make the integration process all the more difficult and only add to the problem rather than solve it.

## 2. TRANSITION TO HIGHER VALUE-ADDED ACTIVITIES AND INNOVATION-DRIVEN BUSINESS PROCESSES

Such transition is all the more necessary as the penetration of new technologies into all economic sectors is ever increasing, as well as the danger of losing jobs to new automated processes. This requires a broader adoption of e-business methods and modern business models, deeper business integration at the regional, national or international levels, and forging new partnerships with key innovation actors, from universities to large firms on the domestic market or multinationals, and various government agencies. Limited financial flows and difficulties to access external financial sources may raise further obstacles to this transition.

## 3. UNPREDICTABILITY OF THE BUSINESS ENVIRONMENT

Uncertainty about the future has been highlighted as a key obstacle to investments by SMEs in CEE countries in a recent study<sup>6</sup>, and was also confirmed by the Focus Group participants, especially in terms of the political situation, stability of regulations and policies, availability of funding sources and workforce, job losses and negative impacts on the healthcare system, the pensions system, etc.) New regulations (GDPR, tax, accounting, etc.) have also contributed to some confusion.

## KEY POLICY RECOMMENDATIONS

- ▶ Facilitate targeted investments in consolidating the SMEs’ knowledge and innovation base, especially in terms of modern infrastructure, equipment and acquisition of new skills and competences in strategic management, technology and innovation management, and entrepreneurship, to better prepare employees for the challenges of Industry 4.0 and other technological developments.
- ▶ Facilitate interactions between SMEs and large firms in local and international supply chains, in professional networks, clusters, research consortia, etc. in order to create new win-win opportunities and “virtuous circles” for knowledge and technology spillovers.
- ▶ Facilitate improvements and simplification of the regulatory

frameworks, adoption of more effective procedures to allow access to finance and availability of financial advisors to customers. Make sure regulatory environment supports SME growth instead of supporting inefficient SME business models.

- ▶ Encourage inter-regional cooperation and internationalization for stronger integration into regional and global value chains.
- ▶ Facilitate diffusion of information about EU incentives for SMEs, including specific initiatives such as the [SME instrument of the H2020 programme](#) and the [Smart Specialisation Thematic Platforms](#), managed by the European Commission’s Joint Research Centre in Seville. While all the Thematic Platforms are open to SMEs, some are specifically focused on SMEs, such as [“SMEs for Industry 4.0”](#) in the Industrial Modernisation Platform, which aims to increase the absorption of specialised digital services in SMEs.

6 Dr. Anabela Santos, European Commission’s Joint Research Centre, based on data from the [EIB Investment Survey \(EIBIS\)](#), edition 2017/2018. Available at: <https://data.eib.org/eibis/>