

# Entrepreneurship and Competitiveness: The Europeanisation of Small and Medium-sized Enterprise Policy in Croatia

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*This article presents the current position of the small and medium-sized enterprises (SME) sector in Croatia and some selected indicators of the level of entrepreneurial activity. It also evaluates different components of SME policy and performance in the context of Croatia's progress in the European integration process. The main part of the article presents qualitative research findings based on focus group interviews with Croatian entrepreneurs. In conclusion, the main obstacles to effective policy implementation are identified and the role that the Europeanisation of policy can play in improving the process of policy implementation in this field is examined.*

## Introduction

Since the beginning of the 1990s, the development of the *de novo* private enterprise sector has served as one of the main policy instruments underpinning economic growth in many post-socialist emerging market economies. The particular focus within that policy has been on the development of small and medium-sized enterprises (SMEs), which remains one of the main avenues for building a vibrant and competitive private sector in these countries. Support for the SME sector has also become an increasingly important part of the industrial policy of the European Union (EU) over the last decade. The development of SMEs is a central pillar of the Lisbon Agenda to create the world's most dynamic and competitive European economy by 2010. Although this ambition has recently been scaled back in favour of an emphasis on reducing unemployment, the role of the SME sector has, if anything, gained in prominence as it is increasingly recognised that the failure of the Euro zone economies

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to exhibit the desired dynamism, in contrast to the more successful Anglo-Saxon model, is closely linked to the insufficient support given to entrepreneurial activity and to the development of the SME sector. In February 2005 the European Commission re-launched the Lisbon Agenda as the Growth and Jobs Strategy, which emphasises improved support for SMEs (CEC 2005a, 2005b). The new strategy will focus on fewer targets and adopt an action programme in which support for SMEs plays a prominent role. In particular, it will redirect state aid towards sectors with high growth potential, create an SME-friendly business environment and improve regulation in order to reduce the burden of administrative costs. It also focuses strongly on support for innovation by aiming to increase expenditure on research and development (R&D) to 3 per cent of EU gross domestic product (GDP), promoting the uptake of Information and Communication Technologies (ICTs) and developing innovation poles linking regional centres, universities and businesses.<sup>1</sup> The recent opening of membership negotiations with the EU has brought all these issues into greater prominence in relation to SME policy in Croatia.

As part of its drive to develop an EU-wide policy to promote entrepreneurship, the European Commission has encouraged the adoption of the European Charter for Small Enterprises, which sets out indicators of best practice for policy in this field. Croatia endorsed the Charter at the Thessaloniki summit in 2003, indicating the important place of support for SMEs in Croatia's industrial policy. Yet this ambition to promote an entrepreneurial and competitive economy in Croatia is beset by multiple obstacles and policy inconsistencies. In this article, the main obstacles involved are identified and the directions that policy would need to follow so that the SME sector could better contribute to the domestic and international competitiveness of the Croatian economy are highlighted.

Over the last fifteen years, the SME sector in Croatia has played an important role in industrial restructuring and generating new employment. It has been able to absorb, as well as offer employment opportunities to, many of the workers laid off by the large enterprises that have gone through a continuous trend of downsizing employment levels. In 1991, large enterprises employed 75 per cent of the labour force in Croatia—a figure that had dropped to about 35 per cent by 2003 (FINA 2004). By then, SMEs, including the significant craft sector, had increased their share of employment to over 55 per cent—a figure similar to that found in the new EU Member States from Central Eastern Europe (CEE). It also contributed about 48 per cent of the GDP in 2002, and close to 28 per cent of the total value of exports (Croatian Chamber of Commerce 2004). According to the European Commission, the share of SMEs was 99.6 per cent of the number of enterprises and accounted for a 65.7 per cent share of employment. By comparison, the same data for the EU are 98 and 66 per cent, respectively (CEC 2004a).

The SME sector has thus grown considerably in size and scope over the period of transition since the early 1990s. However, the increase in the share of SMEs in employment and GDP owes more to the decline of the large enterprise sector than to a strong pace of new firm formation and the growth of the SME sector as such. Moreover, the stagnation of Croatia's exports and the growth of international debt that has reached

as high as 87 per cent of GDP in recent years have fuelled growing concern about Croatia's international competitive position, understood as the ability of the economy to produce sustained economic growth alongside a broadly balanced external payments position.

This weak performance draws attention to the relationship between entrepreneurship and competitiveness in Croatia. 'Entrepreneurship' here is defined as the activity of risk-taking in economic affairs, with the adoption of a narrow definition of this as the propensity to start up a new firm, and the activities of SME owners and managers in implementing business growth. While we recognise that entrepreneurial behaviour may also be a feature of the large firm sector, we view the SME sector as the one in which entrepreneurial behaviour is most characteristic. Moreover, this sector is of special interest due to its capacity for job generation. This is an additional priority owing to the high level of unemployment, which has hovered around 18 per cent in recent years. We take the position that the low rate of new firm entry and SME growth (entrepreneurship) in recent years has had a direct adverse impact on Croatia's ability to combine economic growth, job creation and external balance of payments (competitiveness). Hence, we argue that the promotion of entrepreneurship is an essential component of a policy designed to improve competitiveness. Of course these effects do not take place in a vacuum, and the Croatian economy is affected by the increasing pace of globalisation and EU integration. We are therefore also interested to explore the extent of Europeanisation of Croatia's SME policy and the impact this is likely to have on the development of entrepreneurship.

In the following sections, the position of the SME sector in Croatia is analysed, some selected indicators of the level of entrepreneurial activity are outlined and different components of SME policy performance are evaluated. We draw on the findings from focus group research among Croatian entrepreneurs carried out by the authors as part of a recent qualitative study of the small enterprise sector (OECD 2003b, 2005). The policy dimensions examined in the field survey are identical to those covered by the European Charter for Small Enterprise and thus could serve as a good indication of progress in the Europeanisation of SME policy in Croatia.

### **Selected Indicators of Entrepreneurial Activity in Croatia**

The creation of new enterprises is an important indicator of a business-friendly environment conducive to the growth of entrepreneurship. However, although the absolute number of firms in Croatia has steadily increased, the gross firm formation rate<sup>2</sup> has not ensured a substantial expansion of new jobs as many newly created firms stay rather small,<sup>3</sup> have modest growth potential or do not survive for long,<sup>4</sup> indicating that there are significant impediments to business growth. The average annual gross rate of new firm formation in Croatia remains rather low, at just above 2.1 per cent per year in the period 1999–2004 (Table 1). The preliminary statistical data for 2005 are more optimistic, though, and show encouraging growth, which hopefully might reverse the trend of stagnating average yearly rates in the last five years.

**Table 1** Firm Formation Rate in Croatia, 1999–2005

	1999	2000	2001	2002	2003	2004	2005
Number of registered enterprises <sup>a</sup>	155,247	156,825	159,211	162,087	165,659	172,141	180,379 <sup>b</sup>
Index, 1999 = 100	100.0	101.0	102.6	104.4	106.7	110.9	116.2
Firm formation rate (%)	1.8	1.0	1.5	1.8	2.2	3.9	4.8

Notes: <sup>a</sup>Trading companies, enterprises and cooperatives (source: *Statistical Yearbook of Republic of Croatia, 1999–2005*, State Statistical Office); <sup>b</sup>Preliminary data for 2005 are from *Monthly Statistical Report*, State Statistical Office, Zagreb, December 2005, pp. 8–9.

The new Member States of the EU have made remarkable progress in transforming their enterprise sectors (through the privatisation of state enterprises and the rapid development of new private enterprises) in order to ensure that their economies are capable of coping with the competitive pressures from the EU. Between 1996 and 2000, the average formation rates of new enterprises were very high in most new EU members and, in most cases, also increasing over the period 2000–2002 (Table 2). One recent study demonstrated that most of the increase was accounted for by micro-enterprises with up to ten employees, and was an important source of economic growth, technological progress and innovation, improved management, and job creation (Radosevic & Mickiewicz 2003). Available comparative data show that by 2002 the formation rate of new enterprises was highest in Latvia at 22 per cent per annum in 2002, and 14.5 per cent in Hungary, 10 per cent in the Czech Republic and 7.1 per cent in Slovenia, while the Croatian enterprise formation rate was only 1.8 per cent. Although the Croatian rate subsequently increased, it is still well below the rate of other countries. Comparisons with the EU Member States are also unfavourable as several of them, including the Netherlands, Denmark, Spain and Italy, have much higher average yearly rates of formation of new enterprises reaching almost 10 per cent in the Netherlands and over 9 per cent in Denmark and Spain in 1999–2002.

There is, of course, another side to this coin. As some analysts of enterprise policy argue, too high firm formation rates might not be very useful or may even be harmful to economic growth—a proposition that calls for caution about the value of policy measures designed to increase business formation rates (Green et al. 2004). Building a competitive enterprise sector surely involves much more than simply increasing firm formation rates. It also involves the development of the preconditions for enterprise growth in terms of market shares, innovation, technological progress, financial efficiency and sustainability of employment levels. In other words, the quality of new firms created is just as important as the quantity, if not more so. Thus, the removal of impediments to the expansion and growth of new enterprises is often much more decisive for the creation of competitive enterprise sector, and at the same time more difficult to deal with as it is a complex structural problem than the removal of mere administrative barriers for the creation of the new enterprises (Bartlett & Bukvič 2002). Apart from

**Table 2** Average Firm Formation Rate in Selected Countries, 1999–2002

	1999	2000	2001	2002
Slovakia	–	10.1	14.9	15.0
Estonia	–	11.2	13.0	11.5
Hungary	–	12.4	12.7	14.5
Czech Republic	–	–	12.5	10.0
Lithuania	–	11.3	11.5	10.3
Romania	–	10.9	11.5	12.6
Latvia	–	16.2	10.2	21.8
Norway	11.4	10.3	10.1	–
Netherlands	9.6	9.4	9.6	–
Denmark	10.9	10.0	9.3	–
Spain	9.6	9.7	9.1	9.3
Italy	7.6	7.8	7.7	7.4
Portugal	8.0	7.6	7.5	6.0
Finland	7.6	7.3	7.2	7.2
Sweden	6.3	7.0	6.6	6.1
Slovenia	–	6.4	6.5	7.1
Croatia	1.8	1.0	1.5	1.8

Source: Schrör, H. *Business Democracy in Europe: Results from 1997 to 2002*, 2005; Eurostat, *Statistics in Focus: Industry, Trade and Services*, 36/2005. Luxembourg, Eurostat.

encouraging dynamic start-ups, it is as important to keep enterprises not only active, but also improve their performance indicators steadily as competitive pressures mount up.

Notwithstanding this, and taking fully into account that the issue of quality of the enterprise sector matters more than quantity, Croatia still needs far more start-ups to address high unemployment levels, although it should be emphasised that the competitive potential of the newly created micro-firms is still rather weak. Fortunately, policy makers seem to be aware of the fact that having high firm creation rates does not solve the problem of the competitiveness of the enterprise sector and therefore seek to ensure improved institutional support for education and training, for the creation of an entrepreneurial culture and for building the general market environment conducive to the growth of productive and competitive entrepreneurship.

The other indicator of the level of entrepreneurial activity often used is firm density (the number of enterprises per capita). Firm density in Croatia increased mildly in 2003 as compared to 2001. It had 37 enterprises for every 1,000 inhabitants in 2003, as compared to 35 in 2001 (OECD 2003a). For comparison, in neighbouring Slovenia the firm density was 57 enterprises per 1,000 inhabitants in 2002.

Another useful indicator is the level of the Total Entrepreneurship Activity Index (TEA Index),<sup>5</sup> which also shows a significantly lower level of newly created enterprises per 100 adult inhabitants. For instance, the Croatian TEA index in 2002 was 3.6 (out of 100), while the Slovenian index for the same year was 4.6, Hungarian 6.6, Ireland 9.1.

The figures for 2004 show a slight increase to 3.7, but nevertheless, according to this indicator, Croatia is a country with rather low entrepreneurial activity (Singer & Lauc 2004: 3).

The relatively low level of new firm entry in Croatia, if continued, could also harm the country's competitive position. The World Economic Forum (WEF) provides evidence on this effect in Croatia based on a composite indicator of the country's competitiveness rank in comparison with other economies. The indicator combines about 200 'hard' and 'soft' variables to measure several dimensions of the national competitiveness rank. The variables are both quantitative (statistical) and qualitative (opinions, assessments) in nature. According to the Annual Report on Croatian Competitiveness, which used the standard WEF methodology, there was a substantial decline in Croatian economic competitiveness between 2003 and 2004—namely, the business competitiveness of the Croatian enterprise sector deteriorated sharply from 52nd place in 2003 to 72nd place in 2004 among 104 countries observed by the survey (National Competitiveness Council 2004: 13). Apart from the low rate of entry of new firms, additional reasons for the decline in competitiveness could be found in unproductive public spending, the low efficiency of the public administration and judiciary, the inadequate efficiency of the financial market and the persistence of corruption. In turn, all these factors affect the SME sector particularly harshly and hamper its potential for growth and expansion.

### **The Financial Performance of the SME sector in Croatia**

In addition to the relatively low entry rate of new firms, enterprise density and TEA index, and the weak competitive position of the Croatian economy in international comparative league tables, the small enterprise sector also suffers from a poor economic performance as measured by a set of financial indicators. Data provided by the financial payments agency FINA indicate that between 2001 and 2004 the share of the small firm sector in total enterprise profits fell from about 50 to 35 per cent. On the other hand, the large enterprise sector has strengthened its position and correspondingly increased its share in the total profits of the enterprise sector from 50 per cent (2001) to 66 per cent (2004). Apart from profits, the large firms are also dominant in various other aspects such as total capital and revenues, and they have also increased their share of employment from 44 to 48 per cent (see Table 3). In sum, as the data show, the performance of the SME sector has deteriorated by almost all financial indicators. However, it is worth mentioning that the medium-sized enterprises form a more robust part of the SME sector and have experienced a significant increase in revenues per employee and after tax profit as well as a somewhat improved total net financial position.

Between 2001 and 2004, the rate of GDP growth in Croatia was relatively high, averaging 4.4 per cent per annum (in 2002 GDP growth peaked at 5.2 per cent, falling to 3.8 per cent in 2004). Judging by the deteriorating performance of the small firms sector in terms of revenue per employee, net financial results per employee and the stagnation in the absolute values of profits, this macroeconomic environment appears to have

**Table 3** Selected Financial Indicators of Croatian Enterprises, 2001 and 2004

	2001			2004		
	Large	Medium	Small	Large	Medium	Small
Number of enterprises (%)	1.0	3.9	95.1	1.4	3.9	94.7
Number of employed (%)	43.8	22.2	34.0	47.7	19.3	33.0
Revenues (%)	48.3	20.8	30.9	59.4	17.8	22.8
In HRK million	164,047	70,645	104,949	287,869	86,053	110,157
Expenditures (%)	48.2	21.1	30.8	58.7	18.0	23.3
In HRK million	161,249	70,588	103,039	276,217	84,534	109,726
Profit (after tax) (%)	50.6	18.5	31.0	65.5	15.4	19.1
In HRK million	7,376	2,697	4,519	14,940	3,507	4,354
Loss (after tax) (%)	47.2	24.1	28.7	43.4	19.6	37.0
In HRK million	5,701	2,911	3,467	5,660	2,559	4,820
Long-term assets (%)	74.5	12.8	12.7	74.6	11.6	13.8
Revenue per employee (in thousands HRK)	520	443	429	744	550	410
Net financial result/revenues (%)	1.2	-0.1	1.2	3.2	1.1	-4.6
Net financial result in HRK million	1,675	-214	1,052	9,280	948	-466

Note: absolute values in italics.

Source: FINA (2001, 2004).

benefited the large and medium-sized firms far more than the small firms. The general message of this analysis is that the SME sector is more exposed to the general trends in the economy, but also to the deeper structural problems, than the large firm sector, and continues to be more vulnerable. This is a further reason justifying the provision of special horizontal measures and institutional framework to provide support to the sector, and to strengthen its ability to weather the downturns of the economic cycle, in particular through measures such as the provision of effective training, advice, counselling, information and networking support. In order to improve the competitiveness of the SME sector, there is a need for urgent action in three areas: to speed up structural reforms that are linked to the process of transition and EU integration; to make improvements in a number of areas including cost competitiveness, public administration and expenditure, innovation and the creation of a more attractive business environment; and to develop the scenario and platform of negotiations with the EU (see National Competitiveness Council 2005).

### The Institutional Framework for SME Policy in Croatia

The Croatian government has recognised the importance of the SME sector as an engine of economic development and job creation and over the last five to six years it has taken a more pro-active approach in creating an institutional environment conducive to the



growth of SMEs.<sup>6</sup> Croatia now has a rather well-developed and diversified institutional support structure for the development of the SME sector on national, regional and local levels, especially when compared to the rest of the South East Europe (SEE) region, as revealed by various studies.<sup>7</sup> Recent OECD studies (OECD 2003b, 2005) confirmed encouraging progress in the strengthening of support structures at the local and regional level due to the activity of regional development agencies and business support centres and incubators. However, SME owners and managers who participated in focus groups on this issue in 2004 claimed that the effectiveness of these agencies had deteriorated.

A major contributing factor to the poor perception SME owners and managers have of the effectiveness of policy implementation is the impact of the abolition of the previously successful Ministry of Crafts and Small and Medium-sized Enterprises. The functions of the previous ministry have recently been transferred to a department of the newly formed Ministry of Economy, Labour and Entrepreneurship. The leading personnel of the former ministry have been largely replaced with new personnel. The interviewed SME owners and managers believe that this reorganisation has obscured organisational responsibility for SME policy since the Directorate for SMEs now operates as a subordinate part of the very large new ministry. The OECD study, based on focus group interviews with entrepreneurs throughout the country, found in particular that communication and consultation with the business community on SME policies had not improved significantly, that the government strategy for SME development was broadly assessed as being 'poor', and that the aim of creating 400 business zones was considered to be far too ambitious.

The Croatian Agency for Small Business (HAMAG) was established in 2003. It implements and coordinates the provision of various incentives, guarantee schemes, loans and loan interest subsidies, consultancy and education for SME development. It is expected that the HAMAG would take a more profound role in supporting the SME sector in the future. In 2004, the Agency focused on achieving progress in two particular areas: the simplification of procedures for the provision of guarantees, and the development of an efficient network and certification of consultants. An 'Incentive Programme for SMEs' was adopted in May 2004 to promote production and exports by SMEs. The programme has set several new strategic goals for encouraging SME development in the medium-term:

- A more equal development of all the Croatian regions.
- Increasing the number of SMEs (TEA Index).
- Creating new entrepreneurial zones.
- Removing administrative obstacles.
- Increasing the competitiveness of the various sub-sectors through investment in enterprise development, education and new technologies.
- Changing the structure of activities in favour of manufacturing activities.
- Strengthening the export orientation of the sector.
- Creating a positive entrepreneurial spirit and culture.
- Networking within the small business sector as well as between SMEs and large companies (developing networks, cooperatives and clusters).



- Increasing the number employees in crafts from an average of 1.4 to 2.
- Reducing the tax burden.
- Including youth, women and war veterans in entrepreneurship activities.
- Developing additional education and training programmes for entrepreneurship.

The ambitions set out in this policy agenda are well-directed and address some of the main problem areas that have faced the SME sector in recent years. If effectively implemented, it could potentially reverse the relatively weak position of the small enterprise sector in the Croatian economy. However, as the research reported in subsequent sections reveals, the government has a long way to go in order to realise this ambitious programme.

### **The Regulatory Environment**

The present regulatory framework for the enterprise sector is generally considered to be in line with a functioning market economy. However, despite significant progress in 2004 in adopting a number of laws as well as various codes and practices guiding market behaviour, problems remain, particularly relating to enforcement, inconsistency and sometimes over-regulation. There is scope for further improvements especially in the context of harmonisation with EU legislation. The strong external pressure for the continuous improvement of the regulatory framework affecting business in Croatia will continue, especially since the process of negotiations for full membership in the EU began in the autumn of 2005.

The procedures for company registration mainly conform to standard EU practices and do not present crucial legal or administrative barriers to business start-up (World Bank 2004; CEC 2004; FIAS 2002). However, due to inconsistency and inefficiency in the application of these procedures by the public administration at both central and regional levels, company registration is still slower than in the EU and the most advanced transition countries (Table 4). Although there have been some improvements in the regulatory environment, including amendments to the Law on Commercial Companies that were adopted in July 2003, the administrative system is still highly bureaucratic and there are still significant costs and delays in starting a business. These administrative obstacles include:

- Inconsistency and inefficiency in the procedures for company registration.
- Difficulties in obtaining licences, permits and certificates.
- Lack of online registration of enterprises.
- Lack of a single reference number for each enterprise.
- Limited progress by the Inter-Ministerial Task Force on Removing Administrative Barriers and slow implementation of its Action Plan for Reducing Business Barriers.
- Slow pace of reform of registries for land, real estate and other property.

Business simplification task forces have been established, but progress has been limited (OECD 2005), while the grey economy, bribery and corruption continue to hinder small business growth (Ott 2002). Several surveys identify the lengthy administrative

**Table 4** Business Registration Data

	Albania	Bosnia and Herzegovina	Croatia	FYR Macedonia
Days to register a company	47	54	49	48
Number of procedures	11	12	12	13
Days to register a property	44	331	956	74

*Source:* World Bank (2004: 97–120).

procedures required for business start-ups. The OECD study reveals that in order to register a limited company in Croatia, a business founder may need as long as 50 days on average. The 2004 survey on implementation of the EU Charter for Small Enterprise (CEC 2004b) reveals that one may need from 14–120 days depending on the type of company to be established.

The data from the World Bank survey (2004) are similar to the OECD study with regard to the time needed for the registration of a new company in SEE, but most discouraging is their data related to the registration of property—especially for Croatia, where it could take up to 956 days due to the present state of property registers. According to recent surveys, land acquisition, registration and site development are still the most complicated parts of starting a new business in Croatia, and continue to impede the higher inflow of foreign investment. The procedures are bureaucratic and time-consuming, but the key issue is the chaos in land and cadastre registry, which is now being tackled with World Bank and European Commission assistance and is expected to come to fruition by 2007. A report of National Competitiveness Council (2004) suggested that the time required for registration should be substantially reduced if the government wants to achieve its goal of increasing the number of new enterprises. The recently established ‘One-Stop-Shop HITRO’, which was set up in May 2005 with offices in Zagreb, Rijeka, Split and Osijek, is an important step forward. Initial reports indicate that the average time for establishment of a new company has been reduced to less than two weeks.<sup>8</sup>

### **Tax policy**

Tax incentives have been introduced to encourage R&D, and specific tax incentives have targeted economically depressed regions. The government introduced additional tax incentives for new industrial enterprises under the ‘Programme for the Development of Entrepreneurial Zones’ (May 2004). This included the abolition of property tax and a reduction in profits tax, as well as further reductions in income tax rates in the Areas of Special State Concern.<sup>9</sup>

Most analysts believe that the present tax system encourages business development and entrepreneurship in Croatia. This is because of the fairly low profit tax rate and the various income and profit tax exemptions and incentives set out above. The participants in a series of focus groups conducted in 2004 mostly indicated that the system is stable and transparent (OECD 2005). The new R&D tax incentives are very

attractive and should encourage a considerable increase in R&D if the regime is administered in a non-bureaucratic manner. The value-added tax (VAT) refund period has been reduced, which represents an important improvement in the field of small business finance. Simplified procedures exist for tax reporting and tax refunding for small and micro enterprises, though there is room for further improvement in the information and training for entrepreneurs and online submission of tax returns.

However, the focus group research confirmed that most SME owners and managers believe the tax system should be more attuned to their specific needs. There is a perception among the SME business community that the tax system reflects the interests of the large enterprise sector that dominates the economy. Although in principle the system is neutral and treats all enterprises equally regardless of size, large enterprises are, in practice, able to exercise considerable influence over changes and reforms to the tax system in a way that small enterprises cannot. The tax burden is considered too great by many entrepreneurs, especially when it comes to the level of social contributions, which increases labour costs and contributes to the view that labour intensive small firms are relatively uncompetitive compared to larger firms. Several SME owners and managers in the focus groups proposed that special tax incentives should be provided to encourage fast-growing, export-oriented and technologically advancing SMEs in order to build a dynamic and regionally competitive enterprise sector capable of coping with the competitive pressures from EU companies. They expressed the view that too much attention is given to pampering the micro start-ups, while inadequate attention is paid to companies with growth potential, especially in technologically innovative and knowledge-based sectors.

### **Financial Instruments for Fostering Small Business**

Croatia has a relatively advanced financial sector. In this area it is the most developed country in the SEE region and compares well with the new EU accession countries. The range of sources available to finance for SMEs has continued to develop. There has been a substantial increase in the amount of state budget funds available to provide financial support to SMEs. The government lending schemes to the SME sector have been expanded and new ones introduced, such as those targeted at enhancing female and youth entrepreneurship.

A number of problems remain in policy design and implementation of subsidised long-term credits to SMEs that have affected the performance of the support programmes and contributed to the critical views expressed by the focus group participants (OECD 2005). Participants highlighted the lack of transparency and insufficient coordination of the institutions in charge of implementing the various programmes and measures, and the burden of bureaucratic procedures to obtain the subsidised funding. Cautious lending practices adopted by the domestic banks since their restructuring and privatisation and a higher degree of risk aversion as compared to the pre-crisis phase have also contributed to the relatively slow implementation of the government's programmes. Additionally, the Croatian National Bank in early 2003

introduced measures to limit credit expansion due to mounting external imbalances. This seriously affected enterprise access to bank finance and consequently the share of credits directed to enterprise fell more sharply than those to citizens. This may be why focus group participants indicated that bank lending policy to the SME sector has become more conservative in recent years despite the overall growth in bank lending to the private sector (OECD 2005). Another reason may be that while the supply of short-term bank finance for SMEs has been increasing, the provision of long-term bank finance remains insufficient to meet the development potential of the SME sector. Overall, demand for finance from the SME sector still exceeds supply (OECD 2005). Despite the development of the banking sector, the main sources of finance for Croatian SMEs are still entrepreneurs' own funds, and loans from family and friends. The focus groups indicated that the financial sector is not sufficiently responsive to the needs of micro enterprises and SMEs. Loan application processing times are rather long, ranging from two weeks to two months. In addition, access to venture and equity capital is poor and there is considerable potential for the development of venture and seed capital funds. Business Angels as a mode of finance for SMEs do not exist in an organised manner.

A healthy, profitable financial sector is needed to provide access to finance for SMEs on a sustainable basis. Profitable private financial intermediaries are a necessary link between domestic savings and investment by private sector enterprises. Despite the positive trend of deepening bank intermediation, increasing liquidity and decreasing real interest rates, the private sector still regards the risk-averse approach of banks and the cost of obtaining bank finance as major obstacles to doing business. Some of the focus group participants suggested that mutual guarantee schemes could be adopted to deal with the current phase of high risk-aversion of the restructured and privatised local banking system. These have been successful in the more developed OECD countries.

### **Advisory Services for Small Business Development**

In recent years there has been improvement in the availability of advisory services for newly formed enterprises—particularly for small businesses. However, the long-term financial sustainability of business advisory services, especially in remote locations and economically disadvantaged regions, is insecure. In 2004, HAMAG began to build up a network of certified consultants. However, trust in and certification of consultants remains a problem and there is scope for an improvement in the quality of the service and advice provided. An intensive development of business advisory support services began in the mid-1990s (Franičević & Bartlett 2001). The number of business support centres has further increased in recent years as a result of funding programmes at different levels. Most were founded with support from local or county authorities, interested private enterprises and international donors. The former Ministry for Craft, Small and Medium-sized Enterprises provided funds through the Programme of Support for SME Development for the creation of entrepreneurial zones, business incubators and business support centres.

The current government also encourages the development of support institutions, in particular, through the provision of entrepreneurial zones, regional development agencies and business incubators. However, most of the focus group participants and experts consulted considered that the government's policy of creating 400 business zones (GRC 2004a) to be far too ambitious and doubted that Croatia really needs so many zones, bearing in mind that the present 114 zones only operate at between 30 and 50 per cent of their capacity. They believed that a more useful policy would be to focus on improving the operation of existing zones lacking good infrastructure facilities and to provide better advisory support within them in order to exploit fully their operational capacities. Most business support centres face significant challenges relating to their financial sustainability, the appropriateness of their geographical location and the retention of experienced human capital. There are, however, several examples of improvement in the range and quality of services provided. For instance, some of the centres have grown into regional development agencies. The most recent of these is the Medimurje Entrepreneurship Centre, which was transformed into Medimurje Regional Development Agency following the role model and best practices of the Istrian Development Agency.

### **Business Clusters and Incubators**

Inter-firm cooperation and clustering are recognised as important ways to enhance SME development by many of the governments in the SEE region (Bartlett et al. 2005). The National Competitiveness Council (2004) also recommended these policies, and Croatia has issued a tender to provide grants up to €10,000 to promote clustering activities covering the costs of business plans, studies, joint market approaches, development of ICT and databases to facilitate clustering. So far, only a few projects have been initiated, including two in the furniture industry in Zagreb and Vinkovci, and one in the metal industry in Osijek (Singer & Lauc 2004). The Croatian Wood Cluster was initiated in 2002 with the assistance of USAID and has twenty members, while the Vinkovci wood cluster initiated in 2004 has fifteen members. The metal industry cluster, initiated in Osijek in 2003, promotes cooperation between a growing mid-sized company and fifteen smaller firms.

The government's policy of supporting the development of business incubators has achieved some good results. Several new business incubators have been established as a result of the 'Special Funding Program for Enhancement of Development of Business Incubators' initiated by the former Ministry of Crafts, Small and Medium-sized Entrepreneurship, which approved more than HRK7 million in incentives for the operation of business incubators in 2003. The business incubators are often part of other SME support institutions, such as entrepreneurship centres and technology parks. This can make the precise categorisation of these institutions rather difficult. On the negative side, the focus group respondents claimed that information on business incubators is not readily available and the services they offer are not sufficiently specialised. According to OECD (2005) there are about twenty business incubators out of which fifteen are

fully operational in Croatia, while the European Commission puts the number at eighteen (CEC 2004b: 29).

### **Education, Training and Research**

The present education system does not support rapid development of an entrepreneurial culture in Croatia (see National Competitiveness Council 2005; FINA 2004). The report of the National Competitiveness Council recommended that entrepreneurial behaviour be embedded throughout the education system, and that basic entrepreneurial knowledge be incorporated into the curricula as early as primary and secondary schools. It also recommended that the activities of graduate business schools be improved in this respect. Training programmes targeted at SMEs have increased in number in recent years. However, they are still inadequate to meet the needs of entrepreneurs, especially when it comes to acquiring more specialised knowledge such as the development of business plans, new product development, technology requirements, management skills, marketing and financial management.

Until recently, investment in education, R&D and advanced technology was not adequately recognised by the government as a key contributor to economic growth, but this is changing. Support programmes for crafts and SMEs often lack incentives for investment in advanced technology and knowledge-based production and services. An important step was made in 2003 with the introduction of special tax benefits for R&D expenditures in the business sector (see above). EU candidate-country status should also significantly contribute to the expansion of the technological base of the country, not only by stimulating R&D activities, but also by creating a framework for the cooperation of Croatian companies with EU partners that could result in a significant transfer of new technologies.

A recent survey of the European Commission (CEC 2005c) presented indicators of the capacity for innovation in EU members and four SEE countries (Bulgaria, Romania, Turkey and Croatia). Croatia scored just above average for innovation in new services and products, an important driver of competitiveness. However, it is important to mention that both Turkey and Romania belong to the group of highest innovators (together with Slovenia, Luxembourg, Malta and Slovakia), which means that Croatia's position is below that of several of her neighbours.

### **Europeanisation of SME Policy in Croatia**

The Croatian government endorsed the European Charter for Small Enterprises at the Thessaloniki summit in June 2003. The Charter has initiated a process of open coordination of SME policy for the Western Balkans. Annual country reports are prepared that focus on the implementation of SME policy in the region against a set of targets, some of which are common to all and some specific to each country. The annual reports are based upon a standard questionnaire delivered to the governments of each country. Each year a common report is drawn up that assesses the progress made in meeting the targets and setting targets for the next year. In 2004, the first regional

report set a total of 41 targets. The Charter is a 'soft' instrument and there is no legal obligation for harmonisation with Charter targets. The aim is to encourage the dissemination of best practices from EU Member States in the area of small business policy. The fourth meeting of the national coordinators of the Charter in the Western Balkans was held in Albania in March 2004 and launched the 2004–2005 implementation cycle. The second regional report published in January 2005 raised the number of targets to 56. By joining in this process modelled along the lines of the 'Open Method of Coordination' adopted in the EU for this and other sectoral policy areas, Croatia has entered into a significant process of Europeanisation of its SME policy.

As it turned out, Croatia made limited progress in achieving its targets for 2003–2004. For 2004–2005, additional targets were set for education and training, start up, skills, taxation and finance, and e-business. What is most striking about these targets is the detail with which they are specified. According to the assessment of the Commission, the open coordination process is leading to significant policy change as a result of peer pressure arising from the ambition of countries to close performance gaps with their neighbours. According to the Commission, the 'Charter is ... playing a very constructive role, allowing governments to take stock of national policies, to discuss these with stakeholders and to plan new policies and to set new objectives in an annual, cyclical process' (CEC 2005d: 39). The Commission further envisages that Croatia will be able to use this process to access policy advice and good practice experience from the EU Member States—a process of policy transfer that will be enhanced through future participation in Community Programmes. The process has become even more relevant since the opening of Croatia's accession negotiations in October 2005. The implementation report on the Charter process for 2006 concludes that Croatia is among the leaders in introducing reforms to SME policy, driven by the Charter process (CEC 2006).

Further Europeanisation of Croatian SME policy is also part of the government priorities identified in the 'Pre-Accession Economic Programme of Republic of Croatia, 2005–2007' (GRC 2004b). The government has identified the following areas that need to be further synchronised with the EU Charter for Small Enterprise benchmarks:

- Development of the strategy for enhancing competitiveness of the small enterprise sector.
- Ensuring access to diversified sources of finance.
- Promotion of education and training for entrepreneurs.
- Adjustment of legislation with the new EU definitions of small business.
- Enhancing support services for entrepreneurs.
- Promotion of youth and women's entrepreneurship.
- Improving online access to the various sources of information on entrepreneurship.
- Initiating an impact assessment of the legislative framework on SME development.

In March 2005, the government also decided that the Ministry of Economy, Labour and Entrepreneurship should start working towards including Croatia in the EU's 'Multi-annual Programme for Enterprise and Entrepreneurship' in particular for



SMEs, in order to improve access to information and learning from the best SME practices and legislative solutions in the EU.

## Conclusions

Although there has been strong political support for the development of the SME sector in Croatia, the economy continues to suffer from a problem of long-term weakness of international competitiveness (National Competitiveness Council 2005), which has led to persistent balance of payments deficits and growing international indebtedness. While the strengthening of the SME sector is not the only way to support improvement in competitiveness (large firms naturally also make a significant contribution), the SME sector arguably plays an indispensable role. In particular, the entry of new small enterprises provides constant pressure on existing firms to cut costs and increase productivity, while the growth of SMEs underpins the economy's ability to create new jobs. In addition, the SME sector has an important role in the process of invention and diffusion of innovation, and in establishing competitive national innovation systems.

The Croatian government has over time made great efforts to promote the SME sector, and for several years supported a dedicated government ministry for SMEs. Although this has recently become part of a larger ministry, the government has continued to initiate new programmes of support for the SME sector—most recently as part of its development priorities for 2003–2007. A range of government programmes to support the SME sector have been introduced by both the current and previous governments. These have included the 'Programme of Support for SME Development' and the 'Special Funding Programme for Enhancement and Development of Business Incubators' introduced by the previous government, and an 'Incentive Programme for SMEs' and a 'Programme for Development of Entrepreneurial Zones' adopted by the current government.

Several positive achievements resulting from these and other policy initiatives and efforts have been identified in this article. Procedures for company registration are in line with EU standard practices, tax incentives have been introduced to support R&D, the banking sector has become more and more integrated into EU capital markets, the number and range of advisory services has been improved, the policy of supporting business incubators has achieved some positive results and the government has adopted the European Charter for Small Enterprises. The results of the OECD survey and the EC questionnaire demonstrate that the Croatian government has put in place a relatively strong policy framework to support SME development. It also has a rather well developed and diversified set of support institutions at the local level.

Nevertheless, despite all this policy effort, the rate of new business start-up remains very low, even though improvement is still far behind that in the new CEE EU Member States and other SEE EU candidate states. The competitive performance of small firms remains weak and in fact appears to be falling further behind that of other sectors of the economy according to recent financial indicators. There is therefore a puzzling gap

between the relatively well-developed SME policy and the relatively poor SME performance in Croatia.

In explaining this gap, four main problem areas stand out from the focus group research. First, until recently, SME policy has been oriented to support for existing firms rather than encouraging new firm start-up. Since the establishment of the 'One Stop Shop' in May 2005, procedures for company registration have improved significantly. Nevertheless, significant problems in registering new businesses are still in evidence. In particular, the time taken to register a property is by far the longest of any country in the region. There are some improvements in this area, but this problem will be solved fully only with the completion of current reform of cadastre and property registers, which should be carried out by 2007. Second, although there is a relatively developed financial system, entrepreneurs still have many problems obtaining long-term finance, and demand for finance from the SME sector still exceeds supply. There is a noticeable gap in the development of venture capital funds and the institution of Business Angels is almost completely absent. Third, despite the development of dedicated advisory services and business zones for small businesses, many of these institutions lack adequate infrastructure and advisory support and entrepreneurs consider that existing facilities should be improved before yet more new facilities are created. Fourth, the development of entrepreneurial culture is not sufficiently supported by the systems of education, training and transfer of technology to the SME sector.

In order to develop an economy capable of facing up to, and benefiting from, the competitive pressures that future EU membership will bring, action should be taken to improve the implementation of these policy areas for small business development. The focus should be on the creation of a business environment that would further reduce the barriers to entry of new firms, facilitate faster market exit, improve access to sources of long-term finance, consolidate the support infrastructure and create stronger linkages between research institutes and SMEs to promote innovation. The involvement of the Croatian government in the European Charter for Small Enterprises, and Croatia's greater integration into EU programmes to support the SME sector as negotiations for EU membership move forward will most likely have a major positive impact in all these areas. The Europeanisation of SME policy in Croatia is therefore a positive development. However, Europeanisation is unlikely to be effective in itself, and the main challenge facing the government will remain the implementation of policy beyond the design stage and into practice.

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## Notes

- [1] There are of course many other elements in the competitiveness story, including the key role of systematised innovation, which is necessarily carried out by the large industrial corporations. However, as Baumol (2004) has recently emphasised, the SME sector has a crucial role to play in the innovation process, especially as the source of new breakthrough inventions that are typically taken up to be developed and diffused throughout the economy by larger companies.
- [2] The gross firm formation rate is the annual growth in the number of registered enterprises. A more sophisticated indicator based on an extensive sample survey of enterprises is constructed in Eurostat (see CEC 2002). It takes into account the enterprises that are not only registered, but active. However, such a survey has not yet been done for Croatia. A more useful indicator of entrepreneurial activity is the net firm formation rate, which is the difference between the number of firm births and the number of firm deaths divided by the stock of firms in existence at the start of the period. We do not use this indicator in this article due to data deficiencies in Croatia.
- [3] In Croatia, the average number of employees per entrepreneur in 2002–2003 was 6.5 (Singer & Lauc 2004)
- [4] Many of registered companies exist only ‘on paper’ and are not active. Only about 40 per cent of existing firms are economically active. The exit of firms is a rather slow process due to the inefficient procedures of the bankruptcy courts and the weak enforcement of bankruptcy regulations.
- [5] The Total Entrepreneurial Activity Index (TEA) measures the number of newly established companies in relation to the adult (ages 18–64) population of a country over the past 42 months. The index is calculated within the Global Entrepreneurship Monitoring Project (GEM) of London Business School and Babson College Boston (GEM 2003).
- [6] The policy for SMEs is an integral part of official government documents on economic development programmes, 2000–2004 and 2004–2007. For details see: <http://www.vlada.hr>.
- [7] Similar conclusions are drawn in GEM (2003), Čučković, (2005), CARDS (2004) and Singer and Lauc (2004).
- [8] *Vecernji list*, 16 August 2005.
- [9] The Areas of Special State Concern cover the war-affected areas of Croatia and some municipalities and towns outside those areas that are for other reasons poor and underdeveloped.

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