

THE DYNAMICS OF THE SME SECTOR AND THE BUSINESS ENVIRONMENT IN ROMANIA IN THE EUROPEAN CONTEXT

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ABSTRACT

Although economic theory has not fully agreed whether the growth and consolidation of the SME sector causes, or is a result of economic growth, there are consistent arguments that certain characteristics of the business environment can positively influence the entrepreneurial business sector, enhancing its contribution to economic growth, employment and innovation. In the process of economic integration, the European Union (EU) recognizes the importance of SMEs for economic development, and supports this sector through numerous policies, funds and strategies to create a friendly business environment, enabling them to perform at the highest standards. As a member of the EU since 2007, Romania has made significant efforts to adjust its policies and strategies to the single market, to create a better framework for starting and developing new businesses, facilitating companies' access to financial and human resources, to market opportunities and internationalization. In this paper, by using a series of data from various business surveys and statistics, we attempt to identify a relation between the dynamics of the SME sector and the quality of the business environment (reducing bureaucracy and administrative burden, business freedom etc.). The findings are mixed: despite strong opinions in favour of a positive relationship, there is only a moderate correlation between the quantitative growth of the SME sector, the creation of new firms, and the business environment improvements.

KEYWORDS: business regulations, Romania, Small Business Act, SMEs, start-ups.

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1. INTRODUCTION

The importance and role of small and medium-sized enterprises (SMEs) in the economy and society, the value of private initiative, the goal to set up new businesses, the need of measures to support and encourage the creation of new firms are fervently debated topics in academia, as well as by practitioners and decision makers. It is assumed, almost inflexibly, that the expansion of the SME sector implicitly leads to economic growth, prosperity, that the gradual transformation of the administration into one that is responsible and sensitive to business needs, as well as financial or non-financial support measures, can only accelerate and strengthen this process, and the mutual effects will rapidly appear.

The perspective is, however, very optimistic, and an important part of economic research (less so in the political discourse) calls into inquiry these relationships considered immutable, and demands for more analysis and argumentations in this area. There is no doubt that the SME sector needs to be

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supported, that the establishment of new companies, especially in innovative dynamic sectors, the experience and ideas of capable people, should be encouraged, but what kind of measures should be taken, what is their degree of selectivity and what indicators can accurately show us the effects of these measures and their interrelationships? What measures, sectors or policies should we abandon or reform, and what are the most effective areas and policies for the future?

In this paper we aim to identify, in the case of Romania, what are the expectations of entrepreneurs on the business environment and the quality of regulations, but also the relationship between the evolution of the number of SMEs and start-ups, on the one hand, and the evolution of indicators of the business environment (parallel economy, control of corruption, quality of regulations, level of bureaucracy, index of business freedom, cost of starting a business), on the other hand. We consider the identification of a model able to predict more clearly the influence of these factors on the development of the small and medium business sector, and in particular of start-ups, has valuable theoretical and practical values both for the economy of this country and for the analysis of the effectiveness of support measures in the field of SMEs, promoted within the European Union.

2. THEORETICAL BACKGROUND

The establishment, growth and consolidation of SMEs are an eagerly debated topic in the economic literature, at least because they are related to the survival and development of existing companies, as well as to the replacement of those that disappear from the economic landscape, and the share of SMEs is often used as a suggestive indicator for the effervescence of the business climate (Acs & Armington, 2004; Lee, Florida, & Acs, 2004; Lee & Hicks, 2011). Also, the number and dynamics of firms, their size, are closely related to employment, and have a major impact on government budgets and individual or household incomes.

Another factor that underlies the importance of analysing companies and their dynamics is their effect on economic growth. Downstream or upstream influences, and their size and persistence over time are associated with the evolution of active firms, their ability to recover and capitalize on opportunities, their resilience and availability for innovation (Wong et al., 2005). Business growth is frequently associated with innovation and technological change. The survival, growth and consolidation of companies is not only an effect of quantitative accumulations, but rather to the incorporation of new technologies, an open attitude towards innovation, whether technical, managerial or commercial (Audretsch, et. al 2005; Thornhill, 2006), through the dissemination of knowledge (Becattini, 1990). Moreover, empirical evidence suggests that the externalities of knowledge provide relevant explanations for spatially unequal economic and innovative performance (Jaffe 1989; Acs et al. 1994; Acs et al. 1992; Feldman et al. 1999). The evolution of the number of existing companies and new entrants determines the concentration and competitiveness of the market. Studying the evolution of firms can shed light on the importance of the selection process after a firm has entered the market (Audretsch et al, 1995; Jovanovic, 1982), a process by which less efficient firms reduce their size and disappear, and the most effective survive and grow.

Last but not least, the evolution and dynamics of the number of companies has practical consequences on policies and support measures aimed at increasing employment and boosting economic activity. Disparities in entrepreneurial activity between countries (or regions) can be explained by the quality of their support institutions Baumol (1990 & 1993). The pressure and abundance of regulations (probably well-intentioned initially) can also generate net negative effects for the establishment and survival of existing companies (Henrekson, 2007). In countries with a complicated regulatory environment, with high labour taxes, business development is more difficult and riskier, so they prefer to stay smaller (Gudici et al., 2000). The pressure of the institutional framework will often prove more harmful for smaller and more entrepreneurial employers, compared to larger firms (Henrekson, 2007).

This is because existing entrepreneurs have acquired certain skills and routines to cope with this complicated and often corrupt environment, perceived as extremely uncertain and pessimistic by potential entrepreneurs (Estrin, et al., 2013; European Commission, 2020; Marian et al., 2022). Higher levels of corruption, less effective protection of intellectual property rights, will have a negative impact on entrepreneurship, while a favourable business environment, with institutions that support entrepreneurial activities, with a system of governance based on transparency and trust, will positively influence the desire to start new companies and will enhance the impact of entrepreneurship in the economy and society (Baumol, 1993; Davidsson, 1995).

3. THE ROLE AND IMPORTANCE OF THE SME SECTOR IN THE EUROPEAN UNION AND ROMANIA

The role of SMEs in economic development, employment, generating income for entrepreneurs, employees or local or national budgets, in stimulating innovation and the dissemination of knowledge, skills and technical progress is obvious, but simply proclaiming and adhering to these values does not automatically mean the transformation of the SMEs sector into a high-performance one, a real driver of development. The European Union recognizes this role and not only asserts it insistently, but also supports it through numerous measures, funds and strategies to create a business-friendly environment and help SMEs to perform at the highest standards. At the heart of the European Commission's action is the Small Business Act (SBA), which provides a comprehensive policy for SMEs within the EU and member countries. The SBA promotes the "Think Small First" principle for all actions and measures that focus on, or influence, the SME sector and it has the ambition to awaken and empower the entrepreneurial spirit among European citizens (Commission of the European Communities, 2008).

Some key elements stand out from the analysis of the last years following the crisis period, regarding the role and importance of SMEs in the economy of the European Union states. First, the contribution of SMEs to growth in value added and employment has exceeded expectations based on their relative importance in the economy, but the performance across the EU has continued to vary. Second, grounded on strong economic growth, between 2014 and 2016, the number of EU-led growth-oriented firms increased by 24%, but about two-thirds of them came from just six EU Member States, namely Germany, United Kingdom, Spain, France, Italy and Poland (European Commission, 2019a). Third, the outlook for the coming years remains positive, but somewhat uncertain due to international conditions and the recent global pandemic crisis. Fourthly, the Single Market is proving its importance and special attractiveness for EU SMEs. In 2018, it accounted for 70% of the value of SME exports, with about 80% of exporting SMEs trading in other Member States, although in many reports and analyses the economic importance of the indirect contribution of SMEs to export is frequently underestimated (European Commission, 2019a). Developments at the EU level are not evenly reflected in the Member States. Overall, however, SMEs have made a significant contribution to the further recovery and expansion of the EU economy. They accounted for 47% of the total increase from 2008 to 2017 in value added generated by the non-financial business sector, and 52% of the aggregate increase of employment in this sector (European Commission, 2019a).

Start-ups and scale-ups (young companies with an average annual profit of at least 20% in the last 3 years with at least 10 employees) have fully benefited from the economic growth of recent years. There are signs of healthy development in the still small segment of growing businesses, especially fast-growing businesses based on innovative products and a clearly designed growth strategy (European Commission, 2021), an optimistic signal for the future (Badulescu et al., 2020) although the EU is still lagging behind dynamic partner regions and countries, such as the United States. We also cannot expect that the very favourable economic conditions in the EU, that have fuelled the recent advance of growth-oriented companies, will be maintained for a long time in future. Also, the

2019's forecasts predicted that value added in the non-financial business sector in the EU-28 would increase by a similar ratio both in 2020 and 2021. However, the current global pandemic crisis seriously calls this scenario into question. The same goes for employment for EU-28 SMEs, which was projected to increase by 1.3-1.5% in 2020-2021. This positive outlook is also subject to already known risks such as the consequences of Brexit or potential international trade disputes (European Commission, 2019a; European Commission, 2021). At this stage it is difficult to assess the impact of these factors on EU SMEs.

Following the accession to the EU in 2007, Romania has made significant efforts to adapt policies and strategies to the single market, to support and develop new businesses and strengthen existing ones, facilitating access to financial and human resources and market opportunities. Shortly after accession, Romania was affected by the international economic and financial crisis, and the declines of the main macroeconomic indicators were consistent. However, throughout the analysed period (2007-2020), Romania's economic development was remarkable, GDP per capita in 2020 is over 70% compared to 2007 (World Bank, 2020), in a deep restructuring process of the whole economy. A large part of the economic and social progress and transformations of this period are related to SMEs, a key element in the Romanian market economy.

However, Romania's SMEs sector has a number of weaknesses, underperforming relative to EU standards and averages, which have yet to be addressed and improved in order to resume development and catch up with the better-placed European countries. Although the SMEs sector performs well in terms of entrepreneurial intentions, business growth expectations or the rate of starting a new business, the new companies do not have a significant effect on employment. At the end of 2020, more than 622,000 SMEs were registered, representing about 99.8% of all companies, of which 89% were micro-enterprises, 9% were small enterprises and 2% were medium-sized enterprises (National Institute of Statistics, 2020). The SME sector in Romania generated about 66% of private sector employment (slightly below the EU average of 66.6%) and contributed about 53% to the value added in the economy (almost 4% below the EU average) (National Institute of Statistics, 2020). However, Romanian start-ups face a low survival rate, below the EU average, even beyond the first 3-5 years of existence (European Commission, Directorate-General for Research and Innovation, 2017).

The Romanian economy as a whole has a low performance in innovation and the generation of advanced skills, and the SMEs sector is affected and, in turn, affects the low performance in innovation of the economy and society as a whole, placing Romania well behind the EU average at innovation and skills categories. Romania is ranked as a "modest innovator" according to the European Innovation Scoreboard, a deteriorating performance in the last 10 years (European Commission, Directorate-General for Internal Market, Industry, Entrepreneurship and SMEs, 2020). Finally, Romania is poorly represented in the category of innovative enterprises oriented towards sustained growth, ranking below the EU average. Despite all these unfavorable situations and premises, there are also signs of positive change - the increase in the share of educated labour, especially in high-tech fields, the share of exports of high-tech products, the importance of companies oriented to sustained growth in innovative sectors, in creating added value on the economy and in employment (Simut, et al., 2021).

The World Bank Doing Business ranking (World Bank Group, 2020) grants Romania a score of 73.3 points for 2019-2020 (rank 55), highlighting positive changes and progress in several areas, such as foreign trade, enforcing contracts, starting a business or obtaining a loan. In statistical terms, the growing share of exports of high-tech products, the importance of fast-growing firms in innovative sectors in creating added value in the economy and in employment are encouraging (but not sufficient) signs in this regard.

4. THE IMPROVEMENT OF THE BUSINESS ENVIRONMENT, ADMINISTRATIVE BURDEN AND THE SUPPORT MEASURES FOR ROMANIAN SMES

Regarding the *administrative burden*, Romania's performance is in line with the EU average, but in recent years there has been no major progress compared to the previous period, although some indicators have improved significantly since 2008. For example, *the time to pay taxes* decreased from 230 hours in 2011 to 163 in 2019 and other indicators maintained their strong performance over several years. Since 2014, to start a new business in Romania takes (average duration) about 1 day (one of the best results in the EU), due to the availability of online registration (European Commission, 2019b), although in other World Bank report this duration is higher (Word Bank Group, 2020). Since 2016, only 26 euros (or about 4% of the average monthly net income / inhabitant) are needed to start a business in Romania (European Commission, 2019b; Word Bank Group, 2020). However, most indicators have remained almost unchanged since 2015. For example, *the number of tax payments per year*, *the cost of executing contracts* or *the number of procedures required to start a business* have not decreased over the period 2014-2020. However, the latest World Bank Report mentions two business-friendly measures taken between 2019 and 2020: *the possibility of starting a business online*, and, respectively, *reducing the number of taxes and contributions paid by employers* (Word Bank Group, 2020, p. 70).

For Romania, the complexity of administrative procedures remains the most important challenge for a responsive administration aiming to encourage the business climate in Romania, as 86% of Romanians consider that this is a serious problem for the opportunity to do business in Romania, one of the highest percentages in the EU. Also, 82% of respondents agree that frequent and unpredictable changes in legislation are a major problem for business planning and conduct (European Commission, 2019a).

Concerning the situation of start-ups and their perception on bureaucratic and fiscal burdens and the attractiveness of the business environment, the Romanian Startup Business Barometer developed by Ernst et al. (2019) provides interesting information to outline this perspective. Thus, in recent years (2016-2019) the fiscal and regulatory environment has deteriorated for most entrepreneurs (52% of responses), and especially for those who intend or have already started a business. In 2019, those who perceive a worsening are 8% more than in 2017, and 22% more than in 2016, despite that in the previous year (2018) several laws and regulations were adopted aimed at improving the business environment and encouraging entrepreneurship. The regulatory environment and fiscal conditions may explain the relatively low survival rate of start-up businesses in Romania, but also the slowdown of companies' growth in recent years (Eurostat, 2020a), (Ernst et al., 2019).

However, in the entrepreneurs' opinion, there are several measures that could improve the regulatory and fiscal environment for start-ups, such as reducing labour taxation (76%) and bureaucracy (71%) or improving the stability of the fiscal and regulatory environment (70%). Interesting, only one of these proposed measures is related to stimulating innovation (69%) as a means of consolidating small, young businesses and improving the business environment, while the vast majority of measures are limited to reducing the tax burden. This could be a signal that business taxation is perceived as an obvious obstacle to launching and consolidating new business, but also that digitization and stimulating innovation are second-rate priorities for entrepreneurs.

The E&Y study also emphasizes on identifying an administration measure (at least one) that would have the greatest impact in supporting launching a business. Among answers we could find the following: exemption or reduction of fees and taxes for start-ups (33% of options), improved access to finance (27%), fiscal predictability (5%) and better entrepreneurship education (5%). Interestingly, non-financial support measures such as business incubators, reducing state involvement in the economy, access to mentoring do not have notable scores. Moreover, one of the shortcomings stated as hindering the modernization of the Romanian economy and society (and thus negatively affecting

the business environment), namely the lack of digitalization of institutions and e-government measures, have modest scores in these proposals (3% in 2017 and 2% in 2019).

5. THE RELATIONSHIP BETWEEN THE NUMBER OF SMES AND START-UPS, AND THE ADMINISTRATIVE BURDEN AND THE QUALITY OF THE BUSINESS ENVIRONMENT

In our approach, we analysed, in the case of Romania, the relationship between the evolution of the number of active enterprises (SMEs) and start-ups (as dependent variables) and relevant indicators of the administrative burden and the quality of the business environment at macroeconomic level, and namely: *Tax preparation time*; *Number of taxes paid by enterprises*; *Cost of starting a business*; and, respectively, *Business Freedom Index* (as independent variables). The indicators for Romania were selected, mainly from the World Bank database (The Global Economy, 2020), and, respectively, Eurostat (2020a, 2020b), and the National Institute of Statistics of Romania (2020), as time series for the period 2000-2020.

5.1. Correlations between dependent variables and each independent variable

To obtain a clear image of the associations between each independent variable, on the one hand, and each dependent variable, on the other, we used Spearman correlations (Table 1). Although Pearson correlations would be more powerful, they cannot be applied because none of the dependent variables are normally distributed.

Table 1. Results of Spearman correlations for independent variables in the category Administrative burden and business environment

Independent variable	Dependent variable	Current year		Vs. Previous year	
		ρ Spearman	P value	ρ Spearman	P value
Tax preparation time	Active enterprises	-0.62	0.015	-0.59	0.029
	Start-ups	-0.21	>0.15	0.08	>0.15
Number of taxes paid by businesses	Active enterprises	-0.78	<0.001	-0.8	<0.001
	Start-ups	-0.45	0.13	-0.37	>0.15
Cost of starting a business	Active enterprises	-0.97	<0.001	-0.96	<0.001
	Start-ups	-0.85	<0.001	-0.81	0.007
Business freedom index	Active enterprises	0.34	0.140	0.37	0.12
	Start-ups	0.48	0.041	0.53	0.028

Source: Own elaboration

We note that, overall, the total number of active enterprises and the number of start-ups are equally affected by changes in independent variables, but there are some notable differences - *the decrease in the number of taxes* and *the time of tax preparation* are associated only with the increase in the total number of start-ups. The differences between the effects of the change in the *business freedom index* on the two dependent variables are negligible, although the statistical significance was demonstrated only for the correlation with the number of start-ups.

5.2 Short-term causality analysis

Subsequent, we tried to confirm the meaning of the association, and implicitly the correctness of the classification of the variables in dependents and independents, using the Granger causality test (Granger, 1969) with a lag (a delay) of 1 year. It should be noted that the Granger test provides only the argument of succession in time (i.e., that a change in the "effect" variable is preceded by a change in the "cause" variable, and not vice versa), necessary but not sufficient to prove the existence of a causal relationship. Because for the two dependent variables (and most of the independent ones) the original series is not stationary, the variables were transformed by base-10 logarithm and the first difference. The results of the Granger tests, applied in both directions, are presented in Table 2.

Table 2. Granger tests results

Independent variable (first difference of $\log_{10}$)	Direct causality		Inverse causality	
	F statistics	P value	F statistics	P value
<i>A. For the total number of enterprises (first difference of $\log_{10}$)</i>				
Tax preparation time	0.289	>0.1	0.0182	>0.1
Number of taxes paid by businesses	0.0264	>0.1	0.3534	>0.1
Cost of starting a business	0.1626	>0.1	12.3536	0.004
Business freedom index	0.0033	>0.1	0.3588	>0.1
<i>B. For the total number of start-ups (first difference of $\log_{10}$)</i>				
Tax preparation time	3.868212	0.097	2.952074	>0.1
Number of taxes paid by businesses	1.390751	>0.1	0.389518	>0.1
Cost of starting a business	0.425041	>0.1	0.054843	>0.1
Business freedom index	0.070663	>0.1	0.745648	>0.1

Source: Own elaboration

The results suggest that *the tax preparation time* influences the number of start-ups yearly opened (but only at $p < 0.1$), but for the inverse relationship we cannot confirm this at the same level of significance. For the total number of enterprises, we conclude that changes in the cost of starting a business do not cause a change in the total number of firms, but the opposite. While difficult to rationalize, the relationship is highly significant statistically for the reverse causation, and not significant for the direct causation.

5.3 Prediction of dependent variables by simple linear models

In order to be able to predict the evolution of the dependent variable according to changes of an independent variable, we made simple linear models as

$$y = ax + b + \epsilon,$$

where y = dependent variable (total number of firms or number of start-ups), x = independent variable, ϵ = error term with normal distribution.

For the total number of companies, among predictors with very good R^2 values we note the *cost of starting a business* (0.889) followed by the *number of taxes paid by businesses* (0.553), but for the *number of start-ups*, predictors generally have slightly weaker performance (Table 3). We also notice in this case the variable the *cost of starting a business*.

Table 3. Regression results for the total number of enterprises and the number of start-ups, respectively, by each predictor in the category Administrative burden and business environment

Independent variable	a (se)	b (se)	F (df)	Adjusted R ²	P
<i>A. For the total number of enterprises</i>					
Tax preparation time	-3580 (1674)	1466423 (320210)	4,572 (1, 13)	0,203	0,052
Number of taxes paid by businesses	-2869 (670)	967233 (52037)	18,335 (1, 13)	0,553	0,001
Cost of starting a business	-289364 (25496)	1056880 (32802)	128,811 (1, 15)	0,889	<0,001
Business freedom index	18794 (5914)	-558057 (391512)	10,099 (1, 18)	0,324	0,005
<i>B. For the total number of start-ups</i>					
Tax preparation time	-537 (515)	272527 (99074)	1,088 (1, 11)	0,007	0,319
Number of taxes paid by businesses	-637 (224)	209913 (17305)	8,084 (1, 11)	0,371	0,016
Cost of starting a business	-63960 (8292)	230386 (11009)	59,491 (1, 13)	0,807	<0,001
Business freedom index	4557 (1488)	-152824 (97328)	9,375 (1, 16)	0,33	0,007

Source: Own elaboration (2021)

6. CONCLUSION

Our analysis revealed a number of interesting results, some of which confirm previous assumptions and the validity of economic measures and policies in support of SMEs and entrepreneurship, as outlined in the SBA.

Initially, we found that a decrease in *the tax preparation time* is the only variable causally associated (at a significance level of 0.1) with the increase in the total number of start-ups, probably an effect of the decrease of bureaucracy perceived by those who intend to launch a venture, whereas the Granger-causality from *the business freedom index*, *the number of taxes paid by a business* and *the cost of starting a business* to the two dependent variables does not reach significance. However, the lack of statistical significance may be due to the very limited size of the time series, and even a significant result does not definitively confirm the existence of causality, due to the conceptual limitations of the Granger test.

Through linear regression models, we also found that for the total number of companies, the best predictor is *the cost of starting a business* followed by *the number of taxes paid by businesses* and then, by *the business freedom index*. This leads us to conclude, cautiously, that exceeding a critical size of the number of companies in an economy could also generate qualitative improvement in the economic and political environment (such as pressures to improve the business environment, reduce corruption, comply with regulations etc.).

We can therefore see that the picture is particularly complex, and the evidence on the progress of entrepreneurship and start-ups shows a limited impact of the reforms and measures undertaken so far by the Romanian authorities, and an unexploited potential, about to dissipate.

The administration, together with stakeholders, business associations, academia, has to mobilize and review those ineffective policies that hinder the growth of SMEs and to undertake new SME-friendly policies and tools. After a quantitative accumulation (number of active companies, start-up rate, incipient entrepreneurial activities), we consider a qualitative phase should follow, in which efforts should carefully feed the innovative and growth-oriented firms in the high-tech and knowledge-intensive services industries.

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