



COMPETITIVENESS OF THE SME SECTOR 2007

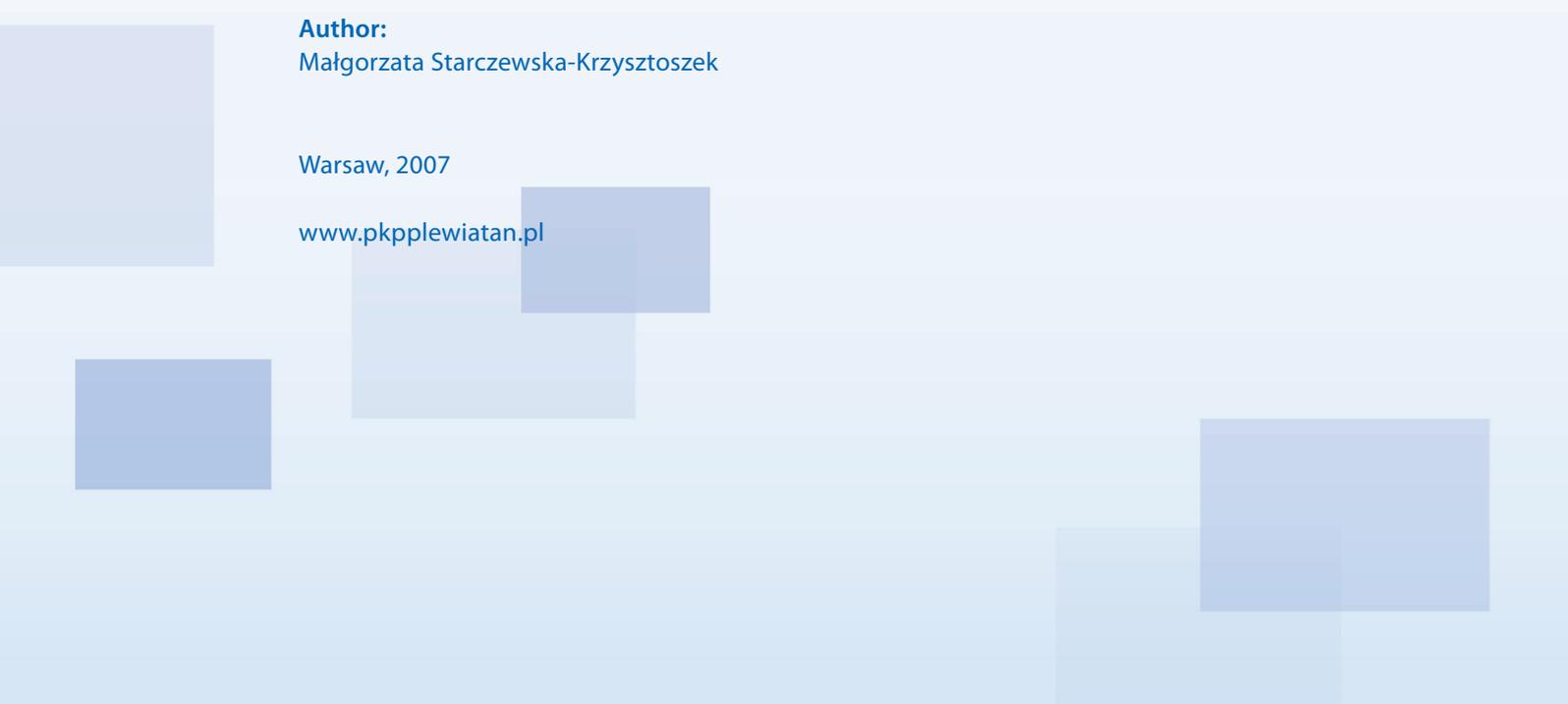
RESEARCH REPORT

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Author:
Małgorzata Starczewska-Krzysztosek

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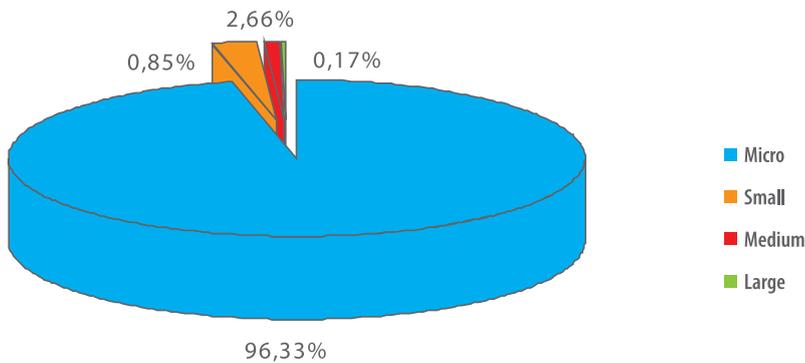
The small- and medium-size enterprise sector in Poland

1. Number of enterprises

In 2006 in the REGON system in Poland there were registered 3,636 million economic entities, including 3,497 million¹ in the private sector. In the period 1996 – 2006 the number of economic entities increased on the whole by 50,7%, including from 2,256 million to 3,478 million private economic entities (an increase of 48,4%)².

In reality only 1,677 million enterprises remained active³ (conducting commercial activities), that is 46,1% from the total number of economic entities registered in the REGON⁴ system. In 2005 there were 2,2% less active enterprises than in 2004 (1,715 million). Mostly micro- and small-enterprises have been registered out of the system. On the other hand the number of large enterprises is growing – from 2754 in 2004 to 2835 in 2005. This is the effect of growth of enterprises, increased employment and advancement in class to large enterprises.

Graph 1. The structure of the enterprise sector according to size, 2005



Source: Own calculations based on "Activities of non-financial enterprises in 2005", CSO, Warszawa February 2007

The sectoral structure of enterprises according to size has for long remained unchanged in Poland. It is comparable to the structure of the enterprise sector in countries. Small- and medium-enterprises (SME) represented in 2005 99,83% of the total number of enterprises in Poland⁵.

2. Contribution of the SME sector to GDP

Value added produced by the enterprise sector in 2005 represented almost 59% of Gross Domestic Product (GDP). Small- and medium-enterprises produced 54,7% of the value added of the enterprise sector.

3. Employment and remuneration in enterprises

In 2005 the average number of employed in the enterprise sector was 5,819 million, out of which 3,522 million worked in the SME sector. This represented 60,5% of the average number of persons employed in the enterprise sector.

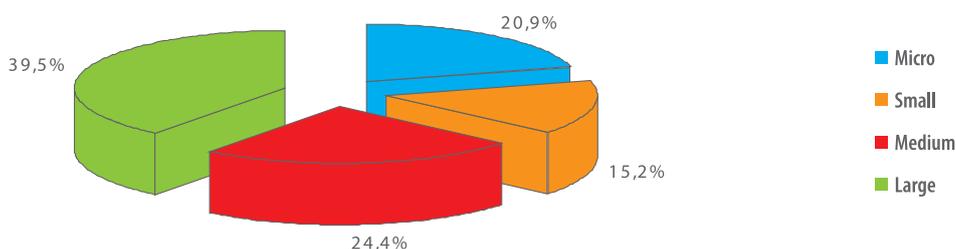
1 Entrepreneurship in Poland 2007, Ministry of Economy, July 2007, p. 31

2 Ibidem

3 The number of active entities is set on the basis of the number of entities sending the so called structural survey to the Central Statistical Office

4 The operations of non-financial enterprises in 2005, CSO, Warszawa, February 2007, Table 1

5 Ibidem (data for 2006 CSO will publish in Warsaw in February 2008)

Graph 2. Employment in the enterprise sector according to size, 2005

Source: Own calculations based on "Activities of non-financial enterprises in 2005", CSO, Warszawa February 2007

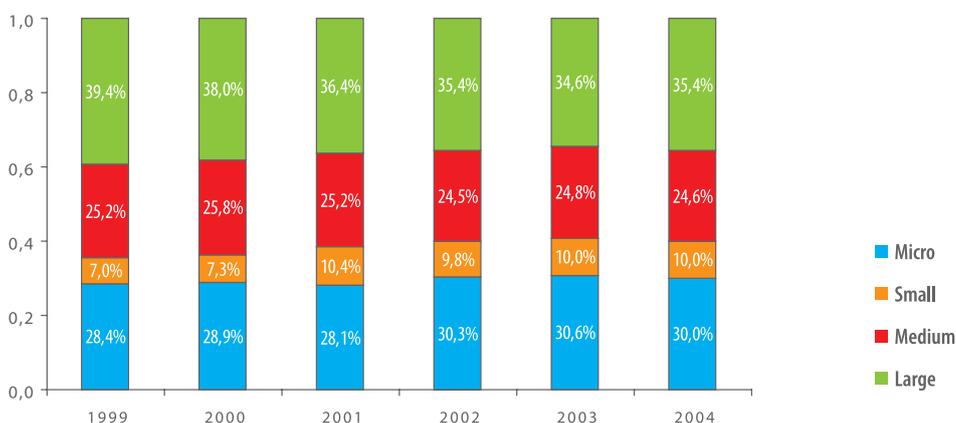
The variation in the average number of persons employed in the enterprise sector is large – from 0,8 employees in micro-enterprises to 810 employees in large firms, with the average being 3,5 employees. We should pay attention to micro-enterprises, where many of the firms do not employ any person, basing rather on self-employment. Estimates from the Ministry of Economy⁶ show that 1,3 million enterprises are self-employed working outside of agriculture, out of which 780 thousand or 60% are one person enterprises not employing workers, persons not being employers. This is why among micro-enterprises average employment is very low.

Table 1. Average employment in enterprises according to size, 2005

	Total	Micro up to 9 employees	Small 10-49 employees	Medium 50-249 employees	Large above 250 employees	SME up to 249 employees
Average employment	5 818 712	1 214 933	885 326	1 421 860	2 296 594	3 522 119
Average monthly remuneration (pln)	2 401,8	1 483,5	2 179,4	2 441,3	2 949,0	2 045,1
Annual remuneration costs (mln)	167 707,8	21 628,2	23 153,9	41 653,8	81 271,9	86 435,9
Total costs (mln)	2 113 860,1	489 509,8	304 234,6	480 550,8	839 564,9	1 274 295,0
Share of remuneration costs in total costs	7,9%	4,4%	7,6%	8,7%	9,7%	6,8%

Source: Own calculations based on "Activities of non-financial enterprises in 2005", CSO, Warszawa February 2007

In the period 1999 – 2004 share of employment in SMEs within total employment in enterprises rose by 6,6% while the share of employment in large enterprises within total employment in enterprises fell by 10,2%.

Graph 3. Structure of employment in enterprises*/ according to size (% , 1999-2004)

* Employed in the private and public sector, excluding agriculture, forestry and fisheries.

Source: Own calculations based on the reports on the condition of the SME sector in Poland during the period 1999 – 2005, PAED

Within the SME sector – the share of employment in micro- and small-sized enterprises in total enterprise employment rose by 13%, while the share of employment in medium-sized enterprises fell by 2,4%. This means that the sector of micro- and small-sized enterprises is growing, among others increasing employment. This growth is faster than among other groups of enterprises – this is among others the reason for the changing employment structure in enterprises.

The average remuneration in 2005 in the SME sector was 2405 pln, and in large enterprises – 2949 pln. The variation of remuneration in the SME sector was large – average salary in micro-sized enterprises was 72,5% of the average remuneration in the SME sector, in small-sized firms – 86,9%, in medium-sized firms – 199,4%.

In 2005 paid out to employees remuneration totaling 167,7 billion pln, out of which 51,5% is remuneration paid out by small- and medium-sized enterprises. The share of remuneration costs in total enterprise costs is shown in Table 2.

Table 2. Share of remuneration costs in total costs*/ in the enterprise sector according to size class, 2005

	Total	Micro up to 9 employees	Small 10-49 employees	Medium 50-249 employees	Large above 250 employees	SME up to 249 employees
Average employment	5 818 712	1 214 933	885 326	1 421 860	2 296 594	3 522 119
Numer of enterprises	1 676 775	1 615 167	44 519	14 254	2 835	1 673 940
Average employment in an enterprise	3,5	0,8	19,9	99,8	810,1	2,1

* Estimates based on average employment in the enterprises sector

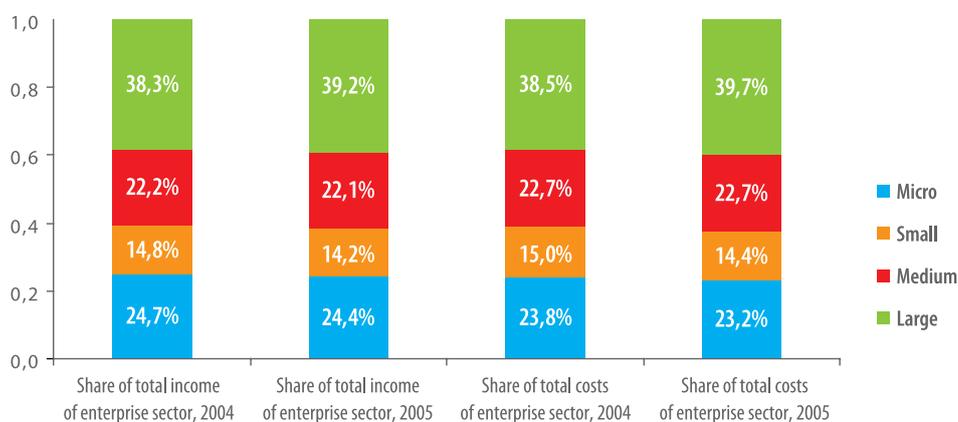
Source: Own calculations based on "Activities of non-financial enterprises in 2005", CSO, Warszawa February 2007

Data concerning the average monthly remuneration in each enterprise size class and the share of remuneration costs in total costs, warranted that in those calculations average employment in the enterprise sector was considered (this is why the level of remuneration costs in total costs is not important, but rather the differences in the value of this coefficient for each enterprise class), shows clearly the large differences between the sector of large enterprises and the SMEs, especially micro-sized enterprises. The share of remuneration costs in total costs is lower in the SME sector by 30% and 55% for micro-sized enterprises compared to large enterprises. There may be several reasons behind this situation, i.e. lower efficiency of labor in smaller enterprises, lower employee competences, higher share of fixed costs in total costs, higher share of the grey economy in employment and compensation of employees. The occurrence of some of these factors can be verified.

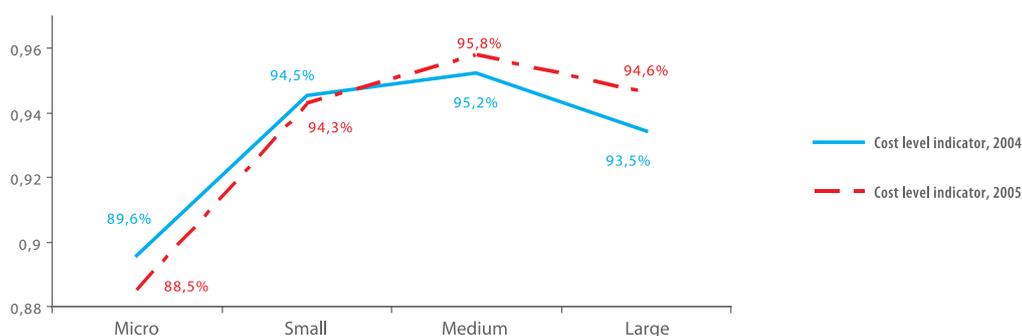
4. Income and costs in enterprises

The costs and income of the SME sector do not correspond to the share of this sector in the number of enterprises. In 2005 the income of the enterprise sector was 2264,4 billion pln. Small- and medium-sized enterprises generated 60,8% of this income (1377 billion pln). In 2005 the per capita income in the SME sector was above 820 thousand pln. The relatively low income of micro-sized enterprises – each micro-enterprise had on average app. 350 thousand pln income – had an influence on the per capita level of income in the SME sector.

The SME share in income and costs of enterprises in 2005, compared to 2004, fell considerably, taking into consideration the short time period (in terms of income by 0,9 pp, in terms of costs by 1,2 pp). This means an increase in the share of large firms, but at the expense of profitability. The fact that the share of large enterprises in total costs is rising faster than its share in income of the enterprise sector points to an increase in the relationship of costs to income and the worsening of profitability of large enterprises. The relationship of costs to income also worsened, and as a result the profitability of medium-sized firms.

Graph 4. Income and cost in enterprises, according to size – share in total income and total costs (% , 2004, 2005)

Source: Own calculations based on: "Activities of non-financial enterprises in 2005", CSO, Warszawa, February 2007

Graph 5. Cost level indicator (% , 2004, 2005)

Source: Own calculations based on: "The activity of non-financial enterprises in 2005", CSO, Warsaw, February 2007

One can see clearly an improvement in the already very good relationship of costs to income in micro-sized enterprises.

The data concerning average income per 1 employee and 1 pln of remuneration is interesting.

Table 3. Total income per 1 enterprise, 1 employee*/1, 1 PLN of wage in the enterprises sector according to their size, 2005

	Total	Micro up to 9 employees	Small 10-49 employees	Medium 50-249 employees	Large above 250 employees	SME up to 249 employees
Income total (mIn PLN)	2 264 420	553 120	553 120	501 361	887 415	1 377 005
Number of enterprises	1 676 775	1 615 167	44 519	14 254	2 835	1 673 940
Average employment	5 818 712	1 214 933	885 326	1 421 860	2 296 594	3 522 119
Annual wage cost (mIn PLN)	167 707,8	21 628,2	23 153,9	41 653,8	81 271,9	86 435,9
Income per 1 enterprise (mIn PLN)	1,4	0,3	7,2	35,2	313,0	0,8
Income per 1 employee (PLN)	389 161,6	455 267,8	364 299,9	352 609,0	386 404,9	390 959,2
Income per 1 PLN wage (PLN)	13,50	25,57	13,93	12,04	10,92	15,93

* Estimates based on the average employment in the enterprises sector

Source: Own calculations based on: "The activity of non-financial enterprises in 2005", CSO, Warsaw, February 2007

Small- and medium-sized enterprises are characterized by higher income per 1 employee than large enterprises (remembering, that in those calculations the average employment in the enterprise sector was used). However this is achieved by the SME sector only thanks to micro-sized enterprises, in which income per 1 employee is 17,8% higher than in large enterprises.

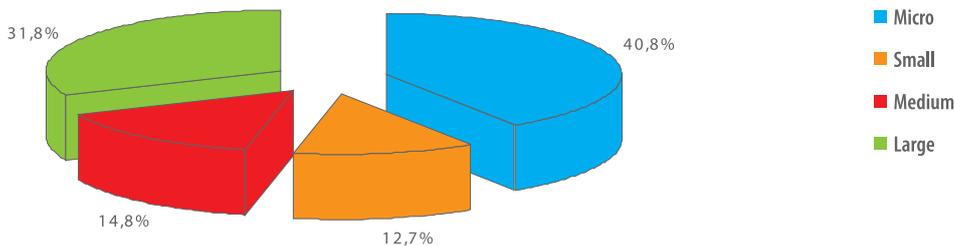
Small- and medium-sized enterprises achieve even better results, when we consider income per 1 pln of remuneration – it is almost 46% higher in the SME sector than in the case of large firms. In the case of this relationship “wages productivity” is higher in all groups of the SME sector than the case is for large enterprises. However also in this case results achieved by micro-enterprises differ substantially from the “wage productivity” in the other enterprise classes.

The above analysis clearly points that the smaller the firm than the “employee productivity” and “wage productivity” is higher. This shows that it’s not the lower “employee productivity” and “wage productivity” that are the sources for the lower share of remuneration in total costs in the SME sector (by 30%).

5. Gross profit and gross turnover profitability of enterprises

In 2005 the enterprise sector generated in total 172,5 billion pln gross profit, of which 70,3 billion pln was generated by micro-sized enterprises (40,8%). In total small- and medium-sized enterprises generated in 2005 68,2% of gross profit in the whole enterprise sector.

Graph 6. Gross profit generated by enterprises, by size, 2005



Source: Own calculations based on: “Activities of non-financial enterprises in 2005”, CSO, Warszawa February 2007

Small- and medium-sized enterprises are more profitable (profitability of gross turnover) than large enterprises. Profitability of gross turnover of the whole SME sector is 8,6% while the profitability of the gross turnover of large enterprises is 6,2%. The highest level of the gross turnover is among the micro-sized enterprises. However gross financial result per 1 micro-enterprise is only 0,22% of the gross profit per 1 large enterprise.

Table 4. Gross profit and profitability of gross turnover in enterprises according to their size, 2005

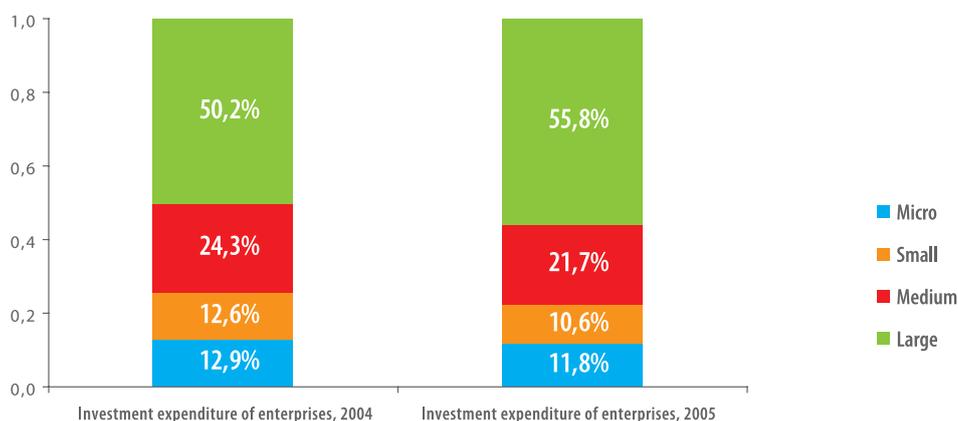
	Total	Micro up to 9 employees	Small 10-49 employees	Medium 50-249 employees	Large above 250 employees	SME up to 249 employees
Gross profit (mln PLN)	172 547,8	70 321,1	21 927,0	25 499,1	54 800,6	117 747,2
Gross profit per 1 enterprise (PLN)	102 904,6	43 538,0	492 531,3	1 788 905,0	19 330 013,2	70 341,4
Profitability of gross turnover (%)	7,6%	12,7%	6,8%	5,1%	6,2%	8,6%

Source: Own calculations based on: “The activity of non-financial enterprises in 2005”, CSO, Warsaw, February 2007

6. Investment expenditure of enterprises

Investment are the element of enterprise operations that decides about their development opportunities. In 2005 the investment expenditure of enterprises was in total 99,972 billion pln (current prices) and were higher in real terms by 8,3% than investment expenditure of enterprises in 2004.

Graph 7. Investment expenditure of enterprises (% , 2004, 2005)



Source: Own calculations based on: "Activities of non-financial enterprises in 2005", CSO, Warszawa February 2007

The growth was achieved thanks to large enterprises, which in 2005 compared to 2004 increased investment expenditure in real terms by 20,5%. At the same time the investment expenditure of small- and medium-sized enterprises fell in real terms by 4%. However the SME group is not homogenous – in micro-sized enterprises real investment expenditure fell by 0,5%, in small-sized enterprises by 8,9% and in medium-sized enterprises by 3,3%.

The changes in investment expenditure per 1 enterprise were a bit different.

Table 5. Investment costs per 1 enterprise, 2004 and 2005

	Total	Micro up to 9 employees	Small 10-49 employees	Medium 50-249 employees	Large above 250 employees	SME up to 249 employees
Investment costs total in 2004 (bln PLN)	90,40	11,66	11,39	21,97	45,38	45,02
Investment costs total in 2005 (bln PLN)	99,97	11,84	10,61	21,70	55,81	44,15
Investment costs per 1 enterprise in 2004 (PLN)	52 700,0	6 870,0	263 450,0	1 570 000,0	16 500 000,0	26 250,7
Investment costs per 1 enterprise in 2005 (PLN)	59 621,8	7 332,0	238 376,9	1 522 576,1	19 687 760,1	26 379,4
Change in investment expenditure per 1 enterprise, real terms	110,8%	104,5%	88,6%	95,0%	116,9%	98,4%

Source: Own calculations based on: "Activities of non-financial enterprises in 2005", CSO, Warszawa February 2007

Enterprise were investing and continue to invest mainly in "new assets and improvement of existing assets" – they spent for this purpose 85,2% of total investment expenditure, which means that the purchase of used fixed assets represents 14,8% of total investment expenditure. However, the structure of investment expenditure in each group of enterprises varied – micro-enterprises used 92% of investment expenditure for the purchase of new fixed assets and enterprises – 76,2% directing a much higher share of investment expenditure than other groups of enterprises for purchase of used fixed assets. A similar structure of investment expenditure occurred in 2004, although medium-sized enterprises in 2005 to a much higher degree than in 2004 invested in new fixed assets.

The picture of the enterprise sector in 2005 as painted by the data of the CSO points to a few phenomena:

1. Despite the rise in the number of enterprises registered with the REGON system the number of active enterprises is decreasing. This process can be the effect of two phenomena. First, the development of enterprises and their progression from micro- to small-enterprises. Secondly, resigning from economic activity without registering out – mainly by entities with the status of physical persons conducting economic activity – as a result of the improving situation on the labor market and the opportunity to find employment in the form of an employment contract.
2. The SME sector is characterized by the following features as compared to large enterprises:
 - Fall in quantitative terms of their share in the enterprise sector – the number of small- and medium-sized enterprises is decreasing while the number of large enterprises is increasing,
 - Fall in the share of the generated value added,
 - Increase of the share of employment in the enterprise sector,
 - Much lower share of remuneration in total costs,
 - Higher “employment productivity” and “wage productivity”,
 - Lower cost indicator,
 - Higher profitability of gross turnover,
 - Low level of gross income per 1 enterprise, as a result not generating the accumulative capabilities of SMEs (on average 70,3 thousand pln in 2005),
 - Fall in the share of income of the enterprise sector,
 - More than a two-time higher value of gross profit,
 - Fall of investment expenditure in real terms,
3. The behavior of micro-enterprises within the SME sector is the most interesting. Among others they are characterized by:
 - The lower average remuneration in the enterprise sector,
 - Much lower share of remuneration in total costs than the case is for other enterprises,
 - Highest “employment productivity” and “wage productivity”,
 - Decreasing share of income in total income of enterprises,
 - Lowest cost indicator and higher level of gross turnover profitability,
 - Very low level of gross profit per 1 enterprise (on average 43,5 thousand pln in 2005), making it impossible to build the financial basis for growth,
 - Growth – as the only group among SMEs – of investment expenditure per 1 enterprise,
 - Concentration of investment expenditure on purchasing of new fixed assets.

The presented characteristic may be a very good background for analyzing the results of the study “Competitiveness of the SME sector 2007” as the study deals with the period January 2006 – June 2007.

Macroeconomic growth conditions of the small- and medium-sized enterprises in Poland

The year 2006 was very good for the Polish economy – GDP growth of 6,2% with a high growth of consumption (5,1%)⁷. Consumption was joined by investment which rose in 2006 by 15,6% (gross expenditure on fixed assets). This was accompanied by a very high, despite the strong zloty, export growth dynamic (above 23%, according to NBP, in Euro)⁸. Though contribution of net export to GDP growth was negative.

⁷ Communication from the Central Statistical Office regarding the correction of the estimate of nominal value (in current prices) for the period 2005 – 2007 and the real dynamics of gross domestic product in 2006, CSP, Warszawa 01.10.2007

⁸ Total foreign trade turnover and according to countries (I – XII 2006) (final data), CSO, Warszawa, 29.06.2007

The budget deficit was 25,063 billion pln compared to 30,547 billion pln (82% execution of the budget)⁹ that had been planned.

The first 6 months of 2007 were even better – GDP rose by 7,1% (in Q1 GDP rose by 7,4% compared to the same period the previous year, and in Q2 by 6,7%)¹⁰. This was the effect of the rise of individual consumption by 6% and rise in investment by 25,3% (in Q1 2007 by 29,6%)¹¹. Only the weakening export dynamic (12% in June 2007)¹² was a source of concern. This was accompanied by the rising import dynamic, something that deepened the negative influence of net exports on GDP dynamics.

Industrial production sold rose in the 6 months of 2007 rose by 10,7%, while industrial production sold of industries considered to be the carriers of technological advancement – rose by 12,6%¹³. Construction-installation production was rising dynamically – by 30,2% in the course of the 6 months of 2007¹⁴. Retail sales rose by 15,6%.

Remuneration rose in the first 6 months of 2007 by 8,4%. Employment also rose – by 4,4%.

Enterprise loans increased – for the end of June they were at 161,8 billion pln at their value was higher by 22,2% than in June 2006 (increase of 29,4 billion pln)¹⁵. This corresponds with the high investment dynamic during the first 6 months of 2007. Enterprise deposits also rose – by 23,7% (129,3 billion pln, an increase of 24,8 billion pln)¹⁶. This signifies the good financial results of the firms (profitability of gross turnover of medium-sized and large enterprises in Q1 2007 was 6,5%, while during the same period in 2006 it was 5,6%, the cost indicator also improved – from 94,4% in June 2006 to 93,5% in June 2007, cash liquidity remained at a very high level – 32,9%)¹⁷.

Budget deficit at the end of June 2007 was 3,678 billion pln, or only 12,3% of the planned deficit (30 billion pln) for 2007¹⁸.

The changes in the macroeconomic surroundings of enterprises was accompanied in 2006 and in Q1 2007 by the consolidation of certain tendencies and changes in others. "Consolidation" refers to the high individual consumption dynamic. This is the effect of the sustained high remuneration growth dynamics and employment growth. Retail sales continue to rise dynamically. Within the Polish economy there is currently no demand barrier.

When at the start of 2006 PKPP Lewiatan conducted the study on the state of the small- and medium-enterprise sector¹⁹ and asked the firms that were not investing (they were 40%) what is the reason for the lack of investment – 71,3% pointed (together in the first 3 places as the most important reasons) to a weak economy and lack of demand. As late as start of 2006 the enterprises saw on the demand side the main obstacles to their growth.

Today the situation is different. NBP research²⁰ shows that problems with finding a buyer for the produced goods is experienced by only 4,3% of the surveyed enterprises. Demand is no longer a barrier to enterprise growth. The firms expect that the high demand for their products will continue in the future. It has its consequences, i.e.:

1. "Consolidation" of the slowing exports dynamics, as the rapidly growing consumption on the polish market is "pushing out" exports from the field of interest of a share of enterprises. In this way they decrease the risk of their operations (especially small- and medium-sized enterprises),
2. The high investment activity of enterprises is maintained (although in Q2 2007 total investment dynamics decreased by 25% compared to Q1 2007).

Demand is no longer a barrier to firm development, but supply barriers have materialized while institutional barriers still remain unsolved.

9 Operative report on the execution of the national budget for the period January – December 2006, MoF, Warszawa 2007

10 Gross Domestic Product in secondo quarter 2007, CSO, Warszawa 30.08.2007

11 Ibidem

12 Total foreign trade turnover and according to countries (I – VI 2007), CSO, Warszawa 10.08.2007

13 Expenditure and results of the industry I – II quarter 2007, CSO, Warszawa 21.09.2007

14 Industrial production and construction-installation dynamic in June 2006, CSO, Warszawa 18.07.2007

15 Preliminary information nr 7/2007, NBP

16 Ibidem

17 Financial results of non-financial enterprises in the period I – VI 2007, CSO, Warszawa 21.08.2007

18 Estimates of the execution of the budget in the period January – June 2007, MoF, Warszawa 16.07.2007

19 Małgorzata Starczewska-Krzysztosek, Competitiveness of small- and medium-sized enterprises 2006, PKPP Lewiatan, May 2006

20 Information on the state of the enterprise sektor, particularly concerning the state of the economy in Q3 2007, NBP

Institutional and supply barriers to enterprise development in Poland

1. Supply demand and the development of enterprises

The supply barriers affects most of the sectors of the economy, but to the largest degree it affects the construction sector, where 40% of the firms surveyed by the NBP²¹ report problems with fulfilling orders. Also 1/3 of firms from the "industrial processing" and the "transport" sectors face supply barriers. The data clearly shows that this is becoming a serious problem.

This is confirmed by the data on the industrial production sold in Q2 2007, which rose by 8,5% compared to the similar period in 2006 compared to a sales increase of 13% in Q1 2007. At the same time the dynamics of industrial production sold indeed fell in June 2007 – it was only 5,6%. Stocks also decreased.

The supply barrier is more and more clearly seen in two fields: (1) the labor market, where there is a lack – despite the still high unemployment – of labor and (2) in utilizing production capabilities.

The problem of lack of workers is growing due to higher demand for labor as a result of economic growth, the lack of structural fit between the labor market and the need of the economy, labor migration of Poles, the low propensity of Poles to look for employment outside of their place of residence (we prefer to travel abroad to find employment rather than commute to work at home), maintenance of pension benefits which cause an early deactivation of workers, the low propensity to hire the disabled. It is impossible to liquidate the labor supply demand in the short run, but one can try to limit its scale. And of course seek to better adjust the labor market to the needs of the economy in the medium- and long-term.

The high and growing level of utilization of production capabilities is the second supply barrier. It measures 84%²². Limiting this barrier also requires time, because in order to do so investment is needed. NBP²³ research shows that the highest level of production capabilities utilization occurs in enterprises employing over 1999 workers (above 90%). The lowest level of utilization – in small firms employing up to 50 workers (82%). One can put forward the thesis that this due to the fact that in large enterprises – compared to the possessed production installations and investment – the orders are growing. The smaller firms dispose of higher "slack" in production capabilities, however not due to relatively higher investment, but due to lower order growth dynamic. Though both groups of firms have exceeded the level of a "safe" degree of production capabilities utilization.

The enterprises are aware that this barrier can only be significantly lowered through investment – in Q1 2007 investment expenditure of enterprises (employing above 50 workers) measured 16,4 billion pln and were higher by 47% when compared to Q1 2006²⁴. However it seems that until the beginning of 2006 the level of investment was insufficient. This was the case not only in the enterprise sector, but the entire economy, where gross expenditure on fixed assets rose in Q1 2006 only by 7,6% (in Q1 2007 it was already 29,6%)²⁵. This despite a clear economic upturn in 2006 generated by the growing consumption demand on the Polish market and the growing export opportunities. This also despite the lower cost of financing (the fall in interest rates on loans in 2006) and the opportunity to benefit from the structural funds.

There are two reasons behind this investment delay. PKPP Lewiatan research²⁶ shows that 39,2% of small- and medium-sized enterprises did not invest (until mid-2006) as they still had unused production capabilities. Similar results are provided by other research. Above all enterprises regarded (and continue to do so) the risk associated with investment as very high. This is why their investment decisions were delayed. This risk was associated and is still associated with the frequent legal regulations concerning the economy, the lack of public finances reform, which threatens with the possibility to sustain taxation burdens, the lack of spatial plans and the lack of regulations, that enforces the preparation of such plans, the lack of regulations concerning ownership issues due to the lack of reprivatization decisions, difficulties in getting access to EU funds. In 2006 the consumption

21 Ibidem

22 Ibidem

23 Ibidem

24 Economic and financial results of economic entities in Q1 2007, MoE, July 2007

25 Gross domestic product..., op.cit.

26 Małgorzata Starczewska-Krzysztożek, op.cit.

dynamic increased so considerably that the enterprises had to make a decision to take up high risk of investment or losing a growing market. Some of them took this risk already in the second half of 2006. Firms from the construction and energy sectors started investing heavily (also in 2007). Thanks to investment the level of production capabilities utilization in the construction sector decreased, although it is still high as it measures 86% (NBP)²⁷. However without investment (which in Q1 2007 rose compared to the same period 2006 by 95,2% (data from the Ministry of Economy)) construction and installation production could not have risen by 30,2% in Q1 2007 (in Q1 2007 more than 50%, although a dominating influence had the weather).

The Polish economy the enterprises operating within its framework stand with one foot in the potential opportunities created in the growing internal and external market, however the second foot is stuck in supply barriers – lack of workers and the very high level of production capabilities utilization.

2. Institutional barriers to enterprise development

The Polish economy since 1989 is going through a process of institutional change, being the effect of distortions to the socio-economic system equilibrium. The process has still not been concluded despite the fact that 17 years have passed since its beginning, and also despite the accession of Poland to the European Union in 2004. This process concerns formal and informal institutional changes, which affect the choices made by people, and as a consequence on how the economy functions. In the market sphere it comprises of creating market institutions, switching coordination thorough the state to coordination through the market, changing the involvement of the state in economic turnover through privatization. In the societal sphere it comprises of changes to "thinking and behavior patterns characterized by inertia"²⁸

2.1. Informal institutional barriers

Informal institutional barriers are informal limitations having the character of a sanction, taboo, customs, tradition, informal codes of behavior, that are created by humans, i.e. "...in order to create order and reducing the uncertainty inherent in transactions"²⁹.

In 2004 the Institute of Public Affairs (ISP) conducted research that allowed to analyze and evaluate the economic awareness of the society after 15 years of the transformation process³⁰. It showed a clear acceptance of the market economy – according to 59% of respondents the market economy is the best economic system in our country ("decisively yes" or "yes"), while 26% of respondents were against the market economy ("decisively no" or "no"). The conclusions drawn by the authors from this research is the statement that "the desired rules organizing the economy should enforce the efficiency of actions, and at the same time guaranteeing the realization of egalitarian values. This is why market mechanisms and competition should act on the part of production and deciding prices, while caretaking mechanisms should concern division and equal opportunities. (...) The state should ensure a high level of social benefits (81%), should conduct a protectionist agriculture policy (65%), fight unemployment (75%) and limit the income of the highest earners"³¹. Analyzing the informal barriers stemming from the ISP study from the viewpoint of building a competitive economy and creating the conditions for the growth of competitiveness of enterprises active on the Polish market one can clearly see, that we managed to conduct the necessary, from the perspective of achievement of the above goals, changes of informal behavior codes. In effect institutional changes still rely to a higher extent on pro-market attitudes of people as consumers and to a lesser extent on their entrepreneurship understood as the propensity to being active and taking risks.

27 Information on the conditio of the enterprise sektor..., op. cit.

28 Veblen T., „The theory of the leisure class”, PWN, Warszawa, 1971

29 Encyclopedia of sociology, Oficyna Naukowa, Warszawa 1999, p. 324

30 The economic awareness of the society and the image of business, L.Kolarska-Bobińska (ed.), ISP, Warszawa 2004

31 Ibidem, p.15-16

2.2 Formal institutional barriers

Formal institutional barriers can be inherited in the constitution, the law, ownership rights. They become evident in the lack of fit of institutions to the market economy, in the still excessive coordination of the economy by the state, in the too large share of the state in economic turnover.

If we read the words in the Constitution of the Republic of Poland, then in Art. 20 it says that the basis of the economic order of the Republic of Poland is the "social market economy based on economic freedom, private ownership and solidarity, dialogue and cooperation of social partners". Art. 22 of the Constitution allows for the limitation of economic freedom but only through "laws and only due to an important public interest". Thus looking at these words one can conclude that there should be no formal institutional barriers in the Polish legal order.

However it is the case that within the economy we have 75 fields, and within them 236 kind of permits for conducting economic activity, or 38 fields, and within them 135 kinds of admission to conduct a profession. The degree of regulation of the economy is very high and instead of decreasing – it is increasing.

The Constitution of the Republic of Poland does not create formal limitations, however it provides with legal basis for them through the inclusion of the possibility to limit economic freedom due to "an important public interest", which it does not define precisely. This is why these words can by the tool used by "thinking and behavior patterns characterized by inertia", can be the key to maintaining their status quo ("...firstly social groups benefitting from "old" legal solutions (...). Secondly – politicians accepting this tyranny in the fear of the results of the next elections. Thirdly – officials (bureaucracy) to whom any change is an attempt at their "ability to adjust", is a "revolution" that can falter their stabilized position"³²).

Not only the fact that 800 legal acts regulate economic activity in Poland is evidence that in Poland one could not define "an important public interest", but also the fact that annually the Sejm enacts more than 200 laws, out of which 60% are amendments to laws already existing.

As the degree of regulation of the economy is not decreasing (and in some fields it is even increasing), the sources of too slow institutional changes should be looked after in the law – its quantity and quality and in the ownership rights.

In Poland there still is the problem with changing the informal limitations stemming from the transformation process, and the formal limitations – those associated with creating and amending laws. Besides informal limitations, so difficult to change (something that is proved among others by ISP research), limit the changes to formal institutional barriers. Inflation of economic laws and its instability is a consequence of "patterns of thought and behavior". This means that in order to conclude the transformation process a necessary condition is the change of informal codes of behavior. Only thanks to this it will be possible to create an institutional infrastructure that will support the development of enterprises, amongst other through identification and lessening the risks associated with economic activity.

Competitiveness of small- and medium- sized enterprises 2007

1. Information regarding the study

"Monitoring the condition of the small- and medium- sized enterprises sector 2006" is the 7th edition of the SME study. It was prepared by the experts of the Polish Confederation of Private Employers Lewiatan and conducted on the order of PKPP Lewiatan by the Public Opinion Research Center (CBOS) during the period July, 19th – September, 5th 2007.

The study was carried out on a random sample of 1093 active private enterprises, that is firms being the ownership of physical persons or companies with majority stakes held by private capital, including priva-

³² More in: Małgorzata Starczewska-Krzysztożek, Public sector vs the private sector – Direction and the force of change, in: The public sector in Poland and the world, Kleer. J. (ed.), CeDeWu, Warszawa 2005

tized state owned enterprises. The studied firms employed 2 or more workers, with the work obligation through a definite or indefinite employment contract.

The interviews with the respondents were carried out through direct interviews (face-to-face) carried out by CBOS pollsters. The pollster carried out the interview in a firm with a couple of people most competent on a given subject. In practice the respondents were most often the owners or co-owners of enterprises.

The study took place during the period January 2006 – June 2007 (some questions and answers relate only to 2006).

1.1. Research methodology

For the purpose of drawing the sample the population was divided into layers based on the 5 sections of the Polish Economic Activity Classification (PKD) and 3 categories of employment size (2-9, 10-49, 50-249 persons employed) in each voivodship. In effect the population was divided into 240 layers (5 PKD sections x 3 employment categories x 16 voivodships).

The following PKD sections were considered:

1. **Section D** – Production activities
 - Food and food processing
 - Other consumption goods (Fast moving consumption goods)
 - Durable consumption goods
 - Investment goods (to other enterprises)
 - Supply goods (to other enterprises)
 - Other than mentioned in section D
2. **Section F** – Construction
3. **Section G** – Wholesale and retail trade
4. **Section I** – Transport, Stocks and communication
5. **Section K** – Real estate services, renting and services associated with catering to economic activity.

In the selection scheme of the sample an unproportionate selection was employed in relation to the PKD section and the enterprise size category and proportionate in relation to the number of private firms in each voivodship.

The unproportionate selection of SMEs in relation to employment size is conditioned upon the structure of Polish enterprises, dominated by small firms employing up to 9 persons. In order to gain the possibility to compare results for firms of different sizes firms employing 10 persons or more were overrepresented in the sample.

The structure of enterprises in relation to PKD section is not so strongly dominated by one section like the size structure dominated by one category, that is small firms. In the group of 5 isolated sections (D, F, G, I, K) the most distinct disproportion is the decisive quantitative dominance of SMEs belonging to section G (Wholesale and retail trade). This section holds the highest number of private enterprises. This is why in the sample the share of SMEs from section G was decreased in order to increase the share of firms from other sectors.

The obtained results were weighted in order to be able to draw conclusions on the population based on results from the sample, that is ensuring representativity. Three weights were developed: 1) Regarding the data as a whole, 2) Regarding the data divided into sections, 3) Regarding the data divided into employment groups.

1.2. Information about the firms

The most numerous group among those surveyed consists of physical persons operating based on entry into the register.

What is the legal form of the enterprise? N = 1093	
Stock company	1,4%
Limited liability company	6,9%
Limited partnership	0,2%
Partnership company	0,4%
Registered partnership	2,9%
Enterprise of a physical person – Based on entry into the register	70,1%
Partnership	15,2%
Other	2,8%
Total	100%

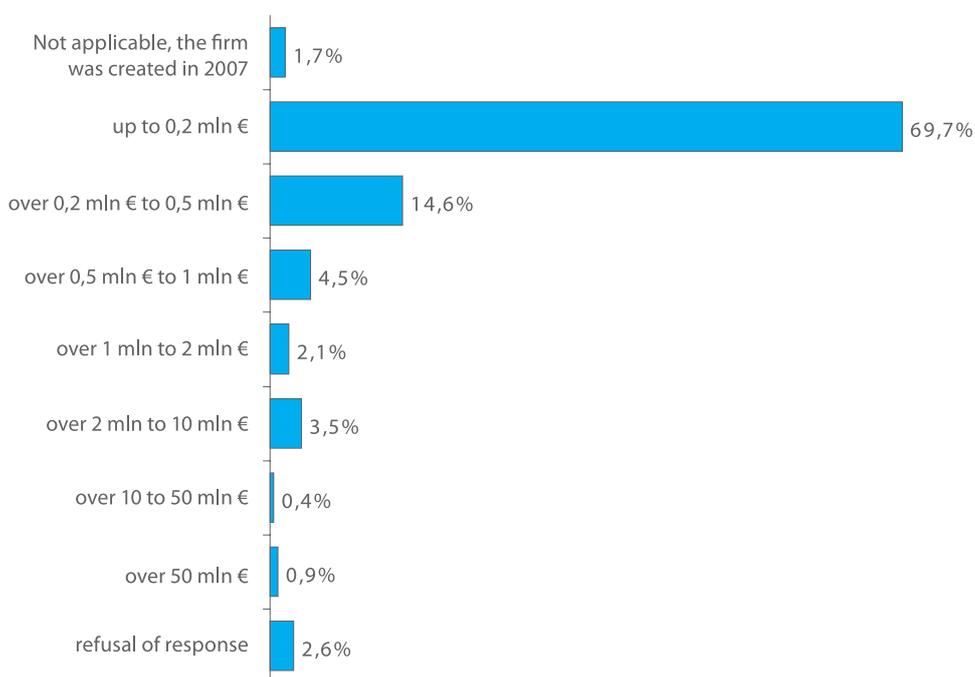
1.3. PKD sections

Quantity and percentage of enterprises in each sector	n	%
Section D – Production activities		
Food and food processing	56	5,1%
Non-Food, Fast moving consumption goods	40	3,7%
Durable consumption goods	67	6,1%
Investment goods (to other enterprises)	42	3,8%
Supply goods (to other enterprises)	36	3,3%
Other than mentioned in section D	59	5,4%
Section F – Construction	185	16,9%
Section G – Wholesale and retail trade	354	32,4%
Section I – Transport, Stocks and communication	115	10,5%
Section K – Real estate services, renting and services associated with catering to economic activity	139	12,7%
Total	1093	100%

1.4. Enterprise size

How many workers does your firm employ based on an employment contract?	n	%
2 – 9 employees	451	41,3%
10 – 49 employees	424	38,8%
50 – 249 employees	218	19,9%
Total	1093	100%

1.5. Turnover value in 2006 (in million Euro)



1.6. Type of ownership

N=1093	
One physical person	70,8%
Many owners, stakeholders	27,7%
Government (the State)	0,0%
Employees	0,4%
Management (Managers)	0,4%
Domestic enterprise	0,4%
Foreign enterprise	0,2%
Other	0,0%
Total	100%

1.7. The manner of settling accounts with the Tax Office

General rules	63,4%
Complete accounts/ Complete accounting	24,7%
Taxation card	6,6%
Lump sum	5,1%
Decline	0,3%

2. Competitiveness of small- and medium-sized enterprises 2007

The study "Monitoring the condition of the SME sector 2007" allows us to analyze and evaluate, based on the opinion of small- and medium-sized entrepreneurs, the condition of the SME sector in 2006 and the first half of 2007, its competitive strength, the factors shaping competitiveness and the barriers limiting the opportunities for development of small- and medium-sized enterprises.

This year's edition, unlike the previous ones, has a context – high dynamic of economic growth based on strong consumption and investment growth, with a negative influence on GDP growth of net exports (which is the result of weakening export growth and higher pace of import growth). All this is happening while employment is rising and remuneration is also rising rapidly.

This is why it will be interesting to find the answer to questions on the influence of small- and medium-sized enterprises on the observed economic growth (which requires first and foremost statistical data, which the study does not provide), and type of benefits that can potentially result from this for small- and medium-sized enterprises – and whether the SMEs are benefiting from this potential. If yes, then what type of changes can we expect in their behavior in the medium and long term. If no – what are the reasons, are they located within the enterprises, or are they the result of external barriers.

Essential will also be the answer to the question if a good economic situation:

1. Weakens the negative influence of formal and informal institutions of the economic environment on long-term business decisions taken by the SMEs,
2. Weakens the negative influence of the legal environment in which the SMEs operate on their activity (unpredictability, instability, lack of transparency of legal regulations, which increases the risk of economic activity to a level that does not allow the SMEs to plan long-term),
3. Weakens the negative influence of administrative procedures and the work by the administration on the activities of the SMEs and their costs (the administration strengthens the negative consequences of the bad, continuously increasing, unpredictable law).

In this context essential will be the answer to the question whether small- and medium-sized enterprises benefit from the economic boom and concentrate on short-term activity, which would mean that the negative influence of formal and informal institutions of the business environment, the negative impact of the legal environment and administrative procedures and the work of the administration is so strong, that SMEs do not change the time horizon of their operations. Or maybe this negative influence is not that strong and the economic boom is used by small- and medium-sized enterprises to build their competitive position for the future.

2.1. The impact of economic growth in 2006 on the condition of small- and medium-sized enterprises

Note: All graphs included in this part of the Report are own work of the author based on the "Monitoring of the condition of small- and medium-sized enterprises 2007", PKPP Lewiatan, the study "Monitoring of the condition of small- and medium-sized enterprises 2006", PKPP Lewiatan, the study "Monitoring of the condition of small- and medium-sized enterprises 2005", PKPP Lewiatan.

The year 2006 was a good one for small- and medium-sized enterprises. According to data by the CSO³³ income in this group of firms rose by 13,9%, net profits by 35,8%, sales profitability by 1/5, share of income from exports in total income by 8%.

The data regarding the financial results of the SME sector in 2006 are still not available³⁴. However the results of the study "Monitoring of the condition of the SME sector 2007" allow us to analyze and evaluate the impact of the good economic situation in 2006 on the small- and medium-sized enterprises. Even more so as in the evaluation of the effects of operations of SMEs in 2006 considerable changes took place compared to the years 2004 – 2005, which in this field were comparable.

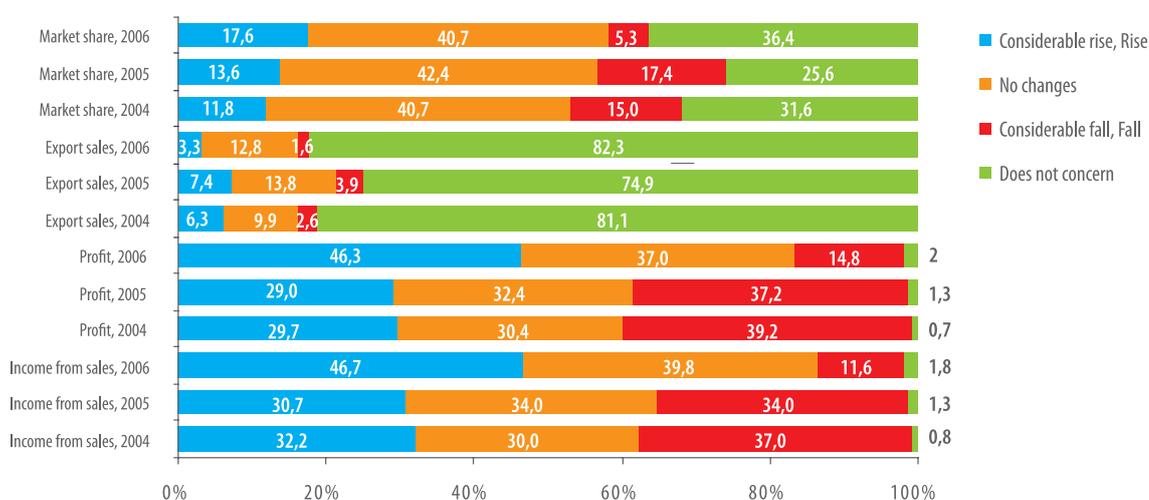
More than 50% of small and medium enterprises increased income from sales in 2006 than the case was in 2005 and 2004. Almost 60% more SMEs achieved in 2006 higher profits than in 2005 and 2004. Almost 30% more

³³ The financial results of non-financial enterprises in the period I – XII 2006, CSO

³⁴ The CSO will publish them in February 2008

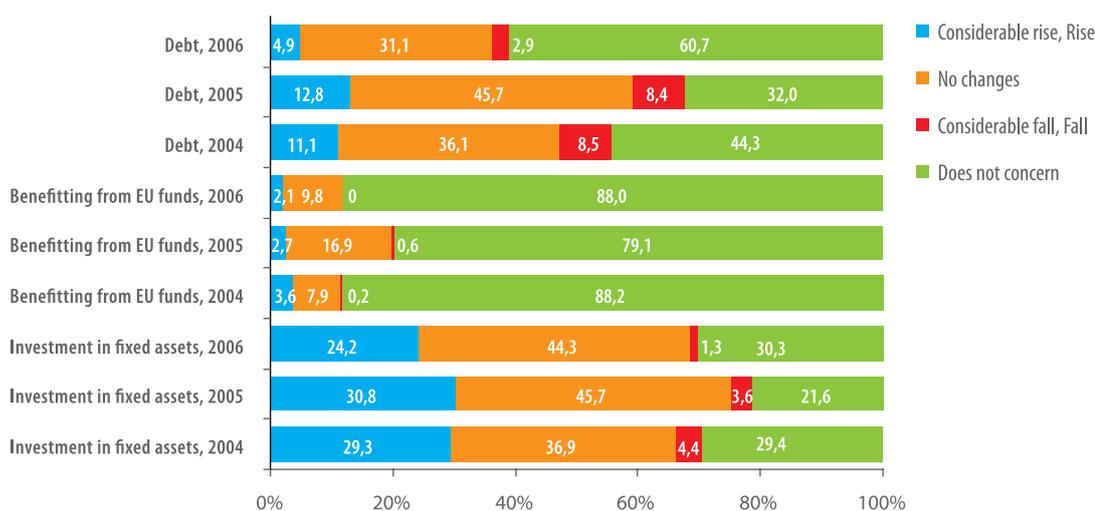
SMEs increased market share, simultaneously only 5,3% of enterprises stated that their market share fell. This means that the rise in market share occurred thanks to rise in the market and not as a result of taking market share away from competitors. This is confirmed by the assessment by SMEs regarding the number of competitors – in 2005 an increase in the number of competitors was declared by 56,6% of SMEs, in 2006 – 51,7%. On the other hand there was a considerable fall (though already low in 2004 – 2005) percentage of small and medium firms which increased export sales (by more than 55%) and simultaneously the percentage of SMEs, that in 2006 did not export rose (almost by 10%). This means that the interest by small- and medium-sized enterprises for exports decreased in 2006. The reasons for this state of things is the fact that demand on the Polish market increased and SMEs took the decision to fully (the percentage of enterprises that export sales does not concern rose) or partly (the fall in the percentage of enterprises that increased export sales) gave up on exports.

Graph 8. What changed in the firm's activities in 2006?



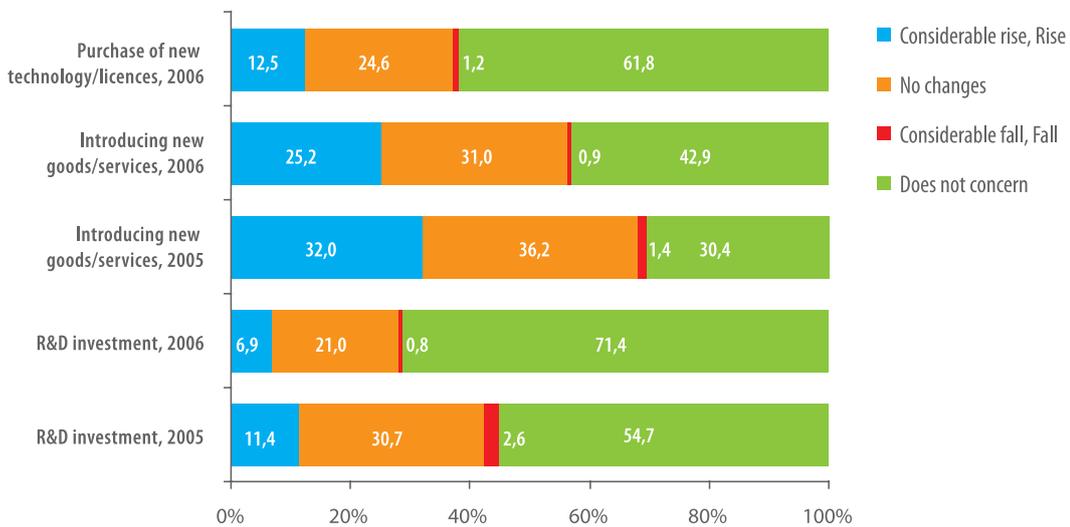
The growing number of SMEs that increased income, profits and market share was accompanied by – by 1/5 – a falling percentage of enterprises that increased investment in fixed assets. This means that enterprises, despite an improvement in the economic situation, the lack of a demand barrier, that is the opportunity to maintain increased sales in the longer term, despite higher credit capability – do not decide on investment in fixed assets. This means either a relatively high level of unused production installations, or other reasons, i.e. difficulty in obtaining loans (please refer to subsequent parts of the Report), awaiting the opportunity to access EU structural funds, or the lack of stability of economic activities, institutional barriers, unpredictable, unstable, unclear legal environment, burdensome administrative procedures, that is the reasons that have been identified as institutional barriers.

Graph 9. What changed in the firm's activities in 2006? (ii)



In the context of rising profits and limiting investment the falling percentage of SMEs that recorded an increase in debt (by 62%), but also an almost double increase of percentage of small- and medium-sized enterprises that declare that debt does not concern them is justified. However EU funds are still used (and this will probably continue in the new financial perspective 2007 – 2013) by a low percentage of SMEs and in 2006 there minor changes compared to 2004 – 2005.

Graph 10. What changed in the firm's activities in 2006? (iii)



One can put forward the question whether 2006 was a good period for small- and medium-sized enterprises. From a short-term viewpoint the answer is definitely yes. However in 2006 the SMEs did not undertake actions of a long-term nature, they did not start investment on a scale justified by the economic situation and the perspectives for its sustainability or on a scale that would create the conditions for increased competitiveness in the future.

The lower SME interest shown for investment into research and development (R&D) and preparation and introduction into the market of new goods and services is worrying. By almost 30% rose the percentage of SMEs that state that R&D investment does not concern them and the percentage of firms that in 2006 increased R&D expenditure compared to 2005 decreased by 40%. By 22% fell the percentage of small- and medium-sized firms that introduced into the market in 2006 new goods and services. This data points to the concentration by small- and medium-sized firms on short-term business actions – in 2006 less SMEs than in 2005 invested in fixed assets, less enterprises decided on introducing new products and offering new services, the percentage of small- and medium-sized firms that increased R&D investment decreased, and simultaneously the percentage of SMEs that stated that R&D investment does not concern them increased.

One should also ask about the impact on the economy of the decisions taken in 2006 by the small- and medium-sized enterprises. Unfortunately these were not good decisions from the viewpoint of the development of the economy – the percentage of SMEs uninterested in exports, already quite high, grew considerably, the interest in investment and credit decreased. Much more firms pointed that investment into environment protection do not concern them.

From the perspective of medium- and long-term business activity it is hard to consider 2006 as successful for the sector of small- and medium-sized enterprises and the economy as a whole. The decision to limit investment was the sole decision of the SMEs themselves. The reasons for those decisions are however essential. One can take on two approaches:

1. SMEs want to use the good economic situation to increase profits, they think and act in a short timeframe, they are not interested in creating conditions for their own growth in a medium- and long-term perspective. Their strategy is based on a short-term perspective and a flexible adjustment to the changing prosperity. Even though the institutional conditions for growth were favorable to taking decisions with a long time horizon they would not use them.

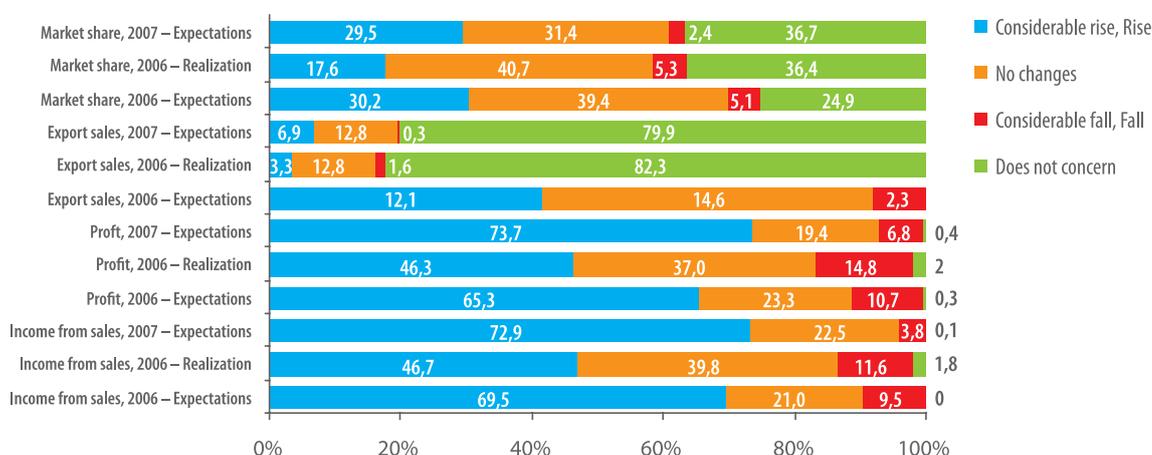
- SMEs are set on using the good economic situation for increasing profits, they think and act in a short timeframe, as the formal and informal institutional limitations do not create the right conditions for such thinking or acting. Lessening the institutional, both formal and informal, development barriers would alter the strategy of small- and medium-sized enterprises, it would lengthen its perspective.

The analysis and evaluation of following elements of the Study should help in answering which of the approaches mentioned above is correct.

2.2. Activities of small- and medium-sized enterprises in 2007 – The expectations

The analysis of the data obtained from the Study shows that small- and medium-sized enterprises do not plan to alter their strategy in 2007. One should remember that the Study was conducted during mid-2007, which would mean that the realizations of SME expectations regarding various aspects of this year's operations are well advanced.

Graph 11. Expectation of SMEs regarding their activities in 2007 (based on expectations and realization in 2006)

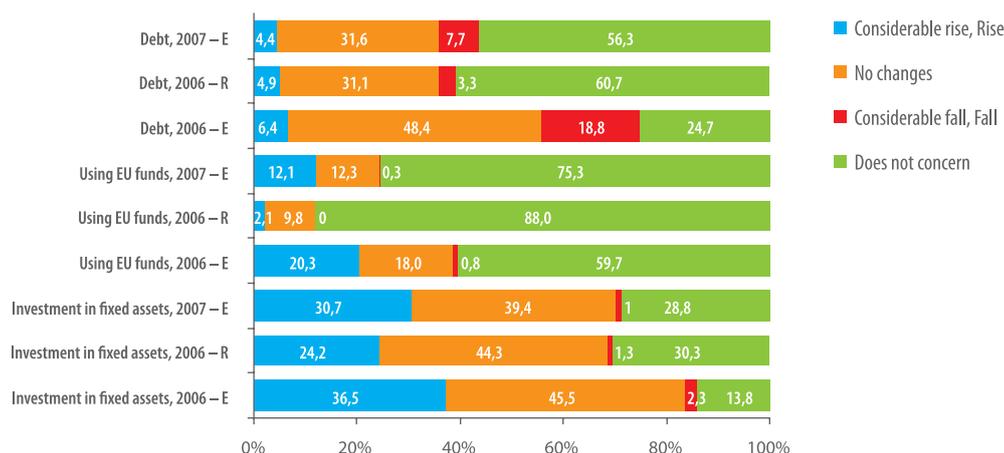


Small- and medium-sized enterprises have even higher expectations regarding increased sales and profits in 2007 than compared to their expectations for 2006. Expectations regarding increase in market share in 2007 are similar to the ones in 2006. However very clearly there was a decrease in the expectations regarding the rise of export sales. Analysis of this data confirms the observations and assessment presented based on the changes in SME activity in 2006.

This is also confirmed by the analysis of expectations regarding investment in fixed assets. An increase is expected by a 17% smaller percentage of SMEs in 2007 than the case was in 2006.

Also expectations regarding increased in debt in 2007 is declared by less small- and medium-sized enterprises than the case was in 2006. It must be pointed out that regardless it is a very small number of firms.

Graph 12. Expectation of SMEs regarding their activities in 2007 (based on expectations and realization in 2006) (i)



One should pay attention to expectations regarding the opportunity to benefit from EU funds – an expectation of higher utilization in 2006 was declared by 20,3% but only 2,1% actually achieved it. Despite this high disproportion between expectations and their realization the expectations regarding the possibility to use EU funds in 2007 are 6-times higher than the actual use in 2006. This gap between expectations and realization in 2006 had a small impact on expectations regarding access to EU funds in 2007. All this while there was information that Poland is still negotiating the Operational Programs with the European Commission, which meant that no EU funds would be made available in 2007 (or at least there are small chances of this happening).

Expectations regarding an increase in 2007 of R&D investment and regarding the introduction into the market of new products and services is declared by less small- and medium-sized enterprise in than the case was in 2006.

Graph 13. Expectation of SMEs regarding their activities in 2007 (based on expectations and realization in 2006) (iii)



The expectations of small- and medium-sized enterprises regarding their activities in 2007 confirm their concentration on the short-term, on capitalizing on the good economic situation in Poland. This does not allow to take the approach that 2006 was a temporary deviation from the necessary development path of SMEs – investment, including R&D investment, introducing to the market new goods and services, rising participation in international exchange.

2.3. The short- or long-term strategy of small- and medium-sized enterprises

The competitive standing of enterprises depends not only on numerous factors that the firms can affect but also on a large number of exogenous factors. Defining the internal factors it is assumed that the most important are³⁵:

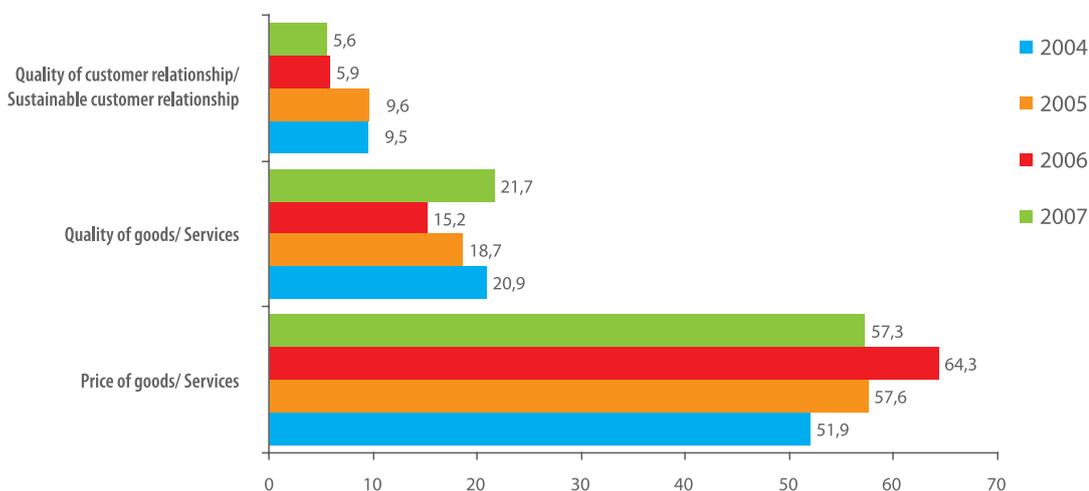
1. Reduction of unit costs and the possibility to offer lower prices,
2. Higher quality goods,
3. The ability to adjust goods to the demands of the customer,
4. Technological innovation,
5. Product innovation,
6. Actions in the sphere of organization and management, which ensure a high dynamic of increase of production and sales and the value of the firm.

35 J. Bossak, The international competitiveness of the nation's economy and the enterprise. Theoretical and methodological considerations, in: Competitiveness of the Polish economy in the era of EU integration and globalization, J. Bossak, W. Bienkowski (ed.), WSE, p. 45 - 46

2.3.1. Factor creating the competitive standing of SMEs on the marketplace

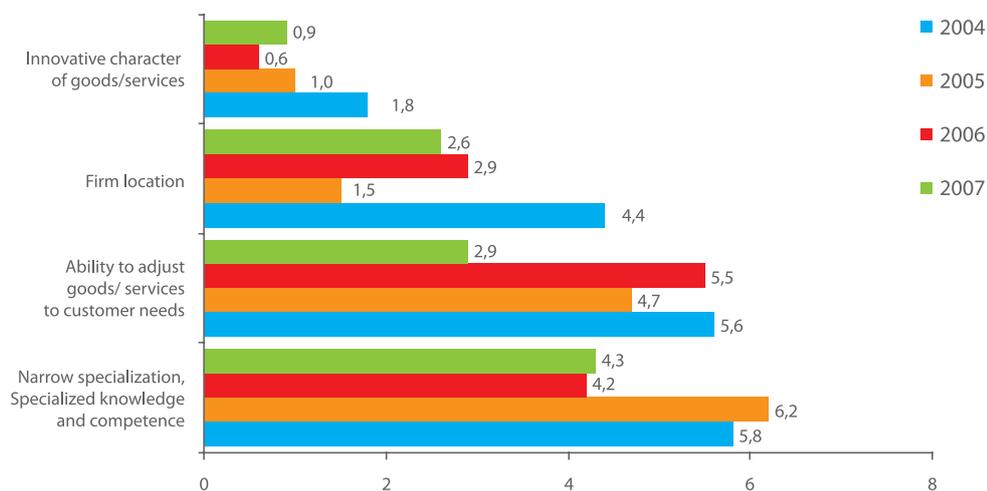
Small- and medium-sized enterprises operating in Poland use part of these factors to creating their competitive standing both on the internal and external markets.

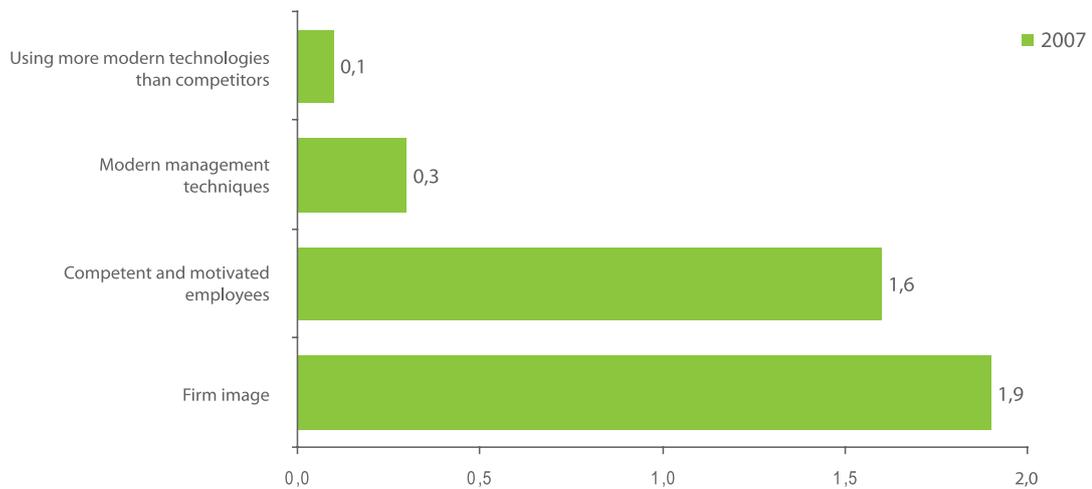
Graph 14. Factors determinig SME competitiveness, 2004-2007



The dominating factor used by the SMEs is price. This worrying trend, as SMEs operating in Poland are unable to win the competitiveness struggle with enterprises from China, India or Brazil, which rose up to 2006 weakened in 2007. Small- and medium-sized enterprises start (once again) to pay bigger attention to the quality of goods and services. The price and quality of goods and services in 79%, according to SMEs, ensures higher competitiveness. The importance of other factors is much smaller and quite "dispersed". The still low, and lower than in 2004 – 2005, importance of an innovative character of goods and services in creating the competitiveness of SMEs is worrying. Also the considerable fall, of the already low in previous years, importance of individualized offer to the customer (the ability to adjust production and services to the needs of the customer) is worrying. It is possible that in both case this is the effect of a lack currently on the market of a demand barrier, and as a result the tendency to standardize and increase the scale of production for decreasing unit costs of production and the ability to maintain costs on an unaltered level (this would be confirmed by the low level of inflation which accompanies the rapid pace of economic growth).

Graph 15. Factors determinig SME competitiveness, 2004-2007 (ii)



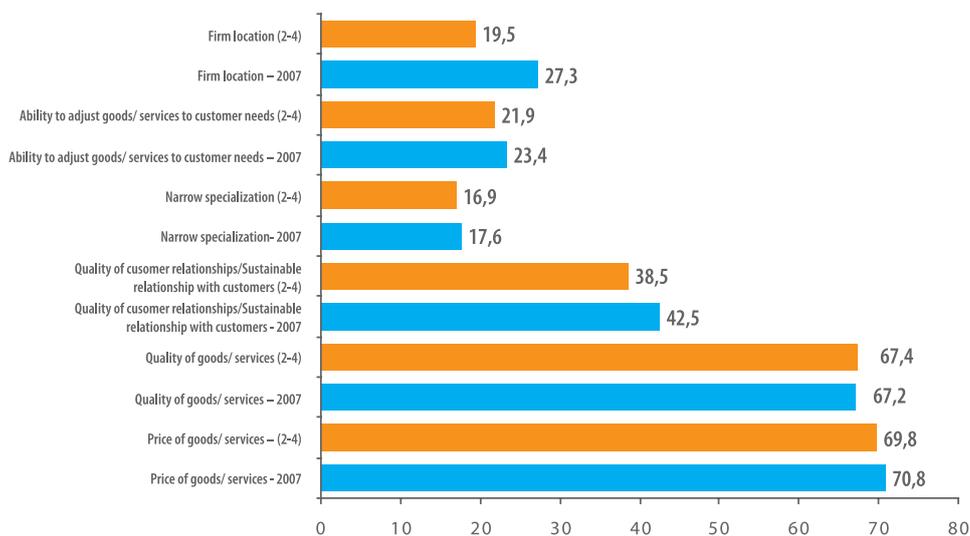
Graph 16. Factors determining SME competitiveness in 2007

The factors that help shape competitiveness of the SMEs that were investigated in 2007, but were not investigated the previous years, are: image of the enterprise, competence and motivation of the employees, modern management methods and the utilization of more modern production technologies than the competitors. The results point to the quite small importance of those factors to the competitiveness of small- and medium-sized firms. Even a factor like competent and motivated employees, which due to the current situation on the labor market, seems to be an important factor was not clearly recognized by SMEs. Even in the construction sector, were 2,6% of enterprises declared it as important to their competitive standing. This can mean that the problems on the labor market do not translate to a large extent into SME competitiveness.

2.3.2. Building the competitive standing of SMEs in the next 2 – 4 years

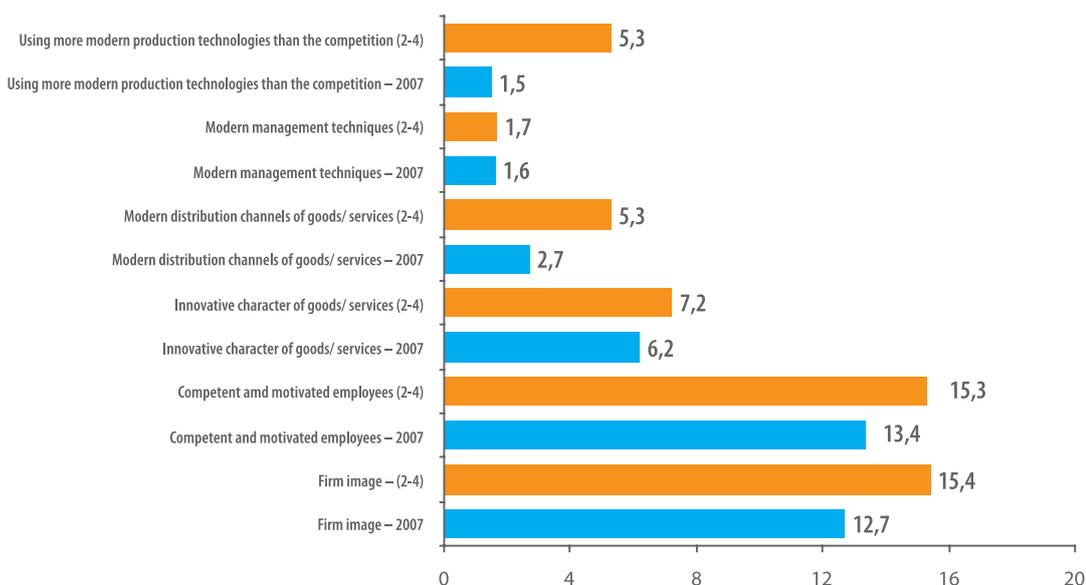
Small- and medium-sized firms do not attempt to change their policy regarding creating their competitive standing. In the next 2 – 4 years price will dominate. However the tendency to decrease its importance should be sustained. The importance of quality, according to the SMEs, will also be sustained. The other factors will continue to remain factors of smaller importance.

However in this group of factors it is important to note the increased importance of enterprise image, competent and motivated employees, creating modern distribution channels and using more modern production technologies than the competitors.

Graph 17. Factors that will determine SME competitiveness in the next 2 - 4 years - 3 most important in total (in relation to determining factors in 2007)

The fact that small- and medium-sized enterprises do not attach importance to modern management techniques attracts attention. This low propensity by SMEs to use modern management methods does not allow benefiting from the reserves held within these enterprises. The sustainability of this tendency is worrying – if in the next 2 – 4 years small- and medium-sized enterprises do not start using modern management tools, competing on price and quality may prove impossible.

Graph 18. Factors that will determine SME competitiveness in the next 2 - 4 years - 3 most important in total (in relation to determining factors in 2007)

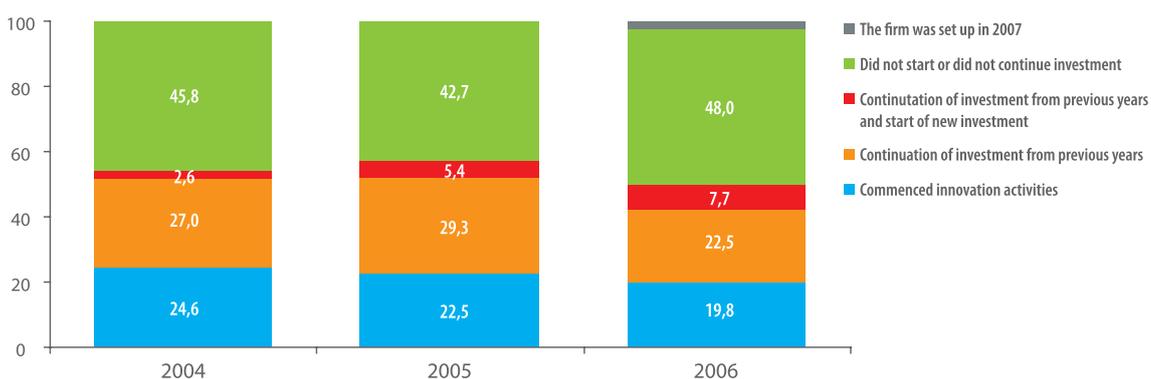


In the opinion of small- and medium-sized enterprises price will still be the most important factor in creating competitiveness, but it will not be as important as in the previous years. SME to a much larger extent recognize the importance of quality of the offered goods and services. Image becomes important in creating the competitive position of enterprises, as well as competent and motivated employees and using modern production technologies.

2.3.3. Propensity to invest and the development of small- and medium-sized enterprises

Since the second half of 2003 the pace of economic growth in Poland is increasing and there is a good economic situation. For enterprises this means opportunities for growth. Simultaneously opportunities for growth mean not only higher production, higher sales and higher profits but also the need to invest. However instead of rising, the percentage of small- and medium-sized enterprises that in a given year start investing is decreasing. In 2006 the percentage of firms continuing investments undertaken in previous years also fell. But most importantly in 2006 as much as 48% of SMEs did not start any investment.

Graph 19. During the years 2004 - 2006 did the firm start or continue investment?



Trade and services had the lowest propensity to invest – in 2007 in this sector 58,1% of small- and medium-sized enterprises did not start or continue investment. Also over 50% of enterprises from the real estate services, rent and services catering to economic activities sector did not invest in 2007. The enterprises from the transport, stocks and communication sector (68,2% of SMEs) and firms from the industrial sector (66,4%) were investing most frequently.

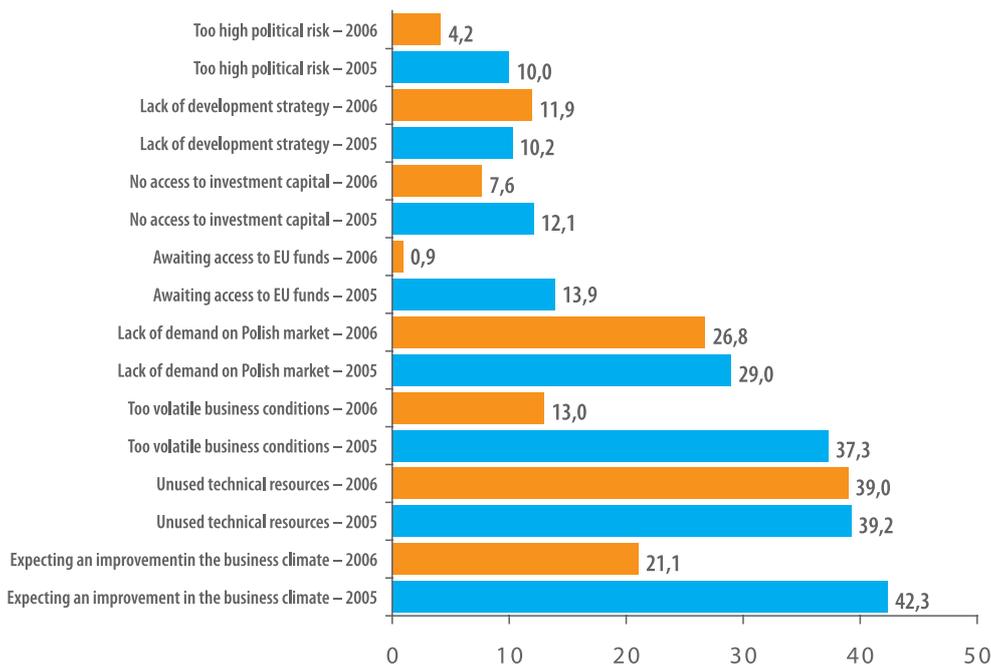
Micro-sized enterprises were the least likely to invest in 2007 (51% did not invest).

Based on the sectoral analysis of the propensity to invest and based on the assessment of the propensity to take risk according to size class, it is clear that investment was carried out by the sectors which were characterized by a higher growth dynamics. This in a situation when enterprises from these sectors, did not point to incomplete utilization of production capabilities as a reason for not undertaking investment.

A comparison of the reasons for the lack of investment in 2006 and 2005 clearly points to the weakening of the main factor that before 2006 had a negative impact on the decision to invest – awaiting an improvement in the economic situation. The importance of the lack of demand on the Polish market when taking the decision to invest also decreased. Access to capital also had a relatively low impact on investment decisions.

The lack of a development strategy, which is understandable (however the lack of a strategy at all is not), had a higher impact in 2007 than the case was in 2005 on not taking investment decisions.

Graph 20. The main reasons for the lack of investment 2005-2006 (the 3 most important reasons in total, %)



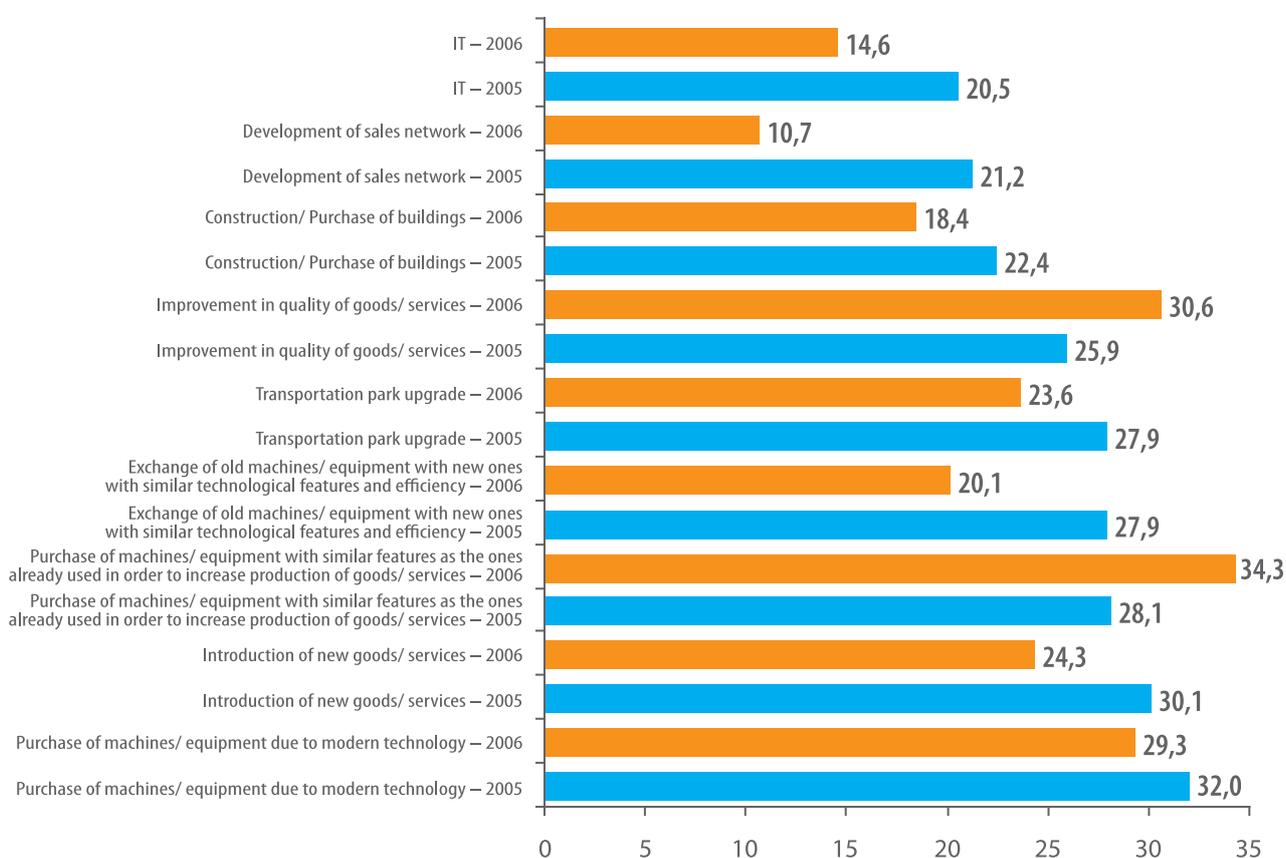
Attention is drawn to the fact that the two so far important (in total) factors having an impact on investment decisions decreased in significance – instability of business conditions and political risk – the percentage of firms pointing to these factors decreased 3-times – from 47,3% to 18,1%. In this case the interpretation problem is that in 2006 nothing that would stabilize business conditions occurred, the political risk also did not change radically. Explaining the lessening impact of these factors on investment decisions is essential in light of the assumption employed in the Report. Answers should be sought in the immunization of the economy from political affairs or the ability of SMEs to get by in unstable conditions. However immunization and getting by is a process, so it couldn't have occurred suddenly in 2006. Answers could also be sought in strengthening of other factors affecting negatively investment decisions or the occurrence of new factors. However nothing new took place. This means that with the available data there is no clear answer to the question about the low propensity to invest by small- and medium-sized enterprises in a period of rapid economic growth.

Without settling the issue of the reasons behind the lack of investment by a large share of small- and medium-sized enterprises, the sustainability of this tendency is striking. In 2007 investment is carried out (new and continuation of previous investment) or planned to be commenced only by 38,9% of SMEs, while in 2006 the number was 50%. Additionally among the 3 main financing sources of new investment in 2007 as much as 88,4% of enterprises cite own funds.

2.3.4 Is the investment structure supporting SME competitiveness?

The structure of the investments realized by small- and medium-sized enterprises in 2006 is correlated with the factor, besides price, creates the competitive standing of SMEs – improvement of the quality of goods and services. In 2006 18% more enterprises realized investments into improvement of the quality of the offered goods and services.

Graph 21. Investment target in 2005 and 2006 (i) (the four most important indications in total, %)



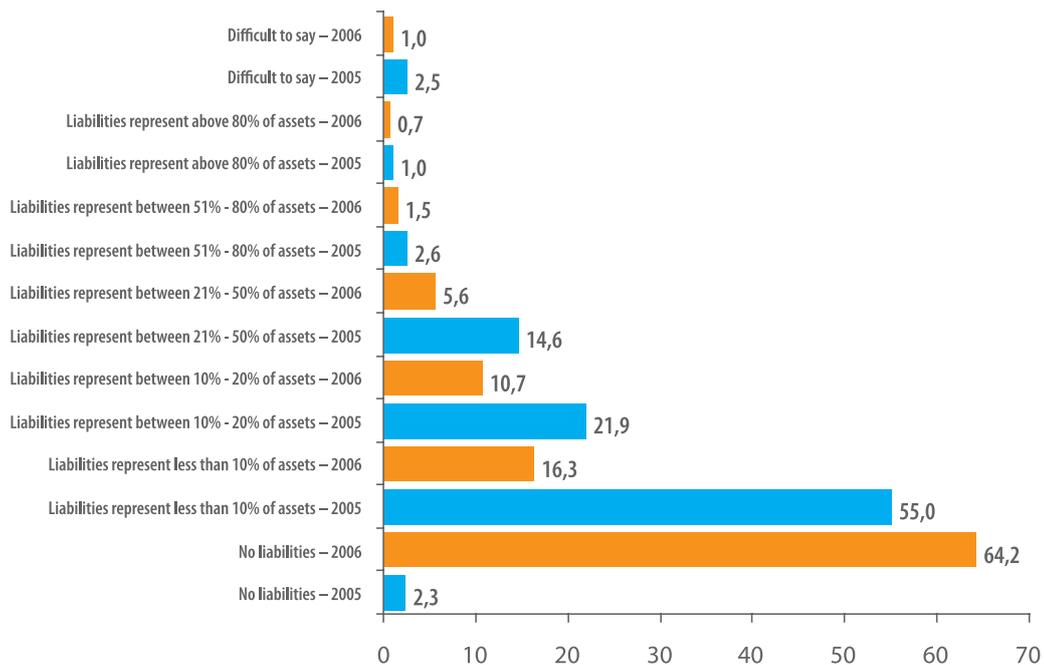
Simultaneously in the investment structure one can clearly see a correlation of realized investments with the short-term policy of SMEs of adjusting production capabilities to the current market needs – more than 22% more enterprises in 2006 bought machinery and equipment with similar features to the ones already owned in order to increase production capabilities than the case was in 2005. SMEs decreased their interest in investment in new technologies, preparation and introduction of new products, development of the sales network. The investment structure clearly confirms the preference of small- and medium-sized enterprises to implement a short-term policy to capitalize on the good economic situation. This type of investment does not help SMEs to gain and sustain competitive advantage.

The question is whether such concentration of investment on short-term goals is an independent choice made by the SMEs, or is the result of external limitations, which do not facilitate the SMEs the necessary conditions to concentrate on long-term goals.

2.3.5 Are the difficulties in accessing external financing sources limiting the SME development opportunities?

Small- and medium-sized firms always to a much higher degree than large firms use in their activities and in financing investment external financing sources. The structure of financing of SME assets in 2006 comprised in most enterprises mostly of equity. In 2005 a lack of liabilities was declared by only 2,3% of firms, but as much as 55% of firms had liabilities valued at less than 10% of firm value.

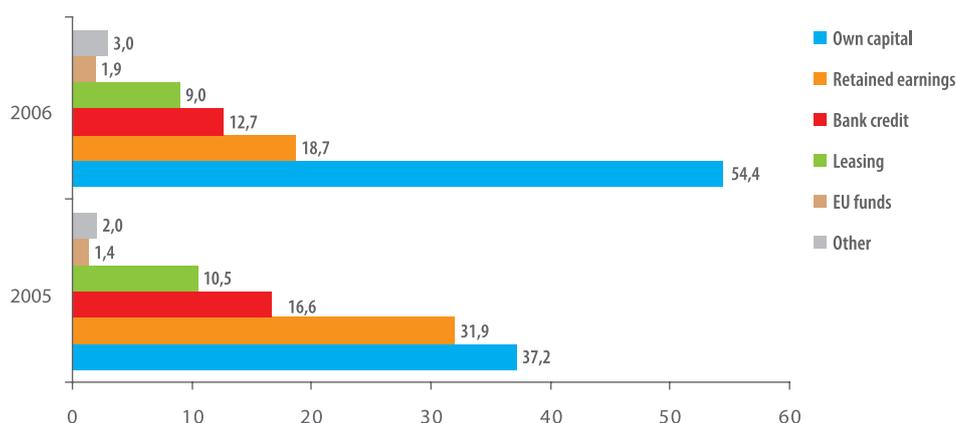
Graph 22. What is the level of liabilities in your firm? (total liabilities/ total assets)



Such a radical change in the financing structure of assets in 2006 could be the effect of the use of the high SME profitability to pay down existing liabilities. Such SME asset financing structure does not allow for the use of leverage and simultaneously the widening of operations and increasing the return on capital employed (on the condition of course that the leverage would be positive). This means that small- and medium-sized enterprises loose, when compared to large enterprises, access to the main development factors, they do not develop as fast as their could, the distance to the large firms is widening. In economic operations relying mainly on equity will not allow SMEs to invest sufficient capital in the development of factors that would allow them to change radically their competitive potential.

Small- and medium-sized enterprises finance investment mainly through own capital and retained earnings – in 2006 73,1% of the amount of investment was financed by SMEs thorough own capital (including retained earnings). The importance of loans in financing SME investment is decreasing.

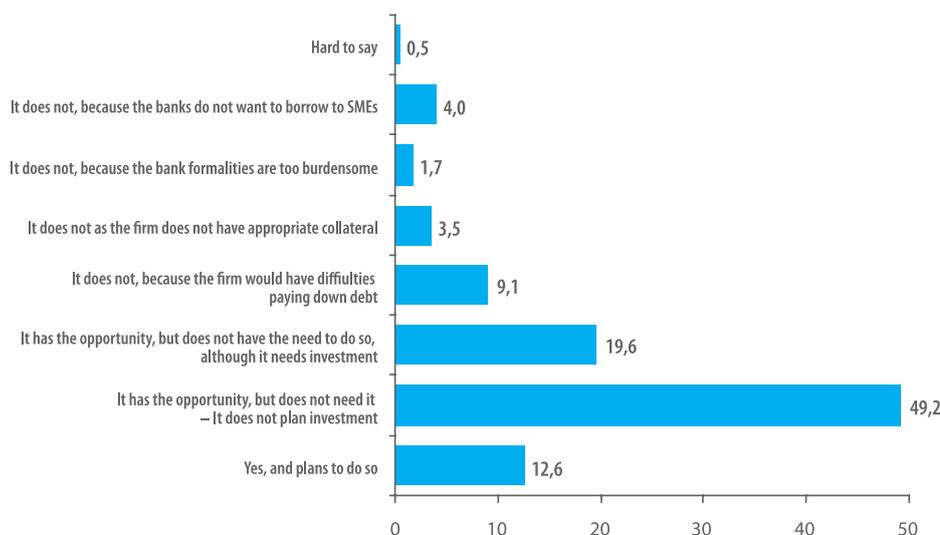
Graph 23. What were the sources of investment financing in 2005 and 2006?



The enterprises confirm this by pointing out that the best source for financing new investment is own capital – it was mentioned by 44,2% SMEs. Bank loan is an attractive financing source for 21,9% of firms. What are the reasons for such choice of financing sources? To what extent are they the result of good financial results of enterprises and to what extent do they result from difficulties in accessing foreign capital?

The analysis of the opportunities to take on long-term debt (or increase it) by SMEs and the analysis of the barriers in the use by SMEs of credit can point to answers to this question.

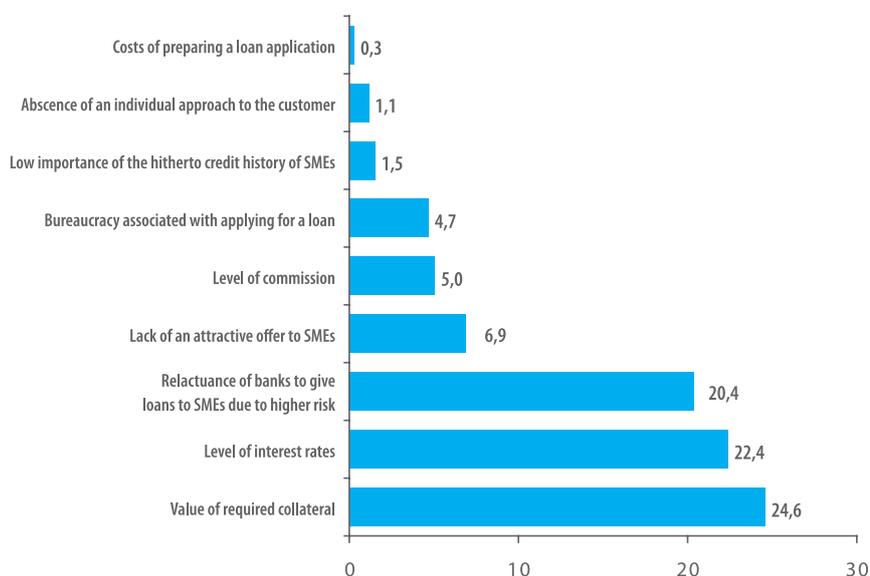
Graph 24. Does the enterprise have the opportunity to assume or increase long-term liabilities?



The data above shows that 81,4% of small- and medium-enterprises had the opportunity to take on or increase long-term debt, but only 12,6% plans to do so. Among the 18,6% of SMEs which in their own opinion do not have the opportunity to take on long-term debt, almost half (9,1%) declare that this is due to the difficulties they would have with paying it down. Only 9,2% of SMEs have a difficult, due to various reasons, access to long-term financing. This means that the scale of the problem defined as difficult access by SMEs to capital is not large.

In the group of 9,2% SMEs that have a difficult access to long-term financing 3 main issues turn up – lack of collateral, burdensome banking procedures and the reluctance of banks to grant loans to SMEs. This is confirmed by the extensive catalogue of barriers to using bank loans.

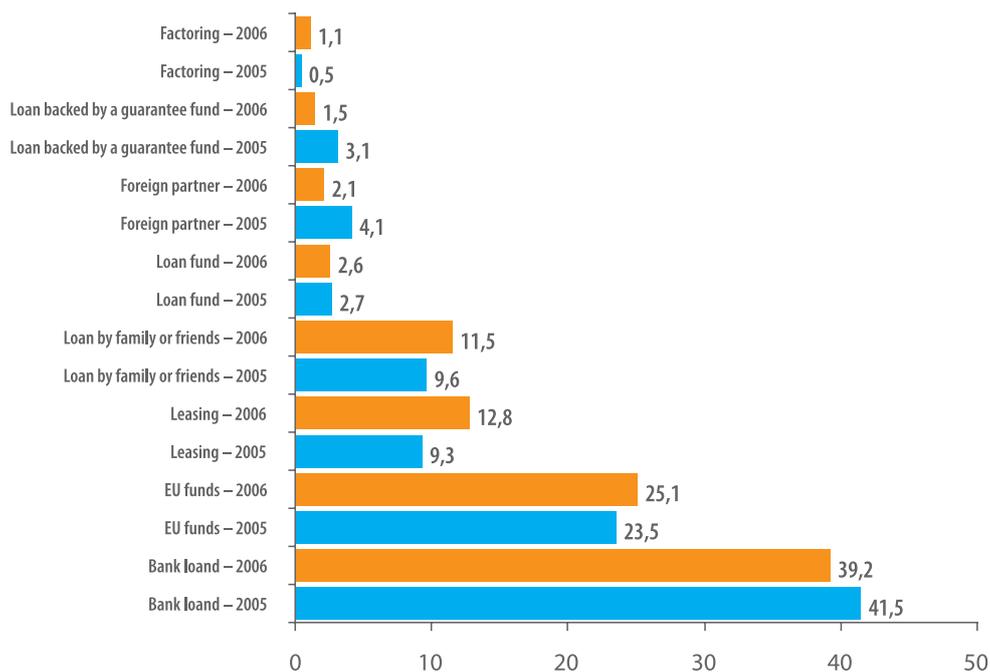
Graph 25. What is the barrier to using bank loans?



A large share of barriers impeding SME access to capital is associated with the high risk of granting bank loans to these enterprises – the higher risk results in the requirement of collateral, cost of capital, bureaucracy, the supremacy of evaluation of the current condition of the firm above the credit history of the firm. Thus on the one hand we have higher formal requirements than in the case of large firms that the SMEs need to fulfill in order to get a loan. On the other hand – the high trust of SMEs to self-financing.

A change is also taking place in the structure, from the perspective of SMEs, of the best external financing sources.

Graph 26. What would in the case of your firm be the best financing source for new investment?



Loans become less desirable external financing source for new investment. On the other hand the importance of leasing is increasing. In the case of SMEs this form of financing has many advantages – among others it offers, according to the SMEs, better financing conditions than a bank loan, the lease object earns the installment repayment, there are favorable taxation regulations, it allows for a more frequent exchange of fixed assets.

On the other hand it is unrealistic to expect that EU funds will push out loans as the amount of funds, though significant, is limited. It seems that the experiences from the financing perspective 2004 - 2006 did not change how SMEs view EU funding.

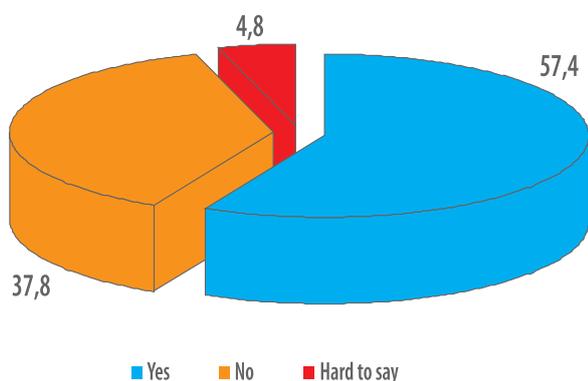
The increased share in external financing of loans from family and friends is evidence that small- and medium-sized enterprises do experience on the financial market difficulties in accessing external financing.

In the case of small- and medium-sized enterprises the problem with accessing external financing in the context of creating conditions for the development of these enterprises is much more complex. If investment with a normal level of risk cannot always obtain financing due to the nature of SME operations, then it will be even harder to obtain external financing for investment project with a higher level of risk. Simultaneously without such investment the opportunity to increase the competitive potential of small- and medium-sized enterprises is limited - of course based on the assumption that they do want to undertake such investment.

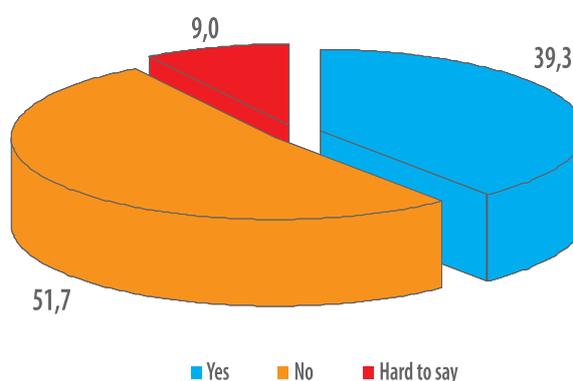
2.3.6. Are the SMEs likely to build their competitive standing on innovation?

The interest for innovation among small- and medium-sized firms decreased. This is evident from the frank declarations of SMEs and the structure of realized investment in 2006 (see point 2.3.4. and Graph 21).

Graph 27. Would the firm innovative activities (2006)?

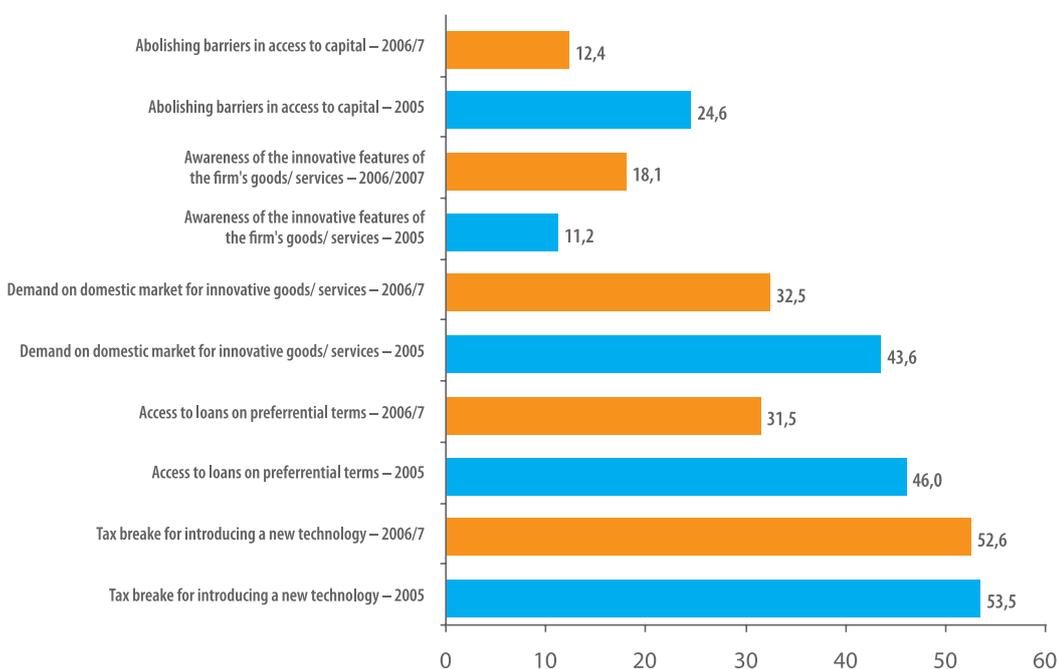


Graph 28. Would the firm need innovative activities (2007)?



Today fewer firms see a justification for innovation activities. This is also confirmed by the analysis of factors that, according to SMEs, could have increased their innovativeness – there is less interest in accessing loans on preferential terms for conducting innovative activities (and generally in abolishing barriers to accessing credit) and the possible increase in demand on the Polish market for innovative goods and services. The importance of a novel and innovative character of goods and services for building competitive standing is decreasing. Interest is decreasing (though still remaining high) for cheap loans for innovative ventures and financing investment into modern technologies through EU funds.

Graph 29. What factors would increase the innovativeness of the firm? (i) (the three most important factors mentioned in total; % SME)



However there are three factors that would activate small- and medium-sized enterprises – knowledge of the innovative solutions of the goods and services on offer, knowledge of innovative management solutions and competition from other, more innovative firms, in the sector.

The fact that tax breaks associated with implementing new technologies is still first among factors that could increase SME innovativeness (with more than 50% of indications) is another proof of the low efficiency in reaching small- and medium-sized firms with information on instruments supporting innovation. It is also evidence of the lack of real interest for innovation among enterprises, because if this interest was in place they would have accessed the necessary information. However this thesis needs verification, because if it is untrue, one (scientific and research centers disposing of solutions

required by the economy and the public administration appointed to support SMEs) should seek to construct an information policy that would react to SME needs. This has already been talked about in last years Report.

2.3.7. Verification of the competitive potential and competitive standing of SMEs through participation in international exchange

In 2006 we were amazed that the value of Polish exports amounted to 88 billion Euro (according to CSO, and 93,3 billion Euro according to NBP) and rose by 23,1% compared to 2005. However already in 2006 the import dynamic (124,2%) was higher than the export dynamic. This had a negative influence on GDP growth. In 2007 exports continue to rise, but its dynamic from month to month is decreasing. The higher import dynamic is strengthened.

Although results of enterprises employing at least 50 workers (medium and large firms) show that the percentage of exporting firms is decreasing³⁶, the share of income from exports in total income is increasing, it is taking place in a group of firms that represent only 1,02% of the total number of enterprises in Poland. Whereas the data on the number of exporters in the whole enterprise sector clearly show a regression – the number of exporters in 2003, the highest-valued year for this indicator, was 50 075, by 2006 it fell by 1/3 – to 31 777 firms³⁷. Though the number of exporting firm with foreign capital stakes fell during this time by 28%, the fall for exporting firms with not foreign capital stakes was much higher – 38% (almost 16,5 thousand firms). Today 54% of Polish exports is realized by firms with foreign capital stakes.

This data clearly shows that Polish export “stands on” large firms with foreign capital. It also shows that the value of exports per one exporting firm is increasing. This means that if somebody is falling out from the exporting game it must be the SMEs. Thus we are faced with large exporting firms strengthening their presence on foreign markets. Their strategy centered on external markets remained unaltered despite higher consumption on the Polish market. Their decision is also unaffected by the strong zloty versus the Euro and the Dollar (with high value exports it pays to hedge against currency risk). Simultaneously small firms give up the struggle for foreign markets – they think it is easier to compete on the domestic market. Concentrating on the domestic market they get rid off (or limit) the currency risk.

The question arises - why is this so? It seems that the reason is not the weakening competitive position of Polish firms (there is no proof to support the statement that this is the reason for the decreasing number of exporting firms), but rather the rapidly growing consumption on the Polish market, that “pushes out” export from the sphere of interest of a large share of firms, as this limits their operational risk (especially in the case of small firms). Even more so as the rise in consumption is accompanied by a strong zloty which decreases the profitability of exports for some firms, especially small ones and those whose exports do not require imports. Additionally for small firms the costs of presence on foreign markets- compared to the relatively small income from export sales – are high. So if there is an opportunity to concentrate sales on the Polish market – they use it. However they must remember that a return to foreign markets will be very difficult, if not impossible.

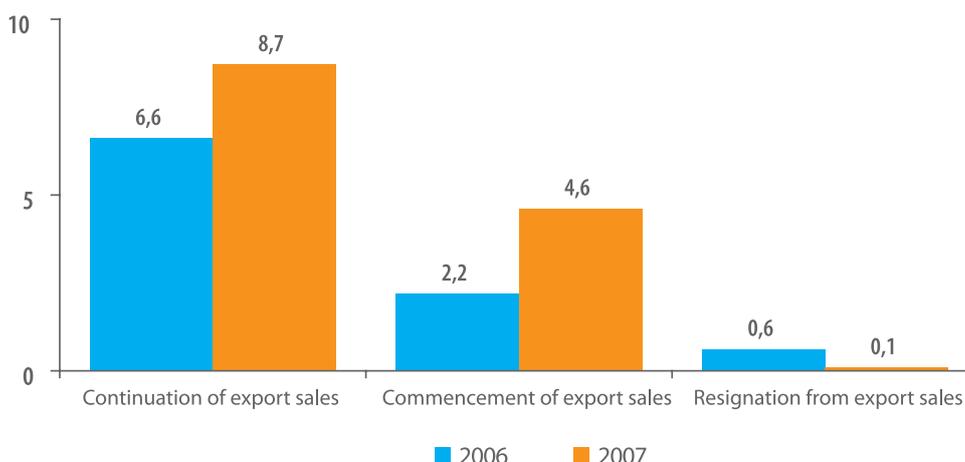
Thus seeking a simple answer to the question regarding the reasons for the decreasing interest for export among firms operating on the Polish market we could point to, as it is often done, to the strong zloty and growing domestic demand.

Based on the information obtained from small- and medium-sized enterprises it seems that in 2006 6,6% of enterprises exported their goods and services (including sales to the EU Internal Market) and an additional 2,2% of firms planned to commence exports. In effect in 2007 exports are continued by 8,7% of firms, and an additional 4,6% plan to commence exports. This means that only a small fraction of SMEs are exporters.

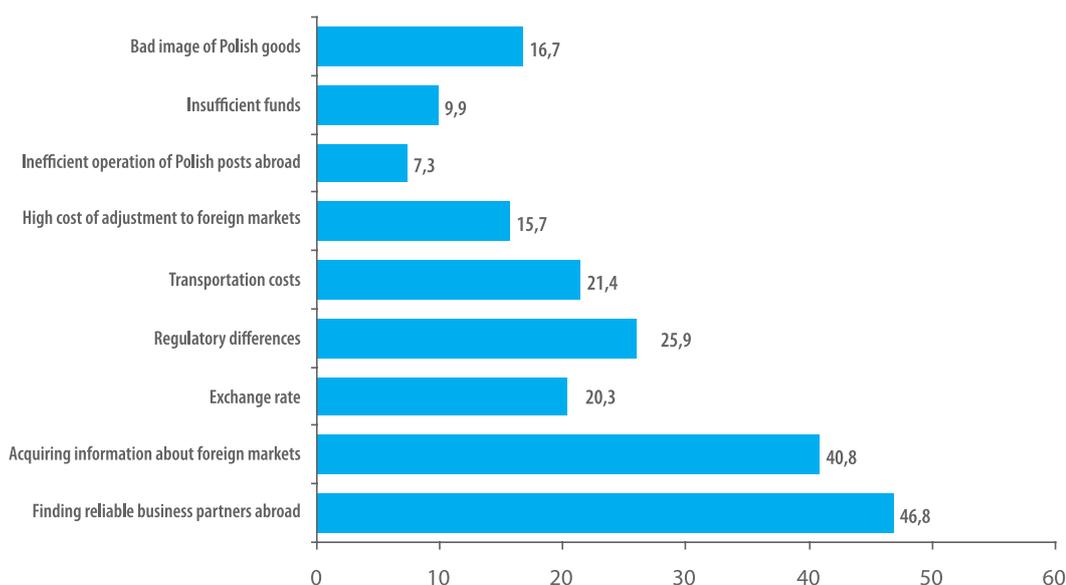
In 2005 83,2% of small- and medium-sized firms were not exporting, in 2006 this percentage was considerably higher – 88,6%. In accordance with enterprise declarations there should be 86,7% non-exporters among SMEs in 2007.

³⁶ Financial results of non-financial enterprises in the period I – VI 2007, op. cit.

³⁷ Ministry of Economy

Graph 30. Will the firm continue or commence export sales? (%)

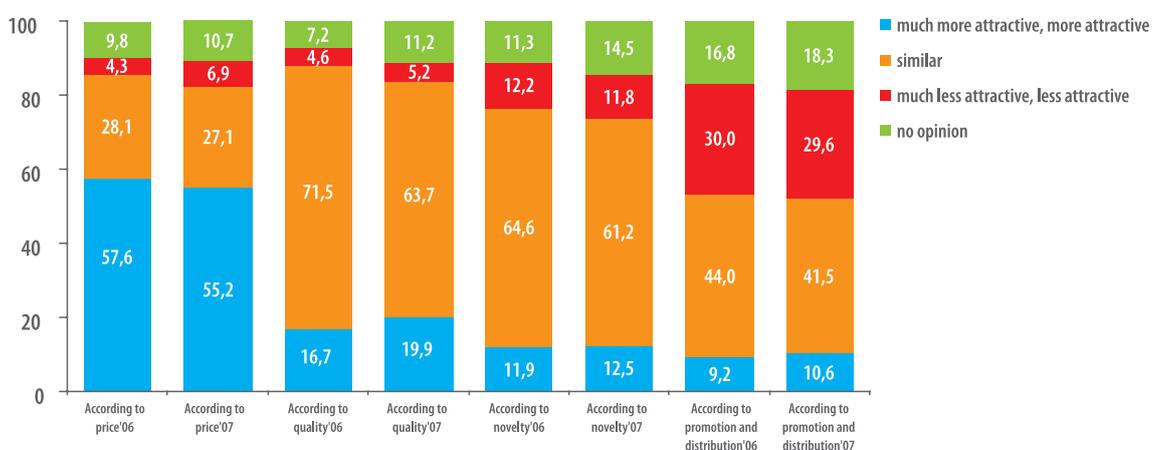
The reason for SMEs giving up on exports is not only the growing demand on the Polish market, this was talked about earlier. The decision to give up is influenced by a very long list of impediments to taking up and conducting exports. In relation to the previous edition of the Study, some alterations on this list took place – mainly the negative impact of a strong zloty on taking up and conducting exports decreased, though it is still among the top 3 barriers for 20,3% of SMEs. The reason for the decreased importance of the exchange rate for exporters can be the compensation of falling income from export by cheap imports due to the strong zloty (of course if the enterprise simultaneously exports and imports). The importance of costs of adjustment to the requirements of foreign markets also decreased – this is surely the effect of having already incurred these costs when entering foreign markets. By half decreased indications of insufficient financial resources as a hindrance to taking up and conducting exports. This change is the result of improving financial standing of small- and medium-sized enterprises.

Graph 31. What is the main difficulty in commencing or conducting export sales, 2007?

Despite the many barriers that existed also in the period when enterprises commenced exports, in the period 2001 – 2003 - the most difficult period also because of the macroeconomic situation on the global markets – the number of small- and medium-sized exporters kept on growing. Today, during much better macroeconomic conditions, SME interest for exports fell. The effects of enterprises turning away from exports will be numerous – i.e. the already mentioned negative “contribution” of net exports to GDP, and as a result its lower growth, decreased competitiveness of Polish SMEs, the need to again sustain costs when entering external markets, when the business interest of the enterprise will require it or domestic consumption demand falls.

A verification of the competitive standing of small- and medium-sized enterprises is also the comparison, in terms of price, quality, innovativeness and distribution channels, of the goods and services delivered to the market by SMEs (regardless of whether given products or services are sold on the EU market or not) to their counterparts offered by firms operating in the EU market. The enterprises evaluate that their price advantage is considerable – in 2007 more than 55% of firms as acknowledged that the goods and services that they offer are more attractive, in terms of price, than their counterparts offered on the European market by EU producers. However compared to 2006 the percentage of firms offering goods and services at a more attractive price than European competitors decreased, the percentage of firms that recognized that their products and services are less price competitive increased. The SMEs loose, in their own opinion, the advantage of price.

Graph 32. Are the produced articles/ provided services comparable to the articles/services sold in the EU? (%SME)



The advantage of quality, novelty, promotion and distribution is indicated by a considerably smaller percentage of enterprises. Still an improvement in these sections occurred compared to 2006. This also concerns quality advantage.

This data confirms that still the main factor for gaining competitive advantage for SMEs is price. However the importance of quality is increasing. If research in the following years confirms these changes, we will be able to talk about the tendency to support price by other factors in the competitiveness struggle – quality, novelty and the use of modern distribution channels. Today we are still unable to put forward such a thesis.

In the year 2006 and the first half of 2007 large changes in the activities of small- and medium-sized enterprises took place – SMEs increased income and profits, their market share is growing, but it is not followed by a higher propensity to invest, including investment in R&D, they are not interested in introducing new products and services onto the market. They base on the still stronger price position when compared to competitors operation on the EU market. Small- and medium-sized enterprises focused on current activities, which they supported with insufficient investment when compared to the level utilization of production capabilities or the demand present in the market. SMEs also showed a smaller interest in exports – some of them withdrew completely from exports, locating their entire production on the Polish market. Good financial results allowed them to decreased financial liabilities, they operate mainly on the basis of own capital. Their interest – already quite small – in innovation decreased. It falls to such an extent that SME interest for tools that could support their innovative activities is also falling. This situation can strengthen, as the SMEs do not plan to change their strategy regarding gaining competitive advantage.

Why don't small- and medium-sized enterprises build today the fundamentals of long-term competitiveness – is it their *differentia specifica* or rather the effect of the existing institutional limitations (formal and informal), that do not allow them do operate with a long-term perspective.

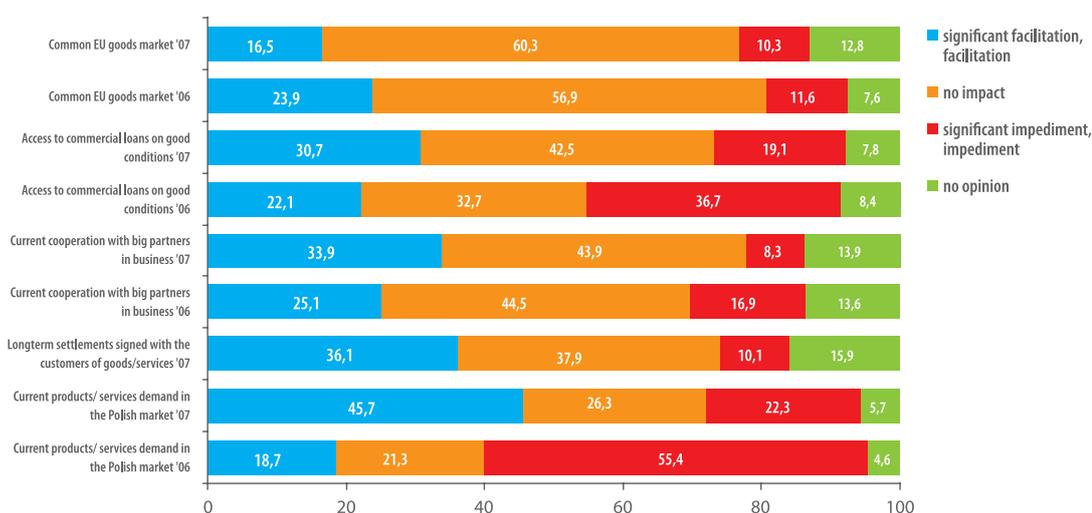
Barriers to the development of small- and medium-sized enterprises

Small- and medium-sized enterprises concentrate on fulfilling short-term goals – it results not only from their strategy but also the many barriers that limited and continue to limit their development. The list of these barriers is long and almost unchanged since many years. The good economic environment slightly improved the situation, but this improvement concerns only the non-institutional barriers.

1. The fall in the importance of non-institutional barriers

The development of the SME sector, looking from the perspective of its results, indicated until 2005 the incomplete utilization of their growth potential³⁸. This incomplete utilization of the potential resulted mainly from barriers to growth faced by enterprises and entrepreneurs in the legal and institutional field. This partly incomplete utilization of potential resulted also from the economic situation and the associated weakness of demand.

Graph 33. What factors and how they influence the development of an enterprise and its economic situation (i)



Today the barrier of demand for goods and services on the Polish market is considerably weaker. There was a drastic change in the evaluation of this factor – today more than 45% of SMEs see demand for goods and services on the Polish market as a factor that favors their development. Simultaneously 60% less small- and medium-sized enterprises experience the negative impact on their activities of the demand factor. This is the effect of an improving economy, increased employment and higher wages, which considerably improved consumption demand.

Improvement in the financial situation of enterprises had an impact on the change in assessment of access to credit – in 2007 almost 50% less SMEs see access to credit as a hindrance to development as compared to 2006. Simultaneously 51% SMEs (that is 39% more than in 2006) see access to credit as a simplification of economic activity.

This drastic improvement in the assessment of access to credit is not only the result of change in the financial state of enterprises, but also the opening of commercial to this customer, the widening of the offer for SMEs.

The change in the assessment of cooperation of SMEs with large business partners is very interesting. Small- and medium-sized enterprises clearly do not see large enterprises as competitors, but rather as a growth opportunity. More than 1/3 of SMEs regard cooperation with large firms as a factor positively influencing their development and economic situation. This means that in Poland we are building a model of cooperation linkages between large firms and SMEs, that favors the development of both groups of enti-

38 Study "Monitoring the condition of the SME sector" for subsequent years, PKPP Lewiatan

ties. What is interesting is that in 2007, as compared to 2006, there was a considerable rise in the percentage of small- and medium-sized trade enterprises, which see cooperation with large business partners as an enabler – rise from 24,5% to 33,9%, with simultaneous fall of the percentage of SMEs that see cooperation with large firms as a hindrance – fall from 16,1% to 6,7%.

Small- and medium-sized enterprises regard long-term agreement concluded with recipients of their goods and services as supporting their growth. For more than 36% of SMEs they are a factor positively influencing their economic situation. In previous years the study did not include the impact of this factor on SMEs. In 2007, due to the situation on the labor market, which could cause difficulties in realizing long-term contracts (the difficulty to find employees with the right competences), this factor was included in the Study. The results show that the assumption of the negative impact of the situation on the labor market on the possibility to realize long-term contracts was not confirmed. Long-term contracts are most important for firms in the transportation sector (55,6% of SMEs from this sector indicated them as a factor enabling growth and improving the economic situation). Long-term contracts are also important for firms in the construction sector, which – due to the most difficult situation on the labor market with construction professions – seemed to be threatened by such form of cooperation with customers. For 42,8% construction SMEs long-term agreement facilitate operations.

The appraisal of the effect of the EU Internal Market on SME development opportunities is interesting – the percentage of small- and medium-sized enterprises which see the common market as enabling their activities experienced a considerable – by more than 1/3 – decrease. Simultaneously the number of SMEs that see the Internal Market as a hindrance decreased. These opinions should be treated as a confirmation of the aforementioned thesis, in times of a good economy the interest of SMEs for the common market is smaller, as they concentrate on the Polish market that is creating development opportunities. In this manner small- and medium-sized enterprises are optimizing their activities in the short-term. One should assume that the interest for the common market will increase when the economic situation will deteriorate in all EU Member State. At that time however the effort to enter those markets with goods and services will require much higher expenditures. However small- and medium-sized enterprises – due to supply barriers, as mentioned earlier, are unable to operate simultaneously on the Polish market and the EU markets.

One can thus clearly see that the good economic situation decreased the development barriers for SMEs. However improvement took place in the sphere of non-institutional factors. Institutional barriers – formal and informal – continue to considerably limit development opportunities for SMEs and negatively impact their economic situation.

2. The durability of institutional barriers

In 2007 there was no spectacular change in the list of factors that negatively impact the development possibilities of firms and their economic situation. Though the strength of their negative impact on the firm development opportunities weakened. This weakening is so insignificant, that one should assume that it is the effect of the improvement in the situation of enterprises and their more positive, as a result, perspective on reality. If small- and medium-sized entrepreneurs still indicate the existence of the same institutional barriers, and we know that since the last study of the SME sector (February – March 2006) no legal regulations were amended, no institutional changes that impact the existence of these barriers occurred, an explanation for the weaker experience by SMEs is the good economic situation and its positive impact on the effects of economic activity.

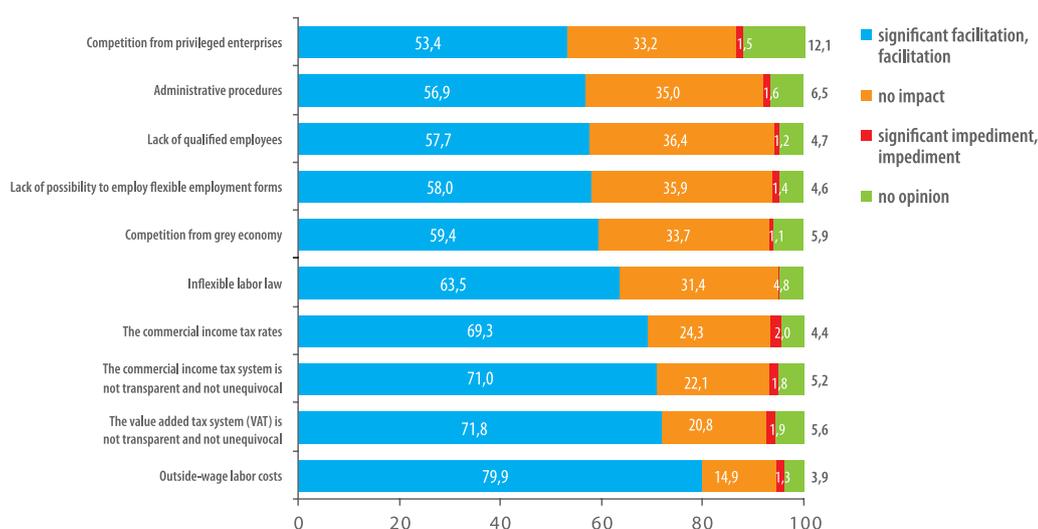
However these barriers exist and cause that the Polish economy and enterprises operating on the Polish market are not willing to undertake actions building a sustainable, long-term competitive advantage. Only the Government and the Sejm can change this. Besides predictable political conditions, stable and predictable legal conditions that should allow firms to plan strategically and increase efficiency should be ensured. At the same time the actions of the Government and the Sejm must be effective – we do not have the time anymore to postpone the structural reforms of the Polish economy, we must increase its competitiveness, ensure appropriate relations between coordination through the market and coordination through the state and we must conduct an institutional reform in order to make the institutions effective.

Small- and medium-sized enterprises ran out of “short-term” competitiveness reserves. When the time of a weakening economy comes – they will lose their competitive positions, and as a consequence – fall. Incre-

asing the pace of institutional reform is necessary – only they can “open” the SMEs to long-term actions.

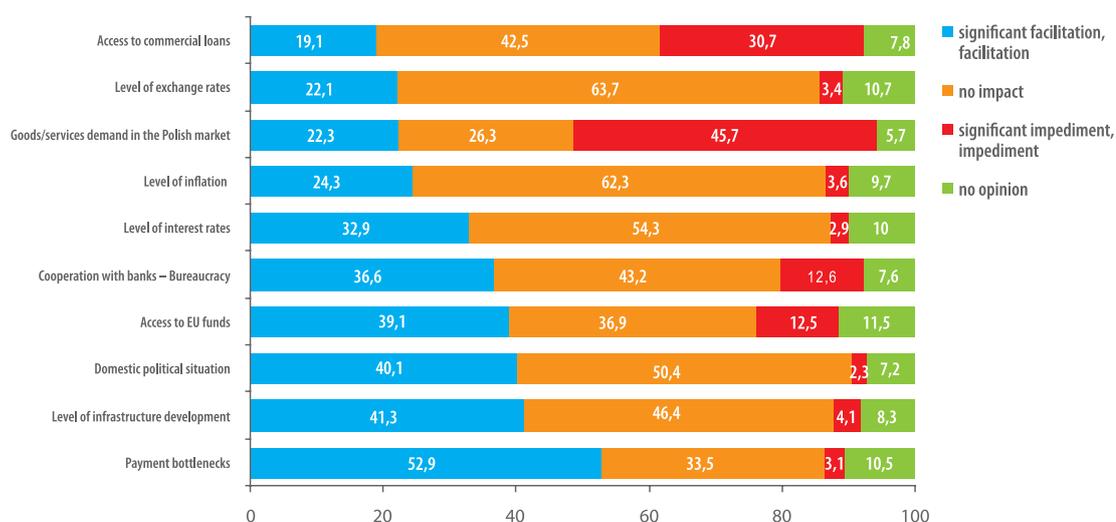
In which spheres should these reforms be made? Invariably these are outside-wage labor costs, taxes – regulations in the tax laws (VAT and income taxes), according to SMEs, are unclear, untransparent, variable, and as a result they increase the risk of economic activity. These are also the still too high taxes. Entrepreneurs point to the inelastic labor law, to the inability to apply flexible forms of employment, to competition from the grey economy, to time-consuming and cost-generating administrative procedures, to the lack of qualified employees and to competition from privileged enterprises. This is the list of the 10 most important, in the opinion of SMEs, barriers limiting their development opportunities and negatively influencing their economic situation.

Graph 34. What factors and how they influence the development of an enterprise and its economic situation (ii)



The next group of factors limiting the development of small- and medium-sized enterprises is also to a large extent associated – directly and indirectly – with institutional barriers.

Graph 35. What factors and how they influence the development of an enterprise and its economic situation (iii)



2.1. Outside-wage labor costs

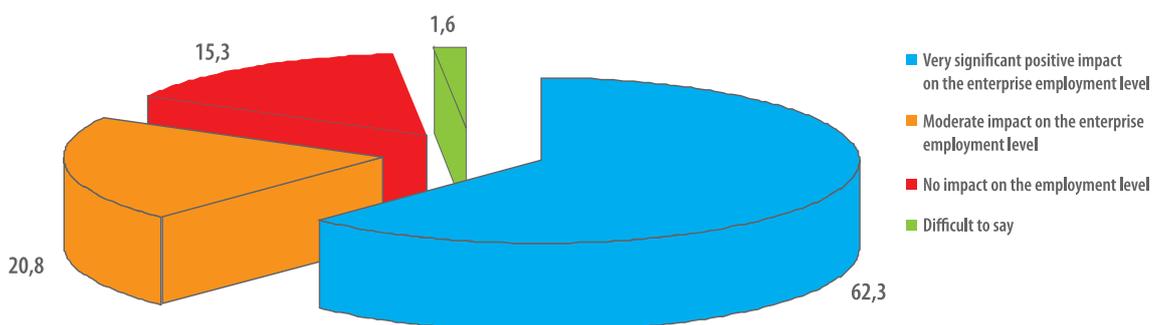
Since 2004, when the commercial income tax (CIT) was lowered till 19% , the first place on the list of barriers impeding the development of small- and medium-sized enterprises is occupied by too high outside-wage labor costs (till 2004 the level of the commercial income tax was indicated by SMEs as the most

important barrier to growth). In the Study on the condition of the SMEs from 2007, although the Sejm enacted lowering the pension premium by 7% (from 13% to 7%) and the first part of this amendment entered into force in July 2007 (lowering of the pension premium paid by employees by 3%), while the second is due to enter into force from January 1st, 2008 (2% on the side of the employees and 2% on the side of the employers) – the small- and medium-sized entrepreneurs did not change their assessment of this barrier. Still for almost 80% of SMEs outside-wage labor costs are the most significant limitation to their growth. The reason is that introducing the lower pension premium in $\frac{3}{4}$ affects employees (5% from 7%), not the employers, so the outside-wage labor costs remain high. This has an important impact on the propensity by small- and medium-sized enterprises to hire, but most of all – it lowers the competitiveness of enterprises. A gross salary of 2,5 thousand pln provides the employee with a net salary of 1,7 thousand pln, the labor cost for the employer exceeds 3,3 thousand pln (depending on employment size). This difference comprises of fixed payments, independent of size of employment – retirement contribution, pension premium, accident insurance premium, Labor Fund premium, Guaranteed Employee Benefits Fund (FGSP) contribution. To these burdens one must also add the National Rehabilitation of the Disabled Fund (PFRON) (employers employing at least 25 employees) and payments to the Institutional Social Benefits Fund (obligatory for firms employing at least 20 employees, facultative for other firms). Additionally employers sustain costs, that should be included in outside-wage labor costs, like the costs of mandatory medical check-ups, remunerations to union members, cost of remuneration for sick leave up to 33 days. One should also add the costs of “servicing” all of the aforementioned contributions. It is thus hard not to be surprised that the SMEs indicate outside-wage labor costs as the most important limitations to their growth. They do not consider lowering the pension premium by 2% as an important change.

This problem will grow, as the character of economic activity is changing and the knowledge and skills of employees become more important (something that small- and medium-sized firms notice), which translates into a sustained tendency to rising wages, and as a consequence rising outside-wage labor costs. If the enterprises are to be competitive contribution to the state must be lowered in real terms – that means all contributions paid by employers, except for retirement contributions.

Entrepreneurs small and medium clearly indicate, that lowering outside-wage labor costs would have an important impact on the employment decisions³⁹.

Graph 36. Possible impact of the reduction of outside-wages labor costs on the enterprise employment level ?



Only 15,3% of SMEs regarded that lowering the outside-wage labor costs would not impact employment. For more than 80% this would mean the possibility to increase employment.

A silent aspect of this question and the answer to it is the issue of the grey economy in employment. The SMEs assess it to be app. 19%. One should assume, that lowering outside-wage labor costs would also to a large extent lead to a lowering of this phenomena that negatively impacts the competitiveness of the firms that do not hide employment.

³⁹ Data from the „Study on the competitiveness of the SME sector 2006“, PKPP Lewiatan

2.2. Taxation barriers

Taxes are a monetary contribution, of compulsory character, non-returnable, involuntary and general, paid to the state (or other public-legal partnership, such as regional government) on the basis of legal regulations, which set the conditions, level and time for the payment of these contributions⁴⁰. It must surely be their compulsory character that irrespective of their level they are always treated by the entities paying them as the most arduous burden. It would surely be smaller, if the level of the contribution was the only problem. Unfortunately this is not the case, as the requirement to pay taxes and their level is combined with the lack of stability and transparency of the legal regulations governing the sphere of taxation. It seems that the creators of taxation law forget that taxes are one of the most important elements shaping the business environment. The tax character, its level, its kind, its structure, impact on decisions of economic entities interchangeably affects their operations. Thus the tax system and the tax level are of key importance for the functioning of the economy and the entities operating within its framework – it can both spur economic growth and slow it down.

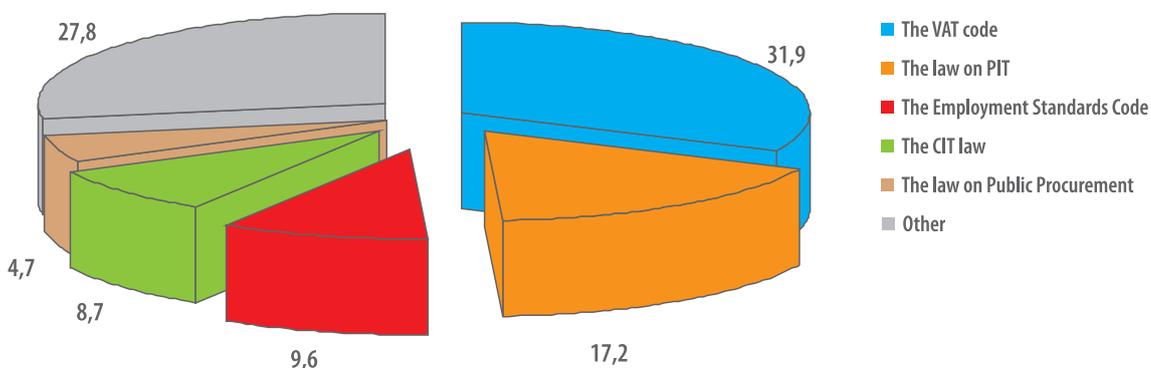
In the opinion of small- and medium-sized enterprises both the taxation system existing in Poland and the level of taxes create considerable barriers to the development of SMEs and affects their economic situation.

2.2.1. Untransparent and unclear direct and indirect tax regulations

The changeability of the laws regulating economic activity is burdensome for all entities functioning in the economy. The unclear and untransparent legal regulations is a burden to all economic entities. However the smaller the entity, the greater the burden (measured in interpretation costs incurred versus total costs).

Small- and medium-sized enterprises have too limited personnel and financial resources to face the challenge of "bad" law. This relates to all regulations, but the obligations stemming from the tax code are special type of obligation, as failure to fulfill them leads to severe legal and financial consequences. Unclear, vague and changeable tax law regulations increase considerably the risk of economic activities. This is confirmed by research, as small- and medium-sized enterprises clearly indicate among the most important barriers (ranked second and third) – lack of transparency and lack of unambiguous indirect and direct taxes. When answering to the question about the most burdensome legal regulations – they also point to the VAT Law and the Law on the PIT and CIT⁴¹. In total almost 60% of SMEs indicated tax laws as most burdensome.

Graph 37. Which laws are the most burdensome for the SMEs?



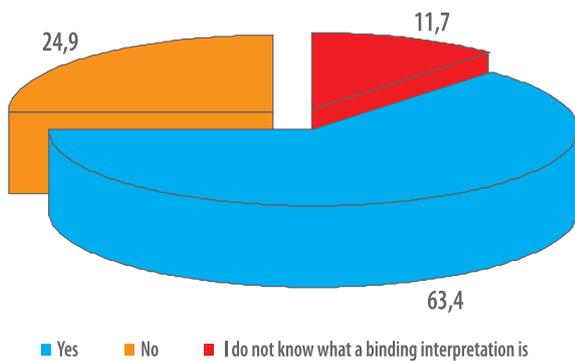
The need for the binding interpretation of the tax code is evident. Of course an optimal solution would be legal regulations that do not require interpreting. However until this is not the case the institution of binding interpretation is necessary. The problem is that small- and medium-sized enterprises do not

40 G. Szczodrowski – Polish tax system. Transformation strategy, p.11

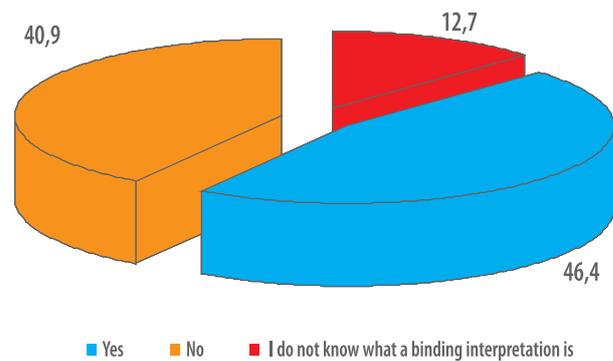
41 Data from Competitiveness of the SME sector 2006, PKPP Lewiatan

know that they can seek a binding interpretation of the tax law (in Monitoring condition of the SME sector 2006, when SMEs answered whether they applied the binding interpretation in 2005 the percentage of firms admitting to the unawareness of the existence of such a tool was smaller than in the 2007 Study, which can be interpreted as the reluctance to admit to insufficient knowledge).

Graph 38. Did the enterprise employ a binding interpretation of tax law in 2005?



Graph 39. Did the enterprise employ a binding interpretation of tax law in 2006?



However among those SMEs that know what binding interpretation is the percentage of small- and medium-sized firms that applied this instrument rose in 2006 (Study from 2007). Surely in the following years the application of binding interpretation of tax law would increase and also improve the knowledge of SMEs. However this will not be the case as in 2007 a new law removed from the local tax offices the authority to issue binding interpretation and granted this power only to the Ministry of Finance. The effect is already evident – the number of applications for a binding interpretation drastically fell.

2.2.2. Level of tax

Since 2004 the 19% commercial income tax rate is in force in Poland (those conducting autonomous economic activity had the choice between a flat tax rate, or remaining with the progressive tax, but with the possibility of deductions). This is not a competitive tax rate, because in countries like Ireland, Cyprus, Estonia, Latvia, Hungary the commercial income tax rate is lower than in Poland⁴². Looking at economic growth in those countries (except for Hungary, where the problem however is in the public finances as a whole, and not the tax system) the thesis about the relationship between a low level of various levies and high GDP growth is warranted.

In this context, the view – through the prism of public levies, that is taxes – taken by Chinese war strategists is interesting. Already in VII century B.C. they pointed to sources of problems of countries by saying that in some countries "...the space wasn't large, the number of bureaucrats large. The public vaults flourished, the ruler became arrogant, the minister prodigal. Seeking grand achievements that continuously ignited wars. And that is why..." these countries were the first to die. In other countries "...land measurement were set in such a way that the public vaults were empty, there was few bureaucrats, the ruler was economical, and his ministers humble in managing the people that became wealthy..."⁴³.

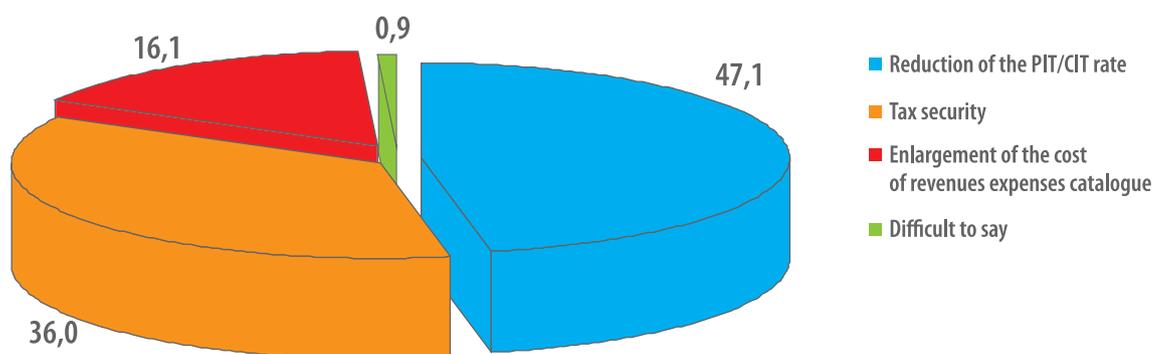
Small- and medium-sized enterprises point to the level of taxes on commercial activity as a barrier to development. And this despite the decrease of the CIT to 19%. This is not only due to the reluctance to pay mandatory levies, but also because Polish enterprises, especially small- and medium-sized, still do not dispose of sufficient capital for development. And taxes additionally limit their capability to accumulate capital.

42 Ireland – 12,5% (does not apply to all types of activity), Cyprus – 10%, Estonia – if the income (net earnings) is not paid out to shareholders and stockholders as dividend (it is retained in the company) it is not taxed. Whereas dividends and other income transfers to shareholders and stockholders are taxed at 22% (21% in 2008 and 20% in 2009), Latvia – 15%, Lithuania – 15%, Hungary – 16%, Slovakia – 19%. From 2008 Bulgaria will lower the CIT to 15%.

43 Sun Zi – Art of war, Krawków 2003, p.30

On the list of barriers level of taxes on commercial activities is ranked 4th, but small- and medium-sized enterprises asked directly about what type of taxation solution would be the most important from the perspective of their firm's operations – whether this would be lowering the commercial income tax rate, or tax security, or widening the catalogue of expenditure regarded as cost of revenues – they indicated lowering taxes⁴⁴.

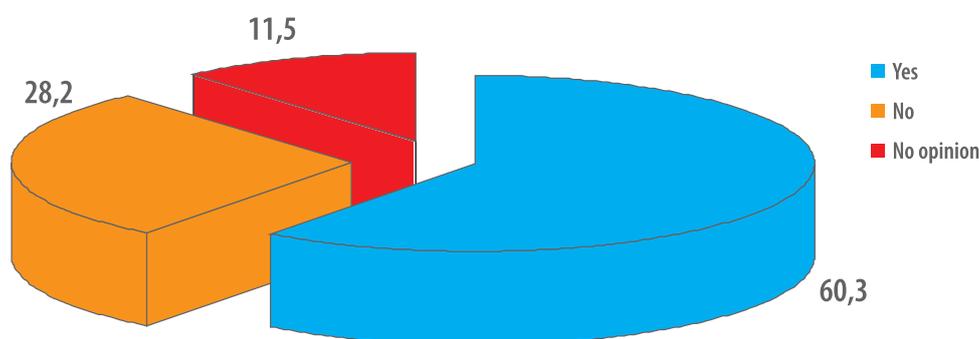
Graph 40. Which among below-listed tax solutions is most important for the enterprise's activity?



However, strikingly, the importance of lowering the commercial income tax rate depends on the size of the enterprise. For micro-enterprises (up to 9 employees) lowering the CIT has a much higher importance than for small firms (from 9 to 49 employees) and medium ones (from 50 to 249 employees). At the same time from the viewpoint of small- and medium-sized enterprises tax security is much more important than lowering the commercial income tax. An explanation to these differences should be sought after in the degree of complexity of tax settlements which rise along with the scale of operations, and as a result together with the rise of the significance of transaction costs, cause by the ambiguity and instability of the tax laws, born by the enterprise. Along with the increased scale of operations tax risk is also rising, and thus the importance of tax security is increasing. The absence of tax security can not only endanger the activities of the firm but also its existence.

The fear of ambiguity and lack of transparency of the tax regulations is confirmed by the support by most small- and medium-sized enterprises for a flat VAT tax rate⁴⁵ (a rate of 15% is indicated).

Graph 41. Is a flat VAT rate important for the enterprise's activity?



What's interesting, different from the case of tax security, micro-enterprises more numerous (60%) than medium-sized firms (57,6%) support this solution. However introduction of a flat VAT rate is most important for small firms.

A flat VAT rate is not only a tangible increase of tax security, but also a decrease of transaction costs. Probably for micro-enterprises tax security must be translated into concrete problems and proposals for solutions in order for these firms to address them.

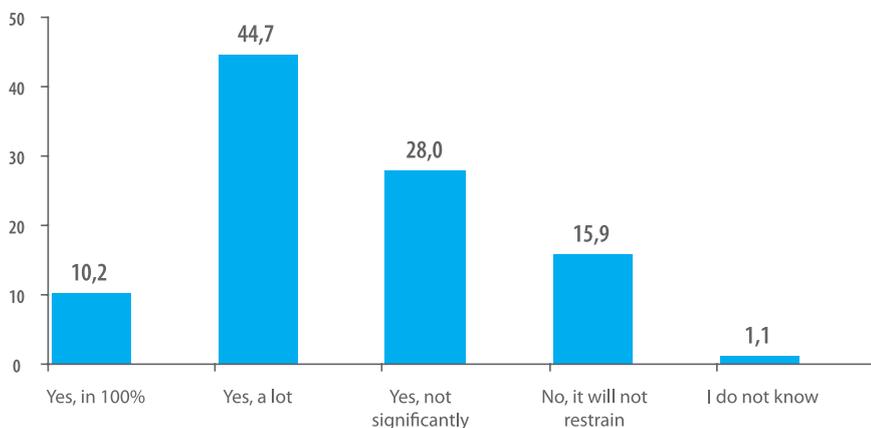
⁴⁴ Data from Study of the competitiveness of the SME sector 2006, PKPP Lewiatan

⁴⁵ Data from Study of the competitiveness of the SME sector 2006, PKPP Lewiatan

2.3. Inflexible labor law

The conditions for economic activity change due to globalization, technological advancement and the need for the firms to adjust to the rules of a knowledge-based economy. Changes in client expectations force enterprises to evolve from mass production to a narrow specialization characterized by flexibility. This means that today firms more and more often carry out projects that have a unique, specialized character. Such a work pattern requires adjustment to the labor law and introduction of flexible forms of employment (fixed-term contracts, telework, part-time employment, possibility to hire temporary workers). A lack of such fit limits the opportunity for transformation within the firm, it limits the firm ability to adjust to changing conditions of economic activity, and as a consequence - it decreases the competitiveness of firms, especially of the small- and medium-sized. It also encourages the firms to seek solutions outside the framework set by the law. The small- and medium-size enterprises confirm this by saying that liberalization of legal regulations governing employment will infringement of these laws⁴⁶.

Graph 42. Would the liberalization of employment laws restrain from breaking those laws (%SME)

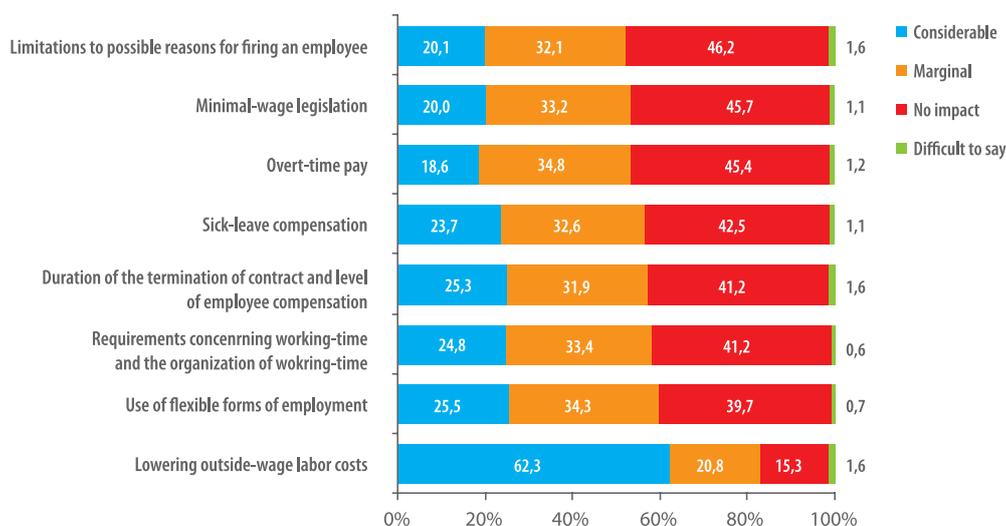


For 55% of enterprises liberalization of legal regulations governing employment is of essential importance (liberalization will erase infringement to the laws governing employment or to a large extent – in total). This would be most important for small firms (for 59,7%). On the other hand we should expect that the limitation of infringements to the labor code, caused by liberalization, will be smallest among micro-enterprises. More than 16% of them indicated that liberalization will have no effect in this regard.

Liberalization of the laws governing employment is most important for firms from the transport sector (63,3% of SMEs from the sector), the industrial sector (58,2% of SMEs from the sector). It is of least importance to firms from the trade sector (52,8% of SMEs from the sector). Within this sector 16% of SMEs declare that liberalization will not help improve the situation – the labor laws will still be broken.

The opinions of small- and medium-size enterprises regarding the opportunities for limiting labor law infringement through liberalization indicate that liberalization is essential, but not sufficient, for limiting infringements to the labor laws.

Maybe then, as the case was with questions regarding tax security – addressing concrete amendments to regulations governing employment would give clearer answers indicating the effectiveness of liberalization. However it must be said that making this more concrete does not provide an unambiguous answer

Graph 43. Impact of liberalization of labor law regulations on employment level (% of SMEs)

Small- and medium-size enterprises indicate the importance of regulations regarding flexible forms of employment, working time, period of termination of contract, remuneration during sick leave on rising employment, and indirectly – for higher adherence to the laws governing employment. From this perspective SMEs see as important additional pay for over-time work, regulations on minimal pay and regulations limiting the possibilities to fire an employee. However these indications concern only slightly more than 50% of small- and medium-size enterprises (Considerable impact and Moderate impact – Together). The highest impact for rising employment – and indirectly for adhering to the regulations governing employment - is attributed to lowering the outside-wage labor costs.

This means that SME indications regarding the most important barriers to their development are confirmed – a key issue for small- and medium-size enterprises is lowering outside-wage labor costs (ranked first on the list of barriers). Liberalization of the labor law is essential (ranked fifth on the list of barriers), together with introduction of flexible forms of employment (ranked seventh on the list of barriers). However the last two are issues with less significance to SMEs than outside-wage labor costs.

2.4. Competition from the gray economy

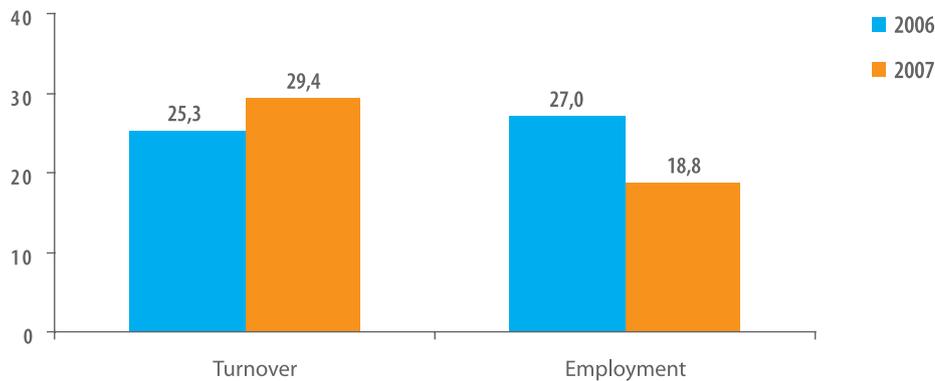
A serious barrier to the development of small- and medium-size enterprises is the existence of the gray economy and its scale. Hiding turnover and employment by some enterprises destabilizes the situation on the labor market and negatively affects competitiveness of firms operating legally and simultaneously incurring full, and thus higher – costs of operations.

The scale of turnover hidden from the tax office is significant according to the SMEs- in 2006 it was more than 25% of turnover, in 2007 it is – in the opinion of enterprises – above 29%. Why is the situation deteriorating despite the improving economic situation. The thesis that exactly the good economic situation is to blame, as it shortens the time necessary for the sale of the produced goods, and thus decreases the risk of being caught with irregularities in settling turnover, seems warranted.

The scale of "gray" employment in the SME sector, though still very high, according to the employers has decreased considerably (from 27% in 2006 to 18,8% in 2007). This tendency opposite to the case of turnover will be explained by the changes on the labor market. Today finding an employee is not as simple as last year. After all this is also confirmed by "lack of qualified employees" being ranked eighth on the list of the most important barriers to the development of SMEs.

According to entrepreneurs the gray economy is largest in the construction sector. Within this sector 37% of turnover is hidden from the tax office and more than 30% of employees work black. The transportation sector is also characterized by a very high level of black employment.

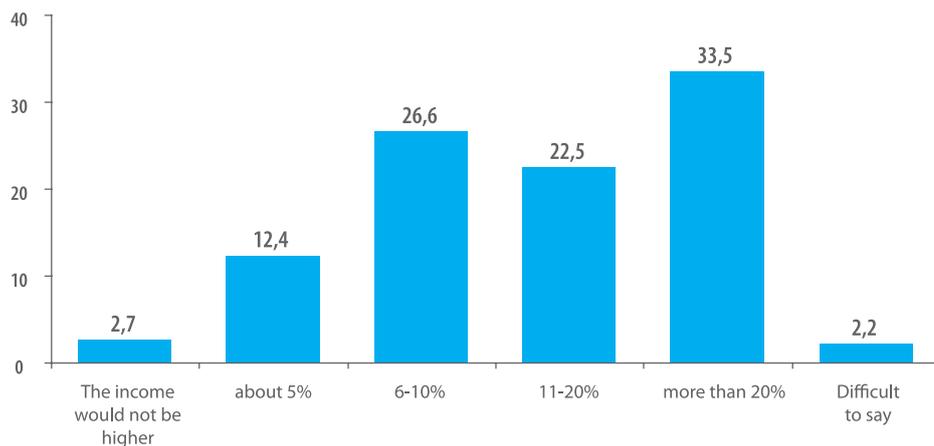
Graph 44. What % of turnover in a typical firm in the sector where your firm operates is hidden from the tax office and what % of employment in the sector where your firm operates is black?



Where should one seek the reasons behind the significant size of the gray economy in Poland? In the too restrictive, inelastic, unadjusted to the needs of the economy laws governing economic activity. It is certain that had it not been for the high taxes and high outside-wage labor costs, just to name the most important barriers for the SMEs, the extent of the gray economy would be much smaller. The associated costs, as well as the costs associated with the lack of clarity, transparency and changeability of laws determining the behavior of enterprises have an influence on decisions by some enterprises not to act within the legal framework. The characteristic of the sector with the largest gray economy – construction and transport – indicates that the operation of these sectors is characterized on the one hand by burdens stemming from legal regulations, but on the other hand the features of these sectors that give room for a much higher level of hidden employment and turnover than the case is with other sectors.

The Research shows that for 50% of small- and medium-size enterprises the existence of the gray economy is limiting their competitiveness.

Graph 45. How much higher income would your enterprise have, if some of the competitors would not be active in the grey economy?



The impact of the gray economy on competitiveness is significant – 1/3 of enterprises whose competitiveness suffers from the existence of the gray economy assesses that it causes a more than 20% drop in income. Only 2,7% of SMEs regard that the existence of the gray economy does not decrease their income, and 2,2% is unable to evaluate this. This means that 45% of small- and medium-size enterprises cannot develop up to full potential, because they are pushed out of the market by firms that offer goods and services at competitive prices, which they are able to set since they do not pay all the obligatory taxes and levies. It would be simple to point out firms operating completely or partly in the gray economy as being liable for the destabilization of competition on the market. But this would mean indicating consequences, not the reason for this situation. And the reason lies in excessive, ambiguous, variable regulations governing economic activities and the associated high costs, and additionally the high taxes and levies.

2.5. Lack of qualified employees

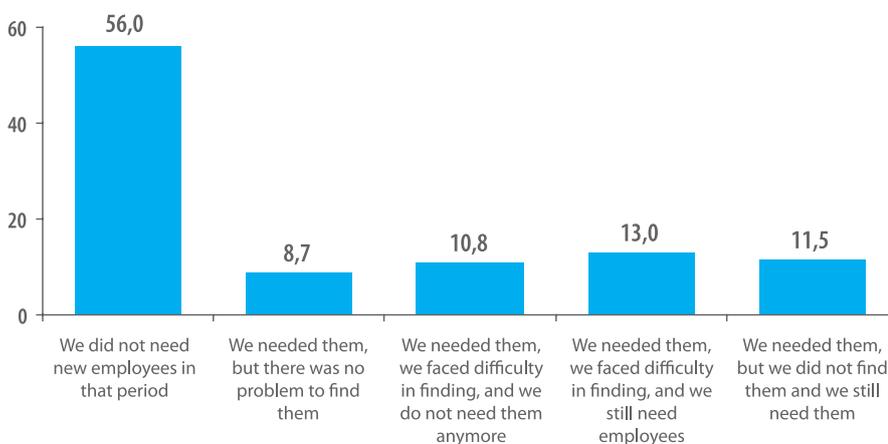
This barrier turned up on the list of barriers for the first time in 2007. For 57,7% of small- and medium-size enterprises the lack of qualified employees is a serious limitations of development. Although in the period January 2006 – June 2007 only 44% of SMEs needed new employees, the difference between the percentage of firms indicating the lack of qualified employees as a barrier and the percentage of firms seeking new employees could result from, among others, the consideration whether to exchange current employees with better qualified and more experienced personnel and the decision to give up on this exchange due to the situation on the labor market.

The situation on the Polish labor market is quite atypical – we still experience a high level of unemployment⁴⁷, a low level of employment⁴⁸ and a low level of professional activity⁴⁹. Additionally unemployment in Poland has a structural character, which means that employers have, and will continue to have in the future, problems with finding employees with the appropriate competences. Even more so as the labor migration of Poles is increasing.

The Study on the condition of the SME sector indicates that this problem affects significantly 44% of small- and medium-size enterprises, as 11,5% of firms (that is more than 26% of SMEs seeking employees) have been looking for employees for the last 1,5 years and have not yet found them. Only 8,7% firms, or 20% of SMEs from the group seeking employees, did not experience such problems.

The most serious problem in finding employees is experienced by construction enterprises – as much as 24,2% of SMEs from the sector have been looking for employees for the last 1,5 years and have not found them yet.

Graph 46. Did your firm face the problem of lack of employees in the January 2006 – June 2007 period?



This is accompanied by a lack of structural fit – small- and medium-size enterprises mainly seek employees for the sales department, specialists and qualified construction workers. However the time period spent seeking employees clearly shows that shortages on the labor market apply to specialists, qualified construction workers and qualified machine operators.

What is the reason for the change in the situation on the labor market? Pointing to a good economic situation is warranted, as the fast economic development of Poland automatically increased labor demand. On the other hand the supply of labor decreased due to labor migration, and continues to decrease, being the effect of the right by authorized groups to go into early retirement.

Also the education policy is not adjusted to the needs of the labor market – estimates of the needs say⁵⁰ that during the period 2001 – 2025 the main spheres where new employment opportunities will be created are IT services and health services. Together both these fields will supply 53% of the new positions (1,32 million). Simultaneously graduates of IT and medicine studies comprise only 4% of university graduates⁵¹.

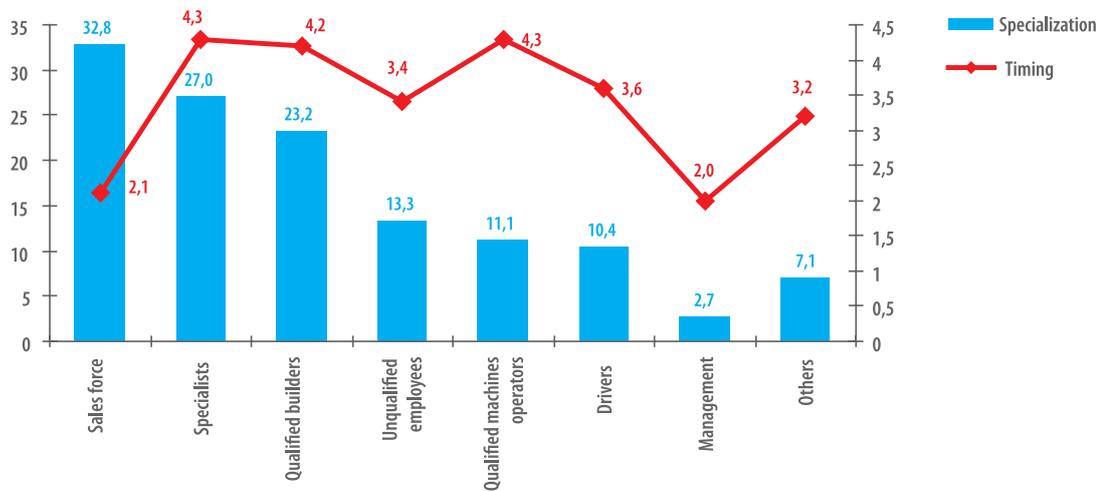
47 The unemployment rate in September 2007 was 11,6%, and at the end of Q2 2007 – 12,4% (CSO)

48 The rate of employment was 48,4% at the end of Q2 2007 (CSO)

49 The activity rate was 53,5% at the end of Q2 2007 (CSO)

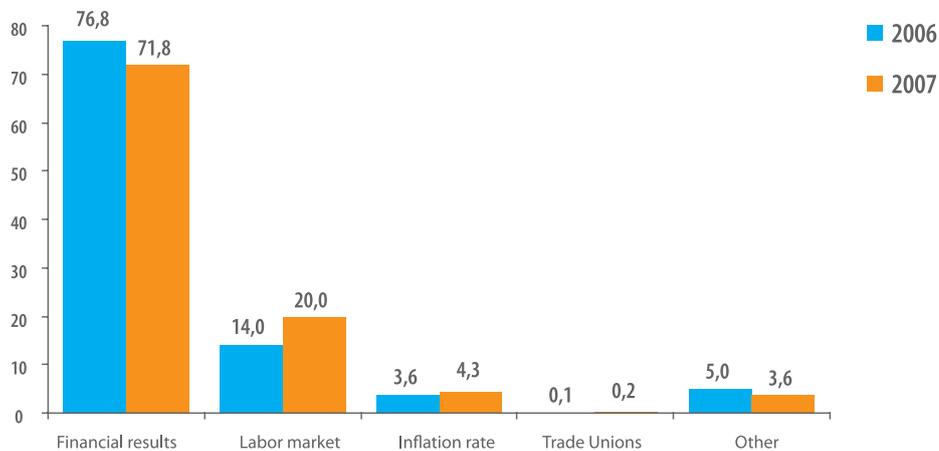
50 A. Karpinski – Education and the labor market, Warszawa 2006

51 Data for the academic year 2004/ 2005, CSO 2006

Graph 47. Specializations in request and timing (in months)

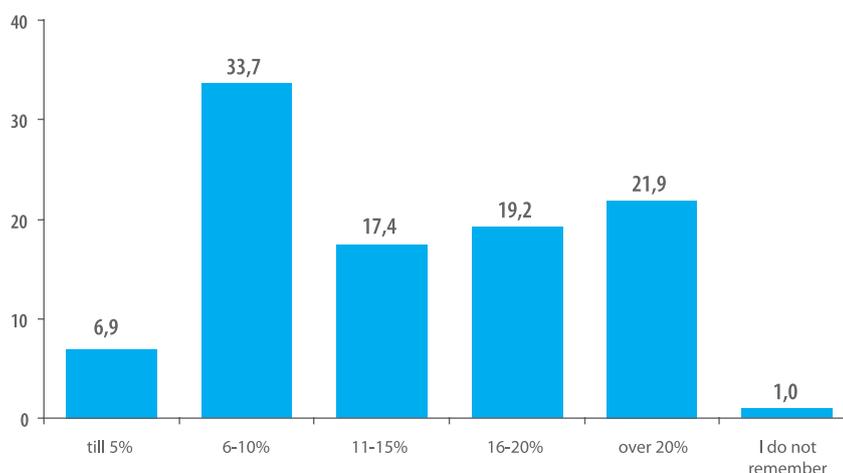
The situation on the labor market is the consequence of negligence by subsequent governments, subsequent Sejms and public administration. Legal regulations that push out of the labor market people in the economic activity age (early retirement) were created, we did not construct a system that binds education with the labor market, we did not create effective tools allowing us to import employees.

In effect small- and medium-size enterprises (but also large firms) had to bear the consequences in the form of higher costs.

Graph 48. Factors influencing wage increase in your firm

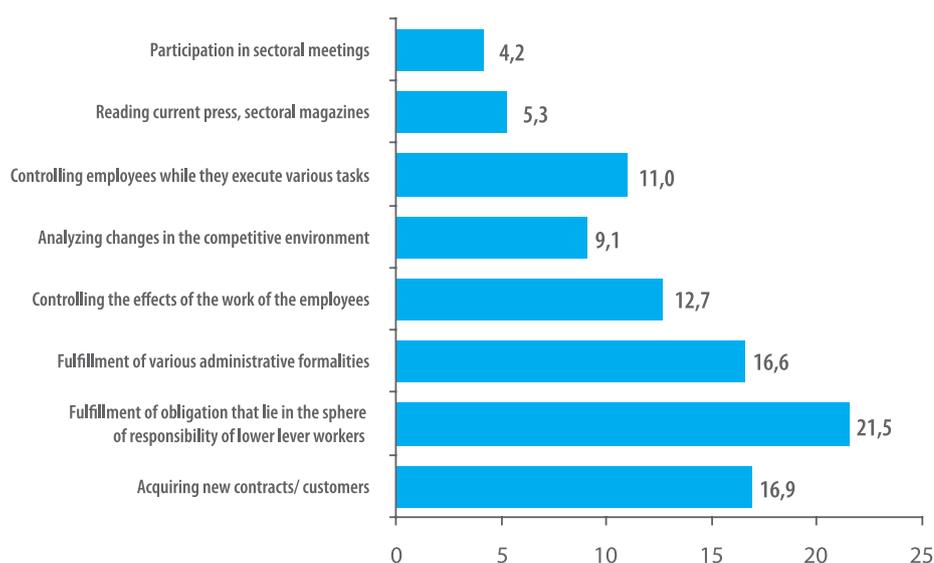
The change in the influence of the labor market on rising remuneration in the SME sector is clear. Although the main factor having an influence on rising remuneration remains the financial result of the enterprise, it must be said that the influence of the labor market on the rise of remuneration is considerable (by more than 40%). This means breaking the connection between labor efficiency increase and remuneration increase, which will result in higher inflation. This danger is evident in the difference between the level of wage offered to new employees and the level that was planned for these employees.

The situation on the labor market and its consequences for remuneration had the strongest effect on small- and medium-size enterprises in the construction sector. More than 36% of SMEs from the construction sector had to offer to new offer wages more than 20% higher than previously planned. This situation will more and more strongly translate into product prices and construction services.

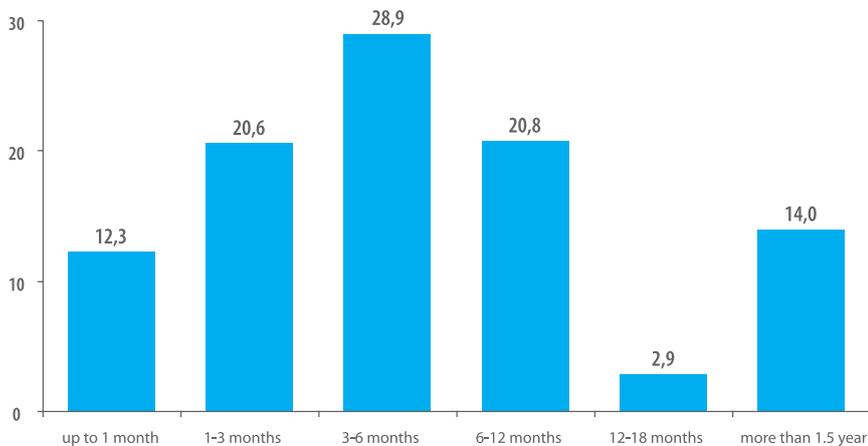
Graph 49. If your firm had to offer higher wage than planned to hire a new employee, what was the scale of this rise?

2.6. Administrative procedures

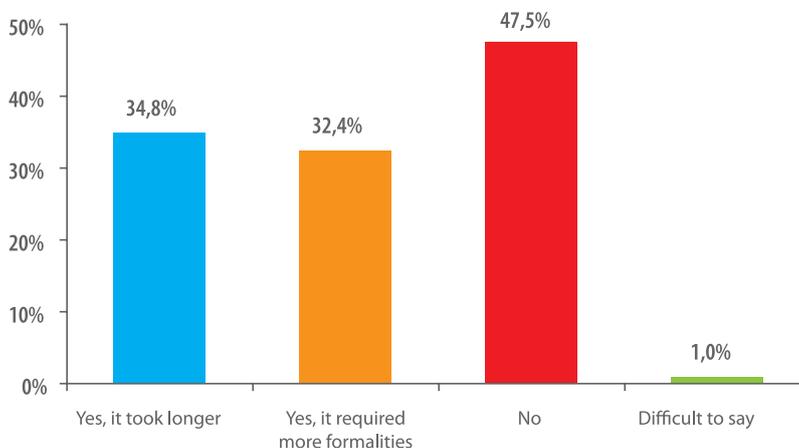
Small- and medium-size enterprises see administrative procedures as being burdensome and costly effects of bad laws, and being incorrectly applied by public administration and unprepared bureaucrats and institutions. Administrative procedures were ranked ninth out of ten on the list of the most important barriers limiting growth and deteriorating the economic situation of SMEs. This is not surprising, because complementing various administrative formalities uses up 16,6% of time of management of SMEs, or 1 hour and 20 minutes per day. In micro-enterprises the time to deal with administrative formalities is even longer – it measures 1,5 hours (18,8% of working time). Due to the low number of people working in those firms each additional administrative obligation falls upon the management drawing them away from main obligations with detriment to economic activity.

Graph 50. What % of time does the management of the firm spend on their duties?

A good example of the burden and costs associated with administrative procedures is the process of obtaining a construction permit.

Graph 51. How long did it take to obtain a building permit?

Almost 38% of small- and medium-size enterprises waited for more than 6 months to obtain a building permit, out of which 14% waited longer than 1,5 years. This mainly concerns micro-firms as in this group almost 16% of firms wait for a building permit for more than 1,5 years. This duration of time spent awaiting a construction permit cannot be explained by lack of spatial plans or matters associated with protection of the environment, or any other reason except for inappropriate administrative procedures and the lack of professionalism on the side of employees of the public administration.

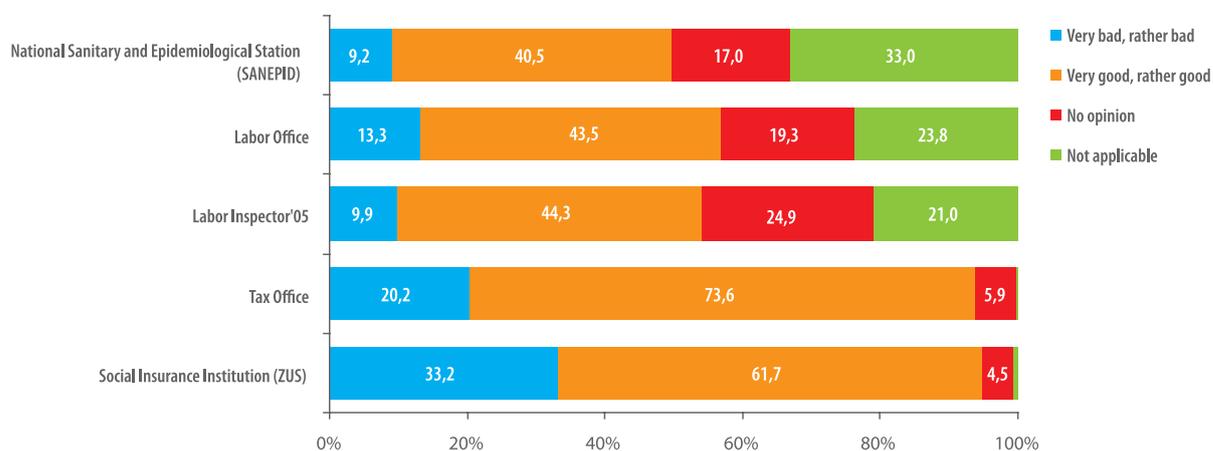
Graph 52. Was the obtaining of the building permit more burdensome in the 2007 than in the previous years? (two answers possible)

Additionally the situation worsened, because in the opinion of 1/3 of small- and medium-size enterprises obtaining a construction permit is today more arduous than in previous years – it takes up more time. Also in the opinion of 1/3 of enterprises – it requires more formalities.

It is thus evident that too extensive administrative obligations are strengthened by a lack of professional service in the institutions, something that also impacts the efficiency of small- and medium-size firms. When assessing the administrative barriers we cannot forget about it, because in the hands of the bureaucrats even the best, most clear and uncontroversial laws and administrative procedures can become unclear and controversial. Entrepreneurs indicate this by complaining about cooperation with administrative institutions. This bad evaluation mainly concerns the Social Insurance Institution (ZUS), though the situation in this case improved slightly when compared to last year. The SMEs give the best evaluation to cooperation with ZUS in the Swietokrzyskie region, and the worst in the Małopolska region. Small- and medium-size enterprises complain about cooperation with the tax offices – especially in the Kujawsko-Pomorskie region. In the Podkarpacie region this cooperation is evaluated very well. The assessment of cooperation with the labor offices deteriorated, which probably is the effect of the situation

on the labor market and the frequent use by SMEs of the services of the Labor Office. This cooperation is weakest, according to small- and medium-size enterprise in the Warmińsko-Mazurskie region, and best in the Świętokrzyskie region.

Graph 53. Evaluation of the firms attendance in public administration



Domestic institutions that are supposed to cooperate with enterprises are too bureaucratic, too inflexible. Their actions are characterized by inertia, this is why reactions to proposals for altering the rules of cooperation with the business environment are slow and ineffective. The flow of information between enterprises and domestic administrative institutions is left to "run its own course". There are no developed channels for exchange of information.

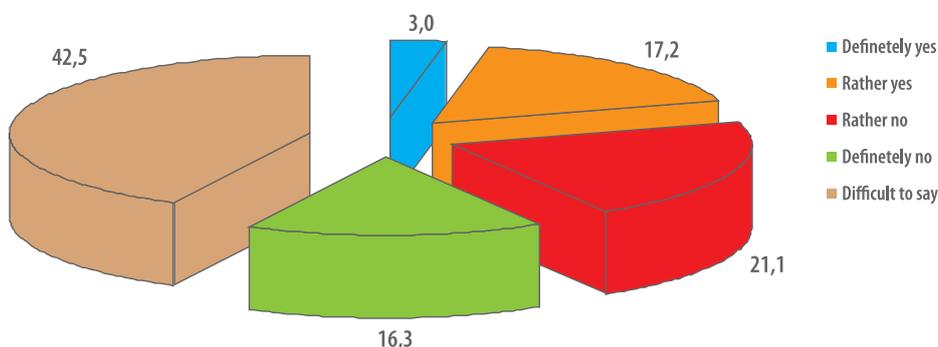
Bad, too bureaucratic law, burdening enterprises with unnecessary, unjustified obligations, non-regulatory, also unjustifiable administrative procedures, lack of professional service in the institutions – these costs and time, that for small- and medium-size enterprises are difficult to carry. And this is not the end of the list of barriers to the development of SMEs.

2.7. Payment bottlenecks

Despite the fact that the financial condition of enterprises has improved, payment bottlenecks are still a considerable barrier to the development of a significant group of SMEs (52,9% versus 66,1% in 2006). The payment bottlenecks are a sign of liquidity problems, this is just a step away from a firm's crisis. Furthermore, litigation through courts is still a drawn-out process – settlement of an economic dispute lasts on average over 800 days⁵². During such a long period, a small enterprise may lose liquidity and go bankrupt. Moreover, even the court's ruling is not a guarantee of recovering the receivables, the bailiff might have serious problems with its execution.

The public administration has already several years ago declared that the legal system would be improved i.e. by redirecting the simpler cases for settlement by a highly qualified court referendary (with a possibility to prosecute in court). Up to date none of the reforms of the economic judiciary has been implemented. In such a case, it is worth focusing on the development and promotion of the institution of arbitration and the institution of mediation in economic dispute settlement. In many cases these institutions could effectively replace courts. It is important to also support the development of the economic information offices. As all of those solutions might not be sufficient – it would be necessary to consider other solutions that would define as taxation cost not only received, but also paid invoices.

Graph 54. Do you believe that in the current economy conditions the legal system will assure your rights (being a consequence of the agreements signed) in dispute settlement with other entrepreneurs?



The small- and medium-size enterprises do not consider economic courts as a solution to their problems. Only 3% of SMEs is certain that in case of disputes with other firms their rights will be respected.

The barriers to development highlighted by the SMEs have to be removed. The good economic situation is the right moment to undertake such actions, as it will be easier to remove barriers that may generate additional budget costs or that may decrease income to the budget. When economic growth will slow down and the barriers remain, the SMEs will have to take on not only the formal and informal institutional barriers, but also the consequences of the decrease in demand, decrease in accumulation capabilities and decrease in creditworthiness, or in other words – they will have to face the difficulties in having access to capital.

Therefore, it is essential to prepare a reform of the legislation process to remove at least some barriers. If it will not be achieved, due to the lack of political will, or due to the tyranny effect of the status quo, the enterprises will have to consider finding individual solution to the barriers to growth. Larger enterprises are already doing this, and the SMEs currently only think about it.

3. Limiting the barriers to enterprises development – moving activities to other EU Member States

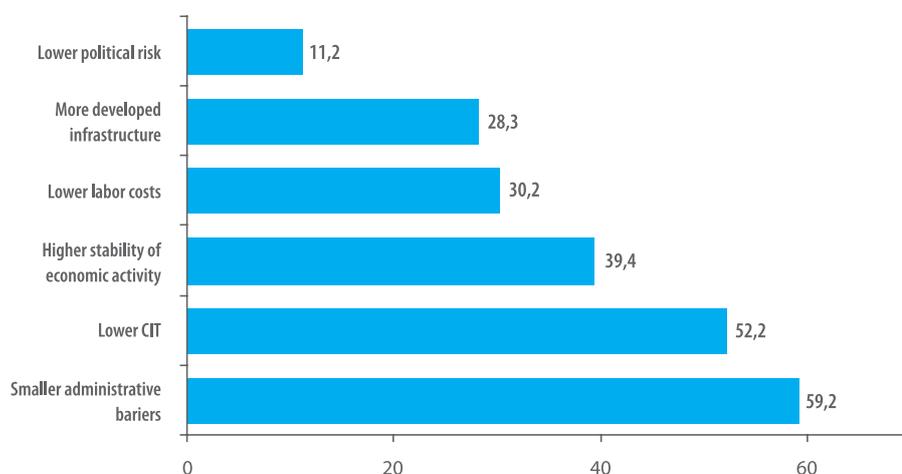
The diversification of the geographic economic activity is one of the strategic options for enterprise development. An enterprise considers it only when it takes into account expansion in a selected market or markets. This strategy is not a remedy to the home market barriers. However, it might become such a remedy. Today, 4,7% SMEs declare the possibility of moving their activity to other EU Member States. This is less than in 2006 when 5,9% SMEs were considered such a possibility. It is worth noting, that 4,7% stands for at least 40.000 SMEs⁵³.

The reasons for a decrease of the percentage of firms that consider the possibility of moving their activity to EU Member States are caused by the good economic situation in Poland that amortizes the negative consequences of the institutional barriers limiting the SMEs activities. Moreover, the reasons for this underlie in the over 3 year long presence of Poland on the EU market that has considerably widened the firms knowledge of the conditions and costs directly linked to moving the activity. Therefore, with a good economic situation in Poland, and good chances for maintain it in the coming years, the SMEs are more careful once planning the geographic diversification of their economic activity.

Those who consider the possibility of moving their economic activity to one of the EU Member States underline the administrative barriers as the main reason behind such a decision. Therefore, they reaffirm the importance of the abovementioned barriers to SME development in the Polish economy. It is worth noting that a growing number of EU markets become attractive due to a lower tax rate. Development of economic activity, based on planning and strategy building, would not be possible without a stable economic conditions and the possibility to forecast them.

⁵³ The survey examined SMEs hiring 2 and more employees, and that stands for a bit less than 1 mln in Poland.

Graph 55. Reasons of deliberation on the moving of the economic activity to other EU countries 2007 (3 answers were given)



The SME inclination to moving economic activities, despite a good economic situation in Poland, means that SMEs are not afraid of thinking and planning their activity in other markets. This in turn means that they are not afraid of those markets. However, on the other hand this inclination confirms that the Polish economic system is of a relatively small effectiveness. This is caused by the ineffective Polish legal system that is also of poor quality, especially the lawmaking process. Hence, it should be reorganized.

4. Limiting the barriers to enterprises development – Reform of the system of lawmaking

Over 200 legal acts are passed by the Sejm, out of which over 60% are amendments to already existing regulations. This is evidence of the quality of legislation⁵⁴. The works on the law on freedom of economic activity of July 2nd, 2004 required the revision of over 800 legal acts. This law "regulates the undertaking, execution and termination of economic activity on the territory of Republic of Poland and the tasks of public administration in this regard" (Art.1) and therefore is a law that limits economic freedom. This means that at least 800 legal acts regulate economic activity. The European Commission has estimated the costs arising from bad regulation from 4% (optimistic option) to 5% (pessimistic option) of our GDP.

Therefore, there is a serious problem. It is not enough to change several legal acts in order to reach the goal that is limiting the barriers to enterprises development. It is not only about changing legislative procedures to allow effective functioning of economic actors and to support building the competitive standing of the Polish economy, it is also about changing the "philosophy" of the lawmaking process. It should be based on the rule of extending the freedom of economic activity. Hence, deregulation is crucial.

Different factors have a negative impact on the possibilities of development of firms and on their economic situation. This is confirmed by data from the SME studies provided in this report. First of all, the enterprises point to the lack of transparent and unambiguous legal acts (mainly tax laws), an inflexible labor code, payment bottlenecks, the gray economy and troublesome administrative procedures.

Everything has its price. According to the European Commission estimates the administrative costs of regulations for firms amounted from 4% to 5% in 2005 (from 7.815mln € to 9.970 mln €). This stands for: 8,5 times more than the structural funds resources designed for enterprises in the period 2004-2006, or almost 80% of the net financial result of enterprises in 2005. The administrative costs are not the only costs that firms incur as a result of constant reorganization and implementation of new regulations. It would be worth adding that the cost of regulatory risk (controlling of compatibility of regulations defining the

54 Data for 2006

enterprises rules of conduct), and the alternative costs (costs of lost opportunities). The latter emerge from firm decisions to give up on investment and operational activities due to the lack of a known date of entry into force and the direction of regulatory changes, including the rate of public fees. In order to control the regulatory costs, not only a change of procedures is necessary, but also a change in the “philosophy” of the lawmaking process.

The outcome of the study on the condition of SME sector carried on by the PKPP Lewiatan for 7 years explicitly shows that regulations are perceived by enterprises – directly and indirectly – as a barrier to economic activity, limiting its development. From the enterprises viewpoint 10 main points may be identified as regulation’s “sins”:

1. a big number of regulations, which as a consequence make the enterprises feel lost and unable to cope with their obligations, this may lead to a “sin of abandonment” (just the tax rules effecting SMEs are to be found in over 70 legal acts)
2. a surplus of regulations: individual cases directly linked to economic activity are dealt with in several legal acts,
3. poor quality of regulations evidenced by the necessity of constant amendments (annually, 60% of the adopted legal acts are amendments)
4. inaccuracy, ambiguity of regulations allowing the freedom of interpretation both on the side of the enterprises as well as the public administration institutions
5. the assumption of “dishonesty” of enterprises results in regulations comprising of “protective” rules impairing legibility of the intentions of the legislator (the tendency to over-regulate)
6. inconsistent treatment of economic actors (i.e. state aid to some public enterprises in the shape of tax remission)
7. restriction (severe punishments for illegal activities even if the failure to comply results from problems with following the legal changes)
8. costly to enterprises – being a result of excessive administrative tasks included regulations; and a big cost for the economy – being a result of the constant need to amend laws due to their low quality and lack of fit with the conditions it is supposed to regulate
9. instability (changeability, inability to forecast) of regulations limiting enterprise propensity to invest.
10. an objective inability to adjust to regulations (the law is dead).

The entrepreneurs require laws that unambiguously formulate their rights and obligations. The lack of transparency generates unjustifiable transaction costs and diminishes the competitiveness of enterprises as well as whole economy. What kind of conditions have to be met in order for the state to assure the creation of regulations, meaning rules, norm, mechanisms that conditions the effective functioning of the economy. It is essential to:

1. change the lawmaking process and the rules of its implementation in order to effectively support the functioning of the economic actors and building a strong competitive standing of Polish economy and the enterprises acting within its framework,
2. simplify – “clean” the legal system
3. deregulate, enlarge the freedom of economic activity (while limiting at the same time the relationship between the state and the economy)

Simultaneously, during a short time period, until the new system has been implemented, it is essential to establish an institution that will bindingly interpret legal acts in all sectors of economic activity (not only the tax law).

A new and effective legislation system should be based on 5 rules:

Rule no. 1: There must be a legislative strategy – it is important to plan ahead new regulations and amendments to the already existing ones. This will improve the predictability of regulatory changes

Rule no. 2: Each legal regulation has to include a professionally prepared regulatory impact assessment – not only for the state budget, but also for the different SME groups (micro, small, medium, private, public, by sector)

Rule no. 3: Procedures allowing the appraisal of the real impact of introduced legal acts (ex post) should be implemented - a monitoring system. Regulatory impact assessments are essential, they may improve the quality of regulation, but they are unable to predict all market consequences of implementation of a certain regulation. Those are experienced first-hand by the entrepreneurs.

Rule no. 4: It is essential to enforce obligatory ex ante controls of conformity of significant legal acts (from the economic perspective) with the Constitution of Poland and with the *acquis communautaire*.

Rule no. 5: It is important to create a system of consultations of the drafted legislation with all stakeholders.

From the Polish economy's viewpoint, the SMEs strength is its significant share in employment as well as its big employment growth potential. The indicator of professional activity in Poland equals 53,5% and the employment rate is 48,4%⁵⁵. Hence, we have a serious problem directly linked to low exploitation of the labor resources. The development of SMEs is a opportunity to change the status quo. Limitations and institutional barriers have to be withdrawn in order to let the SMEs see a justification for their development, also through bigger employment. Today, high outside-wage labor costs, inflexible labor law, the impossibility to exploit various and flexible forms of employment do not provide with incentives for employment growth.

The SMEs are more profitable (the profitability of gross turnover is higher than in large enterprises). This means that SMEs employ the available factors of production more effectively. Without SMEs, the services sector would not develop dynamically. There would be no possibility to satisfy niche demand for goods and services. Large enterprises would not function effectively, as the SMEs allow them to concentrate on core activity. Therefore, the SMEs create conditions to better satisfy the needs of consumers, but also create conditions for the development of large enterprises. A significant role of the SMEs is the creation of entrepreneurial attitudes – micro-enterprises teach the owners, as well as the employees to be active, self-sufficient, responsible, innovative. And even if the enterprise will not exist on the market for a long time, the knowledge gained in the period of its activity will be beneficial in the future.

The SMEs are recognized worldwide as a very important part of the economy, however, a relatively weaker part than the large enterprises. This is due to the relatively small capital strength, smaller accumulative capabilities, and significantly smaller value of assets per enterprise, worse access to information, lack of extended management skills. Those features result from SME size. Therefore, in some countries there are special institutional and legal solutions that are supposed to "soften" SME weaknesses. In those countries access to capital, that conditions development, is facilitated (creation of a loan guarantee fund), or participation in public procurement tenders (under Polish conditions an amendment of the public procurement law introduced rules that indirectly impede SMEs access to public procurement contracts).

This is not about creating special privileges for the SMEs sector, as this would imply distortion to competition in the market. It is important to implement solutions do not disturb economic activity.

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member of **BUSINESSEUROPE**

Polish Confederation of Private Employers Lewiatan

6 Klonowa Street, 00-591 Warszawa

phone (22) 845 95 50, fax (22) 845 95 51, www.pkpplewiatan.pl, e-mail: lewiatan@pkpplewiatan.pl