RESEARCH PAPERS OF WROCŁAW UNIVERSITY OF ECONOMICS
No. 59 2009
Global Challenges and Policies of the European Union
– Consequences for the "New Member States"

**Rokas Bekeris**

Vilnius University, Vilnius, Lithuania

# ARE SMES PREPARED FOR THE CRISIS, AS THE BIGGEST COMPANIES ARE?

## 1. Introduction

There are approximately 23 million small and medium-sized enterprises in the European Union, comprising 99% of all EU companies and employing more than 75 million people. Also there were 60 094 companies in Lithuania in January of 2008, including 59 712 small and medium sized enterprises, that made 99.4% of all active companies [Lithuanian Department of Statistics].

The globalization, technological development, financial crisis, high competition for a market share and developing possibilities for big companies make SMEs to join activities for a better competitiveness in the global market. Being mobile, creating new jobs and decreasing unemployment, fomenting regional competitiveness this business segment becomes the most important engine of economy. That is why SMEs must take the right place in national economic structure.

National authorities have to create a good environment for establishing and developing SMEs, implement novelties of market and scientific researches, motivate the entrepreneurship, innovations and investments, as well as adapt more efficient taxation and legislation system. Government needs not only to stimulate the creation of know-how business but also the prosperity, growth and competitiveness of existing companies and finally it is very important to maintain the same structure and volume of this economic segment during the whole period of a crisis.

The timeliness of this subject is determined by a few reasons. The first is that both science and business society lack methodological solutions in determining the SMEs influence onto environment elements. The second one is that representatives of SMEs have no possibilities to finance different researches due to the constant shortage of financial sources. The identification of such risks can help them answer some general questions of development.

## 2. SME versus large companies assessment

The Observatory of European SMEs has done some researches of economic development of European Union [www.ec.europa.eu]. One of the surveys has showed a decreased consumption (46%) as the biggest problem for SMEs. Administrative barriers (36%) and lack of labour force also with its high price (35%) were mentioned as the other two most important obstacles to do business. Meanwhile the big companies are not so preoccupied with decreasing of buying power but they are more interested in administrative questions (42%) and lack of labour force (35%). The biggest EU companies export more actively than small ones. The export of large companies comprises 19% of their total turnover while export of small companies makes only 5%, despite the fact that they are more productive.

The research also showed that the main remedies for SMEs to cope with growing competition were: prolonging of a working day, finding new markets or decreasing sales or services volume. Those solutions are not satisfactory for the period of crisis because the labour law is not flexible enough in EU countries and finding out new markets is rather complicated due to low level of employers and shortage of business information. Smaller turnover, usually without any profit, is a common thing for majority of companies despite their size during the crisis period.

Along with implementation obstacles of innovations for SMEs the research also determines a lack of financial sources and skilled labour force, as well as its high price and small need of innovative products in a market. If labour cost decreases during the crisis, that will not help in financial situation of all companies, and SMEs particularly, because they do not have any financial reserves as big companies do.

In 2006 the benefits of SMEs in new EU members have increased by 15%. SMEs have spent 3.6% on marketing comparing to 1.7% spent by large companies. Marketing spending shows bigger management costs which directly influence smaller profitability. Most active implementation of innovations which provide effectiveness of the work and profitability of companies was more common for large companies than small ones. 38% of SMEs has their revenues from newly created or renewed product comparing with less than one quarter (24%) for large companies.

The results of the survey showed that in 2006 Lithuania had the highest rate of free working places in EU (19.8%). More than a half (56%) of heads of SMEs that took part in the survey pointed out a problem to find employees and 15% of them admitted being not capable to offer an adequate salary for their employees. Now that the unemployment rate reaches 10% in 2009, this problem can remain only for some deeply specialized companies.

The SMEs have three financing sources: own savings, banks and friends. Only one out of three USA microcompanies borrows, while 90% of companies with the turnover of more than 1.3 million USD do that [Peterson, Rajan 1995].

The survey of UK companies showed that large British banks do not know enough about profitability of small companies, because they are more interested in larger enterprises. Only 10% of SMEs are financed by bank credits which are usually invested to the assets (land, buildings, IT systems, machinery), while the biggest part of financial capital comes from friends and other family members [Cressy 2004]. During economic and financial crisis the possibility not to borrow from banking system could be a strong competitive advantage, particularly in developing countries where bank interest rates are high.

R. Cressy has identified two kinds of SMEs of which perspective ones are interested in long-term growth and investments, while bad ones do not make development projects and just “eat” their profit. This scientist also has found that only 5% of companies create about 50% of new jobs. Bad companies use credit line (11% of assets) and owners of perspective ones willing to achieve a big profit and growth of the company use long-term credits and reinvest the profit, so that credit line makes only 4.4-6%. This is the reason why the short-term debt takes 50% of all debts for SMEs and only one third for large companies. SMEs have enough savings and do not need any credits more expensive than long-term ones. On the other hand, long-term credits for SMEs make only 3% and for large companies – 11.5%.

R. Cressy has said that one of the biggest problem of banking financing system is that banks pay more attention to the assets of the company than to possible profitability of financial flows. This profitability depends on assets’ management, employees’ salary level versus working quality and efficiency of control system. The less asset is the more credits are needed and when the asset grows the intentions to borrow grow too.

It has been noted that SMEs borrow from one bank and only 10% of them use services of several banks. The research has showed that being closer to the client, banks give credits on better terms even in a time of high excess of business information. R. Cressy proposed partnership as other financing source, but owners of SMEs often do not like to lose independence and finally choose refinancing or listing in a stock exchange.

Evaluation of business risk shows that SMEs are more risky than large companies and because of this credits become more expensive. Commercial debt of bigger SMEs (37.9%) comparing to large companies (23.6%) shows that the smaller ones cannot cover their debt by long-term asset as large ones do, and that makes SMEs to be more risky when getting a credit and the credit becomes more expensive.

As it was mentioned before, the taxation policy makes a huge impact on the development of SMEs because they have smaller profit and self-financing possibility. Both Lithuanian Department of Statistics and Lithuanian Ministry of Finance do not make official calculations of taxation load rate. D. Meškauskienė and M. Tvaronavičienė propose to make such calculation taking into account GDP and the revenue of all taxes [Meškauskienė, Tvaronavičienė 2003]. After such calculations had been made it became clear that taxes ratio varied from 28 to 32% depending on the year and the development of the sectors which have different taxation rates. For example, the more active growth of trade, transportation and construction sectors is, the more it contributes to highest taxation rate while real estate and agricultural sectors contribute to the lowest taxation rate. In the period of crisis trade, transportation and construction sectors suffer bigger loss than others.

The comparison of taxation rate with GDP *per capita* enables to note the difference between certain countries and shows that ratio of taxes *per capita* in Lithuania is twice as big as in any old EU member. The fiscal policy directly influences Foreign Direct Investments (FDI). Every investor, whether small or big one, takes taxes into account first of all. The structure of taxes not always has the direct influence on unemployment, inflation rate, GDP growth, etc.

When looking for the factors that influence the state of SMEs, the analysis of bankrupts helps to evaluate better the environment of the latter because all companies try to be profitable and then for some reason they are incapable to get profit and face a big risk of bankruptcy. The survey shows that bankrupts have the biggest influence on the growth of unemployment and FDI, less influence on GDP and inflation rates, and small influence on the import growth [Juchno, Tvaronavičienė 2004]. Certainly all these rates, depending on a combination, can exert very variable and sometimes opposite influence on the number of bankrupts and on the business environment itself. It may sound as a paradox, but in some sectors of economy, such as industry, a high unemployment can be suitable for FDI, because it offers an investor a lot of working force.

Presently, the unemployment have risen more than twice in Lithuania in ten months from 4.5 to 9%, at the same time FDI fell down by 30%, GDP fell down by 15%, while the number of companies increased. If GDP growth is negative and number of companies still increases, the conclusion can be that finally despite all the mentioned SMEs problems they become more and more numerous.

Looking from the company's point of view the unemployment is not negative all the time. High unemployment means there still is a lot of cheap and free working force in a market. Of course, it is just empirical phenomenon and in general macroeconomic environment provides mostly negative influence: due to smaller number of working people the local market became less solvent; the Government gets less finance to support social activities and has to support increasing army of unemployed. Increasing number of companies in a slow development period shows only the increasing competition and decreasing revenue and profit by a company.

How can we explain the vitality of this business? Of course small size is not bad in all cases. In the crisis period SMEs can answer faster to the changed market needs due to the low automation level, then the whole production or even company's structure can be changed faster.

## 3. Business environment risks and influences for small and big companies

All companies as a part of national business have constant influence on macroeconomic environment, such areas as fiscal and monetary policy, investment and competition environment, EU support, international integration and others make daily influence on the competitiveness of country and its business.

EU financial support is very clear in numbers, but the real influence on the local economy is not easy to evaluate. It depends very much on effectiveness of finance assimilation. The EU financial support stimulated the GDP growth by 2% before the crisis and during the crisis period it becomes more important to maintain economic stability.

Joint stock companies and private companies have been the most popular business form for the last few years. Joint stock companies engage more people than others. Despite that 99% of companies are SMEs, large and microcompanies employ the biggest part of employees (Table 1).

Approximately six people are working in an average company in the European Union, while in Lithuania this number is more than twice as big. The Lithuanian companies' structure is very similar to that in the European Union. As it was mentioned, 99.4% of all companies are SMEs having less than 250 employees and these companies employ 70.6% of total working power of the country.

Table 1. Number of employees, company size and legal status as of 1 January 2008

| Item | Number of employees | | | | Total |
|---|---|---|---|---|---|
| | < 9 | 9-49 | 50-249 | 249 > | |
| Sole proprietorship | 51338 | 33682 | 10601 | 3558 | 99179 |
| Public limited company | 246 | 1996 | 18322 | 112295 | 132859 |
| Private limited company | 92126 | 197372 | 212499 | 136827 | 638824 |
| Agricultural companies | 757 | 3572 | 7106 | 1226 | 12661 |
| Cooperatives | 573 | 2062 | 3347 | 884 | 6866 |
| Partnerships | 731 | 1179 | 1210 | 292 | 3412 |
| Others | 199 | 966 | 9595 | 12624 | 23384 |
| Total | 145970 | 240829 | 262680 | 267706 | 917185 |

Source: Lithuanian Department of Statistics.

The biggest part of Lithuanian companies work in retail sales, real estate, construction and manufacturing sectors. Unfortunately, except manufacturing and in some cases real estate, these sectors do not create enough added value and strongly depend on local market development. In period of crisis or slow growth these sectors become more vulnerable due to increasing local competition and decreasing consumption level.

Lithuanian labour force has one of the highest education level in Europe, which let SMEs find out the good quality workers but on other hand the SMEs, as it was mentioned before, very often cannot afford to hire a skilled staff because the salaries in SMEs are by 14-35% less than average in a country (Table 2).

Table 2. Salary level in the companies according to the number of employees

| | Average salary | < 9 | 10-49 | 50-249 | > 250 |
|---|---|---|---|---|---|
| All country | 100 | 64.9 | 84.4 | 102.0 | 122.9 |
| Private sector | 100 | 66.7 | 86.1 | 108.2 | 126.0 |

Source: Lithuanian Department of Statistics.

Because of this the phenomena of unskilled working power, constant employees change, risk of loss of information or clients have appeared. With small revenue SMEs cannot afford the investments to the employees' trainings that also affect the mentioned results.

The human resources before the crisis was a huge problem for businesses. High level of emigration played an important role in poor demographic situation of the country and not efficient high education system caused the lack of human resources. Efficient formation of human resources makes positive influence on GDP growth due to better usage of labour force, increase in productiveness, more sophisticated and more added valued production. Willing to invite foreign investors, the possibility to provide high skilled workers is a great opportunity.

Another factor causing the lack of workers' interest in the SMEs is short life of this business – employees do not feel their future is secure under these conditions. What is more, the work in an unknown enterprise is not very useful for *curriculum vitae*, and last but not least, small company is less attractive because of quite poor carrier possibilities. On the other hand, SME workers can have more universal and dynamic working conditions and wider experience.

Despite that situation some sources say that SMEs are more profitable than large companies. This can be explained by the their competitiveness in a specific market on which there are no mass economics and small profit margin and due to short distance between main company's manager and client it is possible to supply goods or services in better price and quality. Having relevant information about clients' needs a small company can better satisfy them and improve clients' loyalty. Loyal client not only helps to economize spending on marketing but also assures better profitability results by being less "price sensitive."

The commerce internationalization and globalization change constantly consumer behaviour. Open local markets absorb innovations and make local consumer more demanding for new and qualitative products. SMEs need to compete not only with local but also with large foreign companies. The main SMEs' business difficulties are as follows:

- small production capacities,
- more expensive row material,
- bigger management costs,
- lesser production automation degree,
- comparatively biggest spending in logistics,
- lack of financial resources to get necessary business information,
- increasing goods design and quantity needs,
- low possibility to supply wide range of goods and services.

Most acceptable and better priced SME financing measure is a bank credit but as mentioned before this financing source is too expensive and bureaucratic. Banks ask for high collateral value to secure the loan return, which starting business has not got and a lot of potential enterprises never start. The credits, provided and partly covered credit interests with Government guaranties for SMEs towards a bank could be a solution.

The admission to the worldwide organization have not left Lithuanian economy unchanged. Due to less import taxes rate and higher trusting rates the member country can get better trade possibilities and cheaper international credits. That gives possibilities to compete better and to seek higher profitability.

The main possibility for SMEs to compete with large companies is finding out niche sectors not interesting for big companies because of their clumsy structure. Often due to good access to current niche business information and small costs of marketing, profitability is quite high.

Looking at the present situation, a few conclusions of business development directions could be made. First of all creation of clusters and cooperatives allows to collect and to economize necessary financial funds for seeking business information, enlarge assortment, improve quality and company's management system. Secondly: to use more actively and efficiently the Government's financial (guarantees, microcredits, etc.), material (industrial parks) and information (embassies, business information centres, etc.) support. Thirdly: to invest to human resources.

## 4. Conclusions

1. Decreased consumption is the biggest problem for SMEs. Administrative barriers and lack of labour force together with its high price could be mentioned as the other two most important obstacles to do business. Meanwhile the big companies are not so preoccupied about decreasing of buying power but they are more interested in administrative questions and lack of labour force. The biggest EU companies export more actively than small ones. The export of large companies comprises 19% of their total turnover while export of small companies makes only 5%, in spite of their being more productive.

2. The analysis of SMEs financing sources shows that main sources are three: own savings, banks and friends.

3. The comparison of taxation rate with GDP *per capita* enables to see better the differences between countries. For example taxes quantity ratio *per capita* in Lithuania is twice as big as in some old EU members.

4. The most popular business form are the joined stock and the private companies and joined stock companies engage more people than others. Despite the fact that 99% of companies are SMEs, large and micro enterprises have more employees.

5. In the crisis period SMEs can react faster on the changed market needs due to low automation level and faster changing of all production or even all company’s structure.

6. The SMEs have constant influence on macroeconomic environment as a part of national business. Such areas as fiscal and monetary policy, investment and concurrence environment, EU support, international integration and others make daily influence on the competitiveness of national business.

7. The creation of clusters and cooperatives offers possibility to collect and to economize necessary financial funds for seeking business information, to enlarge assortment, to improve quality and company’s management system, to use more actively and efficiently the Government’s financial, material and information support, and finally to invest in the human resources.

## Literature


Cressy R., “European SME financing: An overview”, *Small Business Economics* 1997, No. 9, pp. 87-96.

Cressy R., *Debt Finance and Credit Constraints on SMEs*, Cass Business School, London 2004.

Galinienė B., Mašalaitytė L., “Verslo vertinimo kokybei turintys įtakos finansinės analizės aspektai”, *Ekonomika* 2007, No. 77.

Juchno N., Tvaronavičienė M., “Įmonių bankrotai Lietuvoje: priklausomybės nuo makroekonominių veiksnių tyrimas”, *Verslas – teorija ir praktika* 2004, V tomas, Nr. 2.

Lithuanian Department of Statistics, www.stat.gov.lt.

Lithuanian Ministry of Economics, www.ukmin.lt.

Mackevičius J., *Įmonių veiklos analizė*, TEV, 2007, 510 pp.

Meškauskienė D., Tvaronavičienė M., “Lietuvos mokesčių sistema: mokesčių naštos tyrimas”, *Verslas – teorija ir praktika* 2003, IV tomas, Nr. 1.

Observatory of European SMEs, http://ec.europa.eu/enterprise/enterprise_policy/analysis/observatory_en.htm.

Peterson M.A., Rajan R., “The effect of credit market competition in lending relationships”, *Quarterly Journal of Economics* 1995, No. 110, pp. 407-443.

Smulkių ir vidutinių įmonių verslo sėkmės veiksniai 2006, Department of Statistics, Vilnius 2007.