International Review of Entrepreneurship, Article #1513, 13(3): pp. 169-186.
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Institutions and Social Networks: Explaining Barriers to New Firm Entry and Growth in the EU's Eastern Neighbourhood

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Abstract. In recent decades, economic competitiveness and growth has become increasingly dependent on the dynamism of new entrepreneurial firms. This is especially important in the transition economies of the EU's Eastern Partnership (EaP) region in the context of economic crisis and rising unemployment. However, a number of problematic issues have acted to hold back the entry and growth of entrepreneurial firms in the EaP region including the institutional environment in which firms operate, and the social networks within which they are embedded. The paper presents evidence on the ways in which these factors impose barriers to the entry and growth of entrepreneurial firms as agents of economic development in the EaP countries, with a focus on the cases of Moldova and Ukraine.

Keywords: new firms, institutions, social networks, eastern neighbourhood**.**

JEL Classification: P2, O40, C33

Funding: The research on which the paper is based was funded by the European Commission FP7 Programme, project No. 266834. Address of funder: Unit B.5 "Social Sciences & Humanities", European Research, Area, Directorate-General for Research & Innovation, European Commission.

1. Introduction

Since its eastern enlargement in 2004, the European Union (EU) has become increasingly engaged in the economic development of her new neighbouring countries. The EU adopted a European Neighbourhood Policy in that year, designed to ensure stability on its Eastern and Southern borders. A programme to support the Eastern neighbouring countries known as the Eastern Partnership

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(EaP) was launched in 2009 covering Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. This partnership was further developed in 2011 with an emphasis on inclusive economic development in the EaP countries. A Flagship Initiative for small and medium sized enterprises (SMEs) in the EaP region offered €7 million for technical support to such businesses, backed up by €5 million from the European Bank for Reconstruction and Development for local SME advisory services, and a further €15m from the European Investment Bank as guarantees for loans to SMEs from the banking sector[2]. This concern with the stability and growth prospects of these countries has been brought into sharp relief by recent turmoil in Ukraine starting in November 2013, following earlier conflict in Georgia in 2009.

This paper focuses on the role of entrepreneurial firms as drivers of economic growth in these countries and the barriers that they face. Our main focus is on the cases of Ukraine and Moldova, two countries that border the EU where we carried out field research in 2013, which we contrast with the other EaP countries.

In recent decades, economic growth has become increasingly dependent on the dynamism of small entrepreneurial firms. Analysts have noted the significant role of such firms in both advanced and transition countries in areas such as job creation, innovation and competitiveness (Acs and Audretsch, 1993). Observers have persuasively argued that small and medium sized entrepreneurial firms have an important role to play in the transition countries in generating jobs for those who are dismissed from large state firms undergoing restructuring or privatisation (Tyson et al., 1994; Kolodko, 2000). It is furthermore suggested that the growth of SMEs is a response to new opportunities, which pulls ‘high expectations’ entrepreneurs into dynamic segments of the economy (Welter and Smallbone, 2011). Empirical evidence supports the view that entrepreneurial activity has had a positive effect on growth in transition economies (Berkowitz and DeJong, 2005). The creation of a new entrepreneurial firm sector may therefore play an important role in the process of economic regeneration and job creation. In the context of high unemployment and a declining role of large state firms this aspect has been especially important in the transition economies of the EaP region.

However, a number of problematic issues have acted to hold back the development of entrepreneurship and the entry and growth of new firms in the transition countries, and especially in some of the EaP countries. Firstly, innovative high-growth firms, sometimes called ‘gazelles’, seem to thrive in economies with an institutional framework that supports freedom from government interference, a feature that is more likely to characterise the business environment in developed market economies than in emerging and transition economies (Valliere and Peterson 2009). This represents a challenge for policy makers in the EaP countries where government lacks a tradition of support for the small firm sector and entrepreneurship. Secondly, in the EaP countries, the entry

2. “Update on the Eastern Partnership implementation” EaP Summit, 29-30 September 2011, Warsaw,

and growth of small firms has been held back by state policies that have been ambiguous about support for new entrepreneurs (Barkhatova, 2000). This has been due to the close political connections between ruling elites and the large firm sector, which has created conditions in which powerful monopoly interests have supported the persistence of significant barriers to entrepreneurs to establish new firms in many sectors (Bartlett, 2012). Monopolies and powerful coalitions have sought to stall reforms and preserve the status quo to maintain privileged positions gained during the chaos of the early stage of transition. In Russia, for example, insider networks seem to have inhibited the entry of new business start-ups (Aidis et al., 2008). Other research has reinforced our understanding of the role of institutions in determining the prospects for entrepreneurial firms. Estrin at al. (2012) and Aidis et al. (2012) demonstrate the role of the state is complex, with entrepreneurs benefiting from a strong and effective state able to protect property rights and protect against corruption, and from less government interference in other respects, while social networks also have an important and positive role to play.

Many analysts have explained the difficulties facing entrepreneurs in transition countries in terms of the unfavourable business environment that they face. The explanation is sought in terms of the inadequately developed institutional framework within which entrepreneurs operate (Acemoglu and Robinson, 2010; Estrin et al., 2012). The institutions that are involved are typically viewed as the formal institutions related to the legal system, property rights, the judicial system and the courts (especially in relation to the enforcement of contracts) and the administrative and bureaucratic hurdles that hinder the activities of entrepreneurs (Manolova et al., 2008). Several researchers, as well as our fieldwork, have pointed out that entrepreneurs may also influence and act upon those institutions (Henrekson and Sanandaji, 2011; Welter and Smallbone, 2011). The ability of entrepreneurs to alter the institutional framework means that the barriers posed by institutions are not fixed for all time but is in a dynamic state of flux. Hence the empirical observations of the influence of such institutional barriers tend to change over time.

In this paper we investigate the extent of barriers to entry of new firms and their growth in the EaP countries. We argue that the formal and informal institutional environments in which they operate have had a strong influence on their entry and growth. We further argue that the large firm networks have blocked the development of the small entrepreneurial firms in Moldova and Ukraine to a far greater extent than has been the case in the EaP countries of the Caucuses region, which have been more able to thrive and act as agents of economic growth. We attribute this primarily to the presence of the social and business networks whose members belong to the ruling elite, while at the same time the Caucuses region has had far less persistent legacy of the nomenklatura clans.

The next section briefly reviews the literature on the growth and development of entrepreneurship in the EaP countries, section 3 presents some evidence and arguments on the barriers to entry and growth of entrepreneurial firms in the EaP region, and section 4 concludes with a review of the research findings and a discussion of the policy implications of the research.

2. Entrepreneurship in the Eastern Neighbourhood

Since 1989, the transition countries in the EaP region have experienced a rapid growth in the number of new small firms in the private sector as pent up demand for firm formation was released by the newly liberalised environment following the collapse of communism. In this paper we focus on the cases of Moldova and Ukraine. First in the next paragraph we consider the size distribution of firms in the two countries, before following on with a review of the employment impact of firms of different size groups. We will find that while most firms were in the small and micro size groups in both countries, the large and medium sized firms accounted for a disproportionately large share of total employment and economic activity. Thus, it appears that the entry and growth of new entrepreneurial small firms has faced a number of significant hurdles.

In Moldova, by 2011 there were 48,541 registered private companies, of which three quarters were micro-enterprises with fewer than 10 employees and a further fifth were small enterprises with 10 to 49 employees (Popa, 2013). Taken together, almost all firms were ‘small’ in the conventional definition. In addition there were 1,502 medium sized enterprises (with 50-249 employees) representing 3.1% of all firms, and 1,204 large enterprises representing 2.5% of all firms. In Ukraine, in 2013 the great majority of registered enterprises were small (95%), while just 4.8% of firms were medium sized and just 659, or 0.2% of the total, were large firms[3]. For comparison, in the EU-27, 92% of firms were micro enterprises, and 6.7% were small (together 98.9%), while 1.1% were medium sized and just 0.2% were large (Eurostat, 2011). Thus, after twenty years of transition, Ukraine had a business structure comparable to that of the average for the EU economies, while in the case of Moldova large firms formed only a slightly greater proportion of the total business demography.

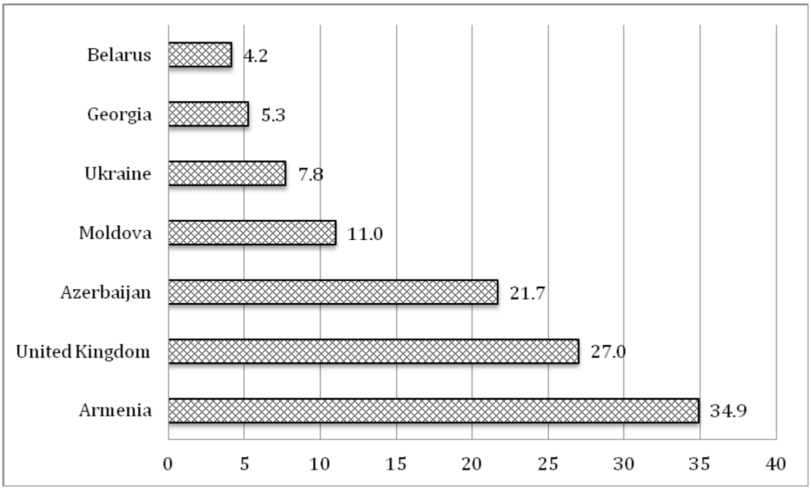
However, in relation to employment, the picture in the two EaP countries is quite different to that in the EU, with a concentration of employment in the large sized enterprises. Thus, in 2011 in Moldova, large and medium sized enterprises accounted for 60.2% of employment, in Ukraine for 72.9% of employment while in the EU-27, 50.5% of employment was in large and medium sized enterprises. Thus, in the two EaP countries, employment was more concentrated in large and medium sized firms and less in small and micro firms. In Moldova, large firms

3. Data from State Statistical Services, Ukraine, 2015

account for ten percentage points more of employment than in the EU, while in Ukraine the main difference is in respect of medium sized firms which account for 23 percentage points more employment[4].

Furthermore, new businesses often cater for basic needs in a way reminiscent of the socialist period, during which the informal economy mainly responded to omnipresent shortages brought about by the failure of state owned firms to supply consumers with basic goods (Ledeneva, 1998; Welter and Smallbone, 2011). The informal economy still plays an important role in Eastern European societies, and entrepreneurs argue that they are pushed into the grey economy by the many administrative hurdles and changes in regulations, and by the different interpretations of these regulations, which often leads to corruption (Welter and Smallbone, 2011). As one of our informants in Kiev noted, “to start a business in Ukraine means to pass through the gates of hell”.[5]

Figure 1: Density of firms per thousand population (average 2006-09)



Source: IFC online database

Due to varying barriers to entry among EaP countries, substantial differences have emerged in the density of new entrepreneurial firms between the EaP countries. The density of firms per thousand of population is extremely low in some EaP countries in comparison to the UK. Belarus, Georgia, Ukraine and Moldova had especially low density rates in comparison to other countries in the Caucuses region (Azerbaijan and Armenia), which had densities more similar to developed countries such as the UK (see Figure 1). The data highlight the

4. Moreover, much of the growth of entrepreneurial activity that has taken place has been concentrated in the cities and major urban agglomerations and relatively little entrepreneurial activity has taken place in rural areas (Kalantaridis et al., 2007).
5. Volodymyr Tarnoy, Kiev, 16th May 2013.

significant barriers that have limited the creation of new businesses in those countries. From the data presented in Figure 1, it seems that entrepreneurs in the EaP countries face many difficulties in establishing their presence on the post-socialist market economy.

3. Institutional Factors: Barriers to Entry And Growth

Observers have identified the main causes of slow entry and growth in the EaP countries as primarily due to the existence of financial and institutional barriers (Aidis et al., 2010). What we might call the 'finance-first' view holds that financial constraints have been the most significant barrier to the entry and growth of small enterprises (Pissarides, 1999). In the absence of a well-developed capital market, firms that wish to expand are constrained by the amount of initial capital at the disposal of the owner and by the amount of profits available for reinvestment. The absence of external finance was especially important in the transition economies in which banks initially had little experience in lending to small firms and found it easier to lend to politically well-connected large enterprises. Absence of collateral to guarantee a bank loan was a further significant barrier to obtaining external finance.[6] In Ukraine for example, one of the principal barriers to growth has been the lack of finance from the underdeveloped banking system. The limited available bank finance has mainly been channelled to the large enterprise sector, while loans to small enterprises have been provided at high interest rates with heavy collateral requirements. Larger firms have attempted to establish and maintain dominant or monopoly positions, making use of close connections between the economic and political elites, which themselves have rotated between positions of political and economic power. This convergence of political and economic power has made it relatively easy for the large enterprise sector to establish and maintain monopoly positions and influence economic policy in ways inimical to the development of the competitive small business sector, and there has been relatively little policy impetus for the promotion of small firms in most of EaP states. As an interviewee noted, "the Ukrainian political elite is "too dependent on big business and therefore governs in their favour".[7]

In contrast, the 'institutional view' holds that no amount of finance will assist small firms if institutional constraints inhibit entry and growth. Institutional factors have been argued to have a strong effect on the rate of entry of new small firms. Djankov et al. (2002) find that heavier regulation of entry is generally associated with greater corruption and a larger unofficial economy. In Russia,

6. In a climate of rising unemployment, many small firms were established. Poverty was one of the main factors that drove the growth of self-employment. However this type of firm usually has only one employee and struggles to make ends meet (Sakova, 2000; Hanley, 2000).
7. Interview, Kiev, 20 May, 2013

Aidis et al. (2008) found that the weak institutional environment explains the relatively low level of entrepreneurship, whether measured in terms of the number of start-ups or the number of existing business owners.

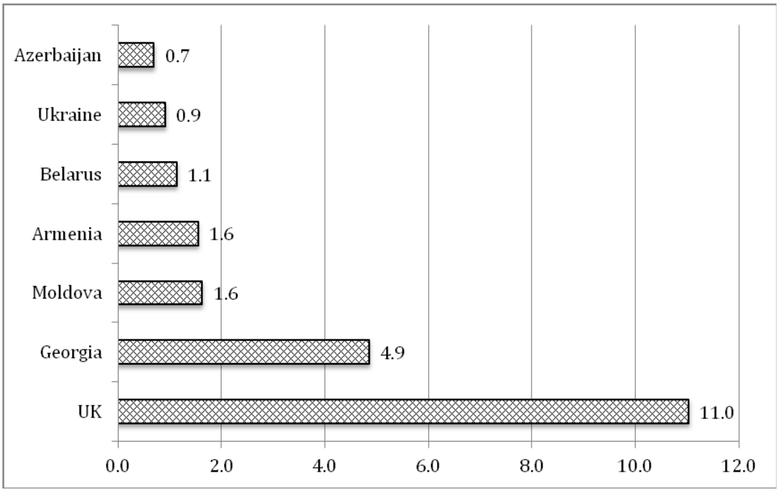
Especially problematic within the institutional view have been the role of business and social networks (Aidis et al., 2008; Estrin et al., 2012). Networks are vital social, economic and political structures. They are and have been a backbone of both Ukrainian state and society. They have had a dual nature. They supported economic growth through trust relations (especially development within one's own network), which substituted for missing institutions. But they also stripped both the state and rival companies of valuable assets (Welter, 2012). As in the rest of the former Soviet Union, in Moldova and Ukraine networks were, and still are, informal institutions based on personal contacts. The advantage in being part of an informal structure is that its workings cannot be traced, as they are not documented. They are dependent on personal contacts and "mediated by the rhetoric of friendship" (Ledeneva, 1998: 37). Networks are embedded in each strata of society and they function differently in each. Among big business and the political elite, networks are defined primarily by financial transactions. These networks function because their members financially reward each other. Even if money is not exchanged, that which is exchanged has a monetary value since the market has spread beyond the economic sphere into state and society (Sandel, 2013). As a result, trust is an important part of these networks, as is *kompromat* (material that compromises a member of a rival network or ruling elite).

In particular, networks that link banks to the state and to larger enterprises, and which divert investment finance from profitable entrepreneurial firms to large loss-making companies that are supported by political connections provide an impediment to the entry and growth of new firms. Furthermore, a lack of effective property rights inhibits the entry of new firms and reduces investment in established firms. Consequently, the growth of new enterprises will be lower when institutional barriers are high and property rights are weak (Aidis et al., 2010; McMillan and Woodruff 2002). The scope of such institutional barriers is wide. The most significant are inadequate property rights, but other issues are also relevant including administrative costs, costs of obtaining licences, delays in registering a company, the need to pay bribes to inspectors and so on. Aidis (2005) points to the inter-relatedness of institutional barriers, which further complicates attempts to overcome their adverse effects on economic development.

3.1. Evidence on Barriers to Entry

Comparable cross-country data on entry density rates taken from the World Bank Group Entrepreneurship Survey 2010 are presented in Figure 2. The entry density is the number of new firms created in each year per thousand of the working age population (see Klapper et al. 2009). Most countries of the region have entry density rates below 0.2%, well below the benchmark case of the UK, which has practiced a very liberal business regulatory policy for many years. An exception is Georgia, which has an entry density rate of 0.49%, suggesting that it has developed a rather more pro-enterprise business environment than other EaP countries.

Figure 2: Entry density rate 2012, EaP countries in comparison with UK per '000 working population



Source: World Bank Entrepreneurship database 2012

In Moldova, while progress has been made in improving business legislation over the last decade, its impact the business environment has been minimal (Popa, 2013). The Strategy of Reform of the Regulatory Framework for Entrepreneurial Activity, launched in 2007, aimed to reduce administrative regulations and the financial and time costs borne by entrepreneurs to open, operate and close a business. The reform strategy initially fuelled optimism among entrepreneurs concerning the ease of doing business, but as the reform has passed through multiple stages with little effect it has lost most of its credibility. Thus, despite several years of continuous reform, the environment for doing business remains unfavourable. Although some progress has been achieved in the improvement of the regulatory framework for business activity, significant problems remain due to poor implementation of laws and the poor functioning of regulatory institutions. One example is that of the National Agency for the Protection of Competition (Popa, 2013). Although this agency was established in 2007 it has proved itself to be incapable of ensuring fair competition on the market. There is also a general perception that property in Moldova is not well defended by the law. The national media is full of stories of attempts at hostile corporate takeovers, corporate scandals, and managers' lack of responsibility (Popa et al., 2012).

In Ukraine, our fieldwork carried out in May 2013 revealed that a heavier regulation of entry, together with the weak institutional environment, was seen as a major obstacle in starting a business. To start a business in Ukraine one has to visit a huge variety of state offices, obtain the necessary documents, hope that they were the right ones, and finally have them officially verified and stamped. All this requires time and money. Although a one-stop shop system has been introduced, observers report that it does not function effectively.[8]

In response to these difficulties, some corrective policies have been introduced in these and other transition countries in order to create a more favourable environment for business. A World Bank survey on the ease of doing business focuses on a number of indicators that are relevant to the issue of the entry of new firms. The most recent survey, carried out in 2015, covers 189 countries, including those in the EaP region. Although it only includes limited liability companies based in the capital cities, the information provided is useful in gauging progress in reform, and in benchmarking the ease of starting up a business in different countries.

Table 1: Ease of starting a business in selected EaP countries

	Starting a business rank	Number of procedures	Time taken	Cost (% income per capita)	Overall ease of doing business rank
Armenia	4	2	3	1.0	45
Georgia	5	2	2	3.4	15
Azerbaijan	12	3	5	3.1	80
Moldova	35	5	6	4.6	63
Belarus	40	5	9	0.8	57
Ukraine	76	6	21	1.2	96

Source: World Bank Ease of Doing Business Database 2015

Table 1 shows the results of the survey for the EaP countries, sorted by the ease of starting a business. Three of these countries are in the top 12 of the global ranking (Armenia, Azerbaijan and Georgia), i.e. the Caucuses countries. In comparison, Moldova, Belarus and Ukraine were ranked between 35th and 76th with Ukraine placed in last place among this group of countries. Ukraine is particularly weak concerning the time required to start a business, although the cost of starting a business is however relatively low in Ukraine.

We expect the entry density rate to be correlated with the institutional environment for ease of starting a business. To identify the strength of this

8. Interview, Kiev, 16th May 2013

relationship in the EaP countries we run a simple regression of entry density rate against the ease of starting a business rank and a dummy variable for membership of the EaP region. The data used is from the World Bank Entrepreneurship database and the World Bank ease of doing business survey, introduced above. The format of the regressions is:

$$g(i) = \alpha + \beta(1) * x(i) + \beta(2) * EaP(i) + \beta(3) * CIS(i) + \varepsilon(i)$$

where:

- $g(i)$ is the Entry Density Rate for country i
- $x(i)$ is the Ease of Doing Business rank score for country i (where a higher value means a less friendly set of institutions for business start-up)
- EaP(i) is a dummy variable that takes the value 1 if a country is in the Eastern Partnership (EaP) group of countries
- CIS(i) is a dummy variable that takes the value 1 if a country is in the Commonwealth of Independent States (CIS) group of countries
- $\varepsilon(i)$ is an error term assumed to be normally distributed and uncorrelated with the regressors.

The results of the OLS regression are displayed in the Table below.

Table 2: Dependent variable – Entry density rate 2012

	Coefficient	**Standard error**	**t-value**	**P>|t|**
Ease of starting a business rank	-0.038**	0.018	-2.13	0.046
EaP dummy	-3.489**	1.461	-2.39	0.027
CIS dummy	-2.726*	1.485	-1.84	0.081
Constant	6.405***	1.243	5.15	0.000
Adj Rsq=0.229				
F=3.28				
N=24				

Note: *** indicates statistical significance at 1% level; ** at 5% level and * at 10% level.

Table 2 presents evidence for the hypothesis that the entry density rate is positively related to the institutional arrangements to promote business entry with a more conducive business start up regime (indicated by a lower value of the Ease of Doing Business rank score) being associated with a higher rate of small firm entry. The coefficient on the ease of starting a business rank is -0.038, meaning that a ten step improvement in the ease of starting a business rank score leads on average to an increase in the entry density rate of 0.038 percentage points.

The adjusted R-squared value of 0.23 shows that the model explains about one quarter of the variance in the dependent variable, and so further investigation is warranted to identify additional causal factors involved such as industry structure, and other non-institutional barriers to entry[9].

The significant negative coefficient of the dummy variables for EaP and CIS indicates that the autonomous entry density rate is lower in these regions than elsewhere in Eastern Europe. In fact, the average entry density rate is 0.18% in the EaP group of countries and 0.16% in the CIS groups of countries, compared to 0.44% in the rest of the Eastern Europe region. Experiments using an interaction of the independent and dummy variables yielded no improvement in the model revealing that the size of the effect is the same in all regions.

The findings suggest that a set of additional barriers hinder new firm entry in EaP and CIS countries compared to other countries in Eastern Europe. These barriers may be related to unobservable informal barriers to entry. The most important of these unobserved barriers, we would suggest based on findings from our field research, are the existence of strong social and business networks among owners of large tycoon enterprises, which effectively block the entry of new entrepreneurial firms in important sectors of the economy.

Weak property rights have also been identified as an important factor that inhibits entry (Aidis et al., 2010). In our field research in Kiev, we found that property rights are often in question, since inheritance laws have produced multiple ownerships of land and properties, which together with the high demand for properties has led to a lack of respect for the law and consequently to its weak implementation.[10] Furthermore, few companies are under foreign ownership, since only citizens can start a business and have a right to buy or sell property. Consequently, the market is highly localized. In Ukraine, it has been reported that some domestic companies have registered their headquarters abroad due to political instability (Aidis and Welter, 2008).

3.2. Evidence on the Barriers to the Growth of Small Firms

Barriers to the growth of small businesses have been one of the main themes of research into the relatively slow development of the small business sector in many transition economies (for a critical review see Doern, 2009)[11]. Recent analysis of surveys carried out in a large sample of transition economies have shown that

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9. Klapper et al. (2009) find a similar relationship for a larger group of countries worldwide.
10. Interview, Kiev, 20th May 2013
11. The references in this literature include for example Aidis (2005), Bartlett and Bukvic (2003), Brown et al. (2005), Pissarides (1999) and Pissarides et al. (2003).

while the force of financial barriers diminished in many countries as transition progressed, in the higher middle income countries a lack of skilled labour and infrastructure gaps emerged as significant barriers to business growth (Mitra et al., 2010). However, the global economic crisis that hit the region at the end of 2009 once again brought financial constraints to the fore, as bank credit dried up on a global scale. In EaP countries, entrepreneurs have felt increasing financial distress, and the proportion of non-performing loans in the business sector is on the increase[12].

Table 3: Share of firms evaluating the following aspects as major constraints for their activity, 2009

	Moldova	**Ukraine**
Access to finance	19.5	10.0
Inadequately educated workforce	15.7	4.4
Access to land	10.4	4.6
Corruption	10.1	10.6
Tax rates	9.0	17.5
Practices of the informal sector	7.1	10.2
Political instability	5.9	23.2
Business licensing and permits	4.5	5.9
Electricity	4.5	1.1
Tax administration	4.5	3.2
Customs and trade regulations	4.4	2.8
Transportation	1.6	0.2
Courts	1.2	3.0
Crime, theft and disorder	0.9	3.1
Labour regulations	0.7	0.3

Source: BEEPS 2009, EBRD; Note: data for Ukraine is for 2008

Entrepreneurial firms in the EaP countries seem to face many barriers to growth. In Ukraine, the contribution of small and medium sized enterprises (SMEs) to economic growth has decreased in recent years, while employment in such firms fell by around 10% each year between 2007 and 2011. As noted by one of our interviewees, "after the new Tax Code was adopted in 2010, despite the changes made in response to the protests, more than one million SMEs closed down."[13] As the OECD noted in a report at the time, although Ukraine began to

12. Bank non-performing loans as a percentage of all loans reached 14.5% in Moldova and 16.5% in Ukraine in 2012.
13. Interview, Kiev, 17th May 2013

provide support for small entrepreneurial business and the government made a number of commitments to support SMEs, it failed to follow up with implementation of the proposed reforms (OECD *et al*, 2012: 39).

Analysis of the most recent EBRD Business Environment and Enterprise Performance Survey carried out in 2008 and 2009 (see Table 3) shows that the greatest constraints on business activity in Moldova are in the following categories: access to finance (19.5% of firms evaluated it as a major constraint); an inadequately educated workforce (15.7%); access to land (10.4%), and corruption (10.2%). The importance of financial constraints to growth can be explained by a number of factors (Bartlett and Bukvic, 2003). Firstly, banks perceived small firms as high credit risks and typically required two or three times the value of a loan as collateral. Commercial banks often preferred to lend to larger firms, due to political connections as well as limited capacity to evaluate credit risks presented by small firms. Bank credit is often provided on a short-term basis at a relatively high cost (Kraft 2002), and owners of small firms therefore often self-financed their business investments.

In Ukraine, political instability is seen as the main obstacle to business by 23.2% of firms, followed by high tax rates (17.5%). In addition, about a tenth of Ukrainian firms claimed that access to finance, corruption and informal practices are major constraints on their activity.

The importance of tax rates as a hindrance for entrepreneurs can be seen from the way in which small business owners stood up to President Yanukovich and his crony business partners when, in early November 2010, the Parliament approved tax reform legislation aimed at balancing the national budget and reducing tax evasion. Critics of the bill argued that the laws would give tax breaks to large firms, while increasing tax audits and operating fees on small entrepreneurial firms. Demonstrations against the government began across the country after the bill was passed by the parliament, with the largest protests taking place in the capital Kiev. Hundreds of protesters, supported by a pair of opposition parliament members, occupied the Maidan Square putting up military tents, a field kitchen, field heaters and 24-hour security in protest against the planned tax rises on small- and medium-sized businesses. Ukrainian President Viktor Yanukovich vetoed an early version of the controversial tax bill, in a concession to the protesters, but that brought him into open conflict with his own political party. Ukraine's Parliament passed a revised version of the tax code, but protest organisers said the amended law remained regressive, and they continued to fight the President and the parliament until nearly its last days in Autumn of 2013.[14]

14. 17th May 2013.

4. Conclusions

The EU's Eastern neighbourhood has become a region of instability in recent years. If economic growth is to be restored, it seems likely that a major role will have to be played by the region's entrepreneurial firms who are the most likely agents of innovation, job creation and growth. This paper has therefore examined the barriers to entry and growth facing entrepreneurial small firms in the region. In this paper we focus on the cases of Moldova and Ukraine where we carried out field research in 2013, just before the break down of order following the Maiden Square protests. Comparisons with other countries in the European Partnership (EaP) region have been made where appropriate.

In the course of the transition to a market economy that has taken place over the recent decades, the business structure of both Moldova and Ukraine has approached that of normal market economies in relation to the business demography: the majority of firms are in the small and micro sized categories. However, in looking at the size distribution of firms by employment shares, it can be seen that most economic activity is still concentrated in the large and medium firm sectors. Moreover, in relation to population size, the density of firms is especially low in Moldova and Ukraine. This suggests that entrepreneurial firms in both countries face considerable barriers to entry and growth. In this paper we identify financial barriers and institutional barriers as the two key barriers to entry and growth that entrepreneurial firms face.

Concerning entry, we find that entry density rates are especially low in the EaP region, and Moldova and Ukraine are no exception. In 2012, the entry density rate per thousand working age population in Moldova was 1.6 and in Ukraine just 0.9, far below that in developed economies such as the UK which has an entry density rate almost ten times higher than Ukraine. This finding is backed up by the relatively poor showing of the two countries in the World Bank Ease of Doing Business survey, which shows Moldova in 35th place in terms of ease of business start-up and Ukraine in 76th place. A correlation of the entry density rate with the ease of business entry conditions revealed that both countries were performing relatively poorly in relation to expected rates of entry, suggesting that additional unobservable factors have been at play besides the formal legal institutions that govern the entry of new firms. We identify the role of social and business networks among the tycoon owners of large businesses as being especially important unobservable barrier to the entry of new entrepreneurial firms in both Moldova and Ukraine, while insecure property rights also seem to have a role to play.

Concerning barriers to growth, we analyse the most recent business surveys produced by the EBRD and the World Bank and find that financial barriers have been the main problems facing the growth of entrepreneurial business in Moldova. Indeed both countries have faced rising rate of non-performing loans in recent years, in common with some other transition countries during the period of the financial and eurozone crises. In Ukraine, the main barriers to growth have been political instability and high tax rates. The latter factor relates to the issue of business networks and the political connectedness of large firms under tycoon ownership, as our field research revealed that recent reforms to the tax system had favoured large firms over small entrepreneurial firms, a factor that was associated with the development of the protest movement in Ukraine in 2013.

In the EaP region as a whole, several factors hinder the establishment of a facilitating institutional framework for new entrepreneurial firms, including informal institutions that hinder the development of small businesses, the high incidence of corruption, and perhaps most importantly the informal networks of large business owners that are connected to powerful political elites. The activities of such power networks are associated with both the political elite and the powerful tycoons that emerged from the privatisation process in both Moldova and Ukraine. The political elite and tycoons redefined trust relationships to such an extent that economic actors trusted only within their own network, making it difficult and costly for entrepreneurs to do business on the basis of arms-length anonymous contracting. Instead, entrepreneurs have had to deal with a smaller circle of business partners who they know personally and can trust to do business with. Institutional trust can be hard to build if rent-seeking clan or social networks reinforce the connectedness between large firms and the political elite. Such political connectedness undermines formal institutions and supports the monopoly positions of local tycoons, and provides both overt and hidden barriers to small business entry and growth. This can drive up business costs and reduce the quality of goods and services, thus reinforcing the weak international competitiveness of the economies of the EaP region. Policy makers will need to address these issues in a serious way if small and medium sized entrepreneurial firms are to promote economic growth and acheive their full potential, in the context of an increasingly competitive global market environment.

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