

## IV. Small and medium enterprises

### (Position and role of SMEs in the Czech economy)

#### Definition of the set analysed

Small and medium enterprises (hereinafter only “SMEs”) make up an important sector of a market economy. The constant attention given to this sector is quite reasonable. SMEs have specific strengths and weaknesses (vulnerability).

The strengths are:

- relative flexibility, quick response (incl. birth or death of a company) to changing conditions
- high ability to absorb labour force thanks to flexibility
- ability to fill a gap in the structure of trading relations between large enterprises (the role of a subcontractor)

Among weaknesses are:

- more difficult and expensive access to capital, information and know-how
- reduced ability to eliminate the impacts of fluctuations of external effects in the start-up period
- less self-restraint to dismiss redundant labour force

That is why governments use various forms of public support for SMEs, including financial support. In case the rules for such support are set correctly, it is not discrimination in favour of these companies at the expense of others (no violation of market rules), but a reduction of the above weaknesses.

For the purposes of this analysis it is necessary to define the set of SMEs. The Business Register maintained by the Czech Statistical Office (CZSO) contains businesses **registered** in compliance with different laws and regulations. Experience says, however, that only a part of registered businesses are **active**. These, defined as enterprise-type statistical units, are registered according to data from statistical surveys, tax returns and social security contributions. Their share in registered businesses oscillates around 50%.

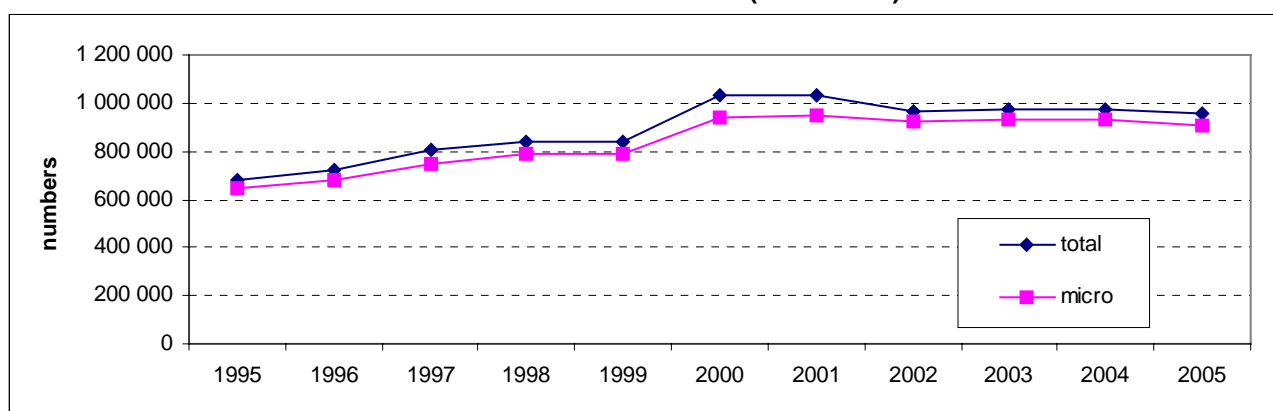
The basic indicator defining **small and medium enterprises (SMEs)** – registered and active as well – is the number of employed persons below 250. SMEs can be split into the groups of micro (up to 9 employed persons), small (10–49) and medium (50–249) enterprises.

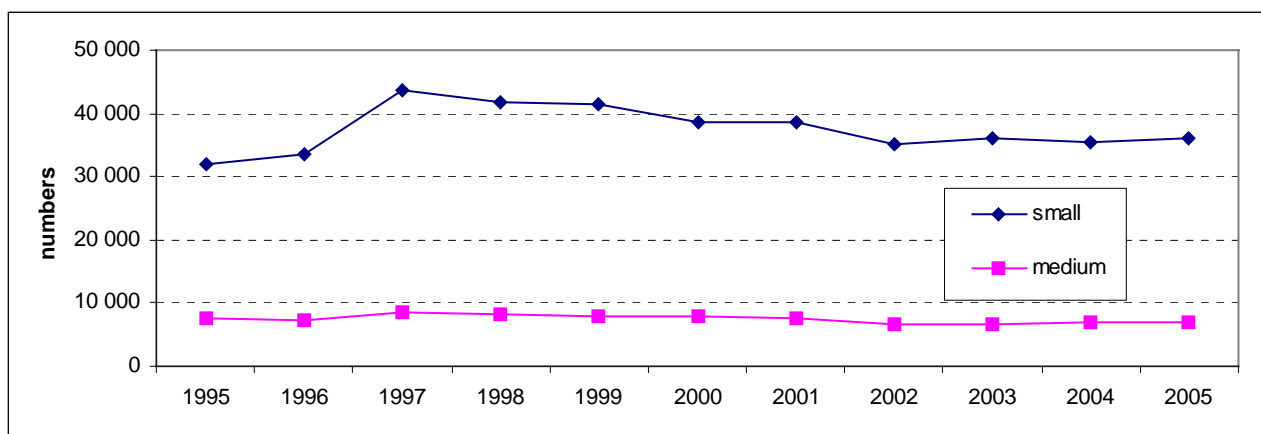
The set of **SMEs (non-financial)** is the basis of regular publications Economic Results of Small and Medium Enterprises (CZSO), i.e. active ones, and the basis of this analysis. Similar information is published also by the Ministry of Industry and Trade in its regular Reports on Small and Medium-sized Enterprises.

#### Numbers and structure of SMEs

We should know that such a relatively long period of time covered by the analysis could not be without methodological adjustments to data collection. The first were made in 1997. Since 2000 activity of businesses has been determined from administrative data (sources are the Ministry of Finance and the Czech Social Security Administration). A unit which submitted a non-zero tax return is considered to be active. This causes certain methodological incomparability with data from the previous years.

Small and medium business (1995- 2005)



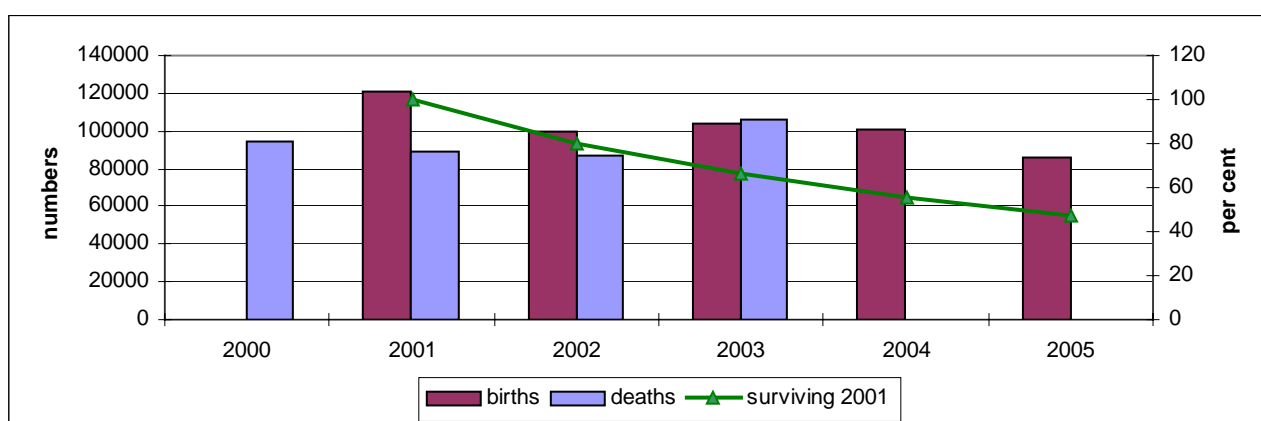


**Size groups.** A more detailed division into several size groups is justified. As expected, the most numerous are enterprises up to 9 employed persons; medium enterprises with 50 and more employed persons are the fewest in number. However, differences between these groups of SMEs measured by average number of employed persons are smaller; micro enterprises employ roughly the same number of persons as small and medium enterprises together. This displays the importance of micro enterprises.

The rapid growth of SMEs at the beginning of the 1990's was a phenomenon of the **economic transformation**, inter alia privatisation, restitution, spin off and business conditions. Since the end of the 1990's the high share of SMEs in the total number of businesses and in the total number of the employed has been stable (about 99% of the total number of non-financial enterprises and households, differences are by CZ-NACE activity). This makes us think that **business conditions** – notwithstanding alleged or real institutional barriers – are fairly stabilised. But there are differences in the structure; whereas the number of medium enterprises levelled off already before 1995 and the number of micro enterprises is more or less stable after 2000, the number of small enterprises (10-49 employees) peaked in 1997 and has been decreasing since. Explanation of these less clear-cut changes is more difficult; we shall try to draw up an outline and make a hypothesis based on the life cycle of enterprises.

**Business demography.** The life cycle of an enterprise is divided into stages; the start-up period is followed – in the case of success – by an expansion and probably a move to a higher category of enterprises which proves the success (expansion). The chart, however, does not seem to corroborate that, which is affected by another demographic feature – births of new enterprises and deaths of the unsuccessful ones. This holds for the category of SMEs, large enterprises experience processes of a rather different kind. Though there are no direct data on the SMEs sector in this respect, such information can be approximated by data for the set of active enterprises (excluding agriculture, public administration and non-profit organisations) which is analysed in a project of Eurostat in participation of the Czech Republic.

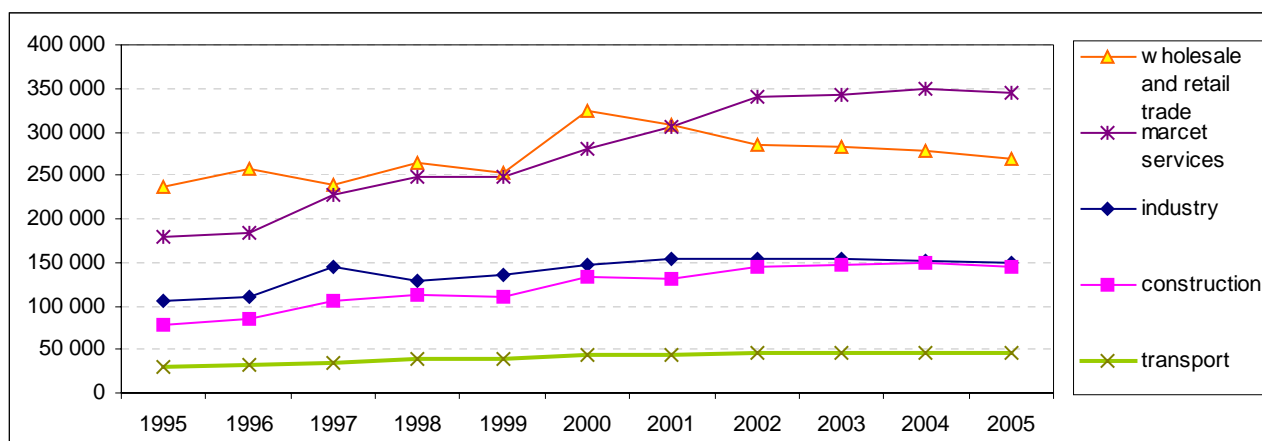
### Business demography



Source: Business Demography in the CR 2000–2005, CZSO, 2006

The **absolute** numbers of births and deaths of businesses vary from year to year, the balance determines year-on-year increases (decreases); births mostly exceed deaths. Important is that the **relative** numbers of births and deaths vary only insignificantly (at least in the sample) and the replacement figure is roughly 10%. The surviving of enterprises is distributed in geometric series into a long period of time (in the first year the cohort falls to 80% on average, in the second year to 63%, in the third to 55% and in the fourth year below 50%). It suggests that the average life of an enterprise takes ten years.

### SMEs by CZ-NACE activity – numbers of enterprises



The **structure** of the SMEs sector **by CZ-NACE activity** is not less important than its size structure. It indicates some important tendencies in the national economy. We give the numbers of enterprises which show stagnating numbers of SMEs in industry and construction over last years, a sharp increase in market services and decrease in wholesale and retail trade.

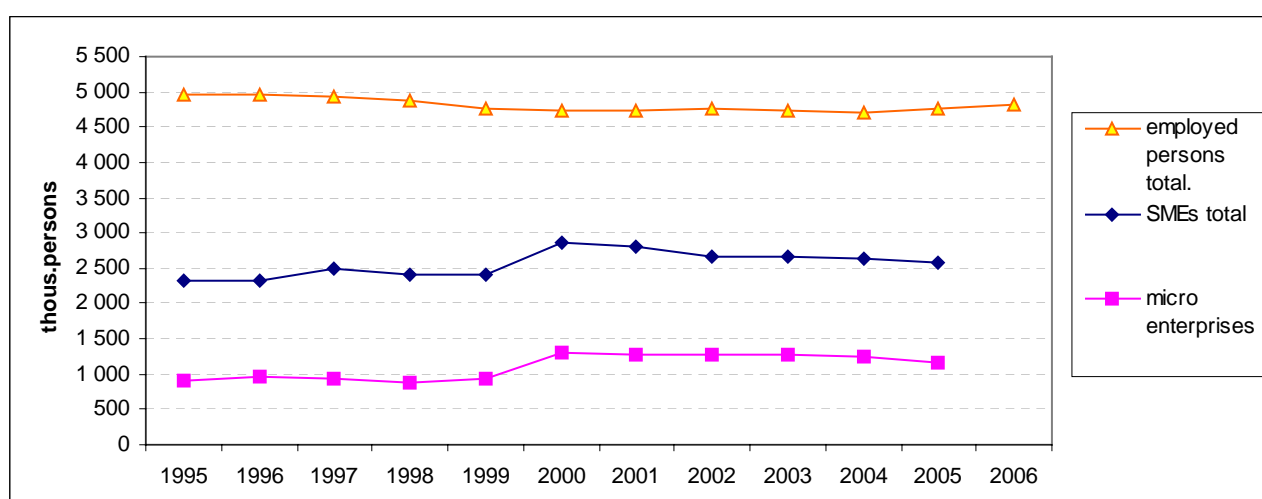
It is difficult to give an exhaustive explanation of changes in the structure of SMEs by CZ-NACE activity, but we can remember some of the facts. A general assumption can be used for industry and construction, namely that the number of SMEs has reached a certain natural limit, and in wholesale and retail trade the SMEs are probably not able to compete with the chain stores. The increase of SMEs in market services takes place predominantly in business activities and one of its reasons is a general tendency in the behaviour of enterprises to discontinue some activities and apply outsourcing.

### Benefits of the SMEs sector

The SMEs size structure and structure by CZ-NACE activity plays an important role in the share of the sector in economic performance. Below is a more detailed analysis of some of the shares.

**Labour force absorption.** Since the importance of SMEs for employment was mentioned at the beginning of the article, our focus will be on observing the rates and shares of the employed in comparison to total employment. The capacity of SMEs (approximated by the number of the employed) has today an important and fairly stable share in economic performance of the Czech Republic – about **70%** of total employment in non-financial enterprises and households (and more than 50% of total employment in the national economy).

### SMEs and number of employed persons

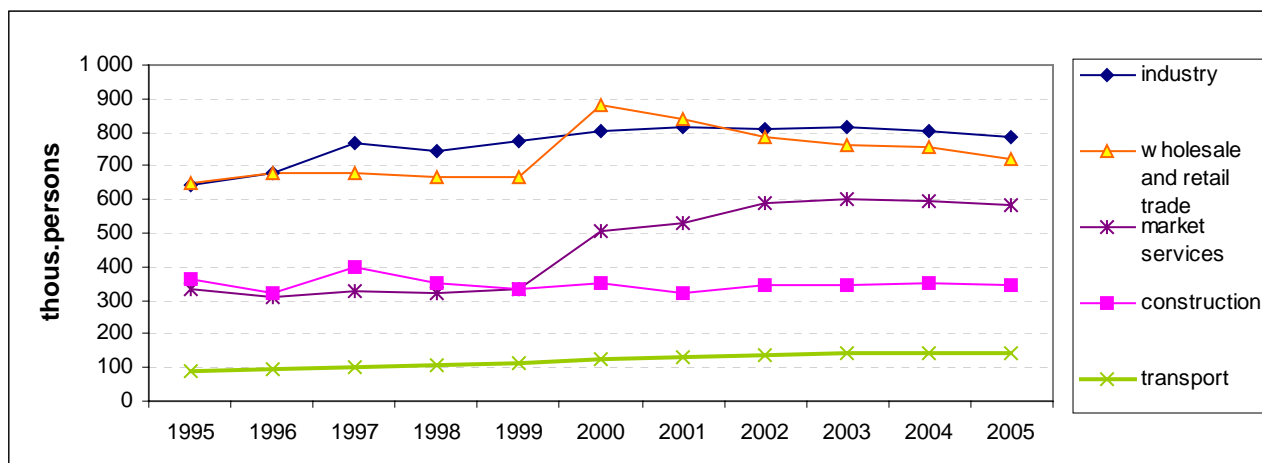


However, behind this generally accepted assumption are more important contexts. In the second half of the 1990's total employment was on the decrease and unemployment was increasing rapidly, but employment in the SMEs sector grew. Without the activity of the SMEs sector, employment would undoubtedly have fallen more rapidly. There is no more convincing evidence of the role of SMEs in the labour market. Surprisingly enough, increases in persons employed were generated especially in the group of micro enterprises.

The numbers of the employed by CZ-NACE activity reveal that SMEs in wholesale and retail trade give work to roughly as many people as SMEs in entire industry (CZ-NACE 10-41), and the rapid growth of SMEs in market services continues.

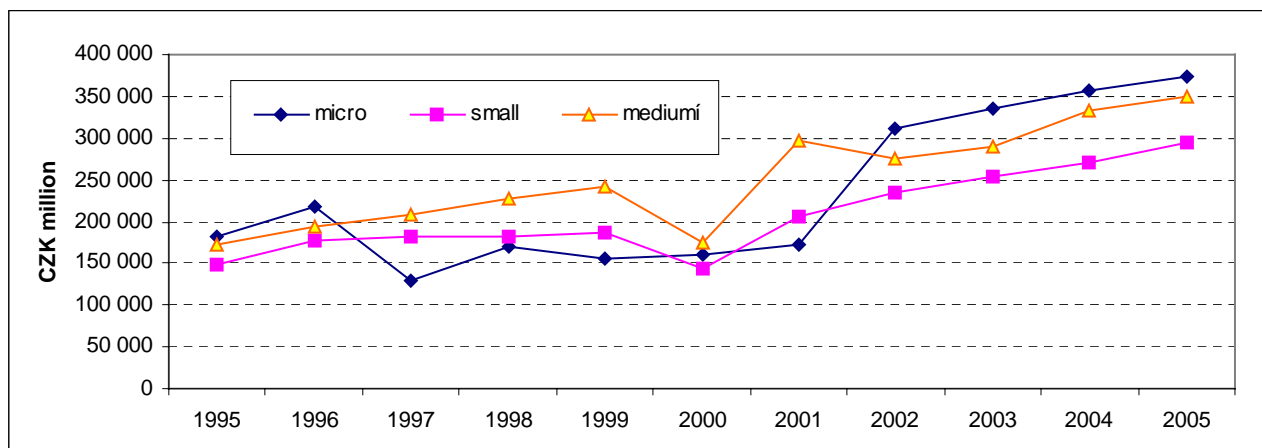
**Economic performance.** Economic performance of SMEs is measured by basic macroeconomic indicators or, more precisely, by share of SMEs in these indicators. Besides general conclusions we shall also mention changes over time.

### SMEs by CZ-NACE activity – employed persons



The share of SMEs in **book value added** is close to **60%** of total value added produced in non-financial enterprises and households. This implies that the economic performance of SMEs grew at roughly the same rates as the performance of the national economy, after 2000 even more. The impact of the decrease in the late 1990's was delayed, with the exception of micro enterprises. It may reflect the function of SMEs as subcontractors to large producers and the delay was a response to preceding downward stage of the business cycle. Increasing book value added in all groups of SMEs in the last years then – in advance – corresponds to the present upward stage of the cycle.

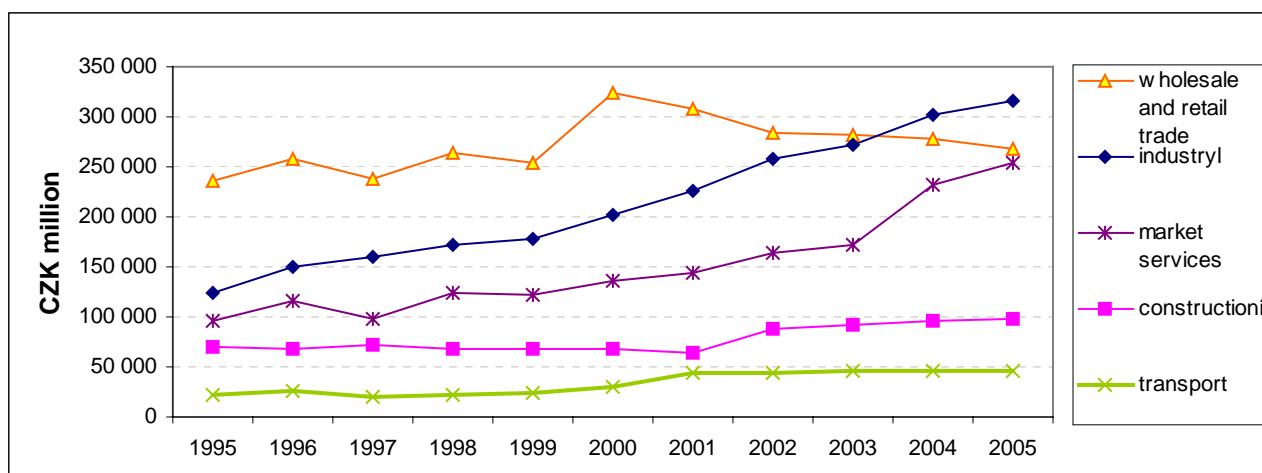
### SMEs and value added



As for the size structure, it is interesting to compare the second half of the 1990's and the beginning of the third millennium. In the former period, the highest rates were recorded for the group of medium enterprises which were hit, like the small ones, by recession at the end of the 1990's. In the latter period, higher rates of growth are registered in all size groups, but the highest ones in micro enterprises; while their share in total value added generated in SMEs was the lowest in the former period, their contribution in the latter period was the highest.

Comparing the share of SMEs in value added and in employment suggests that their **labour productivity** measured by value added is lower than labour productivity in the entire economy (i.e. in large enterprises). This is due to a lower level of fixed capital per employed person; it does not detract from the importance of SMEs, on the contrary. SMEs perform usually no large-scale activities and are able to easier absorb a free labour force, i.e. they are more flexible. Moreover, the results for the total cannot be generalised; SMEs in wholesale and retail trade and in market services record higher productivity than large enterprises and the differences in transport and agriculture are insignificant.

### SMEs by CZ-NACE activity – value added

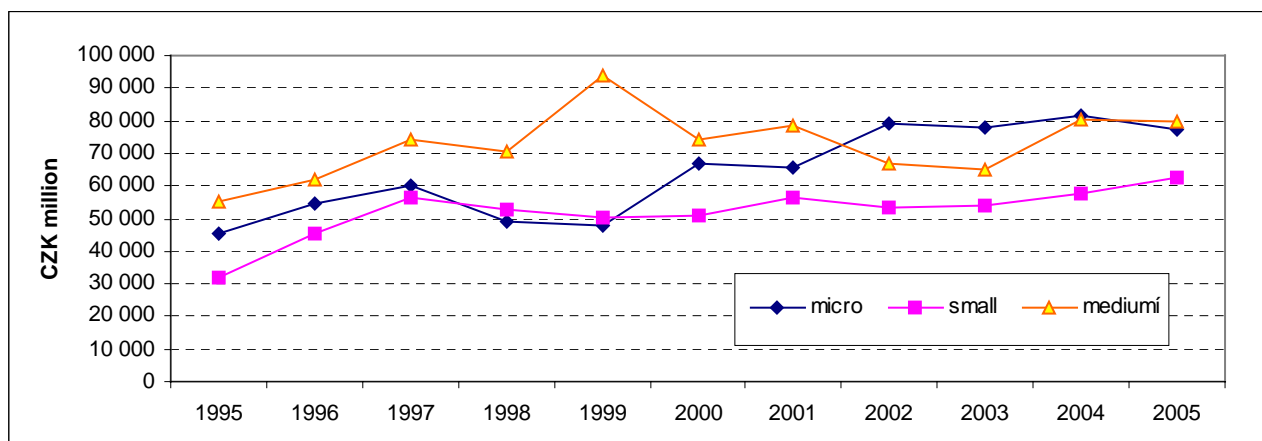


Differences in value added prove relations in the number of SMEs and number of the employed; it also shows an increasing importance of industrial SMEs for value added production.

For the sake of completeness see Annex for the share of SMEs in value added produced in industry by CZ-NACE activity.

**Investments.** The growth of economic performance of SMEs is not possible by increasing employment as the only factor. Another factor is the investment activity. The share of SMEs in **fixed capital investment** (acquisition of tangible fixed assets) is in excess of **50%** and grew by 10 percentage points within the ten years. Hence, investment rate in SMEs increases more rapidly than in the entire economy.

### SMEs and investments



In the 1990's investments grew in all groups of SMEs. What is interesting is that medium enterprises invested the largest amounts at the end of the 1990's and then their investment activity had been decreasing until 2003. After the period of growth, investments of small enterprises tend to stagnate and investments of micro enterprises – after the fall at the end of the 1990's – are on the increase and they have had the same size as investments of medium enterprises.

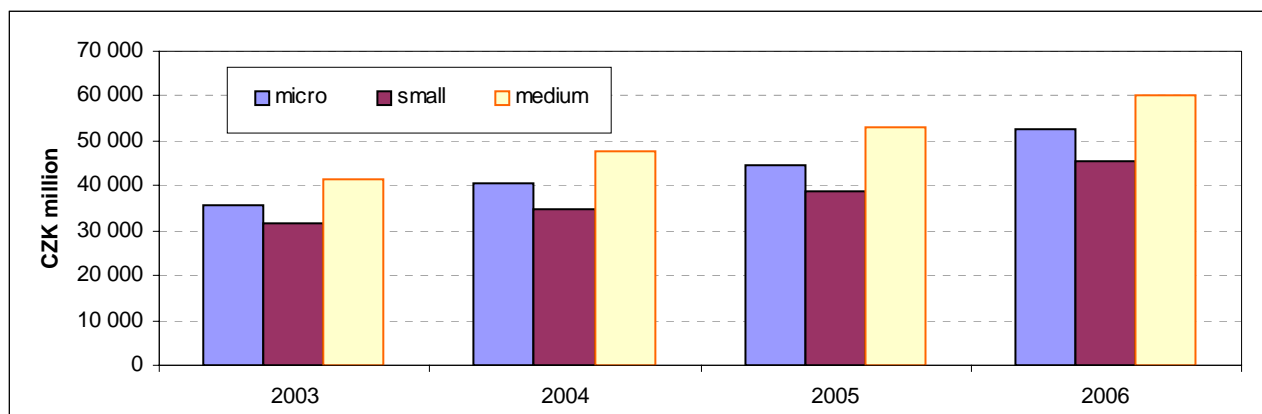
The comparison of the SMEs' share in investment, in value added and in employment offers a conclusion indicated above: the expansion of SMEs is less demanding in terms of **investments** but more **labour intensive** than the growth of the entire economy.

### SMEs and capital

Aforementioned is the fact that the **shortage of equity capital** is a weak point of SMEs. The next step of this analysis is focused, therefore, on two main ways of coping with the problem – the bank loan and the public support.

**Bank loans.** The Czech National Bank provides bank loan data from the Central Credit Register. The structure of the register allows splitting loans by enterprise size, CZ-NACE activity and region. The data offer interesting findings, for example demand has been growing of commercial banks for these otherwise risky clients asking mostly small loans and credits. There are more reasons for that: the banks have reconsidered the risk level in the rapidly growing sector of SMEs and intend to participate in the market which expanded also thanks to the support from the Structural Funds of the EU.

## SMEs and bank investment loans



As at 31 December: SMEs with turnover below CZK 1.5 billion

Source: Central Credit Register, CNB

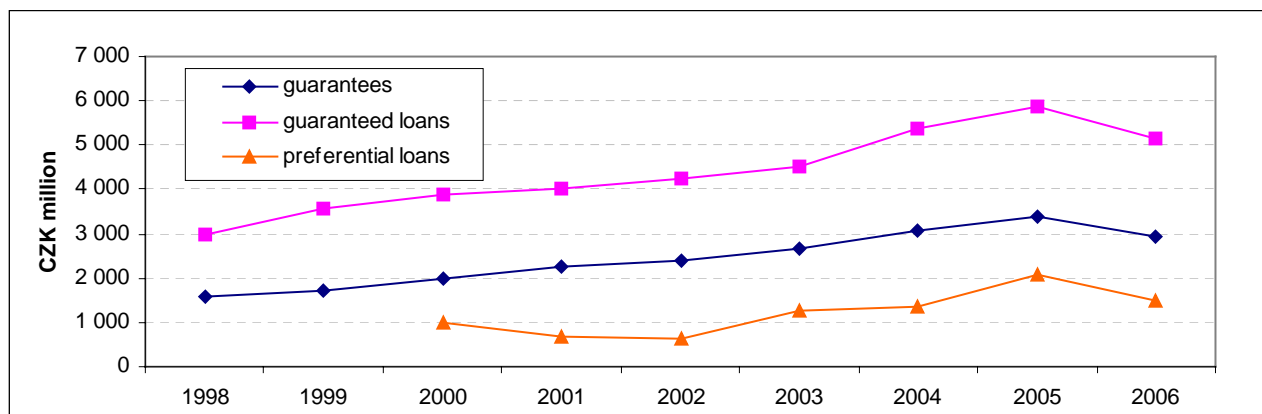
When we focus on bank investment loans, actually their balance to be paid back at the end of the years for which data are available, we can make a comparison with the trend of investments. We find out that the amounts of investment loans and their distribution by size group of SMEs show a similar trend as investments: the amounts with micro enterprises grow more rapidly than the amounts with small and medium enterprises, and the amount of investment loans with micro enterprises is already higher than the comparable volume with small enterprises. Bank loans thus facilitate the growth of SMEs, and in particular the growth of the weakest in terms of capital, which are micro enterprises.

**Public support.** Besides outside financial resources provided on a commercial basis (bank loans, etc.), an important role is played by public support (EU, central government, regions). There are more aims of public support, ranging from better information in the broad sense of the word and improved skills of the self-employed and entrepreneurs and consultancy up to **preferential access to capital**.

Preferential access to capital has multiple forms, from subsidies (non-repayable support) and preferentially priced bank loan guarantees up to preferential loans. This is support provided to **non-agricultural** sector (support for agriculture is a separate issue), but some activities inside this sector are not systematically supported. The main focus is on the most vulnerable segment of SMEs – start-ups and micro enterprises, in recent time on the most perspective clients, i.e. innovative companies or projects and last but not least on enterprises working in specific conditions (regions affected by structural changes and weak regions, employment of handicapped persons).

Public support at the central level is organised by the Ministry of Industry and Trade of the CR through *Czechinvest* (subsidies). Through the Czech-Moravian Guarantee and Development Bank (CMZR Bank, a state-controlled bank) are granted preferential guarantees and loans. The benefit of these repayable forms of support is not only having additional direct capital resources (like with subsidies), but also – and maybe predominantly – their indirect effects; they facilitate access to commercial bank loans not only thanks to preferential guarantees, but recently also thanks to subordinate loans. Unlike subsidies, public resources spent like that are returned to the budget (after some 10% are subtracted to meet bank's guarantee liabilities) for recurrent use.

## SMEs and public support (CMZR Bank)



Note: guaranteed loans are commercial bank loans granted i.a. on the basis of preferential guarantee by the CMZR Bank; preferential loans were not granted before 2000. The decrease in 2005 reflects a reduction of public support resources.

Source: CMZR Bank, annual reports

Broken down by CZ-NACE activity, guarantees are provided mainly to enterprises of manufacturing (60–70%), services make up 20–35% and the rest goes in construction. The share of services in preferential loans is about 50%. The underlying reason may be a more difficult way of getting commercial loans for SMEs in the sector of services.

## Summary

There is no doubt that SMEs play an important role in the Czech economy and their share is more or less stable. In the international context the Czech Republic is not aside, considering certain differences between the “old” and the “new” EU member states and between large and small economies.

Worth mentioning is the fact that the benefit of **micro enterprises** (up to 9 employees) is significant and growing, even more significant than in other countries. The other way round holds for **small enterprises** (up to 49 employees) whose numbers have been decreasing.

It is difficult to explain this peculiarity; a hypothesis from business demography is at hand. There may be obstacles to the ideal life cycle of SMEs, namely to the **transition to expansion stage** after the start-up stage, i.e. obstacles to transition from the micro-enterprise to the small-enterprise category, whereas small enterprises find it hard to withstand the competition of medium ones (see, for example, wholesale and retail trade). One of these obstacles is undoubtedly the lack of equity capital which underscores the importance of public support and changed behaviour of commercial banks (a growing focus on SMEs).

## Share of SMEs in value added in industry by CZ-NACE activity

|  | 2000        | 2001        | 2002        | 2003        | 2004        |
|--|-------------|-------------|-------------|-------------|-------------|
| <b>Industry, total (CZ-NACE 10-41)</b>                                 | <b>35.6</b> | <b>33.2</b> | <b>42.0</b> | <b>41.0</b> | <b>39.2</b> |
| <b>Mining and quarrying</b>  | <b>9.8</b>  | <b>9.4</b>  | <b>16.0</b> | <b>16.0</b> | <b>14.9</b> |
| Mining and quarrying of energy producing materials                     | 0.8         | 0.7         | 1.7         | 1.4         | 1.9         |
| Mining and quarrying, except of energy producing materials             | 72.4        | 62.5        | 85.5        | 89.0        | 80.6        |
| <b>Manufacturing</b>   | <b>41.0</b> | <b>37.9</b> | <b>47.9</b> | <b>46.2</b> | <b>43.8</b> |
| Manufacture of food products, beverages and tobacco                    | 43.9        | 41.1        | 45.6        | 44.7        | 42.9        |
| Manufacture of textiles and textile products                           | 44.7        | 45.7        | 52.8        | 52.7        | 55.8        |
| Manufacture of leather and leather products                            | 55.9        | 51.5        | 75.3        | 81.1        | 86.9        |
| Manufacture of wood and wood products                                  | 75.6        | 46.0        | 78.5        | 80.5        | 77.8        |
| Manufacture of pulp, paper and paper products; publishing and printing | 49.4        | 52.4        | 64.0        | 63.5        | 58.7        |
| Manufacture of coke, refined petroleum products                        | 0.0         | 1.5         | 1.4         | -6.0        | 27.4        |
| Manufacture of chemicals, chemical products and made-made fibres       | 29.2        | 26.8        | 28.0        | 28.9        | 24.3        |
| Manufacture of rubber and plastic products                             | 46.8        | 49.1        | 56.0        | 49.2        | 49.2        |
| Manufacture of other non-metallic mineral products                     | 32.0        | 32.9        | 41.0        | 39.8        | 41.0        |
| Manufacture of basic metals and fabricated metal products              | 49.5        | 49.5        | 60.6        | 58.0        | 51.5        |
| Manufacture of machinery and equipment n.e.c.                          | 48.4        | 39.0        | 60.9        | 59.8        | 57.7        |
| Manufacture of electrical and optical equipment                        | 43.5        | 38.6        | 45.4        | 45.7        | 40.5        |
| Manufacture of transport equipment                                     | 12.6        | 10.0        | 12.5        | 10.5        | 9.8         |
| Manufacturing n.e.c.   | 59.4        | 45.4        | 67.4        | 64.6        | 63.1        |
| <b>Electricity, gas and water supply</b>                               | <b>10.9</b> | <b>12.0</b> | <b>13.7</b> | <b>15.7</b> | <b>15.4</b> |