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## Book

### A comparative study on development of small and medium enterprises (SMEs) in Azerbaijan

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## **A Comparative Study on Development of Small and Medium Enterprises (SMEs) in Azerbaijan**

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## **Abstract**

This research paper explores the role of small- and medium-sized enterprises in the economy of different countries, with a particular focus on Azerbaijan. The purpose of the research is to support and intensify the development of small- and medium-sized businesses in the country by determining the effectiveness of programs held by the government to encourage greater SMEs activity, as well as presenting successful examples from international practices in order to adopt them to Azerbaijan's conditions. In the current period, the improvement of the entrepreneurship culture and enhancing the scope of small- and medium-sized businesses are important for the future economic growth, employment and income of the country's population.

## Table of Content

<b>1. Introduction.....</b>	<b>5</b>
<b>2. Literature Review .....</b>	<b>6</b>
2.1 Importance of SMEs .....	6
2.2 Role of SMEs in development.....	8
<b>3. Methodology .....</b>	<b>10</b>
<b>4. SMEs in the context of Azerbaijan.....</b>	<b>11</b>
4.1 Classification of SMEs .....	11
4.2 Realistic situation of SMEs in Azerbaijan.....	13
4.3 SWOT analysis of SMEs in Azerbaijan .....	16
4.4 Possible constraints in Azerbaijan in terms of SME development and growth....	17
4.5 Overview of small- and medium-size entrepreneurship policy, general strategy in this area.....	21
4.5.1 Support services to SMEs in Azerbaijan.....	22
4.5.2 Innovation Policy .....	24
4.5.3 Provision of profitable and efficient access to financial resources of SMEs .....	24
<b>5. SMEs in the context of the United States model .....</b>	<b>26</b>
5.1 Classification of SMEs .....	26
5.2 The role of the SMEs in the US economy .....	27
5.3 Access to finance .....	30
5.4 Overview of government policies for improving SMEs .....	32
<b>6. SMEs in the context of the Europe model .....</b>	<b>35</b>
6.1 Classification of SMEs .....	35
6.2 The role of SMEs in the economy of the European Union .....	35
6.3 The most common problems among SMEs in the European Union .....	39
6.4 Overview of government policies for the improvement of SMEs in the European Union .....	40
6.5 Improvement of SMEs over the years .....	42
6.6 Access to finance of small- and medium-sized enterprises (OECD, 2017) .....	44
<b>7. SMEs in the context of the Turkey model .....</b>	<b>46</b>
7.1 Classification of SMEs .....	46

7.2	Overview of support programs for the improvement of SMEs .....	47
7.3	Turkish SMEs' Access to Finance.....	49
<b>8.</b>	<b>SMEs in the context of the Russia model.....</b>	<b>50</b>
8.1	Classification of SMEs in Russia .....	50
8.2	The role of SMEs in the Russian Economy.....	50
8.3	Access to finance .....	51
8.4	Government policies for improving SMEs.....	53
<b>9.</b>	<b>SMEs in the context of the Georgia model .....</b>	<b>56</b>
9.1	Classification of SMEs .....	56
9.2	The role of SMEs in the Georgian economy .....	57
9.3	Government policies for improving .....	59
	<b>Conclusion .....</b>	<b>61</b>
	<b>Recommendations .....</b>	<b>63</b>
	<b>Bibliography.....</b>	<b>66</b>

## 1. Introduction

Small- and medium-sized enterprises (SMEs) are crucial economic actors within the economies of nations (Stanworth and Gray, 1993; NUTEK, 2004; Wolff and Pett, 2006). They are a major source of job creation (Storey et al., 1987; Castrogiovanni, 1996; Clark III and Moutray, 2004) and they represent the seeds for future large companies and corporations (Castrogiovanni, 1996; Monk, 2000). Another main feature of SMEs is that they create conditions for the more equitable sharing of production facilities and property, in addition to helping to mitigate income and wealth inequality amongst different layers of society.

Developed countries' experiences show that, in the last years, the role of SMEs in the economy has strengthened and the majority of enterprises have been ranked in the SMEs category – more than 95% (Ayyagari et al, 2011). Especially after the recent economic crisis beginning in 2008, experience has shown that SMEs have been able to respond to the challenges of the crisis more quickly and flexibly than large corporations and, indeed, they succeeded to survive and thrive. With a view to this observation, many developed countries have devised various kinds of non-financial and monetary incentive mechanisms aimed at enhancing the weight of SMEs in different sectors.

Different incentive mechanisms aiming to improve the entrepreneurial environment of Azerbaijan have been observed in the last years, especially after 2014, the beginning of the “post-oil period”. In this sense, some SMEs have been created and an improvement in registration procedures and tax administration has been observed. The number of individual entrepreneurship has increased; yet, in spite of it, the role of SMEs in the national economy is still limited and SMEs have negligible value-added to the overall economy. After a sharp decrease in the price of oil worldwide – oil having shaped the national economy heavily – the necessity of SME development has become an actual government priority. Some constraints impede the growth and effectiveness of SMEs in Azerbaijan, namely: low levels of investment in SMEs, financial and tax issues, complex procedures to access finance (especially in terms of taking credit from banks), insufficient levels of information and technical resources, unequal regional distribution of government funds, lack of market infrastructure and a number of problems in current legislation. All the aforementioned factors come together and demand that their presence be taken into account and not to be underestimated when developing strategies to target entrepreneurial activity in the country. Along these lines, this research intends to shed light not only on the importance and value of SMEs in national economies, but also on essential activities which have to be carried out to enhance entrepreneurial activities and SMEs in Azerbaijan, through analyzing current entrepreneurial activity in country and defining its major constraints.

The research is structured as follows. In the 1th chapter, literature review, definition of small and medium entrepreneurship have been explained and readers could get information about different kind of models related SMEs and their realization mechanism. In the following chapter, the level of development of small and medium sized entrepreneurship in different regions and countries such as United State, European Union, Asia region, Georgia, Russia, Turkey, and its role in economic development are investigated. In the next chapter, the realistic situation of SMEs in the economy of Azerbaijan, SWOT analysis of SME, the possible constrains for the SMEs development and growth as well as the role of the government policies for improving SMEs have been analysed. In conclusion, in order to development of the small and medium-sized entrepreneurs several suggestions have been offered.

## **2. Literature Review**

In a world of globalization, transitioning and developing countries and their enterprises face major challenges in trying to take advantage of trade and investment opportunities. While governments make policies in trade and investment areas, it is enterprises that trade and invest and so, their role in the economy is pivotal.

SMEs are significant players in transitioning and developing countries. These firms typically account for more than 90% of all firms outside the agricultural sector, constitute a major source of employment and generate substantial domestic and export earnings (OECD, 2009). As such, SME development emerges as a key instrument in further poverty reduction efforts.

### **2.1 Importance of SMEs**

SMEs are accepted as a fundamental part of the economy of individual countries and, as such, the underpinnings of the world economy. Duarte (2004) mentions in his article that, without a doubt, SMEs is crucial for the overall sustainability and health of an economy. According to the Organization for Economic Cooperation and Development (OECD, 2000), SMEs represent more than 95% of enterprises and create 60-70% of jobs. Alternatively, the United Nations Industrial Development Organization (UNIDO, 2005) calculated that SMEs account for 90% of private firms and employ 50-60% of the total labour force. Either way, as Wennekers and Thurik (1999) note, “small firms are the vehicle in which entrepreneurship thrives”. Small enterprises are crucial in ensuring competitiveness and bringing new techniques to production and finished products to market. It is worth mentioning that creating a good environment for SMEs, which can supply quality services and competitive products at a low cost, is significant for all countries around the world (Robu, 2013).

Even in crisis times or periods of recession, SMEs have been linked to employment, economic growth and productivity (WIPO 2010). In the Asian financial crisis, small and medium scaled enterprises were depicted as an ‘army of ants’ for Taiwan to fight the crisis (Hu, 2003). SMEs have a considerable role in a country’s economy as healthy competitors; they stimulate competition which leads to greater efficiency, price reduction and higher quality products (Johnson and Soenen, 2003). Without the existence of SMEs, large enterprises would hold a monopoly on several areas of activity. When discussing increased efficiency, SMEs have a significant role to play. According to Stephen Jarvis (1996), certain activities can be done better by SMEs than their larger counterparts, particularly with SMEs acting as subcontractors for large enterprises and supplying raw materials and sub-assemblies or distributing manufactured products. An economist, Zoltan J. Acs (1999), observed small businesses in the US and Europe and found an increasing trend in their importance since the nineteen-eighties. For example, U.S.’s General Motors uses some 37,000 SMEs for subassembly and other services. Not only American, but also European companies employ such practices, with one Italian company, Benetton, carrying out approximately 95% of production by means of subcontracting to SMEs (Iordache, 2014).

Lukasc (2005) posited that SMEs are the backbone of the entire British economy, accounting for more than half of the trade turnover of the UK. In Romania, the share of SMEs in total enterprises is 99.47% and 98% of these SMEs are privately owned (Statistical Yearbook, 2012). Not only European countries individually, but the economy of the European Union as a whole is greatly supported by SMEs; SMEs in Europe are the first in generating revenue, innovation, employment and entrepreneurial skills. According to the Annual Report on the Situation of SMEs in the European Union (European Commission, 2014) in 2012, out of the 20 million businesses that were currently registered in the EU, more than 99.8% were SMEs and a vast majority of which, 92% to be exact, consisted of micro-

enterprises having less than 10 employees. For 2012, it is estimated that SMEs accounted for 67% of total employment, representing over 87 million people and 58% of gross value added. The aforementioned numbers indicate that SMEs are the backbone of the EU economy: they are a main source of private investment, economic growth and jobs. Most countries' economies, both less or more developed, are based on the strength and dynamism of private enterprises (Hallberg, 2000). SMEs are not only important engines of economic growth for developed economies, but also have an important role in transitioning economies and developing countries, particularly with a view to increasing women's employment and promoting gender equality.

SMEs embody an essential source of economic growth, dynamism and flexibility in advanced industrialized countries, just as much as they do in emerging ones, while they play an important role in development. In a study taking into account 132 countries, it was found that there were 125 million SMEs and 71.2% (89 million) of them located in developing countries (Kushnir et al., 2010). SMEs have a huge importance for transitional economies for several reasons. Firstly, they are able to provide economic benefits beyond the boundary of the individual enterprise; namely, they encourage experimentation, learning and adaptability. These skills are especially important for countries which were formerly part of centrally planned systems. Additionally, even if SMEs do not establish net new job places, they do, however, decrease the erosion of human capital by opening new alternative employment opportunities for relatively skilled, unemployed workers (EBRD, 1995).

In most transitioning economies, the SME sector was underestimated and even discriminated against in the early transition period, with emphasis being placed on the rapid privatization of large-scale enterprises (LEs), rather than the development of the SME sector. Though it is often argued that SME development is especially crucial for the early stages of transition (EBRD, 1995; Smallbone and Welter, 2001), it is, in fact, just as important for the advanced stages of post-transition. As M. Porter (1990) has argued, invention and entrepreneurship are at the heart of comparative advantage and country competitiveness. SMEs are also more innovative than larger firms, due to their flexibility and their ability to quickly and efficiently integrate inventions created by the firms' development activities (Acs and Yeung, 1999; Qian and Li, 2003; Verhees and Meulenbergh, 2004; Timmons, 1998). From several viewpoints, SMEs comprise a step forward, as compared to LEs, particularly in areas such as reduced bureaucracy, customer service improvement, more efficient and effective internal communication and less time needed to address problems (Sharma et al., 2005).

According to Fadahunsi and Daodu (1997), in Asian developing countries such as Indonesia, Philippines, Thailand, Hong Kong, Japan, Korea, India and Sri Lanka, 90% of businesses are small businesses; additionally, small business provide employment for 98% of those employed in Indonesia, 78% in Thailand, 81% in Japan and 87% in Bangladesh. Not only in Asia, but the activities of SMEs are also vital for developing African countries, particularly for the promotion of economic growth, job creation and eradicating poverty (Rogerson, 2001). It has long been debated whether SMEs are pivotal to employment creation and economic growth in the African continent, particularly in countries such as South Africa, which has a high unemployment rate at around 40% (Friedrich, 2004; Watson, 2004). According to Rwigema and Karungu (1999), in South Africa, 90% of all formal businesses are small, medium-sized and micro enterprises. The SME sector is one of the largest contributors to the South African economy.

Andersson, et al. (2007) emphasizes another relevant facet of SMEs; namely, the importance of women-owned SMEs in the economy. The author has mentioned that women entrepreneurs are more likely to hire women, not only creating more jobs throughout the country, but also decreasing gender discrimination in the labour market. Additionally, the reduction of female unemployment helps in the



fight against trafficking in women by reducing the risk of being trafficked, while women do not have to search for jobs outside of their communities. Finally, women entrepreneurs can stimulate younger generations by empowering them to execute their own ideas and demonstrating that there are opportunities for them in the workplace and community.

## **2.2 Role of SMEs in development**

On the path towards development, the role played by SMEs and micro firms is crucial, not least because they are defined as engines of economic growth, but mainly because they are the largest percentage of firms engaged in economic activity. Industry and its impact on economic and social development and the environment has been at the centre of the debate on sustainable development since the term ‘sustainable development’ was brought into common use by the Brundtland Commission in 1987. There is now a consensus among policy makers that in order to achieve sustainable development, governments and non-state actors need to make greater efforts to integrate economic, social and environmental goals into industry policy and decision making (United Nations, 1998). In terms of generating jobs and raising incomes, increasing the share of enterprises is an almost universal concern among local authorities. Along with efforts to attract investment, stimulating entrepreneurship is one of the two pillars of most local and regional development strategies (OECD, 2003). The size of these firms is accepted as an important factor on their success, because it allows some flexibility, which is difficult to find in larger firms. Inforegio (2000) mentions that unique features like flexibility and potential for employment creation make SMEs an effective tool for regional development. As argued by many, SMEs are more flexible, speedier and more adaptable than larger organizations. Constrained by size-related disadvantages, small firms typically rely on flexibility and timely responsiveness to customer needs to create and serve profitable market niches. The positive relation found in this study between the capacity to transform and profitability appears to render support to the widely held notion that quick response to market signals is vital for the survival of small firms (Caloghirou et al., 2004). The well-known futurist, John Naisbitt (1994) long predicted the growing importance of the concept: ‘small is beautiful’.

SMEs act as the core of economic growth; they generate, to a greater extent, the technical innovation needed for an economy to progress. Many new jobs come from innovation, and new discoveries bring about even more entrepreneurial adventures. The creativity of small companies is the fuel of the entrepreneurial spirit leading economic growth. Paul Almeida (2004), Professor at Georgetown University, explains that, “SMEs play a unique, active and critical role in the innovation process by their ability to invent new technological spaces and improve high technology information networks”. When confronted with the question, ‘what are the jobs of the future and where will they come from?’, former U.S. Secretary of the Treasury, John W. Snow, responded, “the short answer is that no one knows, but it is certain that small companies and innovation will play a key role” (Zoltan Acs et al., 2005).

In the new context of the knowledge revolution – a concept denoting the passage from an economy dominated by physical, tangible resources to an economy dominated by knowledge – small and medium companies draw significant attention as forerunners of innovation and development. Within SMEs, the small number of components, low amount of tangible assets, and lesser complexity of activities and structures make it easier to situate the preoccupations, decisions and actions of knowledge resources in the foreground of all processes. Entrepreneurial spirit, strength of interpersonal relations and pronounced group cohesion, variability, flexibility and organizational dynamism are all defining elements for an economy and any company based on knowledge. All of the aforementioned are found

in small, dynamic companies, rather than large corporations, making SMEs the blueprint of modern organizational strategies. Additionally, central to the innovation process is the establishment of expansive social networks, both formal and informal, and small companies establish regional networks more easily than big companies do, allowing a greater degree of specialization and exchange of ideas. Stipulating all these, there is a positive correlation between small companies and economies based on knowledge (Nicolescu, 2001).

### 3. Methodology

This research was carried out in parallel with the use of qualitative and quantitative methods. Several methods were used simultaneously, including those of description, modelling, comparison, analysis, statistics, [system and](#) generalization. This paper consists of two main parts, that of preliminary research and that of analysis; the aforementioned methods were used in both parts. During the initial research, the overall dynamics of the SME sector were analysed based on various sources of information and the statistical status of the level of development of small and medium enterprises in different countries and regions was described. In the analysis part of this paper, the classification of small- and medium-sized enterprises in different regions and countries, the reasons preventing the further development of entrepreneurial activity, opportunities for expanding the scope of entrepreneurship and the importance of the measures and initiatives taken to-date have been explained.

First of all, in order to define small and medium enterprises, the description method was used. This method was primarily used in the processing of theoretical portions of the research. At the same time, through the modelling method, different kinds of models relating to SMEs and their realization mechanism have been explained, especially in the literature review. In the analytical part of this paper, both analysis and synthesis methods have been used. The analysis method has been used to evaluate the development of SMEs in the different countries and regions, and to analyse what kind of government policies were implemented in order to improve the activities of those SMEs.

Using statistical methods, the quantitative characteristics of SMEs were described and it was determined under what conditions SMEs develop and receive financial assistance, and which ones are more likely to go bankrupt. Based on the collected statistical data, such dynamics were calculated and a trend was located, allowing for the formation of forecasts. Furthermore, the comparison method was used in order to compare the systematic approaches of different countries to SMEs' problems, leading to the task of unifying these systemic approaches in order to apply them to Azerbaijani culture. Finally, in order to gather more information, connect it all together and come to a coherent conclusion, the generalization method was used.

## 4. SMEs in the context of Azerbaijan

### 4.1 Classification of SMEs

The further development of SMEs in Azerbaijan is crucial in terms of diversification, employment, fulfilling domestic consumer goods demand using local resources, eliminating import dependency and achieving sustainable economic growth. In this vein, entrepreneurial activity in the form of SMEs should be viewed as the first and main form of entrepreneurship. The central focus of the government of Azerbaijan today is to create conditions that enhance the growth of non-oil, tradable sectors; from this perspective, diversification is important. The core of diversification is the creation and stimulation of a suitable environment for entrepreneurship, which is important for Azerbaijan for several reasons. Firstly, taking into account the diminishing price of oil and gas, there is a growing uncertainty of the fate of oil and gas production within the country's economy. Secondly, the downturn in the economic condition of country shows that oil and gas sector dependency should be eliminated as soon as possible, in order to mitigate its negative effects, such balance of payment deficits and undiversified exports. Additionally, the oil and gas sector is capital-intensive, so it has little effect on job creation or employment; while, on the other hand, the non-oil sector is directly responsible for job creation, contributing to net employment and the overall strengthening of the economy. Worldwide experience dictates that SMEs have an essential impact on employment, competitiveness, sustainability and overall economic growth. All considering, in Azerbaijan, creating and improving suitable conditions for SMEs should be a main priority.

Micro and small- and medium-sized enterprises in Azerbaijan are divided into two groups: individual entrepreneurs (i.e. sole owners of the enterprise without forming a legal entity) and small and medium enterprises (i.e. legal entities). All individual entrepreneurs are legally considered small enterprises by default, whereas those registered as legal entities are classified according to two indicators: number of employees and annual turnover (International Finance Corporation, 2009).

The Cabinet of Ministers of the Republic of Azerbaijan has defined the “criteria of SMEs” on the 5th of June, 2015, as a means of improving the channels of addressing the direct impacts of reforms towards SMEs. A new order with slight changes was approved in June 2016, and is currently valid. The new order has simplified the defining criteria of SMEs; according to this new order, as shown in Table 1, classification is defined by the size of the enterprise, and not by the sector in which it works (president.az, 2016).

**Table 1: Criteria of determination of SMEs in Azerbaijan**

Entrepreneurship Category in terms of size	Average Number of Employees (Definition 1)	Average Number of Employee (definition 2) For Tax Purposes only	Annual Revenue Definition 1	Annual revenue Definition 2 For tax purposes only
<b>Small</b>	Up to 25 employees	Self Employed (No hired labor)	Up 200 thousand manat	Up to 200 thousand manat

<b>Medium</b>	Between 25-125 employees		Between 200-1.250 thousand manat	
<b>Large</b>	More than 125 employees		More than 1.250 thousand manat	

**Source: AR Cabinet of Minister's order 29th June, 2016.**

According to the new order, the classification of existing enterprises under the categories small, medium and large is mainly determined by their “average number of employees” and “annual revenue”. If any of the criteria exceed its limits, it causes a change in the classification of the company to the higher level. As for new enterprises, a year after the date of their state registration and tax accounting, small, medium and large enterprises are classified based on their “average number of employees”. Also, based on the new order, the overall value of all of the enterprise's goods, activities and services during the course of one fiscal year is added to its annual revenue.

All of the above are examples of the classification of SMEs in terms of quantity (number of employees or revenue). Besides that, another approach by Blinov and Shapkin (2003) is classification in terms of quality, generally defined as follows:

- Producing less amounts of goods or services
- Comparing to large enterprises, being relatively limited in resources and exhibiting a high usage of de-centralized financial resources, coming together to confine the activities of SMEs
- High organizational-functional agility and mobility
- Low level of management system, simplicity of valuation of firm activities and of regulation procedures
- Being in favor of an open competition
- limited market segments
- Market targeting, free trade, competitive mechanism for self-sustaining production

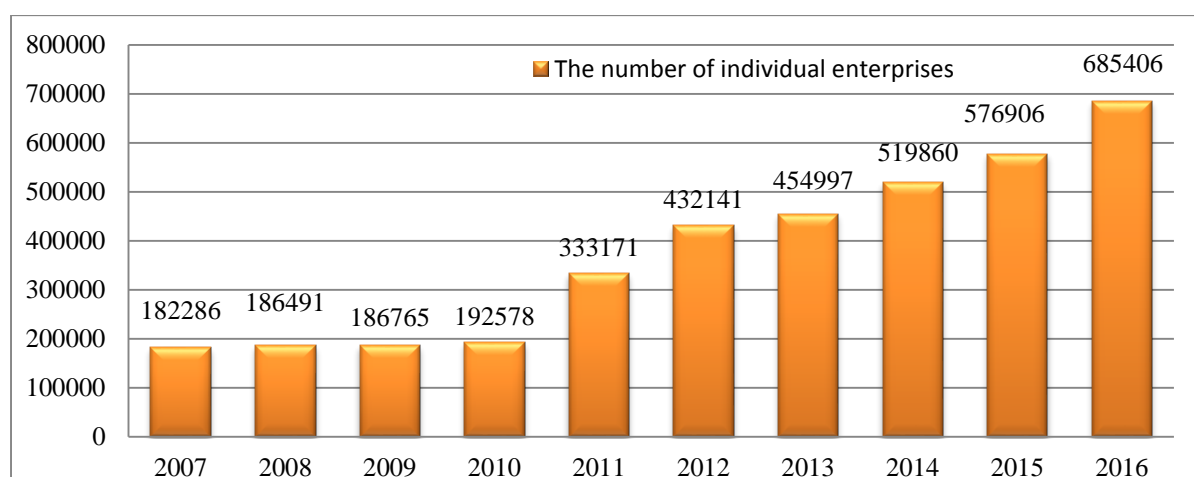
In contrast to Azerbaijan, the classification of SMEs in Europe differs in various aspects. For instance, in Europe, SMEs are defined with the help of indicators such as number of employees, annual turnover and total balance sheet; yet, determination of these indicators differs, too. The rate of development of SMEs in Azerbaijan grows year by year, following the worldwide trend. The sectors in which small enterprises thrive are those which are unfavorable, in terms of economic and social perspective and hard to get into, by medium or large enterprises. Some examples are as follow:

1. Enterprises which produce seasonal products for domestic markets, shops, cafes, workshops and etc.
2. Enterprises which product machinery products (devices, parts, tools)
3. Enterprises which are the intermediary to the medium and large enterprises.

## 4.2 Realistic situation of SMEs in Azerbaijan

According to the data provided by the Ministry of Economy of the Republic of Azerbaijan for 2016, the number of entrepreneurship subjects in all sectors of the economy were numbered 792,764. As it turns out, in 2016, the number of entrepreneurship subjects increased by 77,179, as compared to 2015. According to given indicators, 36.1% of total entrepreneurs were registered in the city of Baku and 63.9% in other regions of the country. In Azerbaijan, individuals (without the establishment of a legal entity) and legal entities may be involved in entrepreneurial activities; as an individual, they will be individual enterprises and as a legal entity, they will be a General partnership, Limited partnership, Limited Liability Company or Join Stock Company. It should be noted that the number of persons engaged in entrepreneurial activity without a legal entity is 685,406; their number has increased as compared to previous years, observed in Figure 26.

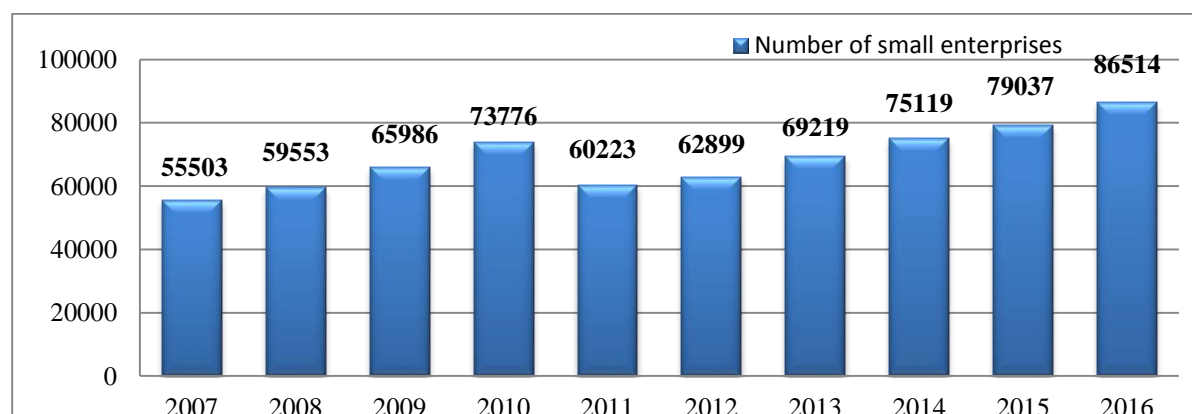
**Figure 1: Number of individual enterprises in Azerbaijan**



**Source: The Republic of Azerbaijan Ministry of Economy, 2017**

Small enterprises have seen further development under market relations. Generally, according to the indicators of 2016, the majority of all enterprises in the country were small enterprises (86,517 units) and from Figure 26, it is clear that the number of small enterprises in 2016 has increased by 7,477 units, compared to 2015.

**Figure 2: Number of small enterprises in Azerbaijan**

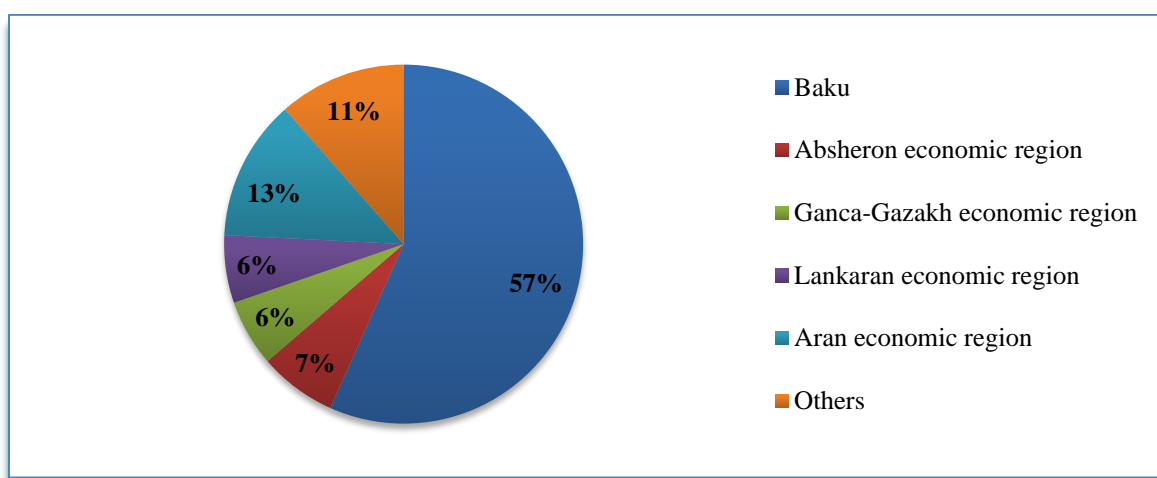


**Source: The Republic of Azerbaijan Ministry of Economy, 2017**

According to official statistical data, the share of small entrepreneurship entities in the non-oil sector was 5.8% of value added, 0.7% in total gross profit, 6.5% in annual average employees and 9.2% in fixed capital investments.<sup>1</sup> Generally, in 2016, the number of small enterprises was equal to 86,514, 7,477 more than the previous year.

It should not be surprising that a large share of small enterprises are mainly located in Baku (56.7%), as can be seen in Figure 28. The main reason is that most of the population is concentrated in Baku and, compared to other economic regions or cities, the majority of economic activity is carried out in Baku. The economic regions where small enterprises are mostly located, after Baku, are Aran (13%) and Absheron (7%).

**Figure 3: Distribution of small enterprises by economic region in Azerbaijan**

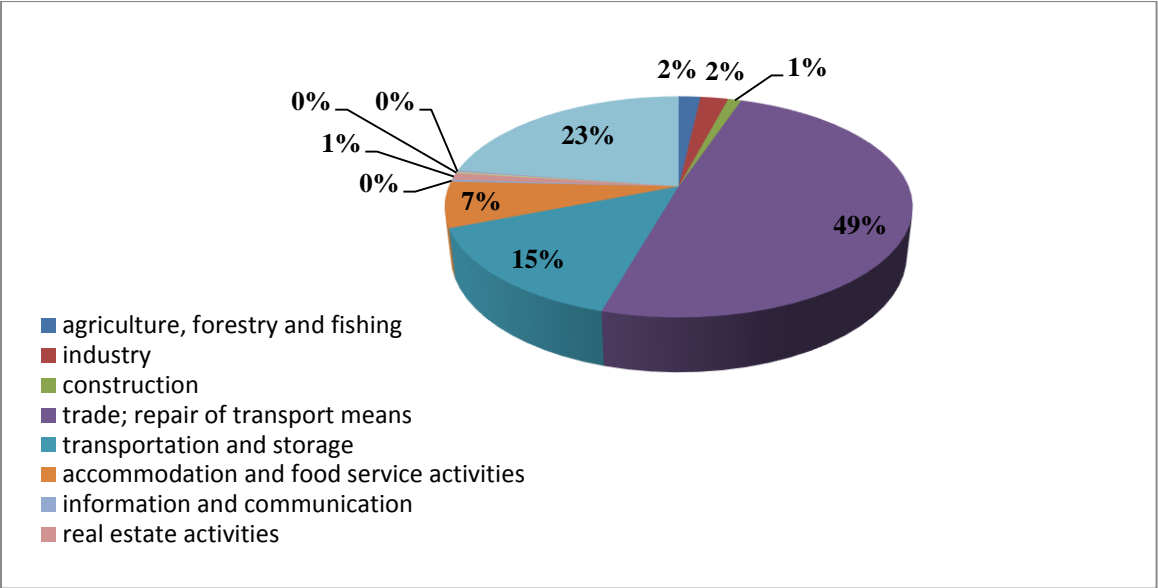


**Source: The State Statistical Committee of the Republic of Azerbaijan, 2017**

As shown in Figure 29, the largest share in the distribution of small entrepreneurship subjects belongs to retail trade, at 49% of small entrepreneurship subjects. The major reason is production spheres have been more weakly developed than consumption spheres in the economy of the country. Other reasons are that: the monopoly in retail trade has been weak and the initial capital requirement is small in the retail trade, therefore citizens have more opportunities to engage in entrepreneurial activity in the retail trade area. After retail trade, 15% belonging to the transportation sector, 7% to accommodation and food service activity, 2% to industry and agriculture, 1% apiece to construction and real estate activities and, finally, 23% belongs to other fields.

<sup>1</sup> The State Statistical Committee of Republic of Azerbaijan

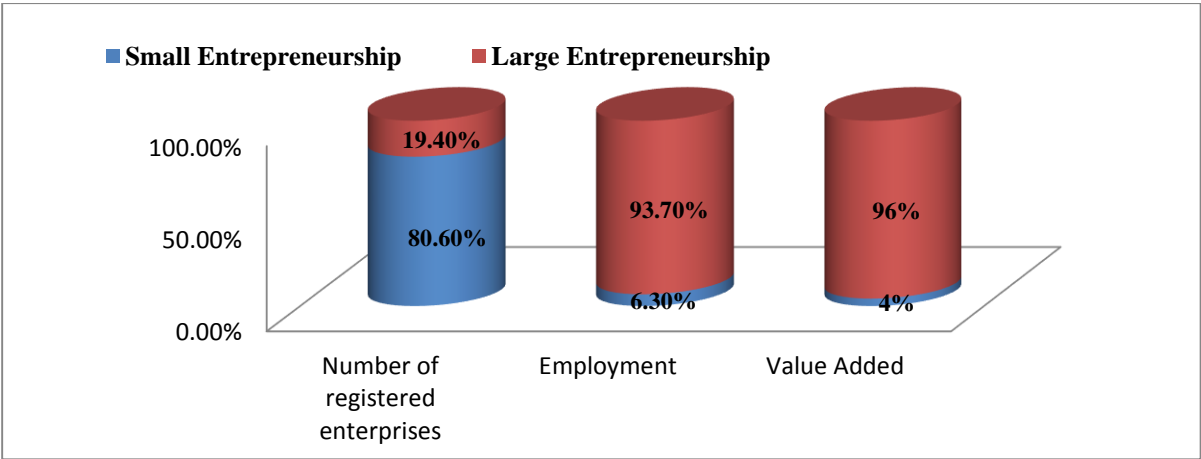
**Figure 4: Distribution of small entrepreneurship subjects in Azerbaijan**



**Source: The State Statistical Committee of the Republic of Azerbaijan, 2017**

The diversification and development of the non-oil sector is one of the key priorities in the development plans of the government of Azerbaijan. In this vein, the government has implemented a number of reforms in order to support SMEs. However, as compared to developed countries, the shares of SMEs in value added for the Azerbaijani economy is relatively low. While SMEs contribute more than 50% of value added in developed countries, for Azerbaijan, this figure equals only 4% in 2016 (see Figure 6). This low figure has been explained as resulting from the fact that Azerbaijan is an oil-producing and oil-exporting country; it is mostly large companies which operate in the oil sector in Azerbaijan and, therefore, the share of large enterprises in GDP is higher.

**Figure 5: Main indicators for enterprises in Azerbaijan in 2016**



**Source: The State Statistical Committee of the Republic of Azerbaijan, 2017**

In Figure 30, the main indicators for enterprises in Azerbaijan were explained in more detail. While small enterprises accounted for 80.6% of all companies in 2016, their contribution to value added was only 4%. At the same time, when compared with other CIS countries, we see that Azerbaijan’s share



of SMEs in employment is not at all satisfactory. The share of SMEs in GDP is about 43% in Georgia, 42% in Armenia, and 58% in Ukraine, but according to the latest figures (2016) in Azerbaijan, this share stands at 4%. Considering that small- and medium-sized businesses play an important role in shaping the market economy, enriching the domestic market with local raw materials, improving the living standards of the population, opening up new jobs and increasing employment levels, creating a free competition environment and solving other socio-economic problems is paramount. It can be concluded that there is a need for more liberalization.

### **4.3 SWOT analysis of SMEs in Azerbaijan<sup>2</sup>**

A SWOT analysis of entrepreneurs in Azerbaijan is one of the main ways to determine the real situation of entrepreneurs in the country, because this analysis will facilitate the creation of favourable conditions for the further development of entrepreneurial activity.

#### **Strengths:**

- Extensive e-government infrastructure, strong track record in business environment reforms (one-stop shops, e-government); favourable environment for business registration and ongoing reforms in other areas (credit bureau, collateral registry, RIA)
- Comparatively good infrastructure and service provision (cf. BEEPS data on electricity, water)
- Government support for the development of SMEs
- The price of energy carriers is lower than in neighbouring countries

#### **Weaknesses:**

- SME policy fragmentation among several state programs without formal coordination and lack of comprehensive strategy
- Lack of public-private consultations and lack of a co-ordinate specialized state organization on SME
- Lack of structured institutional set-up beyond informal cooperation; limited SME involvement
- Limited access to bank finance (high collateral, low levels of access, cf. BEEPS; other sources are underdeveloped (banking sector holds 95% of total assets); growth in credit mostly to households, consumer credit
- The weakness of the monitoring and evaluation system to determine the impact of the state support mechanisms for entrepreneurship
- Low level of business skills, especially mid-level level of skills
- Corruption perceptions are still cited as an obstacle to business
- Difficulties in accessing international and regional markets and low international trade habits

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<sup>2</sup> Note: This analysis builds on those points suggested in “Azərbaycan Respublikasında kiçik və orta sahibkarlıq səviyyəsində istehlak mallarının istehsalına dair Strateji Yol Xəritəsi” and EU4Business Country report Azerbaijan- INVESTING IN SMEs IN THE EASTERN PARTNERSHIP.

### **Opportunities:**

- Adoption of strategic roadmap for development of the national economy, which determines the economic development strategy and action plan for 2016-20, long term vision till 2025 and target vision after 2025
- New export program in development, with a focus on boosting exports of non-oil products
- Involvement of SMEs in public procurement and infrastructure projects
- Ongoing preparation stage for private credit bureaus and registry of movable assets
- WTO membership prospects likely to boost trade
- Untapped potential in non-oil sectors, e.g. agriculture and manufacturing
- Availability of potential workforce

### **Threats**

- Possible foreign economic factors (financial crisis, decline in demand in international markets, etc.)
- Pressure on the banking sector due to the devaluation of the Azerbaijani manat; banks are facing a decline in capital
- Poor domestic competitiveness of local SMEs in international markets
- Dependence on natural resources in times of economic volatility
- Lack of independent implementation agencies in key areas such as innovation and entrepreneurship
- Non-oil exports hindered by delays in defining national standards and technical regulations, limited international quality certification
- The Nagorno-Karabakh conflict that threatens the political and economic stability and absorbs significant financial resources

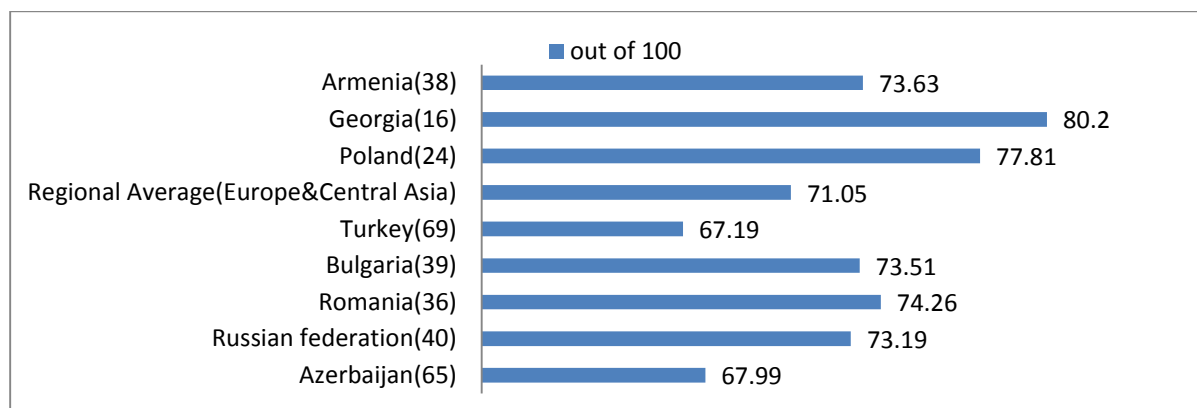
## **4.4 Possible constraints in Azerbaijan in terms of SME development and growth**

According to the Islamic Cooperation for the Development of the Private Sector (ICD), the main constraints of SME development in Azerbaijan are access to finance, tax rate and corruption. Survey data of ICD indicates that access to finance is very important, and the number of people reporting it as a major constraint is 9% higher than the world average, at 16% (Islamic Corporation for the Development of the Private Sector, 2012). The same survey defines tax rates in Azerbaijan as another obstacle in terms of SMEs.

The characteristic feature of SMEs in Azerbaijan is that they are located in the capital of the country and Absheron district, they do not expand to other regions of the country. As a consequence, entrepreneurial activity in the regions has not improved, as compared to Absheron and Baku. This trend, however, causes imbalance and leads to continued poor development of regional entrepreneurship. Based on the statistics of Ministry of Economy, published in 2017, Baku accounted for nearly 54% of overall enterprises in Azerbaijan (Ministry of Economy of the Republic of Azerbaijan, 2016). According to the World Bank, Azerbaijan is in the 65<sup>th</sup> place for its overall business environment out of 189 target

countries (see Figure 7). However, Azerbaijan is in pretty good place among the 189 countries surveyed for “overall doing business environment index”, but the country’s place according to “getting credit” is 118<sup>th</sup>, which is not a good indicator.

**Figure 6: Overall Business Environment index**



**Source: World Bank, Doing Business Database 2017**

#### Access to finance

There are various factors which heavily and negatively affect the functioning of the SMEs. In Azerbaijan, SMEs have a limited chance to utilize commercial banks loans. One reason for this observation is that the interest rates offered by banks are very high, especially while banks prefer short-term loans, which challenge the balance of payment of SMEs. Although Azerbaijani law allows the creation of security interests in terms of both movable and immovable property, in fact, banks rarely extend finance secured by movable property, except registered movable property such as vehicles, ships and securities. A non-possessory security interest, which gives the borrower a chance to keep equipment and use it as collateral, is an important feature of modern secured transaction frameworks, which is undeveloped in Azerbaijan due to the lack of a collateral registry and supporting legal framework. Most of the time, banks require collateral in the form of immovable possessions, which makes SMEs’ financial situation difficult. According to an EBRD survey titled, ‘*Business Environment and Enterprise Performance*’, in Azerbaijan, more than 45% of all enterprises are discouraged to take loans (EBRD, 2014). The same survey indicates that the main reason is a high interest rate (more than 50% of enterprises cited this reason) and then complex procedures, collateral and not expecting approval are all other issues which follow. All of these conditions together urge the reform of the banking sector, at least from perspectives of SMEs. The World Bank reports other obstacles to access necessary funding, including, large amounts of initial investment and challenges in finding business partners (World Bank, 2013). Kuriakose (2013) mentions that the top three cited obstacles in setting up or operating a firm in Azerbaijan are: difficulty finding the necessary funding, large initial investment and difficulty finding business partners. The most commonly cited legal and regulatory constraints were continually changing taxation regulations and bankruptcy legislation making the cost of failure immense.

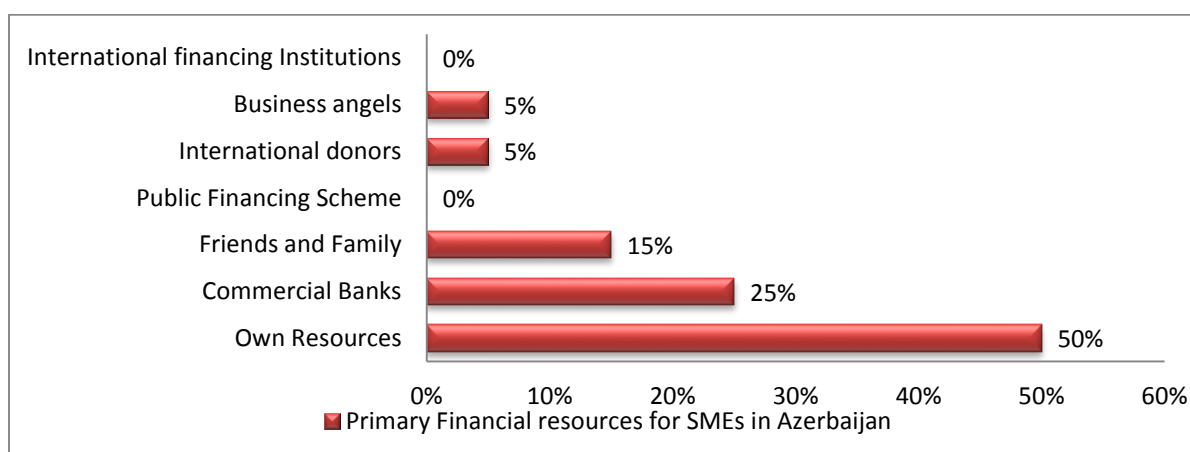
In view of aforementioned challenges in the banking sector, Azerbaijan’s micro-finance institutions tend to be an essential source of financing for SMEs, and their reach is increasing. According to the World Bank (2015), in 2013, micro-finance institutions were estimated to have financed approximately 400,000 SMEs. The share of other financing instruments, such as leasing and factoring,

is still negligible. The World Bank estimated in 2015, that leasing and factoring would be 4% and 2% of SMEs' financing, respectively (OECD, 2016).

Comparable analysis of Eastern Partnership (EaP) countries shows that, in Azerbaijan, the majority of enterprises are built by entrepreneurs' own funds and generally, the trend continues throughout the life of the enterprises. According to this indicator, Azerbaijan falls far behind other EaP countries. For example, an East Survey Index (2012), found that, in Azerbaijan, nearly no SMEs have an intent to take a loan from international donors or international financial institutions. A reasonable explanation for this shortcoming may be a lack of financial literacy on the part of Azerbaijani entrepreneurs. Financial literacy gaps affect both demand and supply; it affects demand, while SMEs with poor knowledge of financial services, available products and financial institutions are less likely to apply for funding. It affects supply, because low financial literacy creates communication obstacles and misunderstandings between financial institutions and clients.

A general overview by the International Finance Corporation (IFC, 2009) has shown that, in Azerbaijan, banks are not willing to give loans to SMEs because of their low possibility of repayment in the case of bankruptcy. This approach, however, retards the acceleration of SME growth and real economy growth. Based on a World Bank report (2013), Azerbaijan is far behind other OECD countries' indicator for bankruptcy. In other OECD countries, this indicator is 73 cents per dollar, but in Azerbaijan, this indicator shows 39.6 cents per dollar. Based on a later OECD survey (2016), among 390 respondents, approximately 2/3 of them mentioned that it was very difficult to rebuild their business after bankruptcy. Figure 8 below shows primary financial resources for SMEs. According to East Invest Survey (2012), approximately half of entrepreneurship set up and continue their businesses with the help of their own resources. Only 25% of them tend to take loan from commercial banks. Alternative loan options such as international financial institutions and public financing schemes are almost totally unused by entrepreneurs. All of these show that SMEs access to finance is not diversified in Azerbaijan.

**Figure 7: Primary financial resources for SMEs in Azerbaijan**



**Source: East Invest Survey 2012**

#### Limited access to markets (local & international)

Insufficient knowledge regarding market awareness is another constraint for the viability of local SMEs. It hinders SMEs' ability to expand their borders into international markets. Regardless of their national or international reach, the majority of SMEs don't have sufficient knowledge about market

requirements, which set up a wall in front of SMEs. Most of the time, entrepreneurs don't take into account market demand or market possibilities and so, they make profits only for the short term. Particularly with a view to integrating into the European Union (EU) market, SMEs in Azerbaijan should keep up with EU market requirements. Also in Azerbaijan, a low level of access to financial markets is another constraint for SMEs innovation and growth. According to the Central Bank of Azerbaijan (CBAR) and Financial Market Supervisory Authority (FIMSA), the volume of stock operations in Azerbaijan has only a 1% share in GDP and bond operation volume is just 7% in overall GDP, which pushes back SME growth and development (president.az, 2016).

### Legal Constraints

It was also observed that entrepreneurs who want to run businesses prefer to register as individual entrepreneurs, rather than legal entities. The aforementioned observation can be explained in several ways:

- 1) the registration process. The registration process is simpler for individual entrepreneurs than for legal entities;
- 2) expenses such as registration, license and permits, have lower costs for individual entrepreneurs;
- 3) tax inspection and oversight. In businessmen's opinions, individual entrepreneurs are less often checked by the local or regional branches of the inspection services, as compared to SMEs, since the headquarters of ministries and agencies do not have a list of registered individual entrepreneurs. Legal entities must register with ministries' and agencies' headquarters; therefore, they are checked by these government structures on a regular basis.
- 4) The simplicity of the procedures in case of termination of entrepreneurship activities.

Another constraint on entrepreneurial activity in Azerbaijan is apparent when one considers the issue of legal institutions; namely, the lack of trust towards law enforcement apparatuses and a difficult business atmosphere in general. This is seen through the observation that the majority of entrepreneurs are willing to avoid courts in the settlement of economic disputes. Also, the following may aid in shedding light on the low level of court applications: influential businessmen/officials are said to receive decisions in their favor more often regardless of proof, the non-transparent nature of procedures, the possibility of giving unofficial payments, the lengthy procedures which are unsuitable for dynamic entrepreneurship and the high cost of processes. The aforementioned all come together to encourage entrepreneurs to avoid taking the risk of embarking on the entire process and losing more money than they otherwise would in the long run. According to an IFC survey (2009) among entrepreneurs in Azerbaijan, half of the chosen entrepreneurs did not agree with the following statements;

- 1) The local authorities clearly and steadily obey all laws and standards of the central government body;
- 2) The local authorities assist in business development by providing equal conditions for conducting business;
- 3) Government representatives interpret the laws and standard acts and regulate business activity, in an adequate and predictable manner;
- 4) The business environment in my city contributes to the development of investment and business;
- 5) The business environment in my city is better than in other regions of the country.

A third important legal obstacle is related to inspections. Despite its importance, inspections may be huge barriers for entrepreneurs and entrepreneurial activity. Shortcomings in the legislation which regulate inspections in a systematic way are a huge problem for entrepreneurs. Despite recent improvements in the legal framework relating to inspections and permits, such as centralized e-registries of inspections<sup>3</sup> and for permits and licenses<sup>4</sup> – both of which are supported by the IFC – progress is not as effective as anticipated. Transparency and certainty must be enhanced; the government should ensure it adheres to its legally established methods and targets, which should be objective, transparent and available to all enterprises.

#### Limited knowledge base / business skills

In Azerbaijan, the low market relevance of mainstream education and the inertia of the educational system in response to the changing demands of the labour market make the school-to-work transition difficult. Thus, there is a gap between the needs of the local job market and the professional qualifications of the work force, resulting in a lack of adequately skilled employees and a workforce misfit to the local and national market. In addition, the significant transformation of the national economy has induced a high demand for professional reconversion.

### **4.5 Overview of small- and medium-size entrepreneurship policy, general strategy in this area**

Recent reforms in the country have created more beneficial conditions in order to develop individual and small-scale entrepreneurship, compared with previous years. Azerbaijan has adopted a number of legislative acts aimed to regulate the development of small and medium enterprises, including a system of economic and legal relations. Examples include the Law on Entrepreneurship, the Law on State Support for Small Business, the Law on State Registration and State Registry of Legal Entities, etc. At the same time, Azerbaijan has taken several steps to strengthen the regulatory, institutional and operational environment for SMEs, especially through simplifying processes relating to company registration and developing e-government services. The institutional support for SMEs has also been developed with the establishment of the Department of Entrepreneurial Development Policy under the Minister of Economy and Industry.

The Department of Entrepreneurial Development Policy in the Ministry of Economy and industry is responsible for both the development and implementation of SME policy in Azerbaijan. Simultaneously, there are several agencies under the Ministry of Economy like the Baku Business Training Centre, the National Fund for Entrepreneurship Support and AZPROMO – which held activities in order to support SMEs. Unfortunately, among these agencies, departments and entrepreneurs, there is no formal co-ordination platform for creating and implementing SME policies. Joining the government agencies, departments and enterprises this platform (committee or working group) could enhance the effectiveness of SME policy making.

The Azerbaijani government did not have an SME strategy or program until 2016. However, there was a “Strategic Road Map on Production of Consumer Goods at Small and Medium Enterprises in the Republic of Azerbaijan,” approved by the Decree of the President of the Republic of Azerbaijan

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<sup>3</sup> <http://www.yoxlama.gov.az>

<sup>4</sup> [www.icazeler.gov.az](http://www.icazeler.gov.az)

dated December 6, 2016. This Road Map has been developed as part of the country-wide measures to ensure competitiveness, inclusiveness and sustainability in the country's economy. Simultaneously, for entrepreneurial development and related aspects several state programs were held, such as the Poverty Reduction Program (2008-2015), the Food Security Program (2008-2015), the Program on Social-Economic Development of Regions (2014-2018) and Azerbaijan 2020 Development Concept in order to improve the protection mechanisms of entrepreneurs' rights and legitimate interests, develop entrepreneurship, further improve the business environment. Development of this kind of comprehensive strategy would tend to prevent policy fragmentation and enhance co-ordination between government and non-government.

At the same time, several works have been done, such as the termination of inspections in the field of entrepreneurship for a period of two years, reducing the amounts of the number of licenses and permits for entrepreneurial activity, reducing the amounts of fees, simplified procedures for issuing permits, at the same time continuing the establishment of an electronic portal in this area, establishment of an Appeal Councils for the protection of entrepreneurs' rights, the application of the principle of "one window" (the time for the registration of new enterprises has decreased from 53 days to 3-7 days and the number of procedures from 13 to 5) for the transportation of transit cargoes across the country, the provision of tax and customs privileges for 7 years with a view to increasing investment promotion in the country, to enhance the e-customs services in order to simplify customs procedures during import-export operations, to minimize the number of required documents and procedures during import-export operations, the establishment of "green corridor" and other systems existing in international practice to transport goods and vehicles across the customs border, establishing Call Centres that provide direct response to entrepreneurs' appeals in public bodies, providing information and advisory services, and so on.

At the same time, Azerbaijan has implemented two "National Action Plan on Promotion of Open Government and Fight against Corruption (2012-2015)" to increase clarity, accountability, responsibility in public institutions and public participation in policy making. However, despite this strategy corruption cases are still observed in Azerbaijan and there is no formal framework for legislative review.<sup>5</sup> As can be seen from the aforementioned list, several initiatives have been enacted to address the gap in SME support and legislative frameworks in Azerbaijan; however, some improvements still need to be made.

#### **4.5.1 Support services to SMEs in Azerbaijan**

The Ministry of Azerbaijan Republic, Ministry of Taxes and other public institutions organize periodic meetings with entrepreneurs, both in Baku and the country's regions, as well as "Open door" days and citizen forums. However, despite these attempts, there is no systematic information available regarding these consultations or their outcomes.

Recently, the registration procedure for new companies in Azerbaijan was improved and it was ranked 5th based on its simplicity based on the "Starting a Business" indicators of the World Bank's

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<sup>5</sup> Note: this section has been expanded from that information found at: "Azərbaycan Respublikasında kiçik və orta sahibkarlıq səviyyəsində istehlak mallarının istehsalına dair Strateji Yol Xəritəsi" [http://azertag.az/store/files/Strateji\\_yol\\_xeritesi/Ki%C3%A7ik\\_v%C9%99\\_orta\\_sahibkarl%C4%B1q\\_s%C9%99viyy%C9%99sində%C9%99\\_iستهlak\\_mallar%C4%B1n%C4%B1n\\_iستهsal%C4%B1na\\_dair.pdf](http://azertag.az/store/files/Strateji_yol_xeritesi/Ki%C3%A7ik_v%C9%99_orta_sahibkarl%C4%B1q_s%C9%99viyy%C9%99sində%C9%99_iستهlak_mallar%C4%B1n%C4%B1n_iستهsal%C4%B1na_dair.pdf)

Doing Business 2017 report. (2017) According to data collected by Doing Business, starting a business there requires 2.0 procedures, takes 3.0 days, costs 1.3% of income per capita for men, and requires 2.0 procedures, takes 3.0 days, costs 1.3% of income per capita for women. Registration for individual entrepreneurs is free of charge and it takes three days for companies to register. Entrepreneurs can easily do their registration in the State Agency for Public Service and Social Innovation's one-stop-shop for public service (ASAN Service Centres). At the same time, if they need to get information about permits and licenses, there is a website created by the government that is called [www.icazeler.gov.az](http://www.icazeler.gov.az).

There is clearly identifiable range of organizations such as Baku Business Training Centre (BBTC) and its seven regional office, The National Fund for Entrepreneurship support, the Export and Investment Promotion Foundation and ASK, supporting SME training, in order to improve managerial skills of SMEs. SME survey administered through BBTC's regional network help identified training needs, while the Ministry of Economy and Industry support financial aid. These organizations conducted several services, implemented various trainings like start-up training in order to help entrepreneurs appropriating skills. Unfortunately, in Azerbaijan the specific action plan for business support services is lack, although the Ministry of Economy provide these services free of charge through BBTC which organize training coerces such as starting a business, developing business plans, investment projects and so on. BBTC is fully funded through state budget and in 2016 this center organized approximately 155 events in different regions of Azerbaijan. BBTC has well-developed online training facilities and approximately 25% of users of online training services are women. At the same time progress can be observed with the launch of several new website by the Ministry of Economy such as [www.biznesinfo.az](http://www.biznesinfo.az) (provide general information on business related topics) and [www.b2b.az](http://www.b2b.az). However, despite the progress in provision of support services to business, according to the OECD survey 79% of SMEs in 2015 were not aware of any services provided by government or other organizations to support small business. (OECD/European Union/EBRD/ETF,2015)

Unlike the other programs listed above, in recent years, the National Fund for Entrepreneurship Support and the ASAN service have partnered to together to address such issues as limiting credit resources of commercial banks, high interest rates as well as lack of skilled and qualified staff through the development of the "ABAD" Centre and Support Services. The ABAD service has targeted such problems relating to finance, infrastructure and skilled workforce. According to the economists from Centre for Economic and Social Development, Orucova and Hasanov (2016), the following activities will be implemented through the ABAD Centre:

- Implementation of projects to support family businesses, small and medium-sized businesses, and establishing a fund to finance these projects;
- Determination of family farms, small and medium entrepreneurs for ABAD projects and creation of conditions for use of modern technological production equipment for production of farm products;
- Organization of transportation and sales of produced goods;
- Trainings on the use of production equipment, providing technical support for these equipment, and information on the most advanced technological innovations used in agriculture.
- Monitoring and evaluation within the project, etc. (Orucova and Hasanov, 2016)



#### **4.5.2 Innovation Policy**

Innovation on the part of SMEs in Azerbaijan was observed only on a very low level, which may in part be due to the fact there exists no extensive, overarching national innovation policy. However, several arms of government have introduced their own innovation initiatives, distributed across various state programs and policy documents, such as the “National ICT Strategy of the Republic of Azerbaijan 2014-2020,” “Azerbaijan 2020 Vision” and “National Industrial Strategy 2015-2020”. Simultaneously, some government agencies and structures, like the Ministry of Economy, the Ministry of Communication and High Technology and the National Academy of Sciences, support the innovation initiatives. However, there is no formal co-ordination arrangement among the above-mentioned structures, so, in practice, efforts are disjointed and slow to appear.

In 2012, the Ministry of Communication and High Technologies of Republic of Azerbaijan established the State Fund for Development of Information Technology (ICT Fund). It finances these activities from the state budget, supports innovative ICT projects in several ways; for instance, it distributes concessional loans through banks with a maximum 5% interest rates. Loans can be small (from 10,000 AZN to 50,000 for up to three years), medium (from 50,000 AZN to 500,000 for up to five years) or large (from 500,000 AZN to 5,000,000 for up to ten years). It also provides venture capital for development projects, technologies, equipment and software. The ICT Fund also awards grants, mainly to SMEs, for development of software products and innovative infrastructure projects. Although the maximum potential size of grants which are awarded by the ICT Fund is 300,000 AZN, but fund gave grants only 10,000 AZN to 12,000 AZN to 30 companies.

”Despite the above progress, innovation by SMEs remains very low in Azerbaijan and product and process innovation is similarly limited, with only 2.2% firms surveyed having introduced a new product and 2.8% a new process in the previous years” (OECD/European Union/EBRD/ETF, 2015).

#### **4.5.3 Provision of profitable and efficient access to financial resources of SMEs**

Generally, Azerbaijan made some progress in SME access to finance through the National Fund for Entrepreneurship Support. However, access to finance through banks remain key challenge because entrepreneurs do not considers banks as a effective, available mechanism for finance due to high rate. According to the this reason, the government give a financial support to SMEs with subsidies financing, through National fund for Entrepreneurship Support, the State Fond for Development of Information Technologies, as well as the State Service on Management of Agriculture Projects and Credits, Azerbaijan Investment Company and Mortgage Fond.

**National Fund for Entrepreneurship Support (NFES) of the Republic of Azerbaijan:** NFES provides entrepreneurs with preferential loans, including an allocation of loans under favourable terms from the state budget. Of these loans in the year 2016, 2,402 (97%) of investment projects financed on favourable terms were small scale (amount of loans 22,887.8 thousand AZN), 34 (1.4%) were medium-scale (loan demand 8,890.3 thousand AZN) and 41 (1.7%) of them were large-scale (loan demand 157,652 thousand AZN) (NFES, 2016). To date, NFES has provided loans to 12,500 enterprises, each with an average of \$47,000 USD. Most of these loans were devoted to the production and processing of agricultural products (Ministry of Economy of the Republic of Azerbaijan, 2016).

**"Azerbaijan Investment Company" (AIC):** AIC, along with domestic and foreign investment also supports the development of other sectors, with the exception of the oil and gas industry, through substantial capital investments. The AIC's share package ensure that venture capital (entrepreneurship capital) is at least \$1 million USD. The AIC's portfolio is multidimensional and combines various industries, such as heavy industry, agriculture, logistics, sub-stocks and food processing.

**Azerbaijan Export and Investment Promotion Foundation (AZPROMO):** In Azerbaijan, AZPROMO is the leading agency which is responsible for the promotion of international trade opportunities for local businesses, including SMEs. AZPROMO was established by the Ministry of Economy with an annual budget of approximately 1 million EUR and offers all services free of charge. AZPROMO helps attract financial resources to non-oil sector SMEs. In Azerbaijan, 2.1% of small and 1% of medium-sized enterprises export directly or indirectly (EBRD, 2014). The main problem is shortage of working capital because 68.2% of Azerbaijan companies use their own or family resources to finance exports and only 20.5% use commercial banks (survey by East Invest, 2014). The World Bank's 'Doing Business 2015' report ranks the country at 166th place for across the trading border easily, due to the large number of documents required and duration of export processes (World Bank, 2014). However, in 2015, these procedures were simplified – the number of document decreased and e-custom serviced became available through the Resolution of the Cabinet of Minister and a Presidential Decree. In addition to incentives and training activities, AZPROMO allocates funds for SMEs to participate in international sales fairs. In 2015, AZPROMO established the Exporter Club, whose main function is to support manufacturers in exporting Azerbaijani products to foreign markets. However, according to those SMEs surveyed by the OECD in 2015, most of them were aware of these government programs for encouraging companies to export.

**State Service for Agricultural Projects and Credit Management under the Ministry of Agriculture of the Republic of Azerbaijan:** Using loans provided by the State Service at a rate of 2% annually, authorized banks can allocate loans to entrepreneurs and farmers on preferential terms, without applying an additional interest rate of more than 5 percent. As a result, participating SMEs are able to receive interest rates of 7% or lower in local currency.

**State Fund for Development of Information Technology under the Ministry of Communications and Information Technologies of the Republic of Azerbaijan:** The Fund is financing start-ups with high technology, with a total allocation of up to 300,000 AZN.

## 5. SMEs in the context of the United States model

### 5.1 Classification of SMEs

It's correct to say that the performance and level of development of a nation's economy depends heavily on its capacity to create a good environment for SMEs, which can supply quality services and competitive products at a low cost and in quantities that are adjusted to the local market. In this vein, the United States (US) is one of the best examples to explore the role of SMEs in the economy.

SMEs, or firms with fewer than 500 employees, are a main part of the US economy, comprising the backbone of employment (Hammer, Jabara, Cardenas, Wise, Grossman, Peterson, Gosney, 2016). The parameters for the classification of SMEs in the US are defined by a governmental department, called the Small Business Administration (SBA). SBA uses constant "size standards" in order to determine a company's classification; seen in the following table is the classification of America SMEs according to the number of employees, annual turnover and line of work.

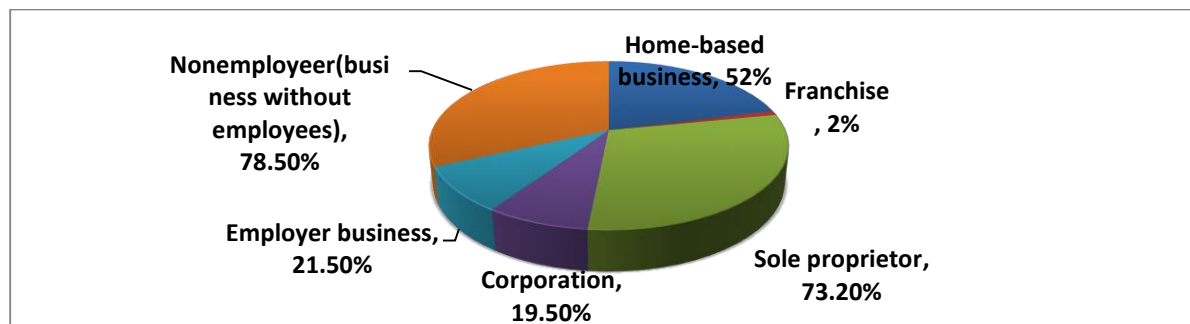
**Table 2: Classification of SMEs in the US**

	Manufacturing and service industry	Services		Agriculture
		Majority	Maximum value	
<b>No. of employees</b>	<500	<500	<500	<500
<b>Turnover</b>	-	≤7 mln. \$	≤25 mln. \$	≤0.25 mln. \$

**Source: United States International Trade Commission, Small- and Medium-Sized Enterprises: Overview of Participation in US Exports, 2017**

Companies are categorized in three broad domains based on the activities they perform: industry, services and agriculture. Enterprises which produce for both domestic and export markets are split according to these lines of work. With a view to the number of employees, if a company has less than 500 employees it considered to be a SME.

**Figure 8: Small Business shares, %**



**Source: U.S. Census Bureau, SBO, SUSB, 2017**

According to Figure 1 above, the majority of SMEs in the US are non-employable business entities, standing at 78.50%. The 2<sup>nd</sup> largest share belongs to sole proprietorships, making up 73.20%.

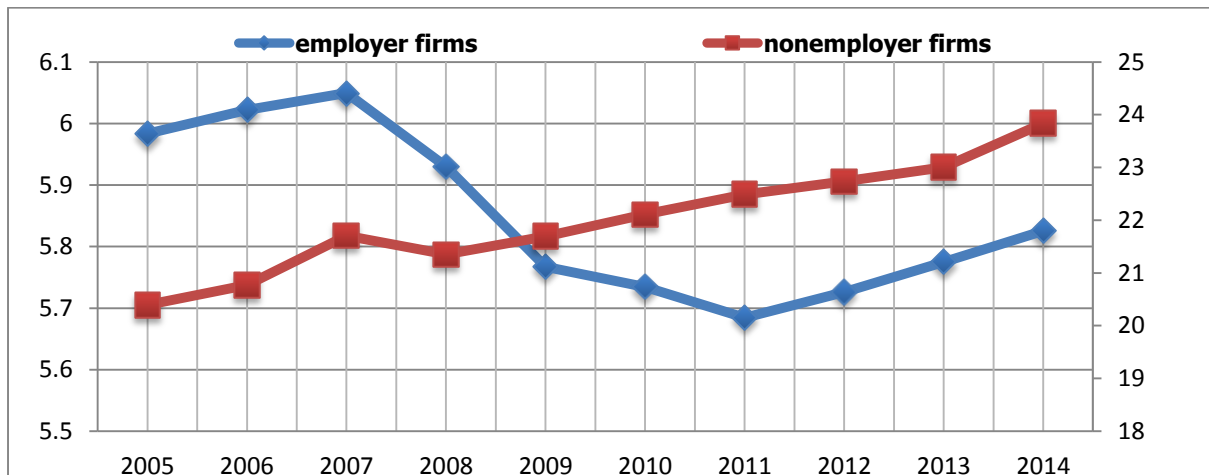
Then successively home-based business, employer business, corporation and franchise have a share, respectively 52%, 21.5%, 19.50%, and 2%.

## 5.2 The role of SMEs in the US Economy

According to the measurements of the Gross Domestic Product (GDP) by the Bureau of Economic Analysis, the US has had seven years of annual output growth. In other words, the US economy has been developing every year since the end of the ‘Great Recession’ of the early 2000s. As of 2016, stock markets (Dow Jones Industrial Average and S&P 500) reached all-time highs. Unemployment by mid-2016, as reported by the Bureau of Labor Statistics, has been consistently at 5% or below, and incomes have recovered, rising 8% from the eve of the ‘Great Recession’ to early 2016 (OECD 2017, United States).

“SMEs are strongly embedded in the US economy in terms of employment, output (production) and technology, and also capture approximately half of the private-sector. Small businesses are the biggest part of the US economy and their weight in value added (GDP) is 50%. The contribution of SMEs to employment is also around 50%. These firms account for more than 28 million businesses, or 99.9% of all firms. They employ about half of the private sector’s employees, pay about 42% of total private sector payrolls, generate about 63% of new private sector jobs and create about 46% of private-sector output” (OECD, United State 2016).

**Figure 9: Number of businesses in the US (millions), 2005-2014**

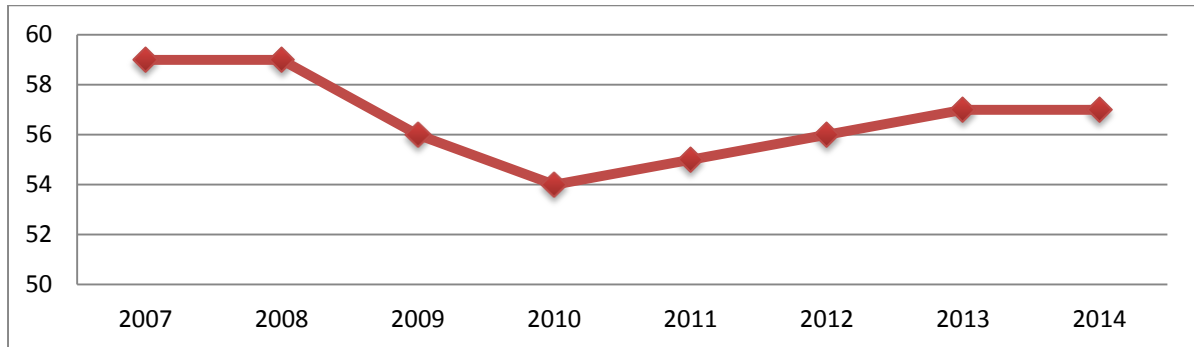


**Source: United State Census Bureau, 2017**

As Figure 2 reveals, there exists an easily observable trend among the number of employer and non-employer firms in the US. According to this graph, during 2005-2014, the number of non-employer firms has grown significantly; however, on the contrary, employer firms show a considerable downward trend starting from 2007 until 2011. After 2010, the number of employer firms started to increase and, in 2014, the number reached approximately 22 million. This number, however, cannot be compared with non-employer firms; over 4 out of 5 businesses in the US do not have employees. One of the main reasons behind the declining number of employer firms since 2007 is, in fact, the financial crisis.

SMEs make significant contributions to the U.S. economy in terms of employment, job creation, entrepreneurship and economic activity, as measured by gross domestic product (GDP). As mentioned before, the contribution of SMEs to employment is 50%. However, the impact of the financial crisis can be observed on the lower number of employees.

**Figure 10: Number of people employed by SMEs in the US (millions)**



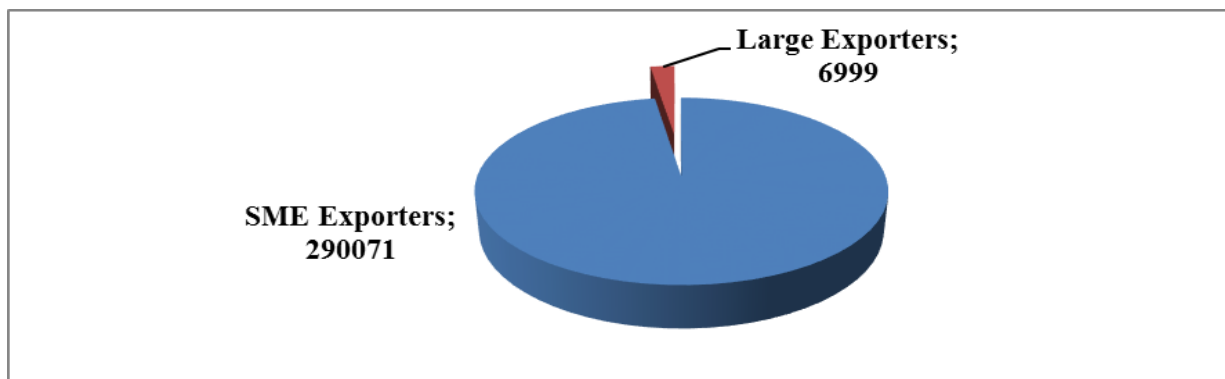
**Source: US Small Business Administration, 2017**

Figure 3 illustrates how SMEs considerably effect job creation and lead to higher levels of employment. Although during this period, specifically between 2007-2010, the number of employed people decreased, this is the result of the declining number of employer firms during this period and therefore does not necessarily mean unemployment rose. It should be noted that during the ‘Great Recession’ of 2008-2009, small firms lost 6 million jobs, but after 2010, a mildly positive employment trend among small firms continued into 2014, after which it reached 57 million. Although small businesses are the main part of the US economy, increasing competition and productivity, a tight lending market held their growth and impeded the start-up culture, affecting the number of employer firms and the number of the employees.

### **The role of the SMEs in export performance**

The US International Trade Commission (Commission or USITC) found, that despite facing trade barriers and other impediments, SMEs in the US that export goods and services are more productive than their non-exporting counterparts, seen in Figure 4 below. SMEs in the US accounted for 97.6% of total identified exporters and 97% of total identified importers, in 2015.

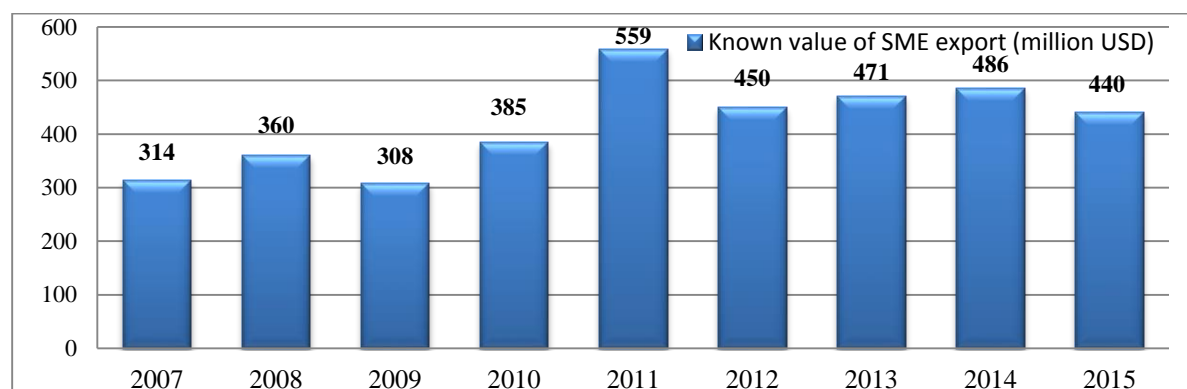
**Figure 11: Total identified US exporters**



**Source: United State Census Bureau, 2017**

At the same time, in 2015, the known value of goods exported by American SMEs was \$642 billion USD, comprising one third of the total goods' trade (by value). Figure 5 details the dynamic of the known value of goods' export by SMEs in the US during the period 2007-2015. Over this period, the upper limit is observed in 2011, equalling \$599 million USD, meaning that 33.3% of the known value of exports belonged to SMEs. A general trend can be observed, where the known value of SME exports increased over the period 2007-2015. Most recently, SMEs accounted for 33.6% and 33% of total known export value in 2014 and 2015, respectively (United State Census Bureau, 2015).

**Figure 12: Known value of SME exports in US (million USD)**

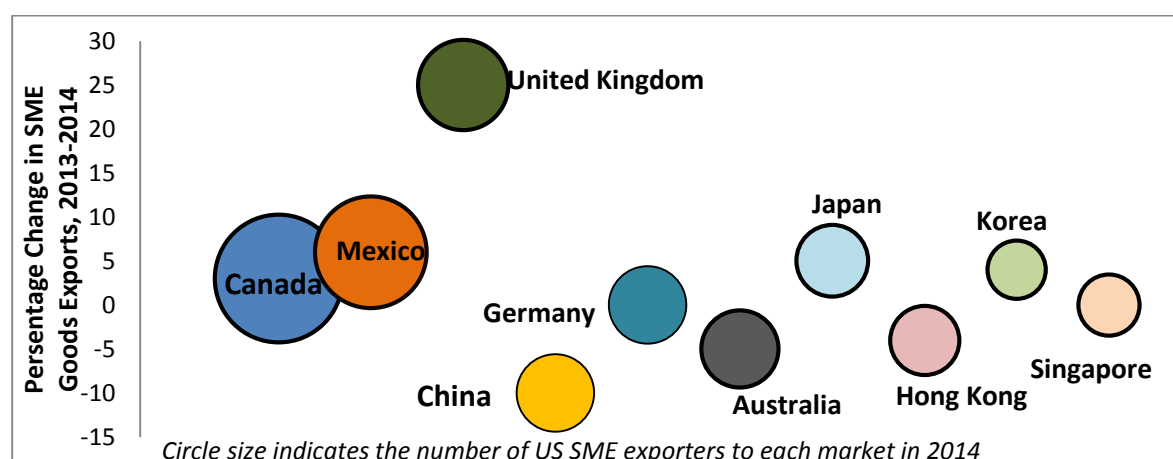


**Source: United State Census Bureau, Profile of US importing and Exporting Companies, 2017**

At the same time, in 2015, among all U.S. manufacturers, 96.5% of manufacturing exporters were small- and medium-sized companies, contributing 19.1% of the sector's \$839 billion USD value. Among wholesalers, 99.2% of exporting wholesalers were small- and medium-sized companies, accounting for 64.8% of the sector's \$303 billion USD in exports.

The majority of SME exporters ship goods to at least one of the US's NAFTA partners, Canada or Mexico, with the U.K., China and Germany also serving as top destination markets, as seen in the following Figure 6. In fact, the known value of SMEs' exports to Mexico increased by nearly 19% between 2012 and 2013. Similarly, SME exports, by value, grew by 5% to Colombia during its second year as a US free trade agreement partner. Nearly 21,000 SMEs exported goods to South Korea and more than 14,000 exported to Colombia in 2013, both of which became U.S. free trade partners in 2012.

**Figure 13: Top SME export markets in U.S**



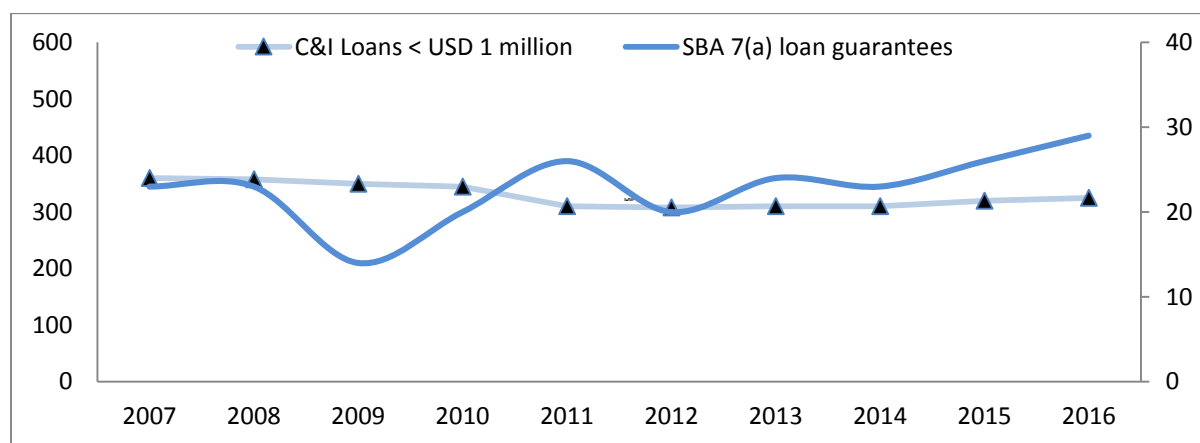
Source: International Trade Administration, 2017

### 5.3 Access to finance

In order to start, expand and contribute to the US economy, SMEs need access to capital, free cash flow and credit. In reality, small firms come across more financing hurdles than large enterprises, due to their lack of ability to increase funds through the credit market, as well as because of their small size and limited assets. Given that SMEs tend to have greater volatility in earnings and growth than larger companies, they are seen as riskier investments and, thus, subject to higher cost of capital. Smaller businesses, especially, still rely on savings and credit and loans, when available, to capitalize themselves. According to Kauffman Foundation survey data on 5,000 new firms, 35% of these firms' capital came from loans, 30% from personal savings, 6.3% from friends and family and 6.2% from credit. Angel investments and venture capital made up only a tenth of the total (Harrison, 2015).

Small business lending has not completely recovered from the 'Great Recession' and, after this shock, monitoring lending became paramount. As a result, capital looks scarce and banks would like a huge level of collateral or loan guarantees in order to lend this capital. However, the situation is improving, as can be seen in the following Figure 7.

**Figure 14: Small business and SBA lending United State, 2007-2016 (million USD)<sup>6</sup>**



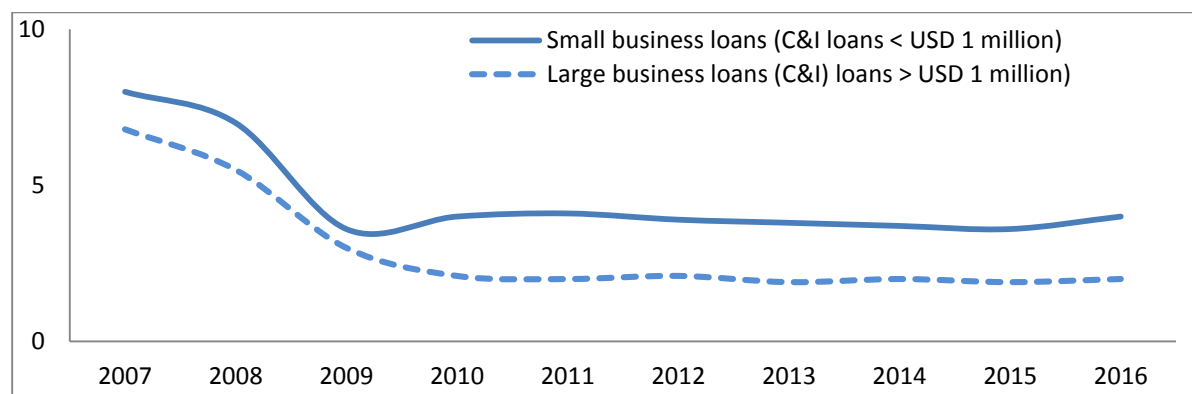
Source: Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard, US Small Business Administration, Federal Deposit Insurance Corporation, 2017

As reported by Federal Deposit Insurance Cooperation, Commercial and Industrial (C&I) lending below \$1 million USD is often used as a proxy for measuring small business lending. Beginning from 2008, C&I loans showed a considerable decrease due to the 'Great Recession,' and dropped to approximately \$200 billion USD. In the third-quarter of 2012, they again fell to \$279 billion USD, but rose 8.4% to \$324 billion USD by the first quarter of 2016 (OECD, 2017 United State). Small business lending grew by 5.3%, from the first quarter of 2015 to the first quarter of 2016. However, looking at the big picture and in inflation-adjusted terms, the small business lending market overall is still down 16% from 2008, a \$52.5 billion USD shortfall (OECD, 2017 United State). Small business financing

<sup>6</sup> Note: Commercial and Industrial loans are the portfolio of loans outstanding under 1 million, while SBA is the 12 month total of loans made.

needs vary greatly. According to the National Small Business Association, 73% of small firms used financing in the last 12 months of 2015, about one-quarters used no financing and for others, the lack of capital caused difficulties growing their business, financing future sales and keeping adequate inventory (National Small Business Association, 2015).

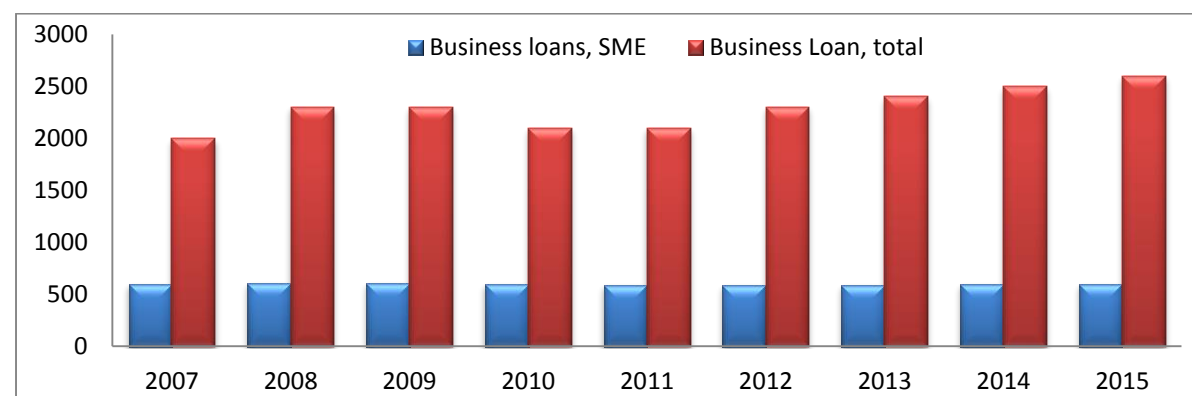
**Figure 15: Interest rate in the United State, 2007-2016**



**Source: Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard, US Small Business Administration, Federal Deposit Insurance Corporation, 2017**

Since the end of the ‘Great Recession,’ interest rates have declined and kept pace, starting in 2009 until 2016 (see Figure 8). During this period, the differences between small and large business loans changed from 1.5 to 2%. Although interest rates were low after the ‘Great Recession,’ banks did not loosen their standards and kept implementing tightening standards on small business loans, limiting capital. Banks reported a decrease in the demand for small business loans, which, with high probability, was a response to tightening standards. At the same time, small businesses tried to get credit from other sources, for instance alternative lenders (OECD, 2017 United State). Figure 9 shows the number of small business loans relative to total business. It can be seen that the business loans allocated to SMEs constitute one-fifth of total business loans.

**Figure 16: SME and total business loans, 2007-2015 (billion USD)**



**Source: Financing SMEs and Entrepreneurs 2017: An OECD Scoreboard**



## 5.4 Overview of government policies for improving SMEs

In order to increase the number of small businesses involved in exporting, the government enacted several programmes to offer financing and provide grants to SMEs. To encourage greater demand for alternative financing instruments, the government has expanded entrepreneurship training opportunities for underserved communities through a re-launch of the Emerging Leaders Programme, as well as by an increased partnership with market players. US financial support for small businesses is very successful.

### Small Business Investment Company

The main player in this arena is the SBA, through Small Business Investment Company programs and a number of loan guarantee programs. The SBA's Small Business Investment Company (SBIC) Program is a public-private investment partnership created to help fill the gap between the availability of growth capital and the needs of small businesses (U.S Small Business Administration, 2017). From its inception in 1958 until now, the SBIC has more than 10 million small business investments, amounting to over \$57.2 billion USD (Global Alliance of SMEs, 2016). The SBA does not make direct loans to small businesses; rather, it sets the guidelines for loans, which are then made by its partners (lenders, community development organizations and micro lending institutions). The SBA works with approximately 5000 banks and credit unions, some 250 Community Development Corporations (CDCs), over 170 non-profit financial intermediaries and Community Development Financial Institutions (CDFIs) and approximately 300 small business interment companies (SBICs). The SBA guarantees that its loans will be repaid, thus eliminating some of the risk to the lending partners. In other words, when a business applies for an SBA loan, it is actually applying for a commercial loan, structured according to SBA requirements with an SBA guarantee. SBA-guaranteed loans may not be made to a small business if the borrower has access to other financing on reasonable terms. SBA loan guarantee requirements and practices can change as the government alters its fiscal policy and priorities to meet current economic conditions; therefore, one cannot rely on past policy when seeking assistance in current market conditions. At the same time, the SBA provides a number of financial assistance programmes for small businesses, which have been specifically designed to meet key financing needs, including debt financing, surety bonds and equity financing.

### SBA's Capital Access Programmes

The largest programme is the 7(a) Loan Program, which provides guarantees for working capital loans up to the \$5 million USD for new and existing small businesses. The second largest sub-programme is the Certified Development Corporation 504 Loan Program, which provides guarantees and co-funding for loans up to \$5.5 million USD for the purchase of fixed capital. The financial and economic crisis of 2008-2009 had a pronounced impact on SBA's Capital Access Programs; however, after several major interventions by the federal government, the dollar volume of these two programs surpassed their peak levels and, in 2014, reached \$24.5 billion USD (An OECD Scoreboard, 2017). In recent years, the number of guaranteed loans has remained flat, especially for start-ups. Loan guarantee programmes have become less effective, which has contributed to many small businesses being cut off from the credit market. The SBA has taken several steps in order to solve this problem, such as reducing or eliminating lender fees, where possible. In the case of small loans (under \$150,000 USD), 85% are guaranteed, compared to 75% of larger loans (Cusmano, OECD 2017).

Previously, the maximum amount for a loan was \$2 million USD, while maturity depended on the use of the loan – for working capital, the threshold was 10 years and for fixed assets, 25 years. The

program also specified a maximum interest rate, pegged to the prime (up to 2.75% above the prime) and decreased with the volume of the loan and its maturity. In order to address the adverse effects of the financial crisis and mitigate the contraction of access to finance for small firms, within the framework of the Small Business Jobs Act of 2010, the maximum amount for a loan was raised to \$5 million USD (Cusmano, OECD 2017). Guarantee fees, generally paid by the borrower, were fixed: upfront, 0.54%, and annual, increased with loan volume and maturity. The maximum upfront fee is set at 3.7% for guarantees exceeding \$1 million USD and a maturity longer than 1 year (Cusmano, OECD 2017).

Another SBA loan program, which started to be implemented in 2013, targets guarantee fees. Through this program, loan guarantee fees are waived for loans under \$150,000 USD, greatly aiding small start-ups access badly-needed capital. At the same time, another action of the SBA includes garnering heightened bi-partisan Congressional support to increase the 7(a) Loan guarantee cap, from \$17.75 billion USD to \$23.5 billion USD, in July of 2015, while continuing to operate without subsidies (meaning fees cover costs). Another beneficial program enacted by the SBA is the Export Express Loan Program. This program offers financing up to \$500,000 USD to small businesses to be used in a number of ways with one major restriction: the business must be at least a year old.

The SBA's Surety Bond Guarantee (SBG) Program helps small business contractors who cannot obtain surety bonds through regular commercial channels. A surety bond is a three-party instrument between a surety (someone who agrees to be responsible for the debt or obligation of another), a contractor and a project owner. The agreement binds the contractor to comply with the terms and conditions of a contract. If the contractor is unable to successfully perform the contract, the surety assumes the contractor's responsibilities and ensures that the project is completed (U.S Small Business Administration, 2017). Through the SBG Program, the SBA makes an agreement with a surety, guaranteeing that the SBA will assume a percentage of loss in the event the contractor should breach the terms of the contract. The SBA's guarantee gives sureties an incentive to provide bonds for eligible contractors, thereby strengthening a contractor's ability to obtain bonds and greater access to contracting opportunities for small businesses. The SBA can guarantee bonds for contracts up to \$5 million USD (and in some cases even contracts up to \$10 million USD), covering bid, performance and payment bonds.

### Overseas Private Investment

The Overseas Private Investment Corporation (OPIC) is a main part of the US government's involvement with development finance. The OPIC gives sizable direct loans to small businesses in order to encourage US businesses to move outside of traditional trade lines. Political Risk Insurance provides insurance toward events like civil war and terrorism, improper foreign government interference with trade and the restrictions of local-currency dealing (Wood, 2016). Furthermore, the United States Trade and Development Agency (USTDA) offers grants and contract opportunities for small businesses for research potential projects.

### Small Business Innovation Research and Small Business Technology Transfer

The Small Business Innovation Research (SBIR) and Small Business Technology Transfer (STTR) programs, also known as America's Seed Fund, are some of the largest sources of early-stage capital for technology commercialization in the United States. The aforementioned programs allow US-owned and operated small businesses to engage in federal research and development that has a strong potential for commercialization. "In the 2017 Fiscal Year, the US's National Institute of Health's (NIH) SBIR and STTR programs will invest over \$925 million USD into health and life science companies

that are creating innovative technologies that align with NIH’s mission to improve health and save lives” (Small Business Innovation Research, 2017).

## 6. SMEs in the context of the Europe model

### 6.1 Classification of SMEs

Small- and medium-sized enterprises also play a significant role in the European economy. The European Union analyses enterprises based on 3 categories to define its size; the following table shows the categories which defines businesses as micro-, small- and medium-sized enterprises.

**Table 3: EU categorization of SMEs**

Company Category	Employees	Turnover	Balance Sheet Total
Micro	<10	< €2 million	< €2 million
Small	<50	< €10 million	< €10 million
Medium-sized	<250	< €50 million	< €43 million

**Source: Commission Recommendation of 6 May 2003 concerning the definition of micro, small and medium enterprises. (2003/361/EC), Official Journal of the European Union, L 124/36, 20 May 2003**

In the Member States of the European Union, businesses are classified based on the number of employees hired, annual turnover and balance sheet total. If an enterprise exceeds the determined criteria during the time period for which statistical results are calculated, the status of the enterprise does not change. However, an enterprise that continues with a higher headcount, turnover or/and balance sheet total than the threshold for more two consecutive accounting periods loses its status as a micro-, small- or medium-sized enterprise and cannot benefit from European policies directed towards them.

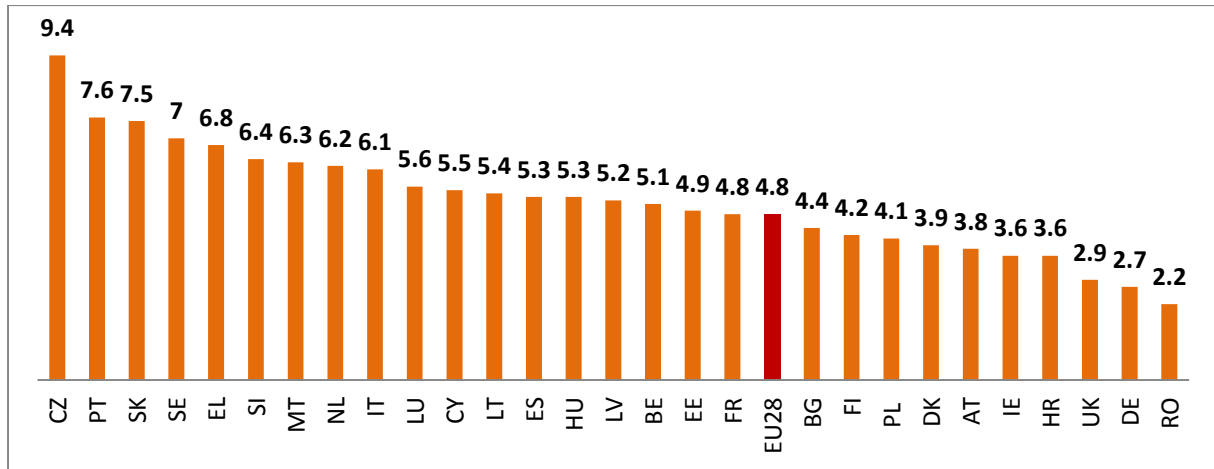
The European Union does not count apprentices or students working for companies as employees. Employee criteria includes, “employees, persons working for the enterprise being subordinated to it and considered to be employees under national law, owner-managers and partners engaged in a regular activity in the enterprise and benefiting from financial advantages from the enterprise”(European Commission, 2005). Additionally, the number of employees is calculated based on annual work year; hence, seasonal workers and part-time employees are considered as a fraction of one unit.

Annual turnover is determined by calculating the revenue of a company, which is the net sales generated by business and does not include the amount of money spent on taxes. Balance sheet total is the value of the assets of a company.

### 6.2 The role of SMEs in the economy of the European Union

Data gathered by the European Commission suggests that SMEs constitutes 99.8% of all businesses and play a significant role in employment by employing two-thirds of the labour force in Europe. The statistics show that SMEs contribute 69% to employment growth and 66.8% to total employment (2016). The relationship between enterprises and growth in employment does not only depend on the number of people enterprises hire, but also on the number of new enterprises. Figure 10 compares the EU Member States to reveal which ones have the most SMEs per 100 inhabitants.

**Figure 17: The number of SMEs per 100 inhabitants, 2015**

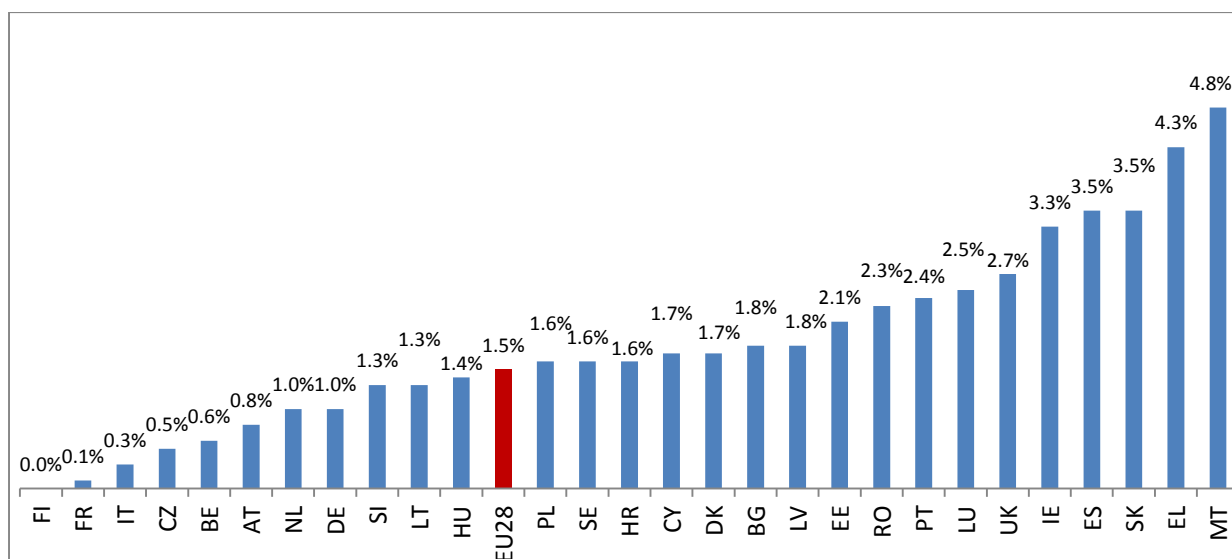


**Source: Eurostat, National Statistical Offices and DIW Econ, 2017**

The same aforementioned report indicates that, mostly, the increase in employment seen throughout the EU-region depends on the amount of newly opened enterprises. Small- and medium-sized enterprises also improve the gross value added of countries. Additional data published by the European Union in one of its annual reports shows that the number of people per enterprise actually decreased over the years following the global financial crisis, which further proves the fact that employment growth is connected with the newly opened enterprises and job opportunities they generate (2016).

If we categorize SME employment growth rates by countries for 2015, the biggest increase in employment was witnessed in Malta, at 4.8% (European Commission, 2016a). One of the reasons for the observed growth in employment rates in Malta was the launching of “The SME Initiative Malta,” which aimed to create a fund of over 60 million EUR for SMEs in Malta, and was co-financed by the Republic of Malta, the European Commission European Investment Bank and European Investment Fund on 15<sup>th</sup> July 2015 (European Investment Fund, n.d.). In second place in the list came Greece, with a 4.3% growth in SME employment. Although SME employment in Greece was decreasing constantly after the global crisis, there was a start at recovery in 2013. In 2013, the number of people employed increased for the first time after the global crisis, and continued to expand (European Commission, 2015; GSEVEE et al., 2014). However, the average growth rate of employment for EU28 is only 1.5%, much lower than that found in Malta and Greece. There are also some countries that have negative or very small SME employment growth rates, for example, in 2015, Finland had a negative SME employment growth rate of -0.3%, while France had a mere 0.1% expansion.

**Figure 18: EU SME employment growth by Member State, 2015**



**Source: Eurostat, National Statistical Offices, DIW Econ, 2017**

Table 3 below shows the number of enterprises under each size categorization, including employees they hired. It is observed that the number of SMEs constitute 99.80% of all enterprises and they employ 66.80% of all employees hired by any sized enterprises.

**Table 4: SMEs and large enterprises: number, employees and value added in the EU28, 2015**

	Micro	Small	Medium	SME	Large	Total
Enterprises	21,256,252	1,378,702	224,647	22,959,600	44,458	23,004,059
Number	92.80%	6%	1%	99.8	0.2	100%
%						
Persons employed						
Number	40,057,408	27,503,428	23,170,352	90,731,192	45,168,732	135,899,904
%	29.50%	20.20%	17%	66.80%	33.20%	100.00%

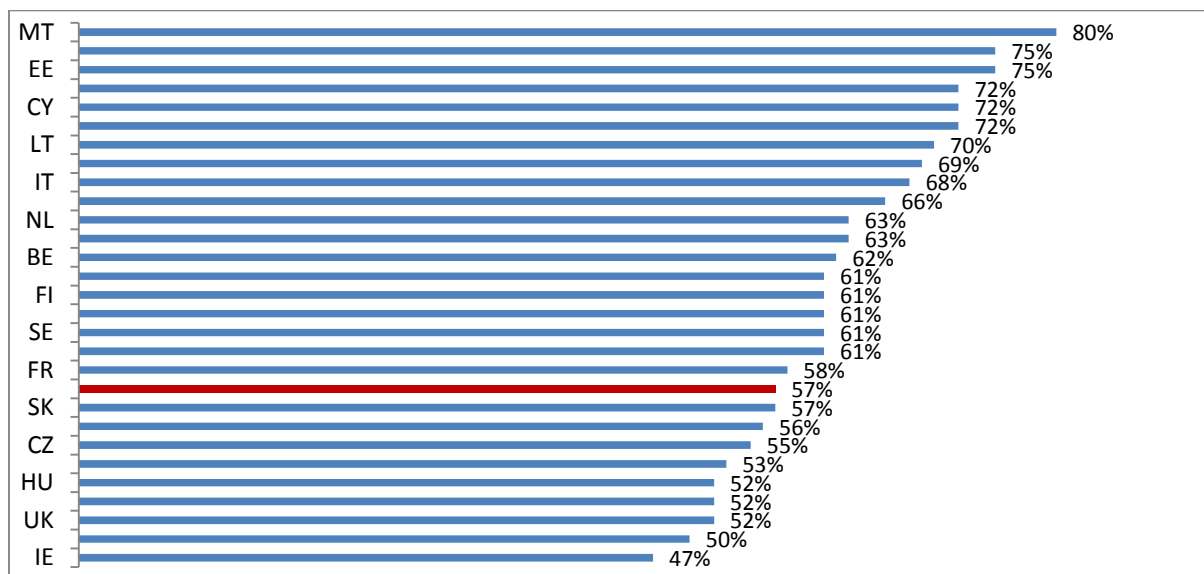
**Source: Eurostat, National Statistical Offices, DIW Econ, 2017**

Although it is unknown if large companies or their smaller counterparts create more growth in the economy, it is obvious from the table above that small- and medium-sized enterprises contributed to the European economy more than large companies in 2015, particularly through lowering unemployment.

## Value added

In 2015, small- and medium-sized enterprises played an important role in value added in Europe, with each countries' contribution seen in Figure 12, below. Value added by SMEs was 3,938,103 billion EUR, which constituted 57% of total value added by enterprises. However, the contribution of SMEs to GDP of individual countries varies, depending on the political and economic situation of the country concerned, as can be seen lower in Figure 13.

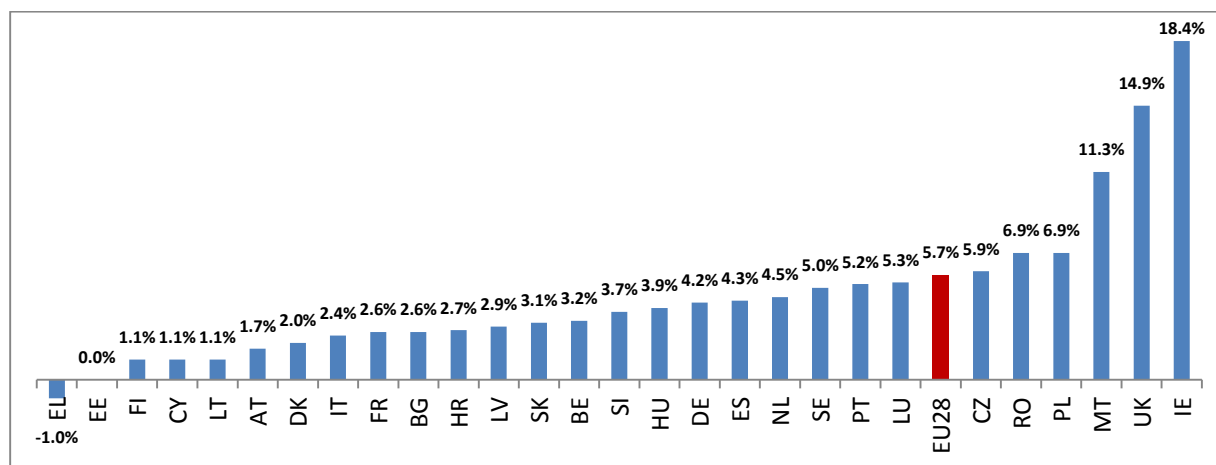
**Figure 19: Contribution of SMEs to value added in different member states in 2015**



Source: Eurostat, National Statistical Offices, DIW Econ, 2017

Moreover, from a sectoral perspective, most of the value added belongs to the wholesale and retail trade sector, at 22%. The manufacturing sector follows, with 20%, while the third most substantial contribution to SME value added is produced by the business services sector, 14%. The Construction and the accommodation and food sectors take fourth and fifth places, with 11% and 4%, respectively. Other sectors aggregately contribute to total SME value added by 20%.

**Figure 20: EU SME value added annual growth by Member State, 2015**



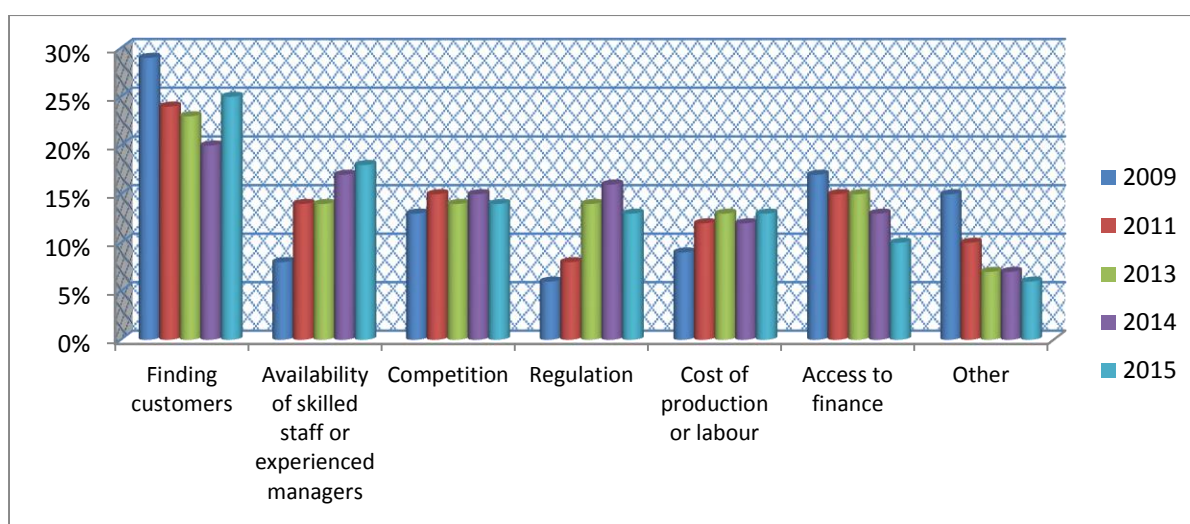
Source: Eurostat, National Statistical Offices, DIW Econ, 2017

### 6.3 The most common problems among SMEs in the European Union

The latest statistics generated by Panteia, obtained from a survey of different enterprises, revealed that the main problems concerning SMEs are finding clientele and qualified or experienced staff, competition, regulation, expenses of production or labour and access to finance, detailed in Figure 14, below (Panteia, 2015). Among the many listed problems, the most concerning issue is that of finding customers. Survey results of every year since 2009 reveal that finding customers was the major problem for small- and medium-sized enterprises. Although the criticality of the problem has decreased over the years, it became a pressing issue again after 2014. The second most frequently faced complication is that of availability of qualified and trained work force. The urgency of this problem has been steadily increasing. According to a 2015 survey, 18% of enterprises experienced difficulty in finding experienced and trained employees. Another major problem small businesses face is competition. Panteia's data indicates that there was not much fluctuation in the urgency of the problem, though, as it has been stable around 14-15% since 2009.

Regulation and the expenses of production or labour are tied in fourth place among listed problems; 13% of small enterprises expressed their dissatisfaction regarding these categories. Regulation consists of European and national laws and industrial regulations. Labour costs include wages, employee benefits and payroll taxes paid by an employer. Some inconstancy has been experienced in the urgency of these problems between 2009 and 2015. In 2009, the issue of regulation was the least crucial problem among other complications; however, since then, it has continually been fluctuating. These costs remain a problem to a relatively constant proportion of EU28 SMEs. The fifth problem of small businesses is access to finance. Although financial predicaments were the second most pressing problem in 2009, policies of European Union helped to ameliorate the situation.

**Figure 21: The most common problems among SMEs after 2009.**



**Source: Survey on the access to finance of enterprises (SAFE)- Analytical Report 2015**



## **6.4 Overview of government policies for the improvement of SMEs in the European Union**

As mentioned previously, small- and medium-sized enterprises are an important and substantial part of the European economy. Hence, over the past few years, the European Union has started copious initiatives to better develop SME policy in order to improve the economy. Those initiatives were aimed to simplify the environment for small and medium-sized enterprises and remove obstacles for their growth.

### European Charter for Small Enterprises

First and foremost is the “European Charter for Small Enterprises,” adopted by the General Affairs Council of the European Union in 2000. With the adoption of the “European Charter for Small Enterprises,” the European Union acknowledged the role of SMEs in the reduction of unemployment and the expansion of economy and recognized entrepreneurship as a valuable skill that should be applauded. At the same time, the EU also pledged “to strengthen the spirit of innovation and entrepreneurship which enables European business to face the challenges ahead, achieve a regulatory, fiscal and administrative framework conducive to entrepreneurial activity and improve the status of entrepreneurs, ensure access to markets on the basis of the least burdensome requirements that are consistent with overriding public policy objectives, facilitate access to the best research and technology, improve access to finance throughout the entire life-cycle of an enterprise, improve their performance continuously, so that the EU will offer the best environment for small business in the world, and listen to the voice of small business and promote top-class small business support” (European charter for small enterprises, 2000). In order to implement those pledges, the EU decided to take several actions, such as teaching entrepreneurship at schools and colleges, facilitating procedures for start-ups, simplifying laws like national bankruptcy laws for small businesses, ensuring that training institutions provide small businesses with sufficient skills, improving electronic access between authorities and small businesses, developing a friendly environment for small businesses, making it easier for small businesses to enter a market, modifying taxation systems to stimulate start-ups and small businesses, improving financial services, promoting technology dissemination towards small enterprises, stimulating efficient business models and creating an easily accessible guidance system for small businesses and, finally, representing interests of small enterprises on the national level (European charter for small enterprises, 2000).

### Small Business Act

In June 2008, the European Union decided to take a further step with the implementation of the “Small Business Act,” to develop the framework they created in 2000. The main purposes of the “Small Business Act” was to stimulate entrepreneurship and small businesses, facilitate regulatory rules hindering processes for enterprises, improve access to finance and to markets, similar to the “European Charter for Small Enterprises” (European Commission, n.d.). The act was intended to broaden the benefits of the framework created for small- and medium-sized enterprises through the European Charter.

### Promoting entrepreneurship

In Europe, the number of people who want to be self-employed or start their own business is just 37%. This number is much lower than few years ago, when it was 45%. It is also lower than in the US and China, where the number is 51% and 56%, respectively. Furthermore, the performance of enterprises are not as high as enterprises in the US and China, they grow more slowly, comparatively.

These statistics demonstrates that Europeans do not have as much enthusiasm as their counterparts in America and China to run a business (European Commission, 2013). Hence, one of main targets of the European Union is to promote entrepreneurship and encourage people to run their own business and prevent unnecessary challenges faced by entrepreneurs. There are several obstacles the European Union planned to solve; for example, the education system does not stimulate students to be entrepreneurial. In order to solve the motivation problem of the European Union, there have been classes set up to teach young people about business skills and entrepreneurship. Investment in entrepreneurship education is considered both significant and beneficial; statistics show that about one-fifth of students who participate in the programs about entrepreneurship start their own company or business in the future (European Commission, n.d.). With the purpose of improving entrepreneurship among young people, the European Union has started targeted programmes, such as “Erasmus for Young Entrepreneurship” and enhanced entrepreneurship education in secondary schools and universities, along with creating support networks, such as “Your Europe Business Portal,” “Enterprise Europe Network,” “SME Internationalisation Support Page” and “Portal on access to finance.”

#### Facilitating regulatory rules

The European Commission has a “Regulatory Fitness and Performance” (REFIT) programme to simplify laws for small- and medium-sized enterprises. Its main target is to make laws simple, easy to understand, more efficient and cheaper for enterprises. There are annual Commission work programmes, which offer new initiatives and a quality review of rules; “to ensure the best outcome, various levels of government are involved: the Commission works with the European Parliament, the Council of the European Union, EU countries and other stakeholder” (European Commission, n.d. b),

#### Improving the access to finance

The European Commission works with several financial institutions, such as banks, angel investors and venture capitalists in order to improve the financial funding system for enterprises. The European Commission does not fund businesses directly; they do it through local financial institutions. There are over one thousand financial institutions that small businesses can apply for funding. The funding requirements vary, since they are determined by the institution being applied to. Over the last few years, the European Union launched several programmes to improve the financial system, in light of the fact that access to finance has been one of the most urgent problems of enterprises. In 2007, the EU designed “The Competitiveness and Innovation Framework Programme,” (CIP) that ran until 2013. Through the CIP, “access to finance was made easier using financial instruments that help businesses raise equity and debt financing. With a budget of over EUR 1 billion, these instruments helped more than 340,000 SMEs get access to loans and equity finance” (European Commission, n.d. c). In November 2011, the European Commission proposed a new programme, called the “Competitiveness of Enterprises and SMEs” (COSME). The European Parliament accepted the proposal in November 2013, and the COSME programme received 2.3 billion EUR. The main target of the programme was to facilitate SMEs entry to markets globally and internally, solve financial problems of small businesses and stimulate entrepreneurship (European Parliament, n.d.). According to the Commission, the programme is expected, on an annual basis, to help 39,000 companies create or save 29,500 jobs and launch 900 new business products, services or processes.

Overall, Member States and the European Commission have implemented several policies to improve SMEs access to finance. Most of the regulatory activity took place in countries, where situation in bank lending to SMEs deteriorated after the global crisis. “The most widespread measure has been

enhancing and strengthening loan guarantee systems, mainly through broadening their scope and increasing the allocation of public funds into such guarantee schemes. Other and less widespread policy measures at national level have addressed: further developing corporate bond markets and alternative markets for SMEs; facilitating the securitisation of SME loans; easing the access and transfer of financial information; developing a regulatory framework for crowdfunding; and enhancing the public venture capital sector. In parallel, promotional financial institutions are being set up in various Member States” (European Commission, 2015b). Future plans of the Commission include to improve capital markets by the help of a Capital Markets Union, in order to increase the variety of funding sources. Other planned measures are to generate a better framework for SMEs to find finance, such as through crowdfunding private placements and loan originating funds, whilst safeguarding investor protection and financial stability. The Commission is also planning to support venture capital and risk capital financing in EU Member states.

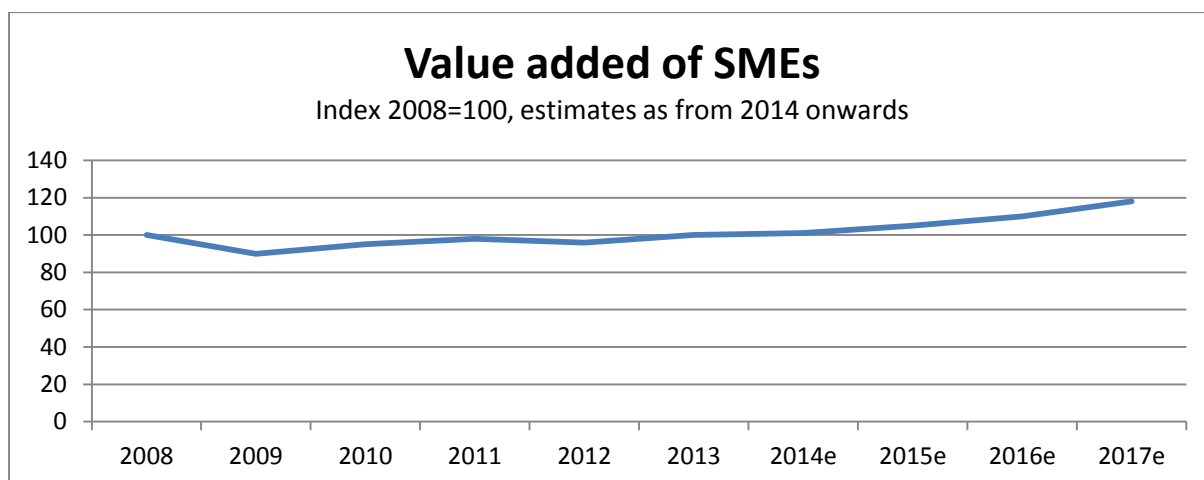
#### Access to markets and internalisation

Most enterprises face difficulties exporting goods and services to other countries. Only one-fourth of small- and medium-sized businesses can export, and the majority of them export to other EU countries. The European Single Market for products and services encompasses over 500 million consumers, providing many opportunities for intra-EU trade. The main purpose of the European Commission is to enhance the ability of SMEs to export, to be resilient to competition, to enter foreign markets and find partners abroad.

### **6.5 Improvement of SMEs over the years**

After the “Small Business Act” (SBA) was signed in 2008, the effects of the act were not immediately obvious, due to the fact that the global crisis contracted economies and damaged SMEs. In the last few years, the European economy started to recover from the impacts of the global crisis and most economic indicators reached or exceeded their pre-crisis level. Even though implementation of the SBA is not complete, statistics published by the European Union demonstrate that it spurred the European economy by boosting the performance of small- and medium-sized enterprises (European Union, 2016). For example, for the first time after the crisis, SME employment grew in 2014, and substantial growth was experienced in value added in 2014 and 2015, 3.8% and 5.7%, respectively. When comparing the numbers of 2015 and 2008, it can be seen that SMEs outperformed their pre-crisis levels in value added. In 2015, value added generated by SMEs was 3.9 trillion EUR, representing a 9% increase, compared to 2008, when considering the non-financial business sector.

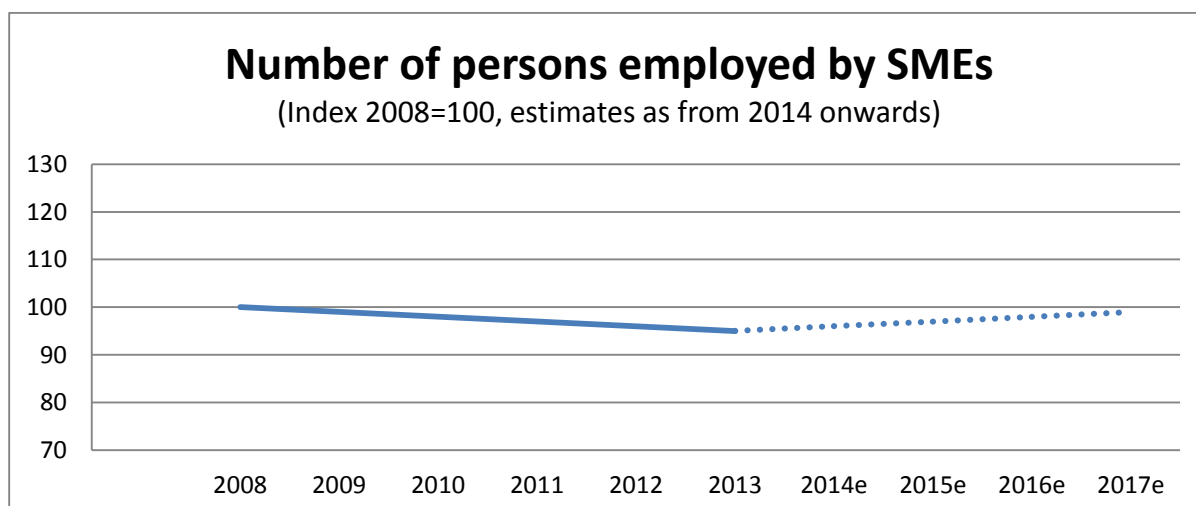
**Figure 22: Value added by SMEs, 2008-2013**



**Source: SBA fact sheet of 2016 by European Union, 2017**

Despite the improvements in value added, SME employment is still lower than pre-crisis levels by 2%. However, SME employment stopped decreasing after 2013, and started to increase for two years in a row. “For the first time since the recession, SME employment grew in 2014 (1.1%). In 2015, SME employment increased by 1.5%” (European Commission, 2016). In total, 90 million people were employed by SMEs, the trend which can be seen below in Figure 16.

**Figure 23: Number of persons employed in SMEs by 2013**



**Source: SBA fact sheet of 2016 by the European Union, 2017**

The main reasons behind the improvement in the performance of SMEs are the improvement in general macro-economic conditions and domestic demand. As written in another section above, European SMEs usually do not export to other countries, and when they do, it is inside the EU28. Hence, domestic demand is significant for SMEs (European Commission, 2016b).

Furthermore, the number of small- and medium-sized enterprises has increased. According to the last statistics, there were around 23 million SMEs in the EU. In spite of the fact that the number of

SMEs fell after the crisis, it reached its pre-crisis level in 2012, and continued to grow constantly. Now the number of SMEs in the EU is 3.3% higher than its pre-crisis level.

## **6.6 Access to finance of small- and medium-sized enterprises (OECD, 2017)**

The 2008 global crises also negatively impacted SMEs' access to finance. Even though, until 2013, there were still some countries whose economies were contracting, after 2013, most of the countries had recovered. This recovery in economic conditions also spurred better conditions in access to finance for SMEs.

In the Member States of the European Union, the main source of funding is bank loans. Loans constitute a substantial part of the finance of the small- and medium-sized enterprises in a number of states, like Greece and Cyprus. In both of these countries, corporate funding is not reliant on the securities market, but on bank debts. Even though the capital market has improved in several countries and big companies do not have to rely on bank loans, oftentimes small and medium-sized enterprises are still dependent on bank debts; the United Kingdom, Germany and France are such examples. However, there are two types of member states in the European Union where small and medium-sized enterprises do not depend on bank loans. The first group constitutes the Nordic Member States, such as Sweden, Denmark and Finland. In these Northern European countries, listed shares are a more common method for financing small and medium-sized businesses. The second group includes Slovakia, Lithuania, Estonia, Czech Republic and Poland, where companies financially depend on their own resources, such as retained earnings.

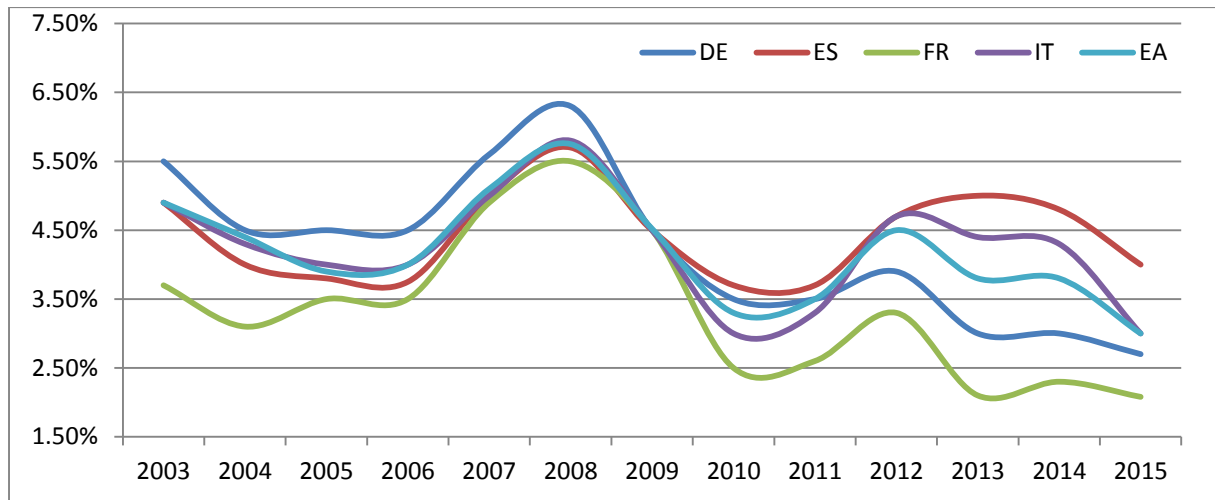
Trade credits are another common method for financing SMEs. They amount to nearly 20% of funding in some of the countries, like Lithuania, Latvia, Czech Republic and Slovenia. However, debt securities play only a small role in the funding of SMEs in the European Union in general. While in some countries, such as Greece, Romania, Lithuania and Cyprus, corporate bonds do not exist, in France, United Kingdom, Portugal, Austria and Finland they have a minor role in funding European companies.

### **Bank Loans**

Bank Lending is a significant part of SME financing in the European Union. Recently, bank loans have increased and bank financing conditions have improved. Interest rates for lending from banks have gone down, while maturity of loans increased. According to a survey taken by the European Central Bank and the European Commission, bank lending conditions have improved and the number of loans given has increased over the last few years. Although the lending situation improved, there are still some lending problems that small- and medium-sized enterprises face. For example, collateral requirements for borrowing are high, loaned money is sometimes less than requested and rejection rates of loan applications are high in several EU countries – rejection rates in some countries are nearly 20%. Countries with high loan rejection rates include the Netherlands (23.5%), Greece (21.5%) and Ireland (18.7%).

The introduction of the single currency in Europe led to the greater integration of financial systems; however, after the 2008 crisis, the situation changed. While interest rates were at a relatively standard rate throughout the various Member States before the crisis, after the crisis harmed the economies of many countries, interest rates began to vary. Although recently financial systems started to integrate once again, interest rates still remain divergent.

**Figure 24: Interest rates for one-year loans up to 1 million EUR**



**Source: ECB/Commission, 2017**

Figure 17 illustrates interest rates for one-year bank loans up to 1 million EUR in several countries and the Eurozone average. It can be seen that, in 2008, the countries listed had similar interest rates around 6.5% and, due to the crisis, there was a downward trend in interest rates after 2008. Although, from 2010 until 2012, interest rates rose slightly, after 2012, they slipped back and reached their lowest point. Also, in the last few years, interest rates in European countries started to differ. The highest interest rate among the chosen countries is in Spain, at 3.5%. Italy and Germany follow Spain, at almost 2.8%. However, the most favourable interest rate for small- and medium-sized enterprises is in France, at about 2%.

#### Non-bank financing

There has been a growth in the number of bonds issued; however, the majority of the bonds were issued by large companies, and not by small- and medium-sized enterprises. Although equity financing is also used in funding SMEs, it is more common for innovative SMEs, which are only a small part of SMEs. The latest statistics show that only 3% of European SMEs were financed by equity financing.

Another way for SMEs to obtain capital for their businesses is by venture capital investments, used for funding start-ups in other parts of the world. Venture capital investments are not the most common way of financing and, in the last years, the number of venture capital investments has decreased. In the European Union, the number of venture capital fundraisings added up to 4.1 billion EUR in 2014, which is less than the statistics of 2013. Additionally, the role of venture capital investments in GDP is negligible. 90% of all companies in the EU funded by venture capital investments were concentrated in only eight member states.

## 7. SMEs in the context of the Turkey model

### 7.1 Classification of SMEs

SMEs play a significant role in the Turkish economy. The determining factors of a company for categorization by the government include headcount, turnover and balance sheet total, similar to the criteria of the European Union. According to Turkish legislation, small- and medium-sized enterprises are classified as 3 types: micro, small and medium companies.

**Table 5: Classification of SMEs in Turkey**

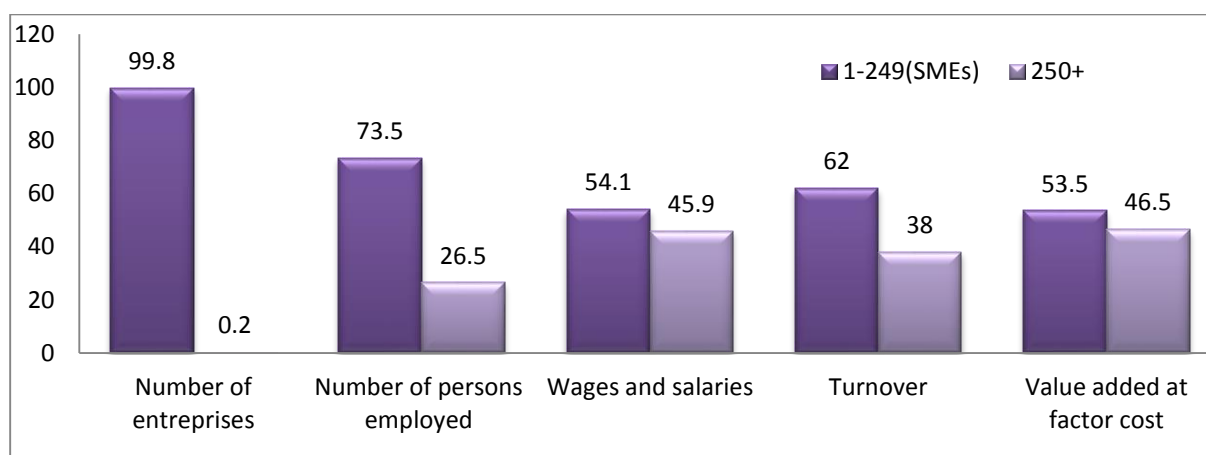
Company category	Headcount	Turnover	Balance Sheet Total
<b>Micro</b>	<10	≤ 1 million TRY	≤ 1 million TRY
<b>Small</b>	<50	≤ 5 million TRY	≤ 5 million TRY
<b>Medium-sized</b>	<250	≤ 25 million TRY	≤ 25 million TRY

**Source: The Union of Chambers and Commodity Exchanges of Turkey.**

Although the headcount criterion is the same as in the European Union, there are noticeable differences in turnover and balance sheet total criteria. European Union standards are approximately twice higher than Turkish standards in the amount of turnover and balance sheet total (Varli, 2010).

According to the Turkish Statistical Institute, in 2014, there were 2,677,00 enterprises and 99.8% of all enterprises in the country were small- and medium-sized enterprises. 73.5% of employment in the country is dependent on the SME sector. Small businesses have a contribution of 53.5 % to value added. They also account for 54.1 % of all wages and salaries, 55% of total investments, 60.1% of total export, 62% of turnover and 24% of total loans. These statistics demonstrate the importance of small- and medium-sized enterprises for the Turkish economy. Moreover, the published statistics also show that small- and medium-sized enterprises contributed to economy more than large companies in 2014, seen below in Figure 19.

**Figure 25: Basic indicators by size class, 2014**



**Source: Turkish Statistical Institute, 2017**

The Figure 19 illustrates the number of businesses, number of employees hired, wages and salaries, turnover and value added at factor cost based on size of a company. It is evident from the chart that small- and medium-sized enterprises were more effective than large companies and contributed more to the Turkish economy in 2014. The number of small- and medium-sized businesses was 99.8% of all companies. Large companies, which only consisted of 0.2% of all enterprises, employed 26.5% of people, while the number for small- and medium-sized businesses was 73.5%. The amount of wages and salaries distributed by SMEs was more than half of all wages given. SMEs exceeded large companies also in turnover and value added with 62% and 52.5%, respectively.

According to the Ministry of Science, Industry and Technology of Turkey, the main problem of small- and medium-sized enterprises in Turkey is access to finance, which is caused by difficulties of banks in providing loans. Other problems are structural and managerial issues, acclimation to new technology, working with a low capacity, supply and stocking, information and technical assistance, marketing and competition, obstacles in investing, compliance with the Customs Union, inadequacy in legal regulations and other bureaucratic obstacles.

The targets and principles set out in the European Small Business Act are also priorities for the Turkish economy, and the structures and practices to be implemented are in line with these objectives and principles. With the SME Strategy and Action Plan that Turkey started to implement last year, they aimed to increase the production level of SMEs, the amount of investment and the added value, with high quality services and support. In 2008, the Small and Medium Enterprise Development Administration of Turkey (KOSGEB) was chosen as a national SBA coordinator of Turkey (Anahtar, 2012). Currently, there are several active programs of KOSGEB to improve the environment for SMEs and support them.

## **7.2 Overview of support programs for the improvement of SMEs**

### **Entrepreneurship Support Program (*Girişimcilik Destek Programı*)**

The purpose of the program is to support and promote entrepreneurship and create successful companies. Only entrepreneurs, small- and medium-sized enterprises and administrative organisations can benefit from the program. The program consists of applied entrepreneurship training, support for new entrepreneurs, Business Development Centre (İŞGEM) support and a business plan reward.

- Applied entrepreneurship trainings are free and open to anyone. Trainings last for 32 hours. Applied entrepreneurship trainings are conducted in accordance with the general objectives of the dissemination of entrepreneurship culture throughout the country and the establishment of successful enterprises, to aid entrepreneurs in gaining the knowledge and skills necessary for business establishment and management, to be aware of their own roles and responsibilities in this process and to acquire the knowledge and experience to prepare a business plan for their businesses.
- Small and Medium Enterprise Development Administration of Turkey funds some new entrepreneurs who attend their trainings in applied entrepreneurship trainings. Financial support can be up to 100 thousand TRY.



- The program will finance the establishment costs and expenses of Business Development Centre that provides business development coaching, access to support networks, access to financial resources, work place space, common office equipment and office services. The support is intended for municipalities, higher education institutions, private administrations, professional organizations and incubators.
- The Small and Medium Enterprise Development Administration of Turkey makes a competition among students taking applied entrepreneurship trainings and rewards the best business ideas, in order to foster entrepreneurial spirit among youth (Kosgeb, n.d. a).

#### SME Project Support Program (kosgeb, n.d. d)

The main goal of KOSGEB in executing this program is the establishment of a project culture and consciousness in SMEs, developing capacity of enterprises to make projects and the need for a flexible support system. They support projects up to 100.000 TRY through this project. Projects presented by businesses in areas of production, management-organization, marketing, foreign trade, human resources, finance and finance, information management and related areas are financially supported.

The project costs to be supported under the program are determined in the Call for Proposals and the Board decides on the project costs to be supported within a predetermined basis. However, real estate purchase, construction, refurbishment, vehicle purchase and leasing, personnel expenses and other costs that are not associated with the project, taxes, fees and social security contributions are not supported.

#### Teknopazar- Technological Product Promotion and Marketing Support Program (KOSGEB, n.d. f)

The Small and Medium Enterprise Development Administration of Turkey plans to increase the competitiveness of technology-based SMEs in international markets, to support mechanisms to commercialize the results of R&D and innovation projects and to support promotional and marketing activities for technological products. Duration of the program is 12 months. Within the scope of this Program, the upper limit of support is 150,000 TRY, which is non-refundable.

#### International Incubation Centre and Accelerator Support Program (KOSGEB, n.d. g)

The aim of this program is to support the establishment of international incubation centres and the participation of enterprises in the acceleration programs in order to make it easier for products to be brought to international markets, to increase the exports, to take domestic technology intensive start-ups into advanced entrepreneurial ecosystems and to carry out R & D and innovation activities in Turkey.

#### Emerging Business Market SME Support Program (KOSGEB, n.d. h)

The program aims to ensure that small- and medium-sized enterprises with development and growth potential are traded in the Stock Exchange Istanbul (BIST) Emerging Business Market and funds are provided from capital markets.

#### Thematic Project Support Program (KOSGEB, n.d. I)

The Thematic Project Support Program is designed to encourage SMEs to develop their businesses and stimulate professional organisations to prepare more projects in order to improve SMEs,

to meet the regional and sectoral needs in the thematic areas determined by taking into account the priorities indicated in the macro strategy documents and to ensure the compliance of SMEs with international legislation and priorities.

#### Interest Rate Support Program (KOSGEB, n.d. J)

With the Interest Rate Support Program, KOSGEB, provides financial support to small- and medium-sized enterprises in order to increase production, quality and standards, solve financing problems, create jobs and make it easier for businesses to compete internationally.

### **7.3 Turkish SMEs' Access to Finance**

SME lending has increased in the period after 2007, with only a small decrease of 1.6% during the global crisis. The latest statistics demonstrate that the number of SME loans grew by 16.6% in 2015. However, venture and private equity investments fluctuated over the years. Although the number of venture and private equity investments experienced a sudden rise, by 600% after 2008 until 2011, later it declined until 2015. However, venture and private equity investments went up slowly, and remained higher than their 2011 and 2013 levels. Non-performing loans (NPL) reached their maximum in 2009, at 8.28%. After 2009, there was a decline in the number of non-performing loans. Despite this, in 2015, the number of NPL among SMEs did not only rise, but also passed 2007 numbers. Moreover, the amount of bankruptcies increased between 2014 and 2015. OECD statistics show that in 2014, there were 99 bankruptcies but, in 2015, the number of bankruptcies increased to 108. Another key thing to remember is that the number of closures plummeted between 2014 and 2015, from 87,474 to 56,684, which shows that bankruptcies among SMEs of Turkey is not prevalent (OECD, 2017).

## 8. SMEs in the context of the Russia model

### 8.1 Classification of SMEs in Russia

According to Law 209-FZ, determining the size of businesses, being classified as small or medium depends upon meeting the criteria of ownership structure, workforce and volume of revenue, seen below in Table 7. As can be seen, these key components which are implemented in Russia are very similar with those seen in the EU. According to the rules regarding workforce, the number of workers should not exceed 250 people and the annual turnover should not exceed 25 mln EUR.

**Table 6: Classification of SMEs in Russia**

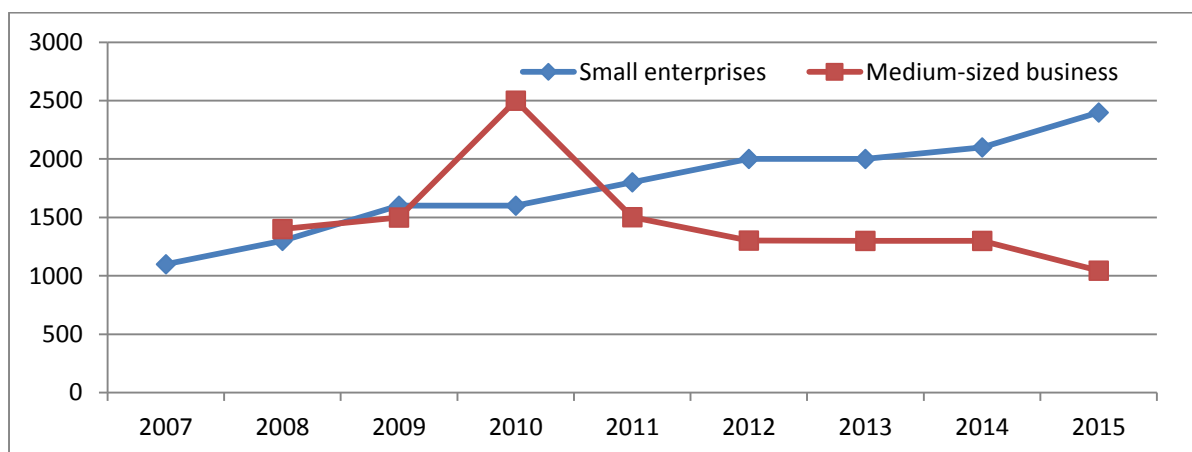
	Revenue (mln EUR)	Number of employees
Micro	< 1.5	<15
Small	1.5 – 10	15 – 100
Medium	10 – 25	101 – 250

Source: European Investment Bank, *Small and Medium Entrepreneurship in Russia, 2017*

### 8.2 The role of SMEs in the Russian Economy

Entrepreneurship in Russia has a long history, starting from merchants to modern businessmen. In Soviet times, small business was banned. According to the leading Communists, speculation was the enemy of the collective economy. Soon after the dissolution of the USSR, small- and medium-sized enterprises began to appear in modern Russia. The recent dynamics of the growth of small- and medium-sized enterprises can be seen in the following Table.

**Table 26: Amount of SME in Russia, 2007 - 2015**



Source: Russian Federation Federal State Statistics Service, *Russia in figures 2017*

According to Figure 20, we can say that small businesses have been steadily growing in Russia, the same which cannot be said of medium-sized enterprises. State support and special programs for small business development contributed to their growth. As for medium-sized businesses, there are problems of bureaucracy, multiple inspections from outside state structures and, of course, market conditions. Therefore, from year to year, the number of medium-sized enterprises in Russia is declining.

However, the state is thinking how to help and develop medium-sized businesses as dynamically as their smaller counterparts.

There are three groups of problems that are most deterrent to the development of small business and the creation of new small enterprises:

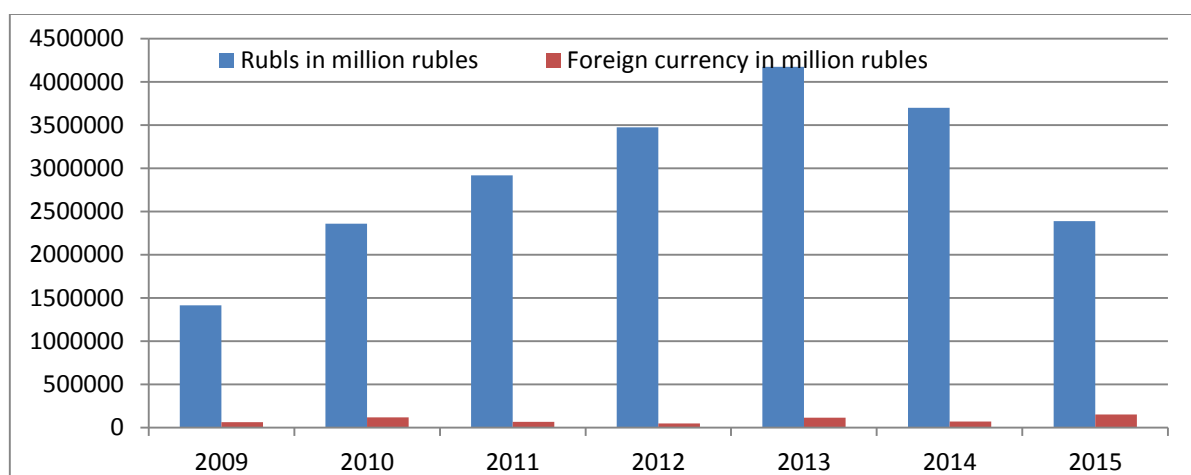
- Organizational problems (registration, legal registration of an enterprise, opening an account with a bank, etc.);
- material and financial problems (the formation of capital for the registration of the enterprise, the formation of seed capital to ensure the functioning of the enterprise, establishing links with suppliers of raw materials and marketing products);
- Factors of the external environment and market conditions (low solvency, reduced demand for products, tax press, lack of financial resources and instability of legislation).

A serious obstacle in the formation and development of entrepreneurial activity is the difficulty in obtaining loans, while commercial banks are reluctant to lend to small businesses. Additionally, there is a problem of lack of production and office space, which hinders the development of regional small businesses.

### 8.3 Access to finance

SMEs in Russia prefer to borrow in their national currency, as can be seen in Figure 21. There are several reasons why Russian small- and medium-sized enterprises prefer to borrow in their national currency: the high cost of credit in foreign currency and the frequent exchange rate fluctuations of foreign currency, in addition to the fact that most SMEs are related to the domestic market, and not external, in other words, poorly developed foreign economic activities.

**Figure 27: The volume of loans granted to small- and medium-sized entrepreneurs, top 30 Russian banks**

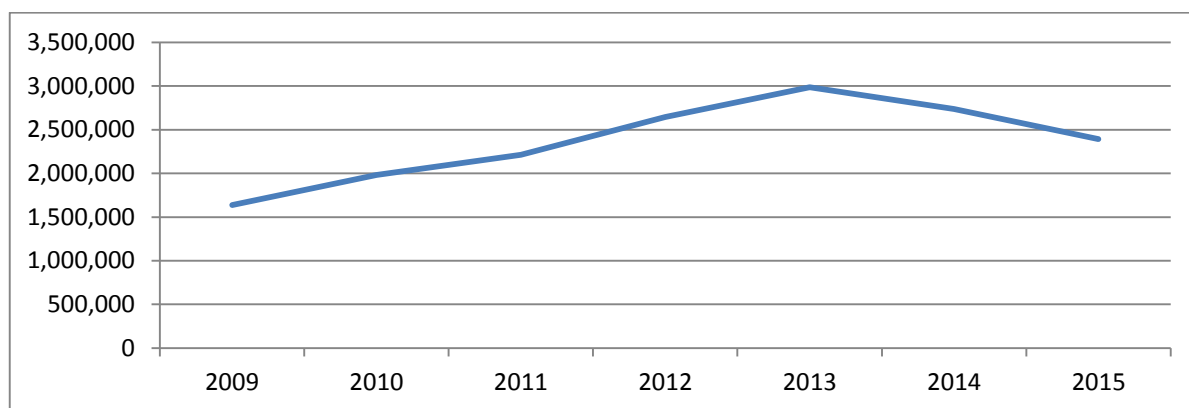


**Source: The Central Bank of Russian Federation, volume of loans granted to SMEs, 2017**

In the Figure 21 can be seen that, from 2009 to 2013, SMEs actively took loans from banks. In 2013, compared to 2009, the growth was 2.95% (in 2010 - 1.66%, 2011 - 2.06%, 2012 - 2.45%). However, starting in 2013, the number of loans issued in the national currency began to gradually

decline. In 2015, compared to 2013, there was a fall in the need for loans from SMEs by 42.7% (in 2014 - 11.3%). The reasons for the fall are sanctions, which limited the financing of the Russian banking system, and the resulting frozen foreign assets of the Central Bank and other Russian banks. One of the main reasons for the reduction in lending to SMEs is the reluctance of banks due to high debts of SMEs to banks. In other words, Russian SMEs have a bad credit history.

**Figure 28: Arrears on loans of small- and medium-sized entrepreneurs, top 30 Russian banks (mln RUB)**

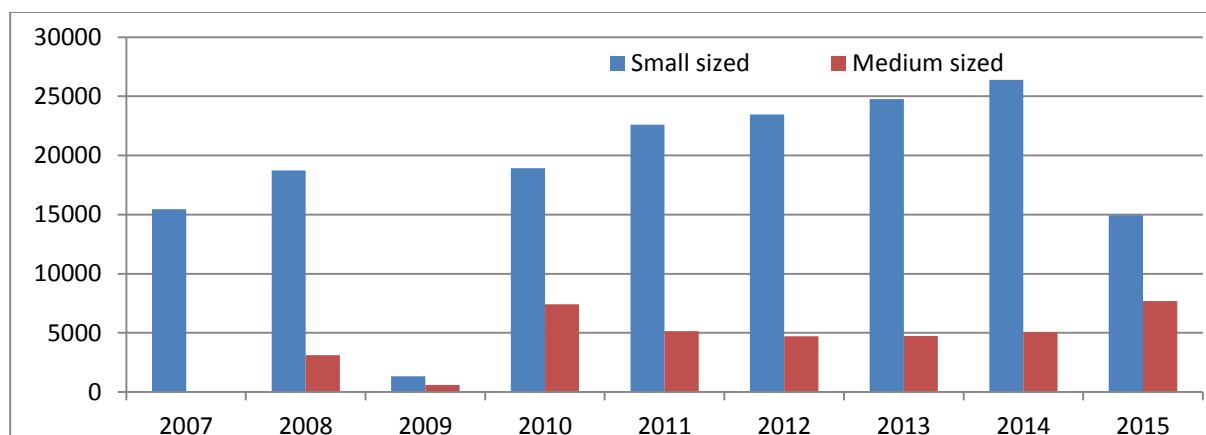


**Source: The Central Bank of Russian Federation, debt on loans to SMEs, 2017**

In the Figure 22, we see that in the period from 2009 to 2013, the credit debts of SMEs have steadily grown. In 2013, compared to 2009, the credit debts of SMEs to the 30 largest banks of Russia grew by 1.8% (2010 - 1.2%, 2011 - 1.3%, 2012 - 1.6%, respectively). Starting in 2013, the credit debts of SMEs to the 30 largest banks in Russia began to fall. In 2015, the credit debts of SMEs, in relation to 2013, fell by 19.8% (in 2014 - 8.2%). The reasons for the fall in debt can be the bankruptcy of SMEs, the restructuring of credit debts and government assistance programs for SMEs.

In comparison with the turnover of European and American SMEs, the turnover of Russian SMEs looks modest. However, the growth trend does not look bad (see Figure 23). As can be seen in the graph below, in 2009, the turnover of SMEs fell sharply. The reason for this was the 2008 financial crisis, which hit primarily the SME sector.

**Figure 29: Russian SMEs turnover, billion RUB**



**Source: Federal State of Statistics Service, Russia in figures 2017**

Considering the dynamics of growth until 2014, in relation to 2007, we can say that in 2014 there was an increase of 1.7% (2008 - 1.2%, 2009 - fall by 14%, 2010 - 1.2%, 2011 - 1.4%, 2012 - 1.52 %, 2013 - 1.6%). In 2015, there was a fall in comparison with 2014, by 43%. The reasons for this may be the impact of sanctions on the Russian economy, the devaluation of the ruble, the tightening of taxation, the growth of inspections by supervisory authorities, as well as the growth of pessimistic sentiment among SMEs.

In Russia, SMEs are broadening their range by exporting products like electronics and household goods. It is an undeniable fact that 13,500 of the companies in Russia are exporting approximately \$5 billion USD worth of goods; however, some development of export SMEs is being hindered by a lack of understanding of foreign markets.

The government in Russia decided to double the share of SMEs in the economy by 2030, and, therefore, according to entrepreneurs, it is essential to give public service to outsourcing, limit benefits for municipal unitary enterprises and support freelancers. The Ministry of Economic Development of the Russian Federation is preparing the strategy for the development of small and medium business up to 2030. As the first version of the plan says, the number of people employed by small and medium business should grow to 40 million people (today it is 17.8 million).

#### 8.4 Government policies for improving SMEs

State support for SMEs today is one of the priorities of the government of the Russian Federation. In order to improve the business environment at the regional level, by Order No. 147-r of January 31, 2017, 12 target models for simplifying business procedures were passed. These models will allow the subjects to form a "roadmap" to improve the investment climate in each area until the end of 2017.

**Table 7: "Roadmap" for the realization of SME support**

№	Name	Main areas of support for SMEs
1	Joint Stock Company "Federal Corporation for the Development of SME"	<ol style="list-style-type: none"> <li>1. Providing affordable financing;</li> <li>2. Expanding access to procurement of certain types of customers;</li> <li>3. Providing information and marketing support;</li> <li>4. Provision of property support;</li> <li>5. Providing legal support. (corpmsp.ru, 2017)</li> </ol>
2	Industrial Development Fund	<p>The Fund offers preferential conditions for co-financing projects aimed at developing new high-tech products, technical re-equipment and the creation of competitive manufactures on the basis of the best available technologies.</p> <p>To implement industrial and technological projects, the Fund on a competitive basis provides targeted loans at a rate of 5% per annum for up to 7 years in the amount of 50 to 700 million rubles, stimulating the inflow of direct investments into the real sector of the economy. (<a href="http://idfrf.org">idfrf.org</a>, 2017)</p>
3	Autonomous non-commercial organization "Agency of strategic initiatives"	<ul style="list-style-type: none"> <li>• Promotion of projects and initiatives of fast-growing medium-sized businesses and in the social sphere;</li> <li>• Development and increase in the number of leaders from medium-sized businesses and the social sector;</li> </ul>

	for the promotion of new projects"	<ul style="list-style-type: none"> <li>• Improving the entrepreneurial climate, creating a positive image of the entrepreneur and entrepreneurship in Russian society;</li> <li>• Promotion of professional competences development;</li> <li>• Formation and support of "new" youth management in social institutions;</li> <li>• Development of non commercial organizations in the social services sector, primarily budgetary. (<a href="http://www.investinregions.ru">www.investinregions.ru</a>, 2017)</li> </ul> <p>Key functions:</p> <ul style="list-style-type: none"> <li>• Support initiatives;</li> <li>• Project management: initiation and search, selection and promotion;</li> <li>• Development of the Agency network;</li> <li>• Elimination of administrative barriers;</li> <li>• Dissemination of best practices;</li> <li>• Management of changes in the regulatory framework;</li> <li>• Support of young professional groups.</li> </ul>
4	Fund for Assistance to Small Innovative Enterprises in Science and Technology	<ul style="list-style-type: none"> <li>• Implementation of the state policy of development and support of small enterprises in the scientific and technical sphere;</li> <li>• Rendering direct financial, informational and other assistance to small innovative enterprises implementing projects on development and development of new kinds of science-intensive products and technologies on the basis of intellectual property belonging to these enterprises;</li> <li>• Creation and development of infrastructure for supporting small innovative entrepreneurship;</li> <li>• Assistance in creating new jobs for effective use of the scientific and technical potential available in the Russian Federation;</li> <li>• Attraction of extra-budgetary investments in the sphere of small innovative entrepreneurship;</li> <li>• Training of personnel (including the involvement of young people in innovation activities). (<a href="http://www.fasie.ru">www.fasie.ru</a>, 2017)</li> <li>•</li> </ul>
5	Russian Agency for Insurance of Export Credits and Investments	<p>Strategic directions:</p> <ul style="list-style-type: none"> <li>• Insurance support for the export of goods and services of Russian production;</li> <li>• Development of a modern system of export financing secured by the insurance coverage of the Agency;</li> <li>• Insurance support of Russian investments abroad;</li> <li>• Support for export-oriented SMEs. (<a href="http://www.exiar.ru">www.exiar.ru</a> , 2017)</li> </ul>
6	Russian Export Centre	State Institute for Export Support, established in the structure of Vnesheconombank with the support of the Government of the Russian Federation. The Centre provides financial and non-financial

		support to Russian exporters in the "single window" mode - here entrepreneurs can get a full range of services from initial consultations to assistance in processing export transactions. ( <a href="http://www.exportcenter.ru">www.exportcenter.ru</a> ,2017)
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**Source: Chamber of Commerce and Industry of Russian Federation, 2017**

In addition to the 12 approved SME development models, there are federal development programs to support SMEs. Since 2005, the Ministry of Economic Development of Russia has been implementing a special program to provide subsidies from the federal budget to the budgets of constituent entities of Russia to provide state support to businesses at the regional level.

The program is implemented in accordance with the Resolution of the Government of the Russian Federation of January 30, 2014, No. 1605 "On the allocation and distribution of subsidies from the federal budget to the budgets of the constituent entities of the Russian Federation for state support of small- and medium-sized enterprises, including peasant (farmer) economies" (Resolution of the Government of the Russian Federation of January 30, 2014, No. 1605) and annually issued orders by the Ministry of Economic Affairs Development of Russia.

In 2015, in accordance with the Decree of the President of the Russian Federation "On measures for the further development of small- and medium-sized businesses" (Federal Law No. 156-FZ of June 29, 2015) and the Federal Law "On Amendments to Certain Legislative Acts of the Russian Federation on the Development of Small and Medium-Sized Enterprises in the Russian Federation"(Decree of the President of the Russian Federation of 05.06.2015, N 287), JSC "Corporation" SMEs ", which will operate as a state institution for the development of small and medium-sized businesses(Federal Portal of SME , 2017)



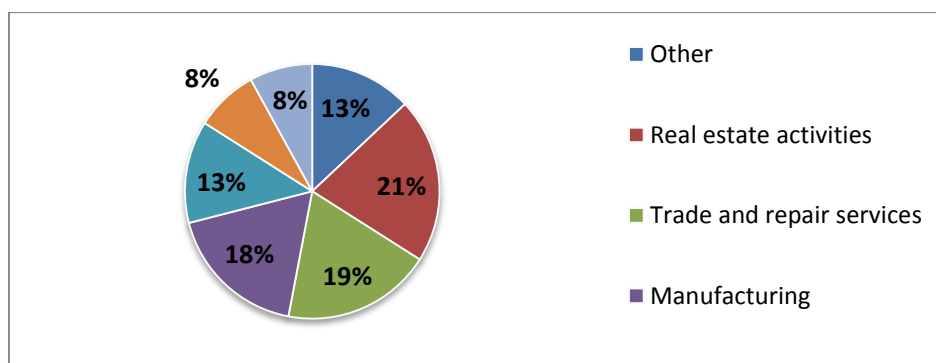
## 9. SMEs in the context of the Georgia model

### 9.1 Classification of SMEs

The definition of a SME differs from institution to institution in Georgia. Therefore, the compilation of statistics on SMEs comparable across sectors and establishments represents a challenging task. The National Statistics Office of Georgia classifies enterprises as small- or medium-sized if the number of employees does not exceed 100 and the average annual turnover is up to 1.5 million GEL. For taxation purposes, the status of a small business may be granted to a natural person whose gross income from economic activity during a calendar year does not exceed 100,000 GEL. As for the financial sector, measures for defining businesses by size are quite diverse among the several market players; some utilize total exposure to the client, turnover measures, annual sales or a combination of these (L. Gattini, 2016).

Today, Georgia is by far the most favourable place for doing business in the post-Soviet space. In Georgia, all the conditions necessary for doing business are created. The main spheres of activity of Georgian small and medium enterprises are tourism, agriculture, construction and others, as seen in Figure 24.

**Figure 30: Branches of small and medium enterprises of Georgia**



**Source: European Investment Bank, 2017**

Georgia currently has two definitions of SMEs, one set by Law on Georgian National Investment Agency and another in the Tax Code. The Tax Code is limited to micro and small enterprises owned and/or operated as self-employed enterprises. The main definition does not define micro-enterprises and does not include a balance sheet criterion, as seen in Table 9 (OECD/European Union/EBRD/ETF, 2015).

**Table 8: Classification of SMEs in Georgia**

Definitions of micro, small and medium enterprises in Georgia				
	Employment		Turnover	
	Definition 1	Definition 2 (for tax purposes only)	Definition 1	Definition 2 (for tax purposes only)
Micro		Self-employed (no hired labour)		≤ 30,000 GEL (12,465 USD)
Small	≤ 20 employees	Self-employed (no hired labour)	≤ 500,000 GEL (207,750 USD)	≤ 100,000 GEL (41,550 USD)
Medium	≤ 100 employees		≤ 1,500,000 GEL (623,250 USD)	

**Source:** Law of Georgia No. 519 of 12 June 2012, on the Georgian National Investment Agency; Tax Code of Georgia

**Note:** exchange rates as of July 2017

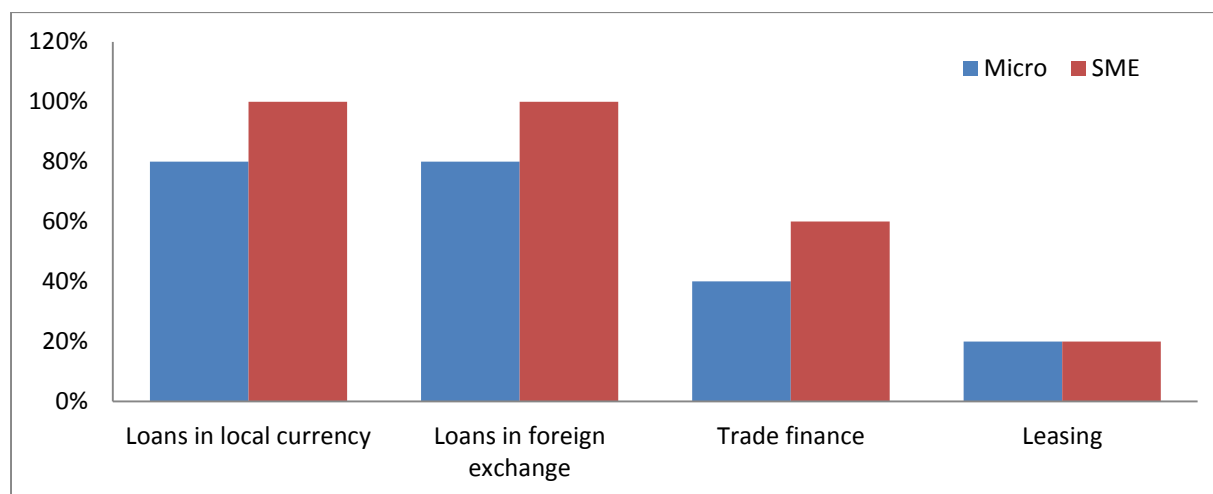
## 9.2 The role of SMEs in the Georgian economy

Today SMEs are the basis of the Georgian economy. SMEs make a significant contribution to Georgia's economy, making up 94,1% of enterprises, 42,7% of employment and 20,6% of value added in 2013 (OECD/European Union/EBRD/ETF, 2015). The role of SMEs is manifested in the fact that it is able to improve early mechanisms to be flexible and adapt quickly to changing conditions of the economy and the market.

### Credit Issues

The banking sector of Georgia is developing dynamically. In an effort to expand the economy and encourage entrepreneurship, the most optimal conditions for obtaining a loan and other financing options for small and medium-sized businesses are being created, as seen in Figure 24.

**Figure 31: Credit provided SME by Georgian Banks**



**Source: European Investment Bank, 2017**

However commercial banks do still apply more conservative and bureaucratic approaches. The most widely used instruments are loans, given their greater availability and simple characteristics. Almost all the banks considered provide loans to SMEs in both domestic and foreign currencies. Fewer banks offered trade finance products, but it was still relatively widespread. As for the leasing segment, it is largely undeveloped due to both supply- and demand-side factors; the lack of demand due to low awareness demotivates banks to expand in this segment. The private equity market is almost non-existent, with very few financial institutions offering it. Moreover, start-up companies (even with collateral) barely receive financing from banks. Most banks require at least three months of operational experience for the company to be eligible for a loan.

Commercial banks provide loans to SMEs either on a short-term basis, mostly for working capital, or long-term. Loans are offered both in local and foreign currencies; however, the availability of local currency loans is very limited, especially with longer maturities.

Georgia is a country with low tax rates and a transparent tax system. In total, there are 6 types of fixed taxes in Georgia<sup>7</sup>:

1. Corporate income tax (15%)
2. Value Added Tax (18%)
3. Excise tax
4. Personal income tax (income tax 20%)
5. Import tax (0%; 5%; 12%)
6. Property tax (Up to 1%).

In Georgia, there are no taxes on social security, capital gains, wealth or inheritance. Moreover, the tax code of Georgia enables companies to use accelerated depreciation of capital assets and transfers of losses for a subsequent period in respect of income tax (10 years). Therefore Georgia is attractive for investors and businessmen.

<sup>7</sup> As listed on [investingeorgia.org](http://investingeorgia.org), 2017.

### 9.3 Government support programs

In 2015, Georgia's government created new support programs for enterprises, titled "Produce in Georgia" ([enterprisegeorgia.gov.ge](http://enterprisegeorgia.gov.ge), 2015). This program aims to help get investment for 133 projects for a total cost of 355,600,000 GEL and contribute to opening 6,759 new job places. This program will affect all sectors of the Georgian economy.

**Table 9: Government investment**

Manufacturing government investment		Agricultural government investment	
Construction materials	26.5%	High Technology Greenhouse	25.3%
Paper and packing	15.9%	Animals and Birds Food Production	7.3%
Plastics	7.2%	High Technology Cattle Farm	22.1%
Metals	15%	Processing of Foods, Berries, Citrus and Vegetables	8.6%
Chemicals and pharma	8%	High Technology Poultry Farm	5.2%
Electric equipment	3.7%	Processing of Bay Leaf, Tobacco and Tea	6.3%
Other manufacturing	4.1%	Fish Processing	23.4%
Food and beverage	16.3%	Refrigerators and Agricultural Products	0.7%
Wood processing	1%	Nuts Processing	3.4%
Apparel and textile	2.4%	Total investment	102.4 mln. GEL
Total investment	253.2 mln. GEL		

**Source: Georgia Today. Government Program "Produce in Georgia" 2015 year in numbers, 2017**

As can be seen from Table 10, more than half of government investment will go to the industry sector and another part to the agricultural sector. Agriculture and industry are also divided into investment groups. According to these groups, we see what priorities the Georgian government has set and what spheres they consider important. As can be seen, the most important areas are construction materials, paper & packaging, food & beverage, metals, high technology greenhouse, high technology cattle farm, fish processing and etc.

According to Georgian authorities, these industries are important. It is for this that they are allocated huge grant funds for development. In addition to state support for Georgian SMEs, Georgian businessmen apply for financial support from the EU. The European Bank for Reconstruction and Development (EBRD) and the European Union (EU) are stepping up their support for businesses in

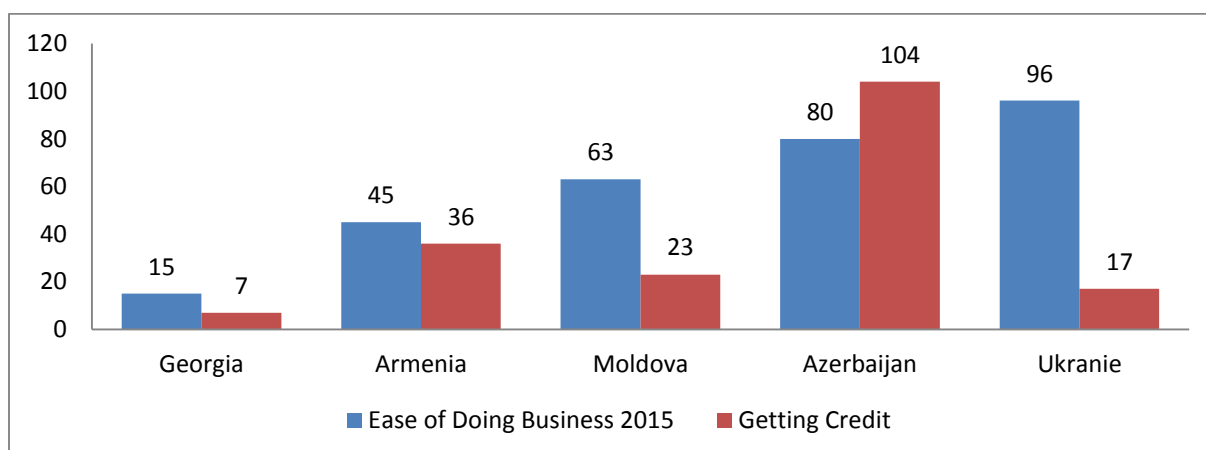
Georgia, with a joint program to help domestic small- and medium-sized enterprises (SMEs) converge with EU standards, so that they can take full advantage of the opportunities offered by the Deep and Comprehensive Free Trade Area (DCFTA) between Georgia and the EU (L.Martikian, 2016).

The establishment of a free-trade area is part of the EU's Association Agreement (AAs) with Georgia, signed in 2014. It will offer local firms access to the EU Single Market, the world's largest free-trade area, and help boost economic development and growth in Georgia (L.Martikian, 2016).

Under the agreement, the EBRD is extending a loan of around 220 million GEL (\$100 million USD equivalent) in a local currency financing package to the Bank of Georgia, in order to support the development of local SMEs. The financing facility is denominated in local currency and will be on-lent to the private sector; it includes DCFTA SME finance of up to \$50 million USD equivalent, SME finance of up to \$40 million USD equivalent, and Women in Business SME finance of up to \$10 million USD equivalent (L.Martikian, 2016).

The facility will help local SMEs invest in improvements to product quality and modernize their services to meet EU standards. This in turn will create an environment that is beneficial to cross-border trade and economic growth in Georgia. Despite the positive moments, Georgia lags behind its neighbours in the "Doing Business" 2015 rating.

**Figure 32: Doing Business, 2015**



**Source: Neighbourhood SME financing Georgia, 2017**

The data presented above is surprising for the reason that, in Georgia, bureaucratic processes have been minimized for the convenience of conducting and opening businesses. It can be inferred, therefore, that the development of small- and medium-sized businesses is hampered by a lack of business skills and inexperience, low levels of competitiveness, lack of access to finance and investment resources, insufficient knowledge of the international market, lack of opportunities for introducing new technologies and high costs, rather than bureaucratic considerations.

## Conclusion

In recent years, small- and medium-sized enterprises have become one of the main accelerators in economies around the world. Small- and medium-sized entrepreneurship support and promotion mechanisms have been widely used in recent years, due to their role in the development of a competitive economy, their positive impact on income distribution, poverty reduction and ability to rapidly react to changing market conditions. In this regard, a number of financial and non-financial incentive mechanisms are in place in the countries studied.

Extensive research demonstrates that the development of SMEs in Azerbaijan is not at the desired level, and their share in economic growth and employment is much smaller than in other developed and emerging economies. In developed countries such as those of the European Union, the United States and Asian countries, 98-99% of total enterprises are small- and medium-sized enterprises. Although in developing countries such as in Turkey and Russia, this figure is smaller, they still take an important place in the national economy. In regard to Azerbaijan, in the country, 83.30% of total enterprises are small enterprises, but this does not mean that the contribution of small business to the domestic economy is high enough. The reason is that, if we look at the share of small and medium entrepreneurship in gross domestic product, we can understand that Azerbaijan is still behind other developed and emerging economies.

This observation is supported by the fact that only 4% of the added value of the country belongs to small- and medium-sized enterprises and the remaining 96% is created by large, private and public enterprises. For comparison, about 50% of the value added in the United States, 57% in the European Union, 47.7% in Japan, 47.6% in South Korea, 56.5% in Malaysia, 43% in Georgia and 58% in Ukraine, are produced by SMEs. At the same time, there is a same situation in the share of small and medium enterprises in employment. In Azerbaijan, about 8.9% of total employment belongs to small- and medium-sized businesses. However, in other developing countries, the opposite is observed. In Turkey, Russia and the US, this share is 76%, 23% and 50%, respectively, and in the EU, this number is approximately 67%. The share of the SMEs in employment is more than 80% in several Asian countries, such as South Korea, the Philippines and Thailand. Around 49% of Azerbaijani small- and medium-sized enterprises are concentrated in wholesale and retail trade. By contrast, the share of small and medium enterprises in production areas is relatively low while 1.8% of SMEs are engaged in agriculture and 2.3% in industry. However, in various EU countries, the main area of employment of small and medium enterprises is related to construction, real estate and public catering.

there are several constraints hindering SME development in Azerbaijan. These impediments include the high level of centralization of SMEs in the Absheron district, non-diversified access to finance, limited access to markets, legal constraints and a lack of entrepreneurial skills. Entrepreneurs suffer from a lack of professional skills trainings for understanding market requirements, which impedes their business's growth. Access to finance is one of the most rigid problems in Azerbaijan for SMEs; generally, in their current situation, most banks are not willing to give loans to SMEs while they are perceived more as potential risks than profitable investments. At the same time, the weak development of other incentive mechanisms also prevents the successful functioning of SMEs in the country. For instance, microfinance institutions, which are considered the main pillars of small entrepreneurship in other countries, have not been properly developed in Azerbaijan, as well as a clear lack of wide-ranging venture capital, loan guarantee programs also common in world practice. According to the "Doing Business" report published annually by the World Bank, in 2016, although Azerbaijan ranked fifth in

terms of starting a business, it took one of the last places in availability of getting credit. This is the main reason why small- and medium-sized businesses in the country do not develop at a desired level.

Nevertheless, several orders in manner of avoidance and mitigation of obstacles facing SMEs have been accepted. Some state programs have been implemented in the country by the Baku Business Training Centre (BBTC), National Fund for Entrepreneurship Support (NFES) of the Republic of Azerbaijan, Azerbaijan Investment Company (AIC) and Azerbaijan Export and Investment Promotion Foundation (AZPROMO). Another relevant initiative, the ABAD project, which was established in the ASAN service last year, is one of the most important steps taken for the development of small- and medium-sized businesses in the country. However, real statistical data and an in-depth analysis of SMEs' increasing role in the national economy don't show effective outcomes. For instance, although several superfluous laws were abolished by the president, survey data among local entrepreneurships has still shown significant uncertainty about the implementation of laws by government representatives and structures.

Given the above, it can be concluded that although SMEs have not developed properly in Azerbaijan, certain steps are already being taken to change this – these steps are mainly related to the simplification of business registration procedures and improvement of tax administration. However, based on statistical indicators, we can say that these steps are still not satisfactory and through taking advantage of world experience, it is necessary to implement more incentive methods. Recommendations to be considered for the greater development of SMEs in Azerbaijan are enumerated in the following section..

## Recommendations

### 1. *Improving Statistic data on SMEs.*

Currently, there is not sufficient and accurate information in national databases to identify entrepreneurs' development dynamics and compare them with other countries. Therefore, reports of the State Statistical Committee and other state bodies must be compiled in accordance with the classification of entrepreneurship subjects prepared by the Cabinet of Ministers of the Republic of Azerbaijan.

### 2. *Access to Finance*

2.1. *A differentiated credit policy (DCP)* – DCP is a credit policy which considers the economic conditions of different regions and the categories of SMEs in the distribution of credit. This policy will help to balance the interest rates of bank loans to certain categories of SME (start-ups, businesses in the agricultural sector, innovative enterprises, etc.) that are needed, developed and maintained as the future support of economic stability of the country. Similarly, the policy of the DCP, considering the economic conditions of the regions, will help stabilize market demand and supply, both in the regions themselves and in the country as a whole.

Implementation mechanisms:

1. Individual approach to each manufacturing sector, being especial conscious to involve regional SMEs;
2. Implementing lower interest rates for loans to regional SMEs, in order to support small- and medium-sized businesses in the regions;
3. The interest rates on loans given to start-ups should differ from those granted to SMEs, because start-ups need for initial capital is critical. In order to stimulate and expand start-up activity, the application of different loan interest rates is considered necessary;
4. Apply loan rates to start-ups less than 6% ANFES maximum interest rate;
5. Identify several criteria for start-ups while giving loans;
6. differential loans should be given to start-ups, making up certain percentages of their projects.

2.2. *Application of the Loan Guarantee Fund* – The recently created Loan Guarantee Fund will provide guarantees for loans issued to SMEs.

Implementation mechanisms:

1. SMEs apply to the Loan Guarantee Fund with their business plans and requested loan amount;
  2. The Loan Guarantee Fund evaluates the business plans of entrepreneurs and, after deciding that the project will be effective, it gives a guarantee to the entrepreneurs to present to banks;
  3. The SMEs apply to the bank with this guarantee paper and, through this guarantee, the entrepreneur can easily get loans from banks without any collateral. The reason is that this loan amount will be converted into non-risk loans for the bank. At the same time, this guarantee can stimulate banks to offer lower interest rates;
  4. SMEs give a certain fee in return for Loan Guarantee Fund services;
- It is planned that the Fund will primarily provide loans in local currency.
- It will be important to ensure that export-oriented loan repayments are provided in the first instance of application.



- The Loan Guarantee Fund will provide guarantees also for areas with higher levels of beneficiary, for example mechanical engineering and the processing of agricultural products
- The charter capital of the Fund will be formed at the expense of public funds. Later, the stock will attract real money from financial markets. Grants and concessional loans may also be the main source of funding for the fund
- The guarantee should cover the total amount of the principal loan.

2.3. *Compensating a certain percentage of loan interest rates by government* - Based on the US's experience, implementing this mechanism in Azerbaijan would address the problem of a lack of financing options for SMEs. Banks would be happy, while their lending interest rates could increase and it would be in the interest of entrepreneurs, while they would more easily be able to get loans from banks.

- An order should be issued for the application of compensation of interest rate
- The rules for the application of compensation of loan interest rates should be approved
- This mechanism is planned to be implemented by the Republic of Azerbaijan Ministry of Economy
- The amount of compensation is planned to be between 7-10% (According to the Central Bank's report in May 2017, the interest rate offered individuals is 16,08% and the interest rate offered by National Fund for entrepreneurs is 6%. However, very few entrepreneurs use the opportunity of the National Fund to help entrepreneurs. From this point of view, the assets of commercial banks should be involved in the financing of the real sector strengthen the financial resources of small and medium sized entrepreneurs. The main purpose of the proposed interest rates is to ensure cost-sharing between loans received from commercial banks and loans received from the National Fund for Entrepreneurship Support)
- Compensation is planned towards specific areas with higher levels of future perspectives (light industry, processing of agricultural areas, mechanical engineering)

*Mechanism:* SMEs apply to the bank for a loan with their business plan. After being offered an interest rate, entrepreneurs will apply to the Ministry of Economy for compensation of loan interest rate with the condition of reporting interest and amount of interest rates and business plan. After the Ministry's evaluation, entrepreneurs will be notified of the outcome. This whole process will be available via internet portal.

2.4. *Hedging of currency risks* – Currency risk hedging is risk insurance against financial losses as a result of unfavorable changes in exchange rates. Hedging is designed primarily to protect companies that carry out foreign economic activities and service foreign currency loans. In order for hedging to become a popular phenomenon in Azerbaijan, it is recommended not to impose a tax on hedging transactions. In most European countries where hedging is popular, only the profit gained from this type of transaction is taxed.

2.5. *SME Mutual Guarantee Network*

Poor payment histories and low repayment capabilities motivate banks to avoid giving loans to SMEs. In order to counter this, a common guarantee network can eliminate these issues. Also, this sort of grouping would allow SMEs to take part in the formation of equity and in the management of the network.

- The Mutual Guarantee Network will not only ease SME's problems accessing finance, but will also enhance SMEs' financial structures and may provide an advisory and consulting service to them. In return, members will pay a certain fee to sustain the Network.
- The Mutual Guarantee Network can be awarded as a tax-free status.

Examples of success mutual guarantee networks are seen in Italy (Confidi), Spain (Sociedades de Garantia Reciproca – SGR) and France (Société de Caution Mutuelle Artisanale).

### **3. Access to Market**

3.1. Farmer Markets – or special places where farmers can sell their own goods without barriers. This type of market should help small enterprises in the agricultural sector sell their products more easily, without expenses for transportation, storage and processing. Advantages of such types of markets are that they have a lot more products with a greater selection, due to the fact that numerous vendors gather to sell their wares.

In order to promote Farmer Markets, the following changes should be enacted:

1. The city administration should allocate promising places for the Farmer Markets;
2. Small and medium sized entrepreneurs should be given tax holidays for 1 year (to help understand what advantages and disadvantages small entrepreneurs will have and what the government should do to solve the disadvantages);
3. Goods segmentation will help SMEs improve goods' quality, increase potential income, correctly divide recourses, improve customer service and etc.

3.2. Interactive platform for SME trading – a platform where manufacturers and consumers could meet via the Internet. This platform would more easily provide: customers with information about goods, the exchange of goods and services between regions, increasing money turnover in the market and etc.

Mechanism of realization:

1. Develop an interactive trade platform for SMEs detailing changes in legislation, where the rights and duties of participants will be indicated;
2. Participation of the Ministry of Information Technologies to ensure the security and smooth operation of this platform;
3. Bank participation for hedging consumers and customers, like PayPal system;
4. Creating a simplified registration system (Company name, phone number, address, account, taxpayer identification number, bank account, etc.).

### **4. Logistics**

Logistic is a major consideration for SMEs. The main purpose of logistics is to develop an itinerary for goods within the shortest time possible and at a minimum cost. Tariffs for cargo transportation for local entrepreneurs are still high. The problems of high cargo transportation rates are caused by expensiveness and underdevelopment of infrastructure and high oil costs.

Mechanism of solving the problems:

1. Setting of certain tariffs for transportation to certain categories of goods (essential goods, seasonal goods and etc.);
2. Free transportation of passengers to the locations of fairs on public holidays

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