

Suggested citation:

Gongeta, S. (2016). Regulatory framework as the primary reason for (no) internationalization of SMEs. In: M. Kosała, M. Urbaniec & A. Żur (Eds.), *Entrepreneurship: Antecedents and Effects* ("Przedsiębiorczość Międzynarodowa", vol. 2, no. 2). Kraków: Cracow University of Economics, pp. 247-256.

Regulatory framework as the primary reason for (no)internationalization of SMEs

Sanja Gongeta

College of Applied Sciences "Lavoslav Ružička" in Vukovar
Županijska 50, 32000 Vukovar, Croatia
e-mail: sanja.gongeta@gmail.com

Abstract:

The objective of this article is to identify the barriers in regulatory frameworks that affect SMEs and entrepreneurs' participation in the international markets. The idea was to analyse how regulatory framework affects an internationalization of Small and Medium Enterprises (SMEs). Member states differ significantly in the way in which they regulate the establishment of new businesses. The reduction of legal burden in European Union is a top-priority not only for the European Commission but also for national legislators. A competitive and dynamic economy requires an adequate regulatory framework so a business friendly environment for existing and potential small and medium-sized entrepreneurs must stay one of the European Union's main objectives. The contribution of this article is to analyse how regulatory frameworks affect the internationalization of Small and Medium Enterprises (SMEs) and suggest ways to overcome the barriers to SMEs and entrepreneurs' participation in the international markets.

Keywords: small and medium-sized enterprises (SMEs); regulatory framework; internationalization; legal form; freedom of establishment

JEL codes: K2, K20

1. INTRODUCTION

European internal market and globalization process have erased the barriers of trade, developed competitive environment and made significant changes on entrepreneurial enterprises. Theory defines business enterprises in terms of small and medium enterprises (SMEs) on the one hand and large enterprises on the other. With their specifics, SMEs differ significantly from large enterprises.

According to the latest Annual report on European SMEs of European Commission, small and medium-sized enterprises (SMEs) represent more than 90% of all businesses in the EU, and form the backbone of a European Union's economy.¹

¹ Same Annual Report shows that in 2014 SMEs accounted for 99.8% of all enterprises in the non-financial business sector in the EU28. For every km² of land surface, the EU has an average of five SMEs. Moreover, in 2014 SMEs employed almost 90 million people – 67% of total employment, and generated 58% of the sector's value added.

The market for small and medium-sized enterprises (SMEs) worldwide plays a key role in shaping and developing the economy (Rozstek, 2015). Support for SMEs is one of the European Commission's priorities for economic growth, job creation and economic and social cohesion (McLaughlin, 2013, p. 29). On average about 13% of all SMEs in the European Union invest abroad but due to their size, SMEs realize additional challenges when doing business abroad (Eckard & Kerber, 2013, p. 3).

Considering Internationalization as an important means of enhancing SMEs' long-term growth and survival, the objective of this article is to identify the legal and administrative barriers in regulatory frameworks that affect SMEs and entrepreneurs' participation in the international markets. The reason for studying regulatory frameworks impact on the internationalization SMEs is the fact that the regulation of entry, as one part of the Economic regulations, is in the TOP 10 burdensome EU laws identified by SMEs (European Commission, 2013).

The structure of the article is as follows. After defining small and medium enterprises (SMEs), in section three, the article analyses the role of SMEs in national and international economy and detects administrative and legal burdens for internationalization process of SMEs. As earlier said European Union's regulatory framework for small and medium enterprises showed to be one of the burdens for internationalization of SMEs and many Member States already adapted their legislative frameworks to the requirements of entrepreneurs.

For the purpose of this article, author compares existing empirical studies on how the regulation of entry affects doing internationally business of SMEs and in addition, author does a descriptive overview of SMEs Exporting Landscape in selected countries.

The contribution of this article is to analyse how various European regulatory frameworks affect the internationalization of Small and Medium Enterprises (SMEs) and to suggest ways to overcome the barriers to SMEs and entrepreneurs' participation in the international markets. Conclusion brings analysis of the latest European Commission's regulation proposal for business friendly regulatory framework.

2. MATERIAL AND METHODS

For the purpose of this article, it is made a descriptive overview of small and medium sized enterprises role in national and international economy through the number of employees in SMEs and their contribution in national and European Union's GDP. The EU Commission, Eurostat and data available in recent literature are used in the article. For the definition of small and medium sized enterprises qualitative and quantitative methods are used. Then, the author analyses and compares the theoretical literature to identify regulatory burdens for small and medium sized enterprises internationalization but also to answer the question does the legal form effects the internationalization of SMEs.

At the end, the article analyses the latest European Commission's regulation proposal for business friendly regulatory framework.

3. LITERATURE REVIEW AND THEORY DEVELOPMENT

There are two main strands of literature dealing with the problem addressed in this article: the literature on SME internationalization and the literature on corporate law. The literature on SME internationalization mostly deals with defining SMEs and reasons pro and contra internationalization of SMEs (Singer & Alpeza, 2015; McLaughlin, 2013, Calabro et al., 2009; Mohanty & Nandi, 2010; Molyneux, 2015). The literature on corporate law deals with legal forms of SMEs² and legal burdens for internationalization of SMEs (Becht et al., 2008; Djankov et al., 2002; Djankov, 2009; Eckardt, 2014, Purnhagen & Rott, 2014). The article is in the spirit by Becht et al. and Djankov et al. (2008) as well as by Eckardt (2014). Becht et al. (2008) studied how the decisions of entrepreneurs of where to incorporate affects deregulation of corporate law, while Djankov (2009) presents data on simplifying entry regulation of entry in 116 countries.

The main hypothesis thus states that friendly regulatory frameworks have a positive impact on internationalization of SMEs and that countries with low cost of business entry are more attractive for entrepreneurs. (H1) First, to define small and medium sized enterprises, it is necessary to make survey of the literature on SME internationalization and then the literature on corporate law.

Table 1. Classification criteria of micro, small and medium-sized enterprises

Enterprise category	Number of employees	Annual turnover (EUR million)	Annual balance sheet total
	EU/Croatia	EU/Croatia	EU/Croatia
Micro	< 10	≤ 2	≤ 2
Small	< 50	≤ 10	≤ 10
Medium-sized	< 250	≤ 50	≤ 43

Source: adapted from: Singer & Alpeza (2015); McLaughlin (2013); OECD (2005, p. 17).

There are similar definitions of the term SME. The European Union defines SMEs as micro, small and medium sized enterprises' (making it an odd abbreviation since the introduction of the 'micro' category) (European Union, 2003, p. 36). The three criteria used by the EU to assess whether an enterprise is micro, small or medium-sized are the number of employees (or headcount), the annual turnover (the sum received for goods and services in a year) and the annual balance sheet total (the total value of the assets or property of the enterprise, less the amount it owes), (McLaughlin, 2013, p. 29; Singer & Alpeza, 2015, p. 11). Table 1 shows classification criteria of small enterprises in European Union and Croatia³ as the small and open economy and the youngest European state member.

² With special accent on Limited liability legal form.

³ Criteria for classification of entities in the small and medium enterprise sector in Croatia are defined by the *Accounting Act* (Official Gazette, NN 109/07, 54/13) and the *Small Business Development Promotion Act* (Official Gazette, NN 29/02, 63/07, 53/12, 56/13).

According to above-mentioned criteria, a micro enterprise is defined as an enterprise that employs fewer than ten persons and whose annual turnover and/or annual balance sheet total, does not exceed two million EUR.

A small enterprise is defined as an enterprise that employs fewer than 50 persons and whose annual turnover and/or annual balance sheet total, does not exceed ten million EUR. A medium-sized enterprise is defined as an enterprise that employs fewer than 250 persons and whose annual turnover does not exceed 50 million EUR or whose annual balance-sheet total does not exceed 43 million EUR.

3.1. THE ROLE OF SMES IN NATIONAL AND INTERNATIONAL ECONOMY

Small and medium sized enterprises play significant role in national and international economy. Despite last financial crises, employment in the SME sector remains positive and it can be said that in the twenty-first century to date, in the EU, new jobs have been created primarily by SMEs, not by large companies.⁴

In the European Union, SMEs account about 99% of all business enterprises and 67% of all employment. McLaughlin (2013, p. 29) represents data that this figures in the UK are 99.9% and 59%, although, pointing out that we must take care in interpreting the figures, as they are not directly comparable due to different underlying methodologies used to compile them. Similar data brings Buliga (2014, p. 5) saying that 99% of all German enterprises are small and medium-sized and they employ about 60.7% of the working population. According to the German Federal Ministry for Economic Affairs and Energy and „AG Mittelstand“, SME sector in Germany created a total of 250 000 new jobs in 2014 (Federal Ministry for Economic Affairs and Energy, 2016).

Table 2 is overview of SMEs in the private business sector, number of their employees and value added in selected European countries in context of SMEs role in national economies.

As seen from the statistics, Small and medium sized enterprises create most of all new jobs in Europe, and they contribute significantly to economic growth.

The good condition of SMEs affects the state of the overall economy both locally and globally (Rozstek, 2015) Globalization has faded the barriers of trade and development and made a competitive environment for SMEs (Mohanty & Nandi, 2010). Many SMEs have discovered that online sales present opportunities for exporting and are finding innovative logistical solutions to reach global customers (UPS, 2014, p. 7). Table 3 brings out an overview of SMEs Exporting Landscape in selected countries.

⁴ According to the Annual Report of European SMEs 2014/2015, the tentative green shoots of growth of 2013 gained in strength in 2014. Namely, in 2014 EU28 SME value added grew by 3.3% and employment by 1.2%, while in 2013 value added grew by 1.6% and employment declined by 0.5%. However, not all Member States shared the positive 2014 experience – SMEs in Cyprus, Sweden, Croatia, Greece, Italy and the Czech Republic showed a decline in value added, which in the case of Cyprus and Italy was also accompanied by a reduction in employment.

As it can be seen, small and medium sized enterprises in Belgium, the United Kingdom, and the Germany send the highest number of shipments outside the European Union. The United States is the most likely export country destination for

Table 2. SMEs and national economy in 2015

Country	Criteria	SMEs (in all businesses)	National employment	Value added
Austria		99.7	67.7	61.2
Belgium		99.8	69.3	61.4
Germany		99.5	62.7	54.4
Croatia		99.7	67.9	54.1
Italy		99.9	79.6	69.5
Poland		99.8	50.0	68.8
Slovenia		99.8	72.7	63.0
United Kingdom		97.7	51.0	53.0

Source: own study based on: Singer & Alpeza (2015); European Commission (2015).

SMEs shipping outside Europe. Among those exporting outside Europe, 53% are exporting to the United States, 49% to countries in Europe outside the EU and 47% to Asia. The United States is the top-ranking export country for SMEs in the UK (54%), Belgium (40%), and Italy (40%). (UPS, 2014, p. 11)

Table 3. The number of SMEs shipping

Country	Inside EU / %	Outside EU / %	Total / %
Belgium	96	75	171
Germany	81	14	95
Italy	16	4	20
Poland	18	1	19
United Kingdom	90	43	133

Source: adapted from: UPS (2014, p. 10).

3.2. INTERNATIONALIZATION OF SMES

Internationalization has been defined as “the process by which firms both increase their awareness of the direct and indirect influence of international transactions on their future, and establish and conduct transactions with firms in other countries” (Bearnish, 1990, p. 77, in: Calabro et al., 2009, p. 395). Traditionally, way of making individual companies present worldwide was export and import. Another ways of internationalization SMEs are alliance or subsidiaries and branches and joint ventures abroad (Mohanty & Nandi, 2010; European Business Development Group, 2016).

Thinking about the internationalization of SMEs, the question is what are the motives for internationalization of SMEs? Many SMEs view Europe as the new domestic market and are now looking for markets further afield. Therefore, we can say that access to new and larger markets is the main reason for internationalization

by SMEs that export or have establishments abroad. For SMEs that have only imports, this access is not a more frequent motive than access to know – how and technology, or high production costs on the domestic market. Still, not of all SMEs tend to be international and there are two main reasons for that. One of the reasons for no internationalization of SMEs is the fact that external barriers are too high.

Currently, there are 21 million SMEs in Europe, and even though 25% of European SMEs export to countries within the European Union, only 13% does business outside the European border. Speaking about burdens, they can be divided in internal and external. For the purpose of this article, the focus is on external burdens only.⁵

The regulation of entry, as one part of the Economic regulations, is in the top ten burdensome EU laws identified by SMEs.⁶ Last global financial crisis has brought changes in Europe's financial regulatory framework that also led to financing problems for SMEs. Their situation further complicates the European economic crisis, which led to a fragmentation of financial markets in the euro area. Belke and Verheyen (in: Calciano et al., 2015) deal with the new tools for the financing of SMEs, which face problems such as information asymmetries, when trying to access funding.

3.3. REGULATORY FRAMEWORK AS BURDEN FOR INTERNATIONALIZATION OF SMES

Countries differ significantly in the way in which they regulate the entry of new businesses⁷ (Djankov et al., 2002). Size, to some extent, determines the legal rules applicable to a company registered under the Companies Acts and to an LLP.⁸ (McLaughlin, 2013)

As earlier said, registration (or cost of entry), as one part of the Economic regulations, is in the top ten burdensome EU laws identified by SMEs. When surveying the regulation of entry Djankov et al. (2002) came to the following conclusions: The number of procedures required to start up a firm varies from the low of two in Canada to the high of 21 in the Dominican Republic, with the world average

⁵ Available results show that more than 30% of the internationalized SMEs perceive no internal barriers for the internationalization process at all.

⁶ The following EU laws have been identified by SMEs as the TOP 10 most burdensome EU laws: REACH (Registration, Evaluation, Authorisation and Restriction of Chemicals); VAT – Value added tax legislation; General Product Safety and market surveillance package; Recognition of professional qualifications; Shipments of waste – Waste framework legislation – List of waste and hazardous waste; Labour market-related legislation; Data protection; Working time; Recording equipment in road transport (for driving and rest periods); Procedures for the award of public contracts (public works, supply and service contracts); Modernised customs code.

⁷ To meet government requirements for starting to operate a business (in 2002.) in Mozambique, an entrepreneur had to complete 19 procedures taking at least 149 business days; an entrepreneur in Italy needed to follow 16 different procedures, and wait at least 62 business days to acquire the necessary permits. In contrast, an entrepreneur in Canada could finish the process in two days and completing only two procedures.

⁸ The Companies Act 2006, for example, applies less rigorous public disclosure and audit requirements to small and medium-sized companies, as those terms are defined in the Companies Act 2006 (as amended and supplemented by the Companies Act 2006 (Amendment) (Accounts and Reports) Regulations 2008 (SI 2008/393).

of around ten.⁹ The minimum official time for such a start-up varied from the low of two business days in Australia and Canada to the high of 152 in Madagascar, assuming that there are no delays by either the applicant or the regulators, with the world average of 47 business days. A large academic literature has followed: 201 academic articles have used the data compiled by Djankov et al. (2002) and subsequently by the World Bank.

Simplifying entry regulation has been a popular reform since the publication of Djankov et al. (2002). In the context of burdens to the internationalization of SMEs, it should be noted that 193 reforms took place in 116 countries (Djankov, 2009, p. 183).

Limited liability legal form plays an important role in supporting entrepreneurial activities. Private limited enterprises account for nearly 60% of all SMEs in the EU-28. SMEs react to incentives resulting from differences in minimum capital requirements in different member states (Eckardt, 2014). Some of significant regulatory reforms of corporate law, made for that reason, were those in United Kingdom's Company Act 2006, Germans "Gesetz betreffend die Gesellschaften mit beschränkter Haftung (GmbHG)" in 2008, but also the other European countries such as Spain, Austria, France and Croatia. The reforms were in field of company law and regulation of the most used legal form SMEs – Private limited company (Ltd.).¹⁰ Becht et al. (2008) as well as Eckardt and Kerber (2013) found empirical evidence that companies migrate to member states with lower costs of establishing a limited liability enterprise.

To this end, through the Small Business Act¹¹, European Commission proposed a number of measures to support SMEs in general as well as concerning internationalization (Eckardt, 2014). Knowing that SMEs can thrive best in a business environment in which regulation respects the specific needs of SME, the European Commission has put the interests of SMEs into the core of its smart regulation agenda. The Commission follows the "Think Small First" principle, which requires that impacts on SMEs be taken into account when designing legislation and that the existing regulatory environment be simplified so that SMEs find it easier and cheaper to comply with regulatory requirements (MEMO/13/68). One of the latest documents for business friendly environment is Regulatory Fitness and Performance Programme (REFIT), which implement 164 initiatives for simplification and regulatory burden reduction identified by the European Commission.

⁹ The survey contained data on the regulation of entry of start-up firms in 75 countries including numbers of procedures, official time and official cost that a start-up must bear before it can operate legally.

¹⁰ German: Gesellschaft mit beschränkter Haftung (GmbH), Croatian: društvo s ograničenom odgovornošću (d.o.o.).

¹¹ The Small Business Act (SBA) is an overarching framework for the EU policy on Small and Medium Enterprises (SMEs). It aims to improve the approach to entrepreneurship in Europe, simplify the regulatory and policy environment for SMEs, and remove the remaining barriers to their development.

4. DISCUSSION

SMEs with international business show a significantly better performance in job creation, turnover growth and to innovation related activities. Statistics show that on average 44% of SMEs in the 28 European Union member states are engaged in international business activities in some form or another. Descriptive overview of SMEs exporting Landscape in selected countries showed that exports outside the European Union lead Belgium, the United Kingdom and the Germany. In all of these international SMEs, 90% are micro enterprises, 8% are small enterprises and 2% are medium-sized enterprises (Eckardt, 2014).

In doing business, entrepreneurs select countries with business friendly legal framework. The regulation of entry, as one part of the Economic regulations, is in the top ten burdensome EU laws identified by SMEs. Reducing the regulatory burden on smaller firms is the first step in making business friendly environment for SMEs. As Eckardt (2014) points out, SMEs react to incentives resulting from differences in minimum capital requirements in different member states. Becht et al. (2008) and Eckardt and Kerber (2013) found empirical evidence that companies migrate to member states with lower costs of establishing a limited liability enterprise.

Although many Member States already adapted their legislative frameworks to the requirements of entrepreneurs, simplifying the legislation and reducing the regulatory costs on the European level is necessary in order to achieve a clear, stable and predictable regulatory framework that will support economic growth and job creation.

In accordance with the REFIT, and to implement the SME initiatives and reforms, countries are reducing paperwork and bureaucracy, minimising administrative burdens and reducing compliance costs for SMEs. Still, all reforms should be made with great caution. Researches show that the best economies are not those with little regulation but those with good rules that allow efficient and transparent functioning of businesses and markets while protecting the public interest.

5. CONCLUSIONS

Small and medium sized enterprises form the backbone of national and European economy. European internal market and globalization process have erased the barriers of trade, developed competitive environment and made significant changes on entrepreneurial enterprises. Due to their size, SMEs realize additional challenges when doing business abroad. Although they represent more than 90% of all businesses in the EU, only 2% of all SMEs in the European Union invest abroad.

Member states differ significantly in the way in which they regulate the establishment of new businesses so the reduction of legal burdens in European Union is a top-priority not only for the European Commission but also for national legislators. The regulation of entry is one of the biggest legal burdens for internationalization of SMEs. Available statistics show that friendly regulatory frameworks have

a positive impact on internationalization of SMEs. European Commission but the national legislators also, are very active in resolving legal burdens for internationalization of SMEs.

The latest document for making business friendly regulatory environment is Regulatory Fitness and Performance Programme (REFIT), which implement initiatives for simplification and regulatory burden reduction identified by the European Commission. A competitive and dynamic economy requires an adequate regulatory framework so a business friendly environment for existing and potential small and medium-sized entrepreneurs must stay one of the European Union's main objectives.

If we really want to take advantages of all the potentials of SMEs in the international market, we must create legal framework with clear aim of supporting SME, creating jobs and facilitating investment. The latest reforms in the field of company law in many European countries made significant step forward. Also, it is necessary to consider that the implemented reforms should serve the improvement of the regulatory framework and not only its simplification.

REFERENCES

- Accounting Act*. Official Gazette, NN 109/07, 54/13.
- Becht, M., Mayer, C. & Wagner, H.F. (2008). Where do firms incorporate? Deregulation and the cost of entry. *Journal of Corporate Finance*, 14, 241-256.
- Buliga, O. (2014). *Measures for Innovating Business Models, Best Masters*. Wiesbaden: Springer Fachmedien.
- Calabro, A., Mussolino, D. & Huse, M. (2009). The role of board directors in the internationalisation process of small and medium sized family businesses. *Int. J. Globalisation and Small Business*, 3(4), 393-411.
- Calciano, F., Fiordelisi, F. & Scarano, G. (2015). *The Restructuring of Banks and Financial Systems in the Euro Area and the Financing of SMEs*. London: Palgrave Macmillan.
- Djankov, S. (2009). The regulation of entry – a Survey. *World Bank Research Observer*, 24(2), 183-203.
- Djankov, S., La Porta, R., Lopez-de-Silanes, F. & Shleifer, A. (2002). The regulation of entry. *Quarterly Journal of Economics*, 117(1), 1–37.
- Eckardt, M. (2014). *Legal Form and Internationalization of Small and Medium-Sized Enterprises in the EU*. Andrassy Working Paper Series No 31, Budapest.
- Eckardt, M. & Kerber, W. (2013). *Horizontal and Vertical Regulatory Competition in EU Company Law: The Case of the European Private Company (SPE)*. Andrassy Working Paper Series No. 28, Budapest.
- European Business Development Group (2016). *EuroDev Whitepaper – Internationalization of small and medium-sized enterprises*. Retrieved from: <http://www.eurodev.com/wp-content/uploads/Internationalization-of-small-and-medium-sized-enterprises1.pdf> (10.02.2016).
- European Commission (2013). *Top 10 most burdensome EU laws for small and medium-sized enterprises: How the Commission is helping SMEs*. Published: 7 March 2013.

- Retrieved from: http://europa.eu/rapid/press-release_MEMO-13-168_en.htm (10.02.2016).
- European Commission (2015). *Annual Report on European SMEs 2014/2015 – SMEs start hiring again*. doi: 10.2873/886211.
- European Union (2003). *Commission Recommendation of 6 May 2003* (2003/361/EC), OJ L 124.
- Eurostat (2016). *Eurostat Newsrelease*. Eurostat Press Office, No. 201/2015. Retrieved from: <http://ec.europa.eu/eurostat/documents/2995521/7076793/4-17112015-ap-en.pdf/1db58867-0264-45c0-94bf-ab079e62d63f> (10.02.2016).
- Federal Ministry for Economic Affairs and Energy (2016). *The German Mittelstand: Facts and figures about German SMEs – Current Economic Climate*. Berlin: German Federal Ministry for Economic Affairs and Energy. Retrieved from: <http://www.bmwi.de/English/Redaktion/Pdf/wirtschaftsmotor-mittelstand-zahlen-und-fakten-zu-den-deutschen-kmu,property=pdf,bereich=bmwi2012,sprache=en,rwb=true.pdf> (10.02.2016).
- McLaughlin, S., (2013). *Unlocking company law*. 2nd Edition, New York: Routledge.
- Mohanty, S. & Nandi, T.K. (2010). *Globalization of SMEs: indepth analysis of impact of internationalization of firms*. Retrieved from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1593104 (10.02.2016).
- Modina M. (2015.). *Credit Rating and Bank – Firm Relationships. New Models to Better Evaluate SMEs*. London: Palgrave Macmillan. doi: 10.1057/9781137496225
- OECD (2005). *OECD SME and Entrepreneurship Outlook: 2005*. Paris: OECD.
- OECD (2015). *Financing SMEs and Entrepreneurs 2015: An OECD Publishing*. Paris. DOI: http://dx.doi.org/10.178/fin_smeent-2015-en (10.02.2016).
- Purnhagen, K. & Rott, P. (2014). *Varieties of European Economic Law and Regulation*. Springer International Publishing Switzerland. doi: 10.1007/978-3-319-04903-8.
- Rostek, K. (2015). *Benchmarking Collaborative Networks – A Key to SME Competitiveness*. Springer International Publishing Switzerland. doi: 10.1007/978-3-319-16736-7.
- Singer, S. & Alpeza, M. (Eds.) (2015). *Small and Medium Enterprises Report – Croatia 2014*. Zagreb: CEPOR.
- Small Business Development Promotion Act*. Official Gazette, NN 29/02, 63/07, 53/12, 56/13.
- UPS (2014). *European SME Exporting Insights. Doing business throughout Europe and beyond: A UPS Consultation Paper on SME Exporting Activity*. Retrieved from: <http://worldsmeforum.org/wp-content/uploads/2016/04/UPS.pdf> (10.02.2016).