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CHALLENGES TO THE DEVELOPMENT OF SMALL AND MEDIUM BUSINESS IN GEORGIA

The practice of market relations has demonstrated that formation of the middle class and sustainable development of the economy in the country is possible only by developing small and medium business. The place of small business in the world economy is impressive. While small business was considered as one of the weakly developed sectors until 1960s, currently it is one of the dynamically developed parts of the U.S. and Western European economies and plays a major role in their socio-economic and socio-political lives. Despite the significant success achieved in Georgia in terms of SME development, this form of business still faces difficulties in a number of areas that negatively impacts the realization of its socio-economic potential. A number of institutional barriers and market failures still remain in small and medium business that hinder development of business. Solving these problems requires improvement of government policy regarding small and medium business. The paper discusses five major challenges faced by small and medium business in Georgia: 1. Imperfect institutional framework; 2. Lack of the sources for financing SMEs; 3. Lack of entrepreneurial skills; 4. Limited innovation activities and little expenditures on R&D; 5. Limited export opportunities.

Keywords: small business; medium business; internationalization; innovation; business environment.

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ПРОБЛЕМИ РОЗВИТКУ МАЛОГО ТА СЕРЕДНЬОГО БІЗНЕСУ В ГРУЗІЇ

Практика ринкових відносин показала, що формування середнього класу та сталий розвиток економіки в країні можливі лише шляхом розвитку малого та середнього бізнесу. Місце малого бізнесу у світовій економіці вражає. Хоча малий бізнес вважався одним із слабкорозвинутих секторів до 1960-х років, зараз він є однією з динамічно розвинених частин економік США та країн Західної Європи та відіграє найважливішу роль у їх соціально-економічному та соціально-політичному житті. Незважаючи на значний успіх, досягнутий у Грузії з точки зору розвитку малого та середнього бізнесу, цей вид бізнесу все ще стикається з труднощами в ряді сфер, що негативно впливає на реалізацію його соціально-економічного потенціалу. В умовах малого та середнього бізнесу все ще залишається ряд інституційних бар'єрів та невдач на ринку, що перешкоджає розвитку бізнесу. Вирішення цих проблем вимагає вдосконалення державної політики щодо малого та середнього бізнесу. У роботі розглядаються п'ять основних проблем, з якими стикається малий і середній бізнес в Грузії.

Ключові слова: малий бізнес; середній бізнес; інтернаціоналізація; інновації; бізнес-середовище.

Introduction. Due to their potential to increase employment and create jobs, SMEs are an important component of economic development of any country. A strong and well-developed small and medium enterprise sector greatly contributes to improving the well-being of the country and formation of a middle class. This, in turn, not only ensures socio-economic stability of the country but also represents a creative part of its improvement and development.

The experience of developed countries shows that the role of small business in the economy is not decreasing and its quantitative growth has a strong tendency across the world. In developed countries (including the EU), small and medium enterprises account for a large part of all the operating enterprises; they generate more than 50% of total turnover of manufacturing sector and create two out of every three jobs in private sector. In the countries of the Organization for Economic Cooperation and Development (OECD), small and medium enterprises account for more than 90% of total number of companies and 2/3 of GDP on average. Small and medium enterprises account for more than 90% of the total number of enterprises in developing and transition economies, but their share in GDP is quite low [SME Development Strategy of Georgia 2016–2020]. Georgia strives to become a country based on European values and achieve economic and political integration with Europe. Today the European Union recognizes the importance of the role played by small and medium business in the economy of Europe [1, p. 212]. Considering that Georgia signed the Association Agreement with the European Union in June, 2014, it is inevitable to introduce the European model of small business policy in our country [2].

Quantitative and qualitative parameters of small and medium business in Georgia. The definition of SMEs is based on quantitative and qualitative criteria (indicators) defined by the legislation of a particular country. Quantitative criteria include, for example, annual turnover, employees, assets. Their purpose is to determine the scale of business. Qualitative criteria include a combination of ownership and management, ability to get capital, economic and legal independence. According to the World Bank studies, in different countries, there are over 50 indicators that determine whether a business is small or not [3]. Each country determines the indicators considering the peculiarities of the national economy and the legal norms defined by the country's legislation. Therefore, in

different countries, definition and classification of small business are different. Generally, the number of employees and annual turnover are the most common indicators. For example, in the U.S., quantitative indicators of small business depend on the particular industry it is in (up to 500 employees in manufacturing; up to 100 employees in wholesale trade; etc.). Small-business size indicators are periodically revised and approved by U.S. Small Business Administration [4].

Quantitative indicators of small business in Georgia are determined based on two aspects - based on statistical and tax purposes. In addition, a new methodology has been adopted by the National Statistics Office of Georgia since 2017 (Table 1).

Table 1

Quantitative indicators of small business in Georgia [5]

	Number of employees			Annual turnover			
	<i>For statistical purposes (old)</i>	<i>For statistical purposes (new)</i>	<i>For tax purposes</i>	<i>For statistical purposes (old)</i>	<i>For statistical purposes (new)</i>	<i>For tax purposes (old)</i>	<i>For tax purposes (new)</i>
Micro business			No employees			≤30 000 GEL	≤30 000 GEL
Small business	≤20	≤50		≤500 000 GEL	≤12000000 GEL	≤100 000 GEL	≤500 000 GEL
Medium business	≤100	≤250		≤1 500 000 GEL	≤60 000000 GEL		

The Tax Code of Georgia provides different criteria for small business and defines the concept of micro business as well. In particular, the status of a micro business is granted to a natural person who does not use the hired labour, conducts economic activity independently, the gross receivable income from which during a calendar year does not exceed GEL 30 000. Micro business is exempted from income tax. According to the amendments to the Tax Code, the status of a small business is granted to an entrepreneur whose gross income from economic activity during a calendar year does not exceed GEL 500 000 instead of GEL 100 000. Taxable income of small business shall be taxed at minimum 1% of gross income instead of 5%. In addition, according to the Tax Code of Georgia, an enterprise whose turnover during any 12 continuous calendar months does not exceed GEL 100 000 is exempted from VAT.) Supply of agricultural products produced in Georgia is also exempted from VAT. As some of the experts note, a new tax initiative launched since July is directed at encouraging small business in Georgia. About 120,000 entrepreneur natural persons (almost 100 percent of entrepreneur natural persons) benefit from this new preferential tax regime [6].

Effectiveness of small and medium business. International organizations and researchers indicate a number of socio-economic functions of small and medium business, which significantly impacts the economic development of the countries [7. p. 64]. Some of the most important are the following: creating opportunities for development and ensuring political stability through economic freedom, independence of entrepreneurship and decentralization of power; ensuring competitive environment on the market; reduction of unemployment; and introduction of innovations.

Researchers indicate a number of **advantages** of SMEs compared with other forms of business; in particular, these are: proximity to the market; employee loyalty; quickly adapting to changing conditions; flexibility in making decisions and implementing them; operating with relatively small expenses; good opportunities for the realization of entrepreneurial ideas; relatively small starting capital; high turnover of own capital; simplicity of working with documents and tax preferences. Small enterprises often encounter serious restrictions that can hamper their successful activities. There are a number of **disadvantages** of small business - high risk of bankruptcy; changes in market positions; dependence on large companies; difficulties in management; high dependence on environmental changes; the difficulty of attracting financial resources; etc.

With the purpose to promote development of small and medium business the government of Georgia has developed SME Development Strategy of Georgia 2016-2020[8]. In addition, the country actively participates in small and medium business panel, collaborates with the Organization for Economic Co-operation and Development (OECD), European Education Fund (ETF), European Bank for Reconstruction and Development (EBRD) and other international organizations.

The reform of the second half of the 2000's have made significant adjustments to the state policy of Georgia, but the transformational processes have not led to the emergence of the necessary sustainable institutions that would contribute to the effective and fair functioning of society. These changes have led to the fact that the state property institution, typical of the totalitarian state and command-and-control type of economic and social relations, was changed to the institute of concentrated private ownership focused primarily on the redistribution of benefits through the institutions of a market economy in the interests of the ruling elites. A dominant goal was formed -

augmenting profits of large private owners[9]. However, the approach changed in the following years. In the assessment of the implementation of the European Small Business Act in Eastern Partnership countries, it is emphasized that based on the results of the successful reforms, since 2012 Georgia has chosen a more proactive policy towards SME development and achieved a significant progress by implementing targeted initiatives [10]. Georgia's rank reflects continuous improvement of the institutional and operational environment of SMEs. In this regard, Georgia remains the leader in the region. Significant progress was observed in terms of improving business infrastructure and access to financing; and abolishing technical barriers to trade. Establishment of the Agency for Entrepreneurship Development and the Agency of Innovations and Technologies of Georgia within the Ministry of Economy and Sustainable Development of Georgia since 2014 is considered to be a substantial achievement. In addition, implementation of the program Produce in Georgia, whose purposes include supporting development of micro and small entrepreneurship in Georgia by providing financial and technical support played a significant role. Signing the Association Agreement with the European Union also provides good opportunities.

SMEs play a special role in creating jobs, as well as in economic development of the country. It is widely recognized that introduction of the latest technologies and techniques that is typical for large businesses leads to the reduction of jobs, while SMEs create jobs and contribute to increase in employment, which is especially important in Georgia currently, as unemployment is the country's most acute problem [11, p. 210]. With the support of the government and international organizations and with the help of entrepreneurial skills that Georgian people have, small and medium business began to develop (although with obstacles) mainly in service sectors like trade, hotels and restaurants, household services, transport and communications [12, p. 70]. According to the official data, small and medium business have occupied an important place in the economy of Georgia and some of their economic indicators are even higher than the indicators of large business (Figure 1) [5].

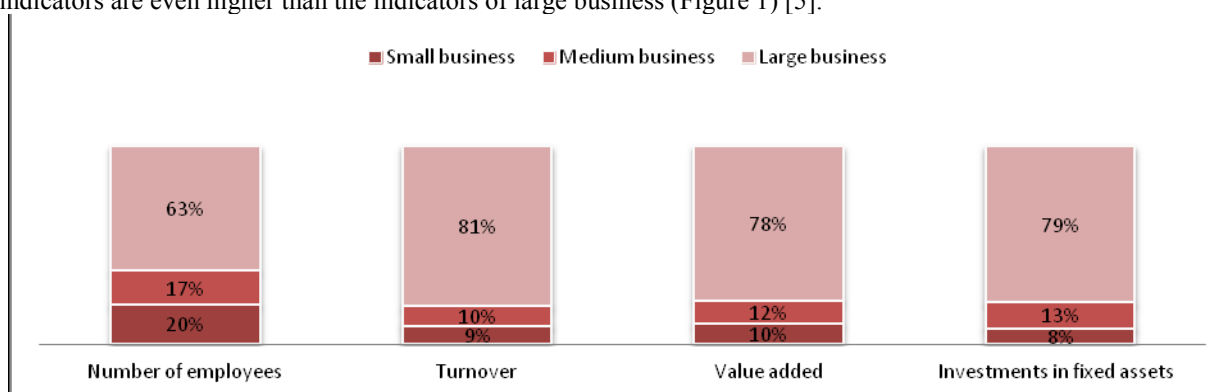


Figure 1. The role of small business in the economy of Georgia in 2017 (by old methodology)

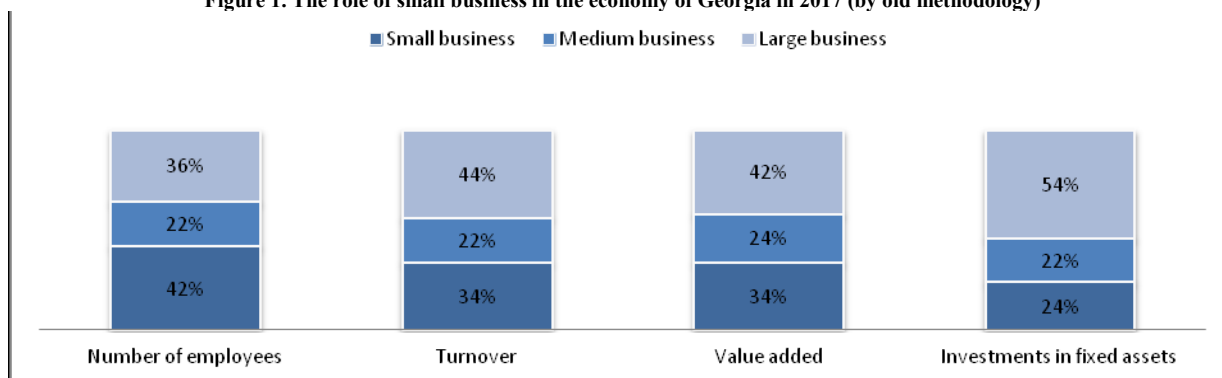


Figure 2. The role of small business in the economy of Georgia by new methodology

Despite the significant success achieved in Georgia in terms of small and medium business development, this form of business still faces difficulties in a number of areas that negatively affects utilization of its socio-economic potential.

SME supporting institutions need to be improved. Although Entrepreneurship Development Agency is really important for the development of business in general, it is less focused specifically on small and medium businesses. Georgian Innovation and Technology Agency also mainly focuses on start-ups and high-tech business. We believe that for further development of small and medium business, it is necessary to establish an institution focused on this field both on central and regional levels. Examples of such institutions can be found almost in all the developed countries – Japan has Small and Medium Enterprise Agency (SMEA) which is responsible for the implementation of the government strategy related to the development of small and medium business in Japan. In addition, there are SME supporting centres in all regions of Japan. Cooperation with each other is also very important for the development of small and medium business. In many countries such cooperation is stimulated and encouraged by legislation, e. g. Small and Medium Business Cooperation Act.

Access to finance remains a challenge. High interest rates and strict requirements for loans (high collateral, security) added by relatively underdeveloped financial system. International experience shows that the main source of financing for small business, especially at the initial stage, is not non-banking resources, but venture and angel financing [13, p. 174]. These types of funding allow small business to be actively involved in innovative processes. Innovative activities of small firms in science-intensive fields is the basis for the structural transformation of the entire economy. Unfortunately, these institutions do not develop in Georgia due to the lack of development of capital market in general. In addition, due to tax purposes, only sole proprietorships are treated as micro and small businesses and they are technically impossible to receive venture financing as this legal form does not provide the practice of alienation of share.

Lack of entrepreneurial skills is an essential obstacle that is partly due to the Soviet heritage. The skills for business planning and development, marketing, strategic and operations management and other skills and the level of knowledge needed for being successful are poor [14, p. 59]. A number of activities were planned by the government of Georgia to solve these problems; however, when we compare international experience with Georgian reality, it becomes obvious that one of the practices, which, unfortunately, was not introduced and is not planned to be introduced in Georgia is using the resource of retired highly qualified specialists (managers, engineers, scientists, finance expert and others). There are service corps of retired executives in practically all developed countries, which represents a group of retired specialists. For example, in the U.S. there are 389 offices which serve over 400 thousand clients annually.

The added value created by SMEs is low; one of the reasons for this is low productivity and lack of innovation [15, p. 410]. Innovative activities of SMEs is quite low in Georgia even compared with the countries of the region. There is a lack of infrastructure needed for innovations that will encourage development of start-ups and SMEs. The rate of commercialization of innovations and transforming ideas into products is also quite low. In addition, at present the whole territory of the country is not covered by high-speed internet [16, p. 95]. For increasing the innovative activities of small and medium businesses, it is necessary to apply widely approved mechanisms, such as development and implementation of financial and technical support programs for innovative activities of small and medium business; introduction of the funds (financial, insurance, risky venture funds, leasing companies, etc.) for supporting small and medium business [17, p. 78]. Introduction of tax benefits for small, beginner innovative enterprises; improvement of the law on intellectual property protection; development of a network of techno parks and business incubators; development of innovative clusters; introduction of the forms of cooperation between private, public and scientific sectors [18, p. 123].

The level of internationalization of SMEs in Georgia is low. According to the Organization for Economic Cooperation and Development, one fourth of the SMEs in developed countries earn 10–40% of the revenue from external economic activities. The goods exported by them accounts for 25–35% of the global export; their export steadily increases and their growth rate exceeds the growth rate of large companies 2 – 2.2 times, while labour productivity is higher in large business. Many Georgian small enterprises realize the advantages of entering foreign markets, but they cannot do so for various reasons [18, p. 841]. There are a number of obstacles to expansion of business activities abroad: low labour productivity; lack of properly trained managerial staff; problems related with operating on foreign markets; lack of Georgian large companies involved in the global chain of value-added; no potential partners abroad; etc.

Conclusion. Based on the study of the current situation in small and medium business sector in Georgia, five major challenges have been identified (imperfect institutional framework; lack of financing sources for small and medium business; lack of entrepreneurial skills; limited innovation activities and low expenditure on research and development; limited export opportunities) that the country has to deal with. Overcoming these challenges will encourage development of small and medium business and increasing the competitiveness, which is very important both in terms of creating new jobs and establishing positions on local and international markets.

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