



SMALL AND MEDIUM-SIZED ENTERPRISE GROWTH CONSTRAINTS: AN UZBEK PERSPECTIVE



“It is widely acknowledged that SMEs are a driving force for economic growth, a possible solution to social problems among young people and women, such as unemployment and poverty, and can lead to a rise in gross domestic product.”



SMEs represent over 99 per cent of the total number of businesses across the economies where the EBRD invests,² and fulfil an important role in any economy. It is widely acknowledged that SMEs are a driving force for economic growth, a possible solution to social problems among young people and women, such as unemployment and poverty, and can lead to a rise in gross domestic product. In 2018 we launched a technical assistance project with Uzbekistan to discover existing policies to support SMEs as well to summarise difficulties faced by SMEs in the country.

A vibrant small and medium-sized enterprise (SME) sector is a vital ingredient for a healthy market economy. In the context of much of the EBRD regions and their economic legacy, having a large and dynamic SME population is particularly important. Given that former communist economies were organised around large state-owned enterprises and conglomerates, small firms can provide a key counterbalance and promote greater competition. However, due to internal inefficiencies and constraints in the business environment, their contribution can be well below its potential.



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² <https://www.ebrd.com/what-we-do/sectors-and-topics/why-small-businesses-matter.html> (last accessed 10 December 2020).



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SMEs have attracted increased attention in the Republic of Uzbekistan lately. This comes as no surprise, given their strategic importance to the economy and the country. The sheer number of SMEs is overwhelming, as they account for more than 90 per cent of enterprises. They play a vital role in providing employment, employing almost 78 per cent of the workforce and account for a substantial part of the economic output.³ Those figures can be further put into context when considering that Uzbekistan is the most densely populated country in the Central Asian region, with one-third of the population under the age of 29 and half of the population residing in rural areas. As 800,000 people under the age of 29 join the labour market every year, job generation is an urgent and challenging priority.⁴

Although SMEs' economic importance attracts the attention of policymakers, it does not solely provide the basis for intervening in the private sector. Smaller businesses tend to be more flexible and quick to change than larger corporates; they are however much more vulnerable to deterioration in the business environment. They are also more sensitive to harassment from government institutions and have fewer resources to draw on when times are hard. It can therefore be argued that SMEs can develop and grow on their own and rely on the general and nondiscretionary activities of the government in relation to the private sector, however in certain cases there is rationale for governments to intervene.

LEGAL FRAMEWORK FOR SMEs

The government plays a leading role in creating an enabling legal and regulatory environment that would encourage SMEs to grow across various sectors. An SME-friendly environment that would promote growth must at the very least be characterised by certainty and clarity.

At the EBRD, we believe that creating the conditions for small businesses to thrive is fundamental for economic growth. We recognise that the challenges facing small businesses are complex. For this reason, we go beyond our usual work with firms and financial institutions: interacting with policymakers and sharing our economic and legal expertise through policy dialogue, in order to help improve the business environment across the economies where we invest.

In this regard, the EBRD launched a technical assistance project at the end of 2018 with the Chamber of Commerce and Industry of Uzbekistan. The project's aim was to provide an overview of existing policies to support SMEs as well as an assessment of difficulties faced by SMEs in Uzbekistan. The key objective of the assignment was to identify legislative and institutional reforms to improve the operational environment for SMEs in Uzbekistan. As part of the project, we carried out a mapping exercise, which has included national stakeholders that work on SME development specifically including ministries, agencies and quasi-governmental organisations. In addition, listening to small businesses and their experience has been important to complete the picture. To this end, the EBRD together with the European Investment Bank and the World Bank has conducted an enterprise survey in Uzbekistan and other countries where the Bank operates: the Business Environment and Enterprise Performance Survey (BEEPS).⁵ The BEEPS VI is a firm-level survey based on face-to-face interviews with managers. It examines the quality of the business environment. In the ensuing paragraphs we will set out some of our key findings.



³ <https://www.adb.org/sites/default/files/publication/524081/adbi-wp997.pdf> (last accessed 10 December 2020).

⁴ ADB Sector Assessment <https://www.adb.org/sites/default/files/linked-documents/42007-014-ssa.pdf> (last accessed 10 December 2020).

⁵ In this article we refer to the data collected in the latest round of the Enterprise Surveys conducted in 2018-20 by the EBRD, the European Investment Bank (EIB) and the World Bank Group and covering more than 25,000 randomly selected firms across the EBRD regions and hereinafter referred to as BEEPS VI. See <https://www.beeeps-ebrd.com/> (last accessed 10 December 2020).

Defining an SME

The term “SME” embraces a broad spectrum of definitions. There is no consistent guideline, nor universal definition. Different organisations and countries set their own guidelines for defining SMEs, often based on headcount, sales or assets. Ideally, the SME definition should reflect the overall size of the economy and be based on structural business statistics that help identify those companies most in need of support. In most instances, SME laws define criteria (number of employees, turnover, and/or balance sheet) and corresponding ceilings (from ... to) for the classification of enterprises into different sized categories. Looking at the European Union (EU), SMEs also need to be “autonomous” in addition to meeting certain size criteria. This is because SMEs tend to have fewer resources than, for example, a group of linked or partnered enterprises as a whole who do not face the same disadvantages. The same logic also applies when excluding state-owned enterprises from an SME definition. The inclusion of an autonomy criterion also avoids the multiplication of business entities under the same ownership solely for the purpose of benefiting from SME support measures or being exempt from regulation that applies to larger enterprises. In EU member states, the definition also includes a time dimension where exceeding the definition in a single year does not immediately remove a company’s SME status. A company needs to outgrow the definition over a period of at least two years to lose their right to SME support. This is to avoid fluctuation around the threshold of the definition and provide legal certainty to companies about their SME status.

To date the legislation in Uzbekistan contains no definition of SMEs. However, the development of this area has been declared a priority by the Uzbek government, and it has developed a strategy for the SME sector. According to the draft President Resolution,⁶ the government intends to propose amendments to legislation and expand the scope of prerequisites required to qualify for being treated as a small business.⁷

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In that respect, the Uzbek authorities have created a national agency fully focused on supporting their growth: the Agency for the Development of Small Business and Entrepreneurship. The agency is a state body established under the Ministry for Economic Development and Poverty Reduction and should provide a focal point for business development.

Challenges to SME growth

There is no doubt that policies are essential to support SMEs as they are constrained by their size.

Literature indicate that in spite of their influence, SMEs continue to face many challenges. The World Bank has identified the following key challenges:

- regulatory and legal frameworks - which includes licensing and registration requirements, and the application of commercial legal frameworks
- access to finance – SMEs also face high costs of credit, which includes land ownership rights and the ability to use collateral as security, information asymmetry and alignment with international accounting standards

⁶ Draft President Resolution “On measures to further stimulate the expansion of small businesses and private entrepreneurship in order to create competitive companies.” Available at: <https://regulation.gov.uz/oz/d/639>

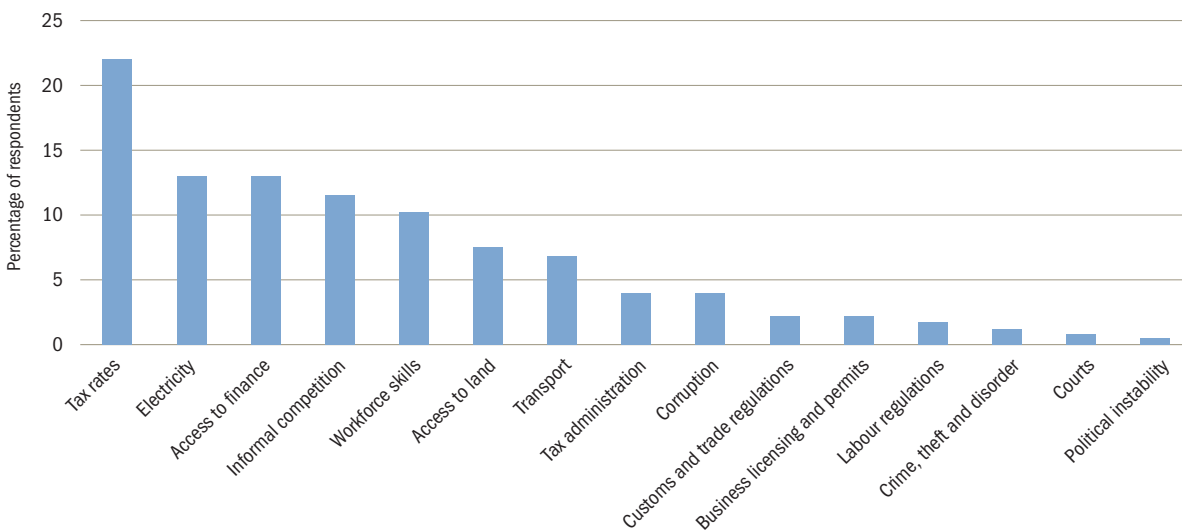
⁷ <https://www.adb.org/sites/default/files/publication/524081/adbi-wp997.pdf> (last accessed 10 December 2020).

- SME support activities – they struggle to define their key competitive edge that allows them to continue to grow and deliver, for example, business development service and access to markets.⁸

In the Uzbek context, the BEEPS VI provides important insights into the challenges SMEs face when it comes to their business operations. Asked what their most pressing issue is, SMEs indicate that they struggle with tax rates, access to electricity and access to finance most. Competition from informal firms and an inadequately educated workforce are also important concerns (see Chart 1).

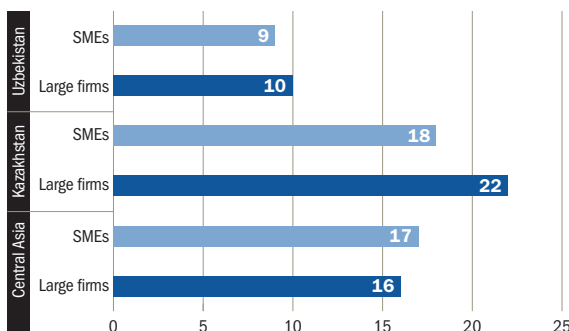
In regards to the issue of access to electricity, there is a clear difference between getting an initial grid connection and having a reliable power supply. Initial access is relatively good compared with other Central Asian countries: with SMEs waiting less than 10 days to get connected, compared with nearly 17 days on average in the Central Asia region. However, power supply is an issue with the incidence of electricity outages far higher than the average in the region (see Charts 2.1 and 2.2). This also leads to higher economic damage in terms of losses in sales.

Chart 1: Most pressing challenge SMEs face in Uzbekistan (share of respondents)



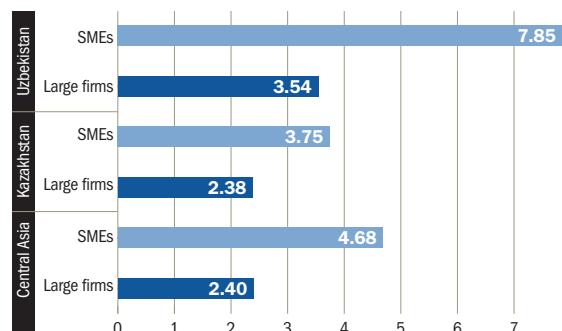
Source: BEEPS VI.

Chart 2.1: Days to connect to grid



Source: BEEPS VI.

Chart 2.2: Number of outages per month



Source: BEEPS VI.



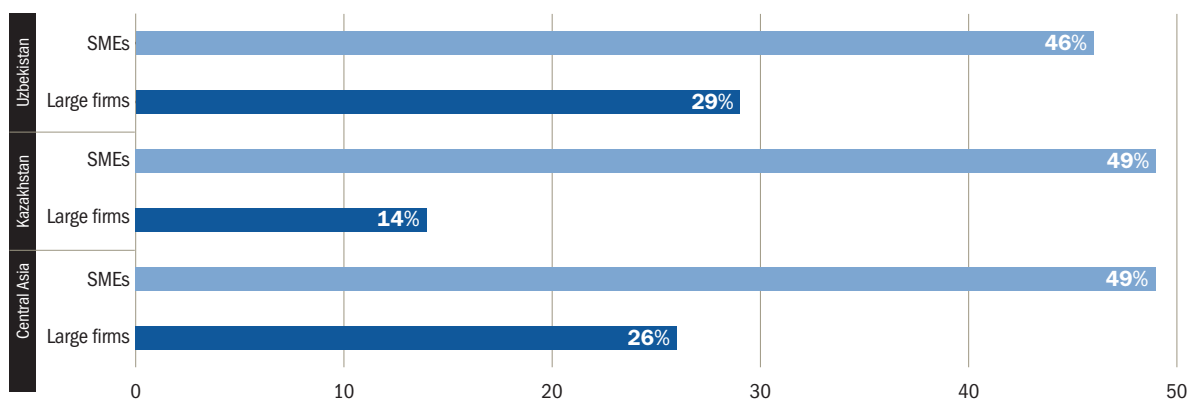
⁸ N. Yoshino and F. Taghizadeh-Hesary (2016), “Major Challenges Facing Small and Medium-sized Enterprises in Asia and Solutions for Mitigating Them”, Asian Development Bank Institute, Tokyo.



SMEs in Uzbekistan also indicate that access to finance is an important issue. Generally, SMEs tend to struggle more with accessing external finance than larger firms because of higher perceived risk, a lack of collateral, but also an inability to present a bankable project due to shortcomings in terms of financial management and business planning. Not all firms want or need a loan. However, access to finance can allow a firm to invest into new assets for an expansion of production, or facilitate working capital management, in particular in environments where reliance on a supplier or buyer credit is low, such as Uzbekistan. It is therefore important that those

firms that identify a need for credit can have a reasonable chance of getting a loan. In Uzbekistan, of those firms that said they needed a loan, a significant share were credit constrained, meaning they were either rejected when applying, or were discouraged from applying in the first place, due to high interest rates, excessive collateral requirements or complex loan application procedures. Chart 3 shows that SMEs tend to be significantly more credit constrained than larger firms. In Uzbekistan, nearly half of SMEs that say they need a loan feel that they cannot access one, an experience comparable with that of other countries in the region.

Chart 3: Share of credit-constrained firms



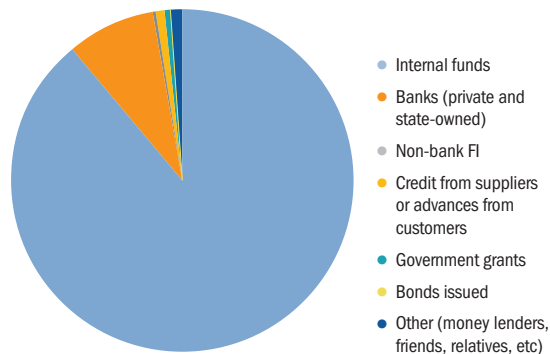
Source: BEEPS VI.

At the same time, SMEs in Uzbekistan who are able to access external financing seem to rely more on bank financing than other types of sources, compared with their peers in Kazakhstan (see Charts 4.1 to 4.4). This suggests that the banking system is a major source of financing for those that are able to tap into it, whereas the reliance on supplier or buyer credit or government grants appears to be comparatively low. Nevertheless, it is worth noting that nearly half of the SMEs are financed through state-owned banks. Their presence is significantly stronger in the country compared with, for example, Kazakhstan or the EBRD region at large, where only around 13 per cent of SME lending is channelled through state-owned banks. Interestingly, non-bank financial institutions such as microfinance organisations, leasing or factoring companies play a negligible role in facilitating access to finance although they can be important alternatives to banks, especially for SMEs. This suggests ample room for development. In many cases, an insufficient legal or regulatory framework inhibits the emergence and growth of such alternative finance providers. In certain economies, introducing a regulatory framework can lead to fair competition as there are clear rules for all participants. Authorities are able to ensure business standards and provide the often-needed assurance for investors and clients.

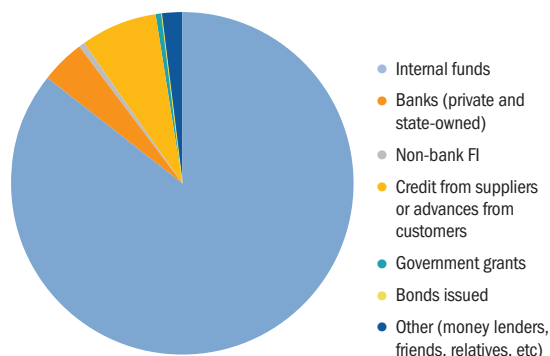
One area that is important for SMEs in particular is their limited capacity to deal with legal and regulatory requirements. As many small businesses are managed by their owner, or have very limited managerial staff, it is particularly crucial for SMEs to have an efficient public service when it comes to permits, licensing, tax administration and similar issues. Ease of use, reduction in administrative steps, and different access points for businesses are important aspects in this context. For example, the provision of e-government services, or one-stop shops where several government services can be accessed in one go, are ways to ease the burden on businesses. In this regard, the Uzbek government has made important progress by putting in place one-stop shops and cutting the number of required licences and permits required to run a business. Indeed, managers of Uzbek SMEs spend less time dealing with government regulation than their counterparts in larger firms, or in Central Asia and the EBRD regions more widely (see Chart 5).

Charts 4.1 to 4.4: Source of financing for SMEs in Uzbekistan and Kazakhstan

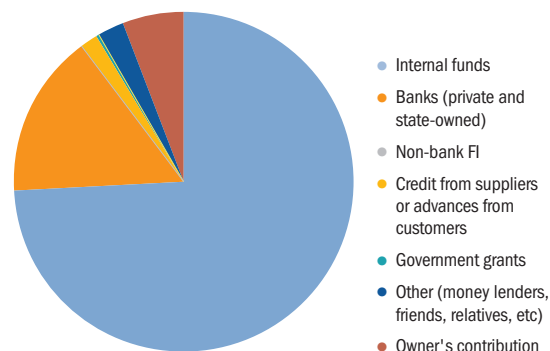
4.1: Uzbekistan - Sources of financing for working capital



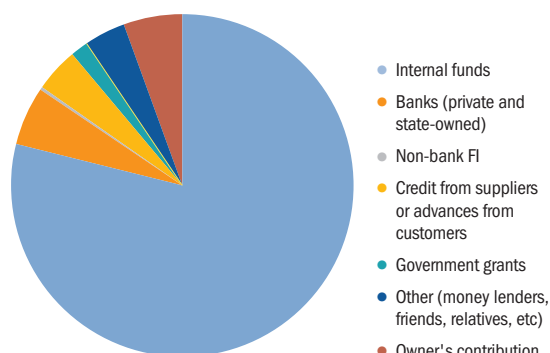
4.2: Kazakhstan - Sources of financing for working capital



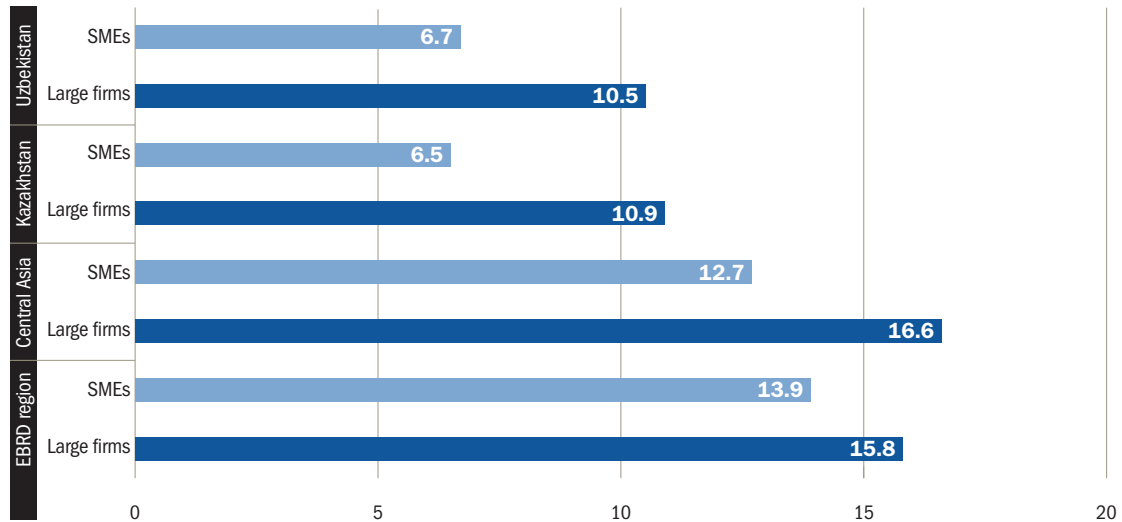
4.3: Uzbekistan - Sources of financing for fixed assets purchases



4.4: Kazakhstan - Sources of financing for fixed assets purchases



Source: BEEPS VI.

Chart 5: Percentage of time spent by senior management to deal with government regulation

Source: BEEPS VI.

Uzbekistan has made major reform efforts in recent years in this regard and climbed a number of ranks in the annual *Doing Business* reports.⁹ It currently ranks 69th out of 190 economies. However, there is further room for improvement. When looking at the *Doing Business* results, an area that stands out is the ease of trading across borders. Uzbekistan has huge potential for producing and exporting goods. But the time and cost of filling in documentation and getting physical goods across the border is a multiple of that in other Central Asian countries. Again, SMEs would be disproportionately affected as they tend to have fewer resources to deal with such obstacles. However, for SMEs in particular, issues associated with the attempt to reach foreign markets tend to go much deeper. They span from complying with quality requirements and obtaining internationally recognised certification, to identifying clients or suppliers abroad. In all of these areas, government services can play an important role to facilitate access to international markets.

CONCLUSION

SMEs make a substantial contribution to the growth and development of economies globally. They can lead to job creation, generate productivity, and in some instances export trade and act as a key link in value chains. While their

contributions in these areas may differ by country, size or statistical definition, there is little doubt as to their importance regarding economic activity. Recognition of their contribution has generated interest from policymakers at both the political and bureaucratic levels. That interest has grown over time in Uzbekistan as it has in other regions.

The main reason for policy intervention is that SMEs face market failures that inhibit their survival and growth. These failures should be the focus of government policy. Regulations remain an obstacle for SMEs as these firms tend to be poorly equipped to deal with problems arising from regulations. Access to information about regulations should also be made readily available to SMEs by policymakers.

As revered as SMEs are, the fact is that many SMEs in Uzbekistan remain fragile, immature and undeveloped. There is a need for them to reach their full potential and enhance competitiveness. Based on the above, this can be achieved through the provision of sustainable and pertinent support mechanisms, including access to credit, through the assistance of the government, but also the private sector can play a key role in providing the right environment to thrive.



⁹ <http://www.doingbusiness.org> (last accessed 10 December 2020).