

# **The Development of SME sector in Poland and New Instruments of Financing**

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## **Summary**

Small and medium enterprises are a key factor in the economies of the Central and East European transition states. The importance of the SME sector in these economies is correlated with such reasons as demopolization of economy, social stability through the development of the middle class, creation of a significant number of new jobs, etc.

The far-reaching economic reforms that began in Poland in 1989, together with changes in the social structure and political system have resulted in rapid development of small and medium size enterprises. SME's development policy faced new challenges after Poland's integration with European Union

The first part of the article presents the role of SMEs in the sustained economic development and the actual development of SMEs growth. Next we describe the main policy approaches followed by the Polish government and we identify future opportunities and threats for SME.

The main aim of the second part of the paper is to indicate the fact that leasing exerting a considerable influence on the development of SME sector in Polish economy. The analysis conducted in the paper is based on specialist literature, information from the leasing branch and opinions of leasing market experts. The article describes the structure of leasing, potential directions of development and main barriers for the development of the most important types of leasing transactions.

**Key-words:** Small and medium enterprises, leasing, economic transformation

**JEL:** M13, P31, L10

## 1. Introduction

The development of small and medium sized enterprises<sup>1</sup> in Poland has received lately bigger attention in comparison with other aspects of the economic processes. Small and medium enterprises have a key role to play in the restructuring economies. The establishment of a broad ownership through the development of independent commercial enterprises, a good number of which are SMEs, creates the social basis for a competitive economic system. SMEs, moreover, are absorbing a considerable proportion of the labour force released by state firms in their adaptation to the new economic system. The creation of a healthy SME culture also helps to work against the distorted firm size structure typical of central planning, a structure characterized by a dominance of large firms and allocation decisions made by central authorities. Emergence of SMEs needs to evaluate the policies that rendered their growth possible, such as the development of the institutional and macroeconomic framework; the rise of self-employment:

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<sup>1</sup>

Enterprise category	Headcount	Turnover	or	Balance sheet total
medium-sized	< 250	≤ € 50 million		≤ € 43 million
small	< 50	≤ € 10 million		≤ € 10 million
micro	< 10	≤ € 2 million		≤ € 2 million

[http://ec.europa.eu/enterprise/enterprise\\_policy/sme\\_definition/index\\_en.htm](http://ec.europa.eu/enterprise/enterprise_policy/sme_definition/index_en.htm)

limitations and barriers to the development of private sector SMEs; state policies regarding SMEs; the development of support networks.

## **2. SME sector development in Poland**

After disintegration of centrally planned economies East European countries ended up with an over industrialized system, with a predominance of a state sector employment, over-extensive social welfare, deep penetration of central planning, and in many cases, macroeconomic instability. From the ownership's point of view, Polish economy was divided into three sectors: state, cooperative and private. The existence of three sectors was not equivalent to the fact that all of them are equal concerning their economic potential: assets, turnover and employment. In general, the state and cooperative sector predominated over the private one. On the other hand private farms remained the dominant form of agriculture in Poland covering approximately 70% of the total areas of farms. The share of the private sector in other spheres of economy was much smaller than in agriculture. An example may be some data concerning industry:

Sector	Gross output		Value of assets
Employment			
State and cooperative	95, 2	93, 6	90, 0
Private	4,8	6,4	10,0

Source: Informacja Statystyczna GUS, 1990, p.388

In state sector predominated big enterprises employing over 200 people. Approximately 20 per cent of employees in 1989 worked in enterprises employing more than 5000 people and 60 per cent in those having more than 1000 employees. A more favorable situation was in the cooperative sector - about 85 per cent of employees worked in enterprises having 50-500 employees, although it should be taken into consideration that state industrial enterprises employed approximately seven times more people than the cooperative ones. The relation was similar in the case of state and private sectors. This partly resulted from the law, obligatory till the end of 1988 that private enterprises could employ at the maximum 50 persons. The only exception was foreign enterprises (Polish-foreign joint venture), which could employ up to 100 people. These limitations have been abolished since 23<sup>rd</sup> December 1988.

The government policy during the first period of economic transformation was particularly focused on macroeconomic issues.

Among the whole number of legislative regulations only a small part was directly determining the activity of the small and medium enterprises. In 1988 was established the Act on Business Activity and there was no other document influencing the development of this sector. The document was not directly focusing on the SMEs, however it permitted entrepreneurs to start their action without any governmental obstacles. That was the beginning of so called entrepreneurship explosion in the beginning of the 90s. In generally, the activity of entrepreneurs within SMEs was favoured, but none of the priorities of the government's socio-economic strategy referred directly to this sector. First attempts to define state policy towards SMEs were undertaken in 1995, when the Council of Ministries approved the document prepared in cross departmental consultations: SME in the national economy: policy towards SMEs - it described the former policy as ineffective. However, first document that was clearly defining as government strategy towards SMEs sector was published in 1999 and was entitled: Government Policy towards Small and Medium size Enterprises until 2002.

In Poland the 1980s were marked by a steady growth of the private sector. A significant rise in its growth occurred in 1989, when the government removed the majority of administrative barriers preventing private firms from entering the market. Further changes in economic environment caused next increase of the

number of private firms. In 1990 the number of private firms increased by 250%, while the number of state enterprises grew by 3%. In 1990 the industrial output of the private sector increased by 8%. At the same time industrial output in State sector fall by 23%. As a result private firm's share in total industrial output was over 11% in 1990, as against only 4, 8% in 1989. Some estimates put its importance at about 20%. This difference is caused by the existence of shadow economy in Poland<sup>2</sup>. Employment in the Private sector outside agriculture reached about 16% of total employment in 1990 (GUS, 1991).

In the end of the 90s in the GDP structure a number of 69% of Gross Value Added was generated by private enterprises. Within these 69% of GDP generated by private firms 36% was created by small enterprises and 9% by medium enterprises. These data bring us to the conclusion that 45% of Polish GDP was generated by the SMEs sector, when only 24% of total GDP was generated by large companies. According to the structure of SMEs output we can observe a trend that great part of them operates with Trade and Repairs Sector (around 40%). The other branches are: construction industry (12%), manufacturing (13%), transport and communication (10%), real estate (12%) and other service activities (13%) (Gemini, 2000).

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<sup>2</sup> On Poland's shadow economy see also: Gikas, 1992, pp.21-25, Wisniewski, 1985, pp.913-936, Landau, 1987, Charemza, Gronicki, Quandt, 1988, pp. 881-884 and Schneider, 2002

The second important figure is the number of people working in SMEs comparing to the whole economy. In 1999 there were slightly above 11, 4 millions people employed in the economy (excluding agriculture, fishery and forestry) whereas almost 7 millions people, i.e. 61, 1%, working in small and medium enterprises (Gemini, 1999). Looking at SMEs essential contribution in generating Polish GDP and the employment of more than half of the working population clearly shows the sectors real importance for the development of the economy.

The last point is the total number of small firms operating on the market in Poland. In 1999, there were 1.567.413 small active enterprises. Medium and large enterprises numbered 12.774 and 3.419, respectively (Gemini, 2000).

In 2002 Polish SME represented 99, 8% of all active enterprises and provides for almost 7 million jobs. For the last three years, Polish SMEs have experiences negative factors. Due to the general slowdown of economy, a decrease in number of small firms and in SME employment was recorded. However, the SME sector turned out to be more resistant to unfavorable conditions than bigger enterprises.

Comparing statistical data (number of companies per ten thousand inhabitants) in Polish economy and European Union of 15 members we can observe that in 2003 there were 4,6 companies with 50-249 employees in EU (3,2 in Poland), 31,7 companies 10-49

employees in EU (6,7 in Poland) and 451 companies 1-9 employees (435 in Poland).

### **3. Barriers to small and medium sized enterprises development**

One of the most important conditions for the success of the economic transformation is the existence of entrepreneurial talent in the population and the influence of the cultural and social environment (Cornwall, 1998). Some experts consider that the era of central administration and economic planning has considerably shaped the norms, value judgments and social orientation of the population, and in consequence has negatively influenced their entrepreneurial spirit. The opposite view concludes that cultural influences do not have a fundamental effect on the entrepreneurial ability is evident in many types of society. Differences are caused rather by the framework conditions for economic activity such as the nature of property rights.

In Poland, for instance, relatively small steps towards liberalization in the 1980s led to a rapid increase in private economic activity. The population, therefore, was reacting positively to changes in the framework conditions. However, many preconditions, which would allow entrepreneurial potential to develop and grow freely, are not met. Problems can be identified in



lack of human capital with marketing or business management know-how, strategic planning, experience of an enterprise culture, employee motivation, training systems, and lack of qualified managers as well as in the financing of SMEs. A further serious obstacle to development entrepreneurial potential is the continued deformed market structure in the industrial sector and the resulting lack of competition. Other obstacles are state bureaucracy and administration and the difficulties of applying new economic laws. The employees of the state administration were as unable to deal with the new economic legislation as the owners of private firms and potential entrepreneurs. The essential problem still is the rather stressed relationship between state employees and the commercial sector. Individual entrepreneurs, who often suffer mistreatment by representatives of state institutions, have great difficulty in recognizing in their counterparts the supposed helping hand of the state for private initiative.

During the era of central planning, private savings and capital achievements were permitted in Poland, though they were limited in range. Entrepreneurs cannot usually develop a long-term stable financial basis from personal savings, nor does self-financing tend to provide sufficient capital for investment. The access of small and medium sized enterprises to credit facilities from banks and financial support programmes is still limited. In addition, there remains a general lack of risk capital. This situation not only slows

down the creation of firms, but also it has a negative impact on business operations such as financing working capital or investment (Ribnikar, 1997). There are a number of reasons for the financial difficulties faced by SMEs. A large part of the problem is rooted in the role of the banking system. Many of the new banks were illiquid as they had inadequate equity capital and unwilling or unable to service their loans. The lack of institutional infrastructure at the regional level, the absence of branch office, creates further difficulties for SMEs. The still underdeveloped competitive structures in the banking industry create a further financial blockage. The lack of expertise in the banks in small-scale credit provision, as well as the continued existence in many banks of centralized and inflexible decision-making mechanisms are important factors in the frequent negative credit decisions against small and medium sized enterprises. As they are usually to provide the demanded level of security, the banks are often cautious in their negotiations with the firms and tend to avoid risk.

The factors that spur Polish SMEs to improve innovativeness, as apposed to Table 1 (in descending order), seem to concern mainly the easier access to capital and the possibility to export goods and services.

Table 1: Factors of improvement of company's innovativeness

Order	Factors
1 <sup>st</sup>	Easier access to capital
2 <sup>nd</sup>	The possibility of export
3 <sup>rd</sup>	Knowledge of new solutions in promotion and distribution

4 <sup>th</sup>	Tax relief
5 <sup>th</sup>	Knowledge of innovative solutions in production
6 <sup>th</sup>	Competition

The rapid expansion of the small business sector is proving to be a dynamic factor in support of economic revival. Despite the persistence of obstacles to small business development, remarkable progress is being made in constructing a macroeconomic and legal framework within which private entrepreneurs can prosper. The next step that policy-makers should do is to consolidate these achievements and design specific policies for SMEs to reduce the remaining barriers to small business expansion. Good legal and economic framework conditions are required to support the entrepreneurial spirit that has developed since economic reforms were introduced. The barriers, however, to the development of an effective SME sector are various:

1. There are gaps in the financing of small and medium sized enterprises, both in the start-up phase and in later growth. Although considerable progress has been made in the banking and financial system since the abolition of monopoly banks and central planning , financial systems have not yet fully developed to meet the new needs of business financing. Small and medium sized enterprises are in a more difficult credit position than the large state enterprises.
2. Vocational and technical training systems have improved substantially. Considerable gaps still exist in the area of

finance, commerce, business management and entrepreneurial training.

3. The competitive situation is far from positive for small and medium sized enterprises, in particular in the manufacturing sector, which is still dominated by large companies.
4. The practical implementation of the legal framework for a market economy is still lacking. Long periods of adaptation should be expected before the new legal norms are rooted in the thinking of entrepreneurs and the population in general, and before they are fully implemented by legal authorities.

In most recent years, national government as well as regional administrative authorities has implemented local state consultancy facilities, business development centers, technology parks and economic development agencies in economically disadvantaged regions. The effective implementation of assistance measures has been in many cases stopped by financial and administrative difficulties. Despite these obstacles, more effort has to be made to include the local and regional dimension of small and medium sized enterprises policies by adapting assistance measures to specific needs and situations. The partnership between support institutions, banks, private suppliers of business related services and further training facilities, in particular at the local level, needs to be notably improved. The same applies to combined action between municipal, local, regional and national facilities in the vertical

cooperation between support institutions, economic self-help organizations and authorities of the state administration.

## **5. Leasing as a new instrument of financing of SMEs in Poland**

A leasing is a relatively new financial instrument, which since 2002 has been gradually gaining the acknowledgement of the market. It was launched in the turbulent context. The initial lack of systemic regulations resulted in great freedom of interpretation of the imperfect law, which had consequences difficult to anticipate. The principle of economic freedom allowed the possibility of running an enterprise providing leasing by entities with limited financial base. These factors led to differing interpretations of the history of leasing services in different groups. In view of this context the branch of leasing has undergone quite a radical change mainly due to new legal regulations.

Until the second half of the 1990s, the leasing market in Poland was dominated by small contracts, especially leasing of trucks, telecommunications and IT equipment. Finally, in December 2000 leasing was fully regulated in civil, tax and accounting aspects. The most popular forms of leasing in Poland are operating leasing, finance leasing with automatic transfer of ownership or purchase option and sale and lease back. Polish accounting law has its own property attribution principles that differentiate between operating

leasing and finance leasing. These criteria closely follow the US GAAP. According to Polish law operating lease structures ensure on-balance financing (in terms of accounting) and tax deductibility of lease payments (including up-front payments). As a result this financing instrument improve the lessee's liquidity, ensure tax benefits due to accelerated lease payments and purchase option at a value lower than book value. On the other hand financial leasing ensure benefits from economical ownership of a lease object (depreciation and interest on a lease payment is tax deductible) and assets from 3-6 group of Assets Classification (under Polish tax regulations) possibility of accelerated depreciation up to 60 months.

Hire purchase and leasing can provide considerable benefits to businesses, but they are not suitable for every business or for every purchase. There are a number of considerations to be made. A hire purchase or leasing agreement is a medium term facility that cannot be withdrawn, provided the payments are made. The uncertainty that may be associated with facilities such as overdrafts, which are repayable on demand, is removed. However, both hire purchase and leasing agreements are long term commitments and it may not be possible, or could prove costly, to terminate them early. On the other hand, the regular nature of the payments and their usually fixed amount helps a business to forecast cash flow. The business is able to compare the payments

with the expected revenues and profits generated by the use of the asset. If, however, the company wishes to alter the payment frequency or amount, this will have to be agreed in advance with the finance company. In most cases the payments are fixed throughout the hire purchase or lease agreement, so a business will know at the beginning of the agreement what their repayments will be. This can be beneficial in times of low, stable or rising interest rates but may appear expensive if interest rates are falling. On some agreements, such as those for a longer term, the finance company may offer the option of variable rate interest. In such cases, rentals or installments will vary with current interest rates; hence it may be more difficult to budget for the level of payment. Also, under both hire purchase and leasing, the finance company retains legal ownership of the equipment, at least until the end of the agreement. This normally gives the finance company better security than lenders of other types of loan or overdraft facilities. The finance company may therefore be able to offer better terms. The decision to provide finance to a small or medium sized business depends on that business' credit standing and potential. Because the finance company has security in the equipment, it could tip the balance in favor of a positive credit decision. Hire purchase and leasing could provide finance for the entire cost of the equipment. There may however, be a need to put down a deposit for hire purchase or to make one or more payments in advance under a

lease. It may be possible for the business to “trade-in” other assets which they own, as a means of raising the deposit. If small and medium sized businesses wish to rely on a mix of finance, hire purchase and leasing can extend the range of facilities available and give them access to medium term finance. It is, however, important to weigh up the interest and other costs of the different forms of finance available, against the benefits provided.

Hire purchase and leasing remove the need to tie up resources in capital equipment, by spreading the cost and timing of the expenditure to coincide with the expected future revenues flows of the business.

Hire purchase and leasing give the business the choice of how to take advantage of capital allowances. If the business is profitable, it can claim its own capital allowances through hire purchase or outright purchase. If it is not a tax paying position or pays corporation tax at the small companies’ rate, then a lease could be more beneficial to the business. The leasing company will claim the capital allowances and pass the benefits on to the business by way of reduced rentals.

The data collected leads to the conclusion that most of SME companies financed their companies using own resources (92%). 23% of companies used bank credit and 21% leasing.

Examining the reasons for using leasing by the Polish SMEs which constitute our sample, we find that 26% mentioned tax



benefits, 21% simplicity of procedures, 21% good financial conditions, 3% difficulties with acquiring of bank credits. Among the reasons of not using leasing most executives of the SME enterprises classify lack of financial needs (47%), high cost (20%), and fear of excessive increase in the companies' liability (14%), lack of information about this form of financing (7%), bad experiences with leasing companies (3%) and others (9%).

Most of the firms of our sample consider as the best way to finance a new investment a bank credit (36, 5%) and EU funds (22, 3%). About 10% believes that the leasing is the best form of financing.

The most frequently financed facilities are machinery, industrial equipment, and means of transportation, production facilities, logistic centers and office buildings. The average percentage of new investments financed by leasing in Poland is growing by around 5-6 per cent. According to the data by the Polish Association of Leasing Companies, the value of new leasing transactions in 2006 reached 4, 5 billion euros, an increase of 26% in comparison to the previous year. The estimated percentage share of leased assets in the wholesale portfolio was: means of transportation - 72, 1%, machinery and industrial equipment 23, 2%, computers and office equipment 2, 4%, other means of transportation 1, 3%, other assets 1%. The last results strongly indicate the dynamic growth of the Polish leasing sector, which is

systematically improving. In last year there was a significant decrease in demand for car leasing with a simultaneous increase in machinery and industrial equipment leasing.

## **Conclusions**

Small and medium enterprises have a key role to play in the Polish economy since they are a dynamic factor in support of economic revival. Despite the persistence of obstacles to small business development, remarkable progress is being made in constructing a macroeconomic and legal framework within which private entrepreneurs can prosper. In most recent years, national government as well as regional administrative authorities has implemented local state consultancy facilities, business development centers, technology parks and economic development agencies in economically disadvantaged regions.

One of the most important barriers in development of an effective SME sector is the gaps in the financing of small and medium sized enterprises, both in the start-up phase and in later growth. Although considerable progress has been made in the banking and financial system since the abolition of monopoly banks and central planning, financial systems have not yet fully developed to meet the new needs of business financing.

A leasing is a relatively new financial instrument on Polish market. In December 2000 leasing was fully regulated in civil, tax and accounting aspects. The most popular forms of leasing in Poland are operating leasing, finance leasing with automatic transfer of ownership or purchase option and sale and lease back. According to the data by the Polish Association of Leasing Companies, the value of new leasing transactions in 2006 reached 4, 5 billion euros, an increase of 26% in comparison to the previous year. Despite of this more efforts have to be made to provide information about this form of financing and its advantages.

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