The Assessment of Formal Barriers to the Formation and Survival of Small Businesses in Lithuania

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A B S T R A C T

Small-and-medium size enterprises (SMES) are considered to be a key to economic development, and market completion. Small businesses are also a crucial source of innovative potential and job creation. In the aftermath of the recent economic crisis many countries experience high unemployment rates. A strong small business sector can provide employment opportunities and contribute to economic growth and speedy recovery. Though the creation of small firms and self-employment is ostensibly encouraged in formal government policies, in practice small businesses are affected by multitude of barriers, both formal and informal. This study explores the relationship between the level of formal barriers such as taxation, accounting requirements as well as other relevant regulations, and the likelihood of small business creation and survival in Lithuania. It uses statistical data, legal documents, and experts' evaluations to determine the regulatory burden experienced by small businesses. The results of the research indicate that regulatory requirements are significant factors in small business formation and performance. Findings of the paper contribute to a better understanding of how entrepreneurship happens and how policy makers could shape their policies to effectively encourage small business formation and sustain their operations medium and long-term.

1. INTRODUCTION

Entrepreneurship is a multidimensional concept. Among other things, it implies innovation and business start-ups. Small businesses are crucial for job creation, economic and social development, and competitiveness of the country. Therefore the economic policy in many countries devotes attention to entrepreneurship and offers incentives for small business creation. Nowhere the importance of entrepreneurial activity is reflected better than in the project called Global Entrepreneurship Monitor (GEM) the report based on the population surveys and experts' opinion conducted globally each year since 1999 (GEM, 2012). According to the GEM 2012, based on the level of economic development Lithuania is efficiency-driven economy, placing it between highly developed countries that are classified

as innovation-driven economies and less developed countries classified as factor-driven economies.

This classification is important for the assessment of the level, success and impact of entrepreneurial activity in country's economy. It implies, among other things, that Lithuanian policy makers have to devote more attention to the sustainable growth of small and medium size enterprises in order to become an innovation-driven economy. This paper necessarily focuses on a narrow aspect of such a complex phenomenon as entrepreneurship, namely the existence of formal barriers to small business creation, performance, and ultimately survival.

The objective of the research is to reveal the current situation with respect to entry regulations, taxation, and accounting requirements obligatory to various legal organizational forms of small businesses in Lithuania and recommend ways to make regulatory burden more amenable to businesses. To achieve the aims of the paper the method of experts' evaluation has been used. The results indicate that small businesses perceive the regulatory and tax burden as excessive and a considerable obstacle to the successful development of this sector of the economy.

The paper is organized in the following way. In sections two and three a review of the literature concerning entrepreneurship and the background of small business sector in Lithuania is presented. The fourth section is devoted to the description of the research method used in the paper. The results of the experts' survey are presented and discussed in section five. Finally, the last section concludes and provides recommendations.

2. LITERATURE REVIEW

Economists agree that entrepreneurs, and the new businesses they establish, play a critical role in the development and well-being of their societies. Small business development is seen as crucial for economic growth, innovations and market completion in advanced democratic economies. (Z. Acs, Audretsch, Braunerhjelm, & Carlsson, 2012; Z. J. Acs & Audretsch, 1990). Global Entrepreneurship Monitor defines entrepreneurship as "any attempt at new business or new venture creation, such as self-employment, a new business organization, or the expansion of an existing business, by an individual, a team of individuals, or an established business" (Global Entrepreneurship Monitor, 2012).

Insights into the entrepreneurial startup environment distinguish *nine entrepreneurial framework conditions*, namely: financing, governmental policies, governmental programs, education and training, research and development transfer, commercial infrastructure, internal market openness, physical infrastructure, and cultural and social norms. (Global Entrepreneurship Monitor, 2012). Though majority or all of those conditions are relevant for entrepreneurial activity at different stages of economic development, this paper limits itself to the review of literature relevant to the identification of institutional factors that encourage or hinder this activity. At least two of those factors are directly related to government policies.

The *government policy* entrepreneurial framework condition relates to the extent to which government policies influence new and growing small businesses. This includes the tax regime, labor market regulation, social security legislation as well as regulations and schemes that specifically aim at the small business sector (GEM, 2012). Researchers also have recognized the importance of institutional factors such as regulation of entry and the rule of law on the level of entrepreneurial activity (Aidis, Estrin, & Mickiewicz, 2009, 2010; Levie & Autio, 2011).

Government policies can either facilitate the establishment of small business or create barriers. Based on previous research and with the focus on transition economies Aidis (2005) distinguishes four types of barriers affecting new business operations: formal, informal, environmental, and skills. (Aidis, 2005). The most important barriers seems to be formal barriers such as high level of taxation (Bohatá & Mládek, 1999; Hashi, 2001) and the general regulatory environment (Brunetti, G. Kisunko, & B. Weder, 1998). Informal barriers such as corruption (Tonoyan, Strohmeyer, Habib, & Perlitz, 2010) and unfair competition from the large informal economy(Muent, Pissarides, & Sanfey, 2001) are also significant hurdles for small firms. Environmental barriers such as lack of financing and low purchasing power further interfere with SME development. Skill based barriers include the shortage of business related skills. Using the dataset based on a mail survey sample of 332 SME owners in Lithuania Aidis (2005) tests the relative importance and interrelation of those barriers. The results indicate that the most significant barriers are formal barriers related to frequent changes to taxes, the tax level, ambiguity of tax policies and environmental barriers related to low purchasing power and lack of funds for business investment. (Aidis, 2005).

3. BACKGROUND

In Lithuania the business is classified as "small business" if its annual receipts do not exceed 1mln. Litai (1 Euro = 3.45 Litai) per year and the number of employees is not more than 10 persons ("The Law of the Republic of Lithuania on Profits Tax," 2001). Owners of small business can choose to legally register its economic activities in several ways. It can operate as a joint-stock company, small partnership, individual enterprise (sole proprietorship), or carry out individual economic activity with a business certificate or with a business license. Four of these business types with the exception of individual economic activity with a business license and relevant regulatory, taxation, and accounting requirements are summarized in Table 1.

Table 1: The comparison of small business organization types in Lithuania

	Small partnership	Joint stock company	Individual enterprise	Individual activity with a business certificate
Who can found a business?	Only physical persons (up to 10 members)	Physical persons and legal entities	Only physical person	Only physical person
Requirements for registration.	Registration upon agreement of the founders.	The initial capital of 10 000 Lt is required. Registration in the register of legal persons.	The initial capital is not required. Registration in the register of legal persons.	The initial capital is not required. There is no registration in the register of legal persons. Certificate is issued by tax authorities.
Legal responsibility	Limited civilian responibility of private legal entity. Responsibily limited to the property of legal entity.	Limited civilian responibility of private legal entity. Responsibily limited to the property of legal entity.	Unlimited civilian responibility of private legal person. Responsibilty covers the property of legal entity and owner's property.	Status of legal entity is not bestowed.
Taxes required to pay	Profits tax (PT), rate 5 %. Taxable base is determined taking into account allowable deductions, limited allowable deductions, and unallowable deductions. Personal income tax (PIT)on wages and salary rate 15% (Wages and salary in fact coincide with the amount of money the member of the partnership can withdraw for personal needs. The member can choose the amount he deems	Profits tax, rate 5 %. Taxable base is determined taking into account allowable deductions, limited allowable deductions, and unallowable deductions. PIT on dividends at the rate of 20 %.	Profits tax (PT), rate 5 %. Taxable base is determined taking into account allowable deductions, limited allowable deductions, and unallowable deductions, except expenses for owner's SIT and HIT. Income derived from individual acitivy is treated as wages and salaries and taxes at 15% of PIT.	PIT : 15 % rate for free professions; 5 % rate for other economic activities. Ta taxable base can be determined: 1) income minus allowable deductions, limited allowable deductions, and unallowable deductions except expenses for owner's SIT and HIT, or 2) income minus standard deduction equal to 30 % of

	Small partnership	Joint stock company	Individual enterprise	Individual activity with a business certificate
	wages and salary) Personal income tax (PIT), rate on dividends 20 %. Social insurance tax (SIT) of 26.3% on the income taxed at the 15% PIT. Health insurance tax (HIT) of 9 %. The ceiling of 71 424 Lt is applied for calculating SIT and HIT (in 2012).		Social insurance tax (SIT) of 26.3% on the income taxed at the 15% PIT. Health insurance tax (HIT) of 9 %. The ceiling of 71 424 Lt is applied for calculating SIT and HIT (in 2012).	receipts. It is not required to provide evidence (documents) for this deduction) SIT rate 28,5 %; HIT rate 9 %. The taxable base is equal to 50 % of taxable income for PIT purposes. The ceiling of 71 424 Lt is applied for calculating SIT and HIT (in 2012).
Accounting requirements	Accounting can be done by the member of the parnership. Accrual basis. Required financial statements: Balance sheet, Profit and loss account, Explanatory note. Shortened form of statements. 1) Applies Business accounting principles (BAP)(based on GAP) only relevant for partnerships, or 2) Applies complete BAP	Accounting is done by a hired accountant. Accrual basis Required financial statements: Balance sheet, Profit and loss account, Changes in stockholders equit, Explanatory note. Shortened form of statements. Applies complete BAP.	Accounting can be done by the owner. Accrual basis. Required financial statements: Balance sheet, Profit and loss account, Changes in equity. Explanatory note. Shortened form of statements. Applies complete BAP.	Accounting can be done by the person engaged in individual activity. On cash or accrual basis. If the person is a registered VAT payer – only on accrual basis. A person keeps receipts-disbursements journal. There's not requirement to produce financial statements.

Sources: ("The Law of the Republic of Lithuania on Personal Income Tax," 2002; The Law of the Republic of Lithuania on Profits Tax," 2001)

Small businesses constitute the majority of enterprises in Lithuania. As shown in Figure 1 small businesses registered as joint-stock companies and individual enterprises (sole proprietorships) account for about 74%-78% of companies.
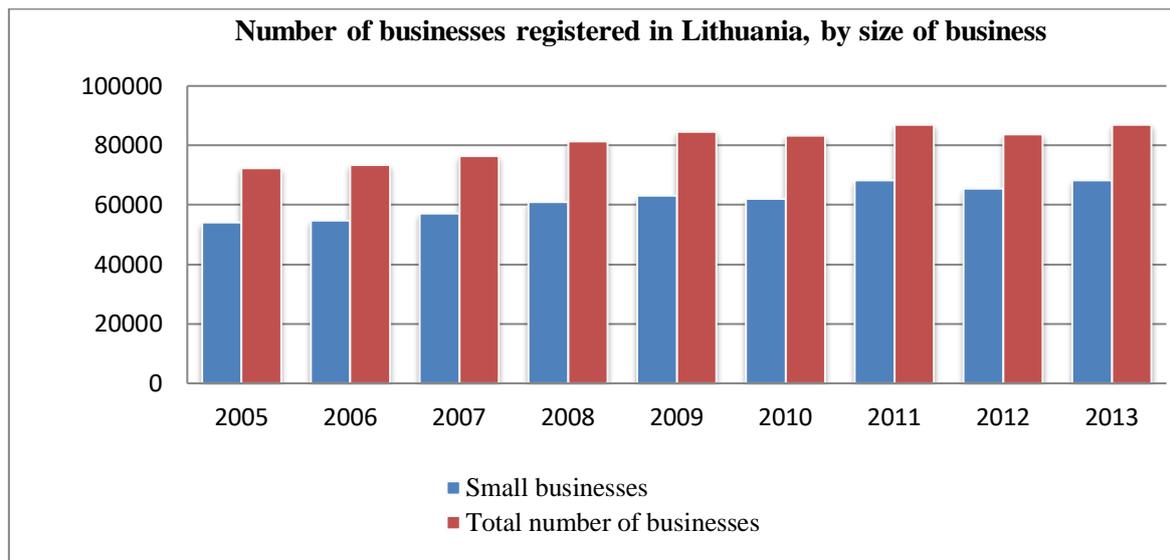

Figure 1: Number of businesses registered in Lithuania
Source: (Statistics Lithuania, 2013)

However, the totals hide quite a turbulent nature of small business creation and survival. Sometimes the number of businesses that discontinue their activities is higher than the number of businesses that register their business during that year. It's best to observe those activities by the type of legal business organization. As shown in Figure 2, numbers of individual enterprises that cease their activities constantly exceed the number of businesses that start their activities that year. It's interesting to note that the economic recession is not visibly reflected in the number of instances of new business creation right after 2008. This might reflect the necessity –driven entrepreneurial activity: as jobs become scarcer self-employment becomes a more attractive option. The decline in the number of registered individual enterprises after 2010 might also reflect the fact that other forms of legal business registration might have become more beneficial taking into account accounting requirements, and changes in tax rates that came into effect in 2010.
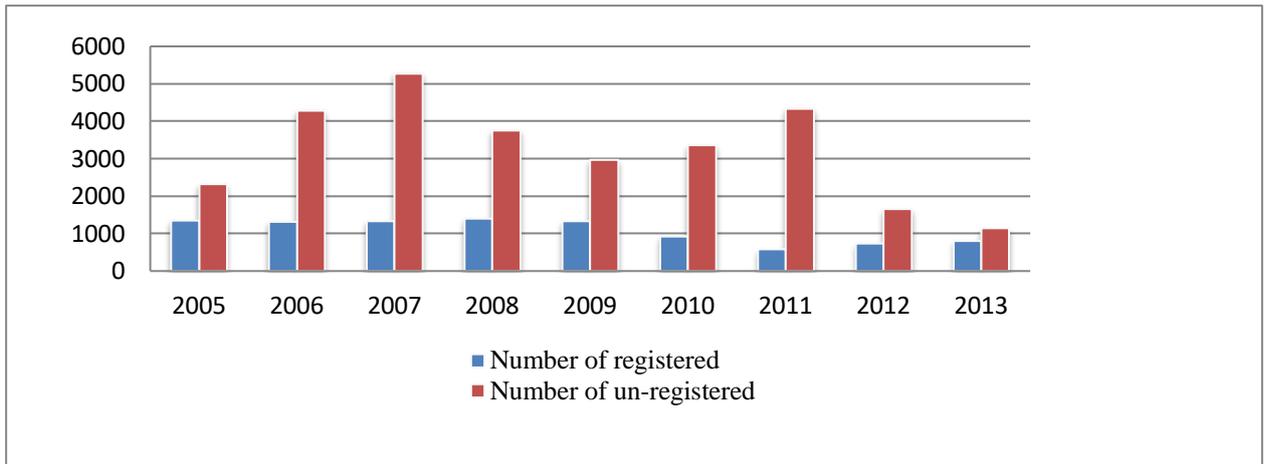
Figure 2: Number of individual enterprises that started and ceased their activities in a given year

Source: (Statistics Lithuania, 2013)

If we take a look at the business creation and "destruction" process of joint-stock companies that employ less than 10 employees and therefore qualify to be classified as "small business" for taxation and accounting purposes, the picture is less bleak. Figure 3 shows the growing trend to register small business as a joint-stock company. The survival rate is much higher than for individual enterprises. The average rate of business termination was about 24% during the observed period.
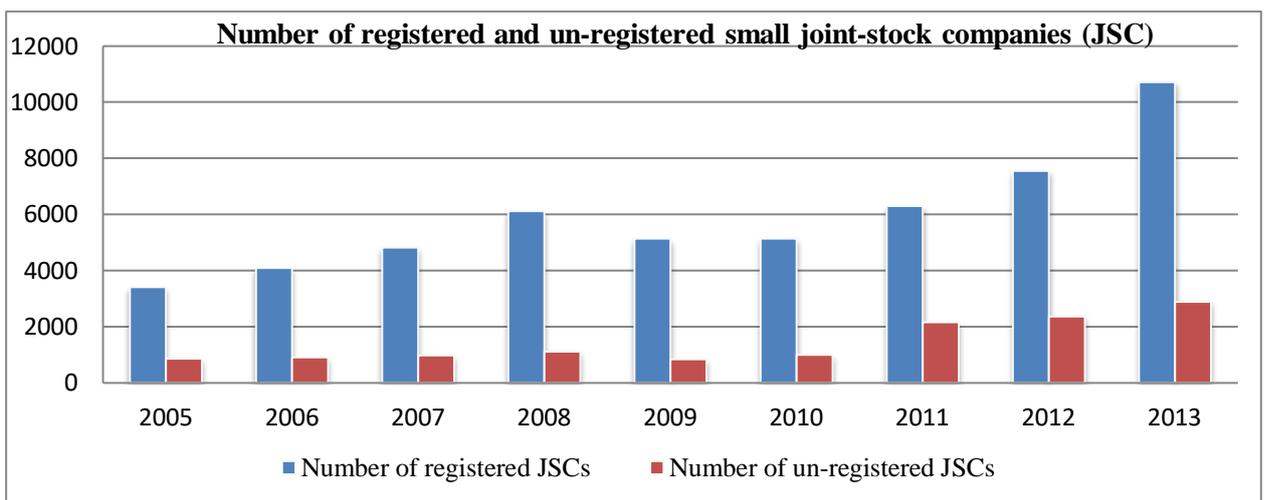

Figure 3: Number of joint-stock companies that started or ceased their activities in a given year Source: (Statistics Lithuania, 2013)

The same sort of turbulence in business creation can be observed in the change of the number of persons engaged in economic activity with a business certificate issued by tax authorities.

(See Figure 4). Although the data for earlier years is not available, in the years from 2008 to 2010 the number of individuals that discontinued their business activities exceeds the number of individuals that formed businesses. The overall trend of individual business activities is rather stable with a number of newly issued business certificates roughly matching the number of revoked certificates. There is a noticeable spike of starts-ups at the end of year 2012.
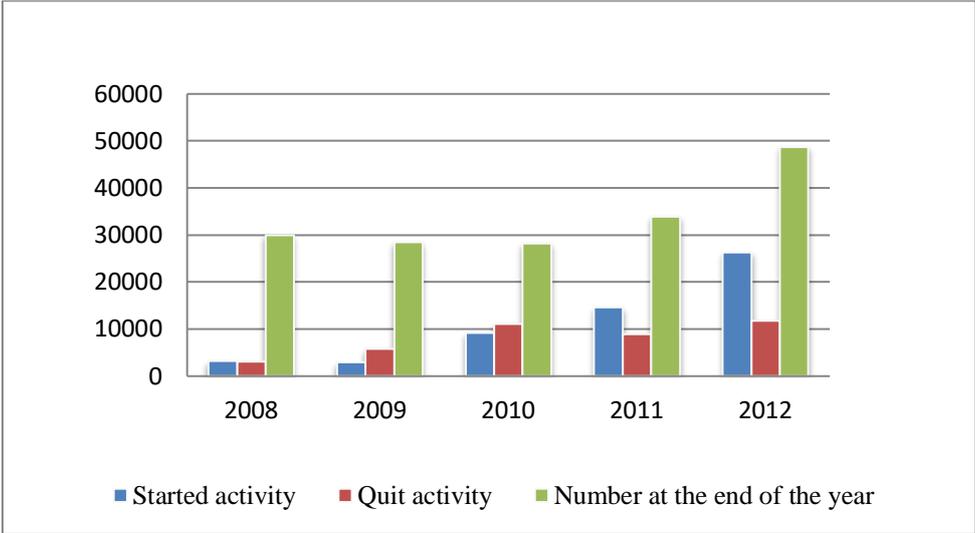

Figure 4: The number of individuals working with business certificates
Source: (State Tax Inspectorate, 2013)

If we compare those three legal forms of small business registration in Lithuania, there are clear indications that in recent years entrepreneurs prefer to conduct their business activities organized either as joint-stock companies or by acquiring a business certificate. Business organization through the registration of an individual enterprise is clearly out of favor with businessmen. This might reflect the fact that economic activity with business certificate enjoys a more favorable taxation treatment and faces lower accounting requirements than individual enterprises. Individuals working with business certificates do not have to keep double entry accounting, and the personal income tax rate has been reduced from 15% to 5% since 2010 ("The Law of the Republic of Lithuania on Personal Income Tax," 2002). Some of the business owners may also switch their legal incorporation from individual enterprise to a joint stock company because of the limited liability status.

In order to make more flexible conditions for small business start-ups and operations a new legal business organization type, called "small partnerships", has been enacted in September of 2012. It is expected that this type would have an advantage over an individual enterprise or an individual business activity with a business cerificate by giving it a status of limited liability. Among the drawbacks can be mentioned a limited possibility for the members of the partnership to share the profits, the requirement to prepare preliminary financial statements, limits placed on the partners to work by job contracts. It is too early to judge if this business organization type has met the expectations of businessmen. The statistical data on the earnings of the members of small partnerships and other performance indicators are not yet available.

4. METHODOLOGY

The aim of the research is to examine the level of the current regulative burden as perceived by small business owners and managers and to solicit expert's recommendations on the possible easing of taxation and accounting requirements that might hinder the development of small business sector in Lithuania.

The method of experts' evaluation has been chosen for this research. This method belongs to the class of qualitative research methods. The method of experts' evaluation is understood as a generalized experts' opinion. It uses a specialist's (expert's) knowledge, experience, and intuition. The experts' evaluation is a procedure that allows us to consolidate the opinions of separate experts and draw a common conclusion (V. Rudzkiene, 2005). In the case of experts' evaluation it is impossible to draw a representative sample. Instead a sample is drawn based on the non-probabilistic selection method. "The reliability of the expert's evaluation method depends upon the selection of experts. Selected experts must be competent persons, have specialized expertise in the area directly related to the research object" (Tidikis, 2003 p. 517). The size of the group (number of experts) also depends upon the competency of experts (V. Rudzkiene & Augustinaitis, 2009). In order to ensure the validity and reliability of experts' evaluation the size of the group should not be less than five experts. However, sometimes the number of experts may reach 30 or 40. The optimal recommended size of the group is from 8 to 10 experts (V. Rudzkiene & Augustinaitis, 2009). For this research the owners, managers of various forms of small businesses, and accounting specialists were chosen as experts' pool. As it happens in some small businesses the owner of the business also serves as a manager

and an accountant in addition to performing other tasks. In order to select competent respondents the following requirements were applied: the expert's educational attainment could be no less than a college degree or higher and the expert must have no less than 5 years of job experience in small business management and/or accounting.

In this research the experts' evaluation was conducted with the use of a survey. A questionnaire was designed and sent out for the experts to fill out. This method allows data to be gathered in a time-saving manner. The questionnaire uses close-ended (multiple choice and ranking) questions as well as some open-ended (comment box) questions. Ranking questions employ a Likert scale with five possible answers using a 1-to-5 rating scale where "1" means "strongly agree" to the notion and "5" means "strongly disagree" of the notion. The questionnaire[1] contains 17 questions. Each question is designed to achieve certain goals as reflected in Table 2.

Table 2: Research goals and corresponding questions in the questionnaire

Goals	Questions
1. Evaluate tax burden and complexity of taxation rules as perceived by small business operators in Lithuania	2, 3, 4, 5, 6, 7
2. Evaluate the complexity and burden of accounting requirements	8, 9, 11
3. Disclose overall attitudes towards small business regulation burden and its impact on the growth of small businesses	12, 13
4. Assess the ease/difficulty to register a small business	2
5. Evaluate the competence of experts and gather some basic information as the type of organizational form of the business, gender of the respondent, and position in the firm	1, 10, 14, 15, 16, 17

The questionnaire was sent to 13 experts. In total 11 questionnaires were received, nine of which met the competency requirements and did not contain missing values and were used in the analysis.

This method requires formal testing of the compatibility of experts' evaluations. The compatibility of the expert evaluations was tested using Kendall's *W (*Kendall's coefficient of concordance). Kendall's coefficient of concordance for ranks (*W*) calculates agreements

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[1] The full questionnaire is available from the author upon request.

between experts as they rank a number of items according to particular characteristics. If the test statistic *W* is 1, then all the survey respondents have been unanimous, and each respondent has assigned the same order to the list of items. If *W* is 0, then there is no overall trend of agreement among the respondents, and their responses may be regarded as essentially random. The following hypotheses are formed:

*H0: The expert evaluations are conflicting (*Kendall's *W is equal to zero);*
*HA: The expert evaluations are similar (*Kendall's *W is not equal to zero).*

Kendall's coefficient of concordance is calculated according to the following formula:

$$W = \frac{12S^2}{m^2(k^3-k)-m\sum_{l=1}^{r}T_l}$$

(1)

Where   W is the coefficient of concordance

S^2 is the sum of squared deviations

m is the number of experts

k is the number of alternatives

r is the number of rows that contain coinciding ranking

T_l is the number of coinciding rankings in the first row of ranks

For the data set based on the survey Kendall's *W* has been calculated using statistical package SPSS (version 13). Results are presented in Table 3.

Table 3: Test statistics for expert compatibility

Kendall's Coefficient of Concordance	.394
Chi-Square	24.849
Degrees of freedom	7
Number of experts	9
Asymp. Significance	.001

Source: calculated by the author using SPSS

The calculated Kendall's coefficient of concordance of 0.394 indicates a sufficiently high level of agreement among experts in evaluating proposed items. We can reject the null hypothesis that the experts' evaluations are conflicting at the 0.00 level of statistical significance. The test statistics indicate that results obtained through the chosen methodology are robust.

5. RESEARCH RESULTS AND ANALYSIS

In total, responses to nine questionnaires have been used for the analysis. Six respondents had experience in the operations and managements of joint-stock companies, one was the owner of an individual enterprise and two were engaged in individual business activity with a business certificate. All respondents had a college degree including one with a master's degree. The years of experience in business ranged from 5 to over 20 years.

The first question was aimed at finding how easy it was to register a business in Lithuania. The results are summarized in Figure 5 and clearly indicate that registering a business is not burdensome. The overwhelming majority of respondents agree that registration of business was a short simple procedure.
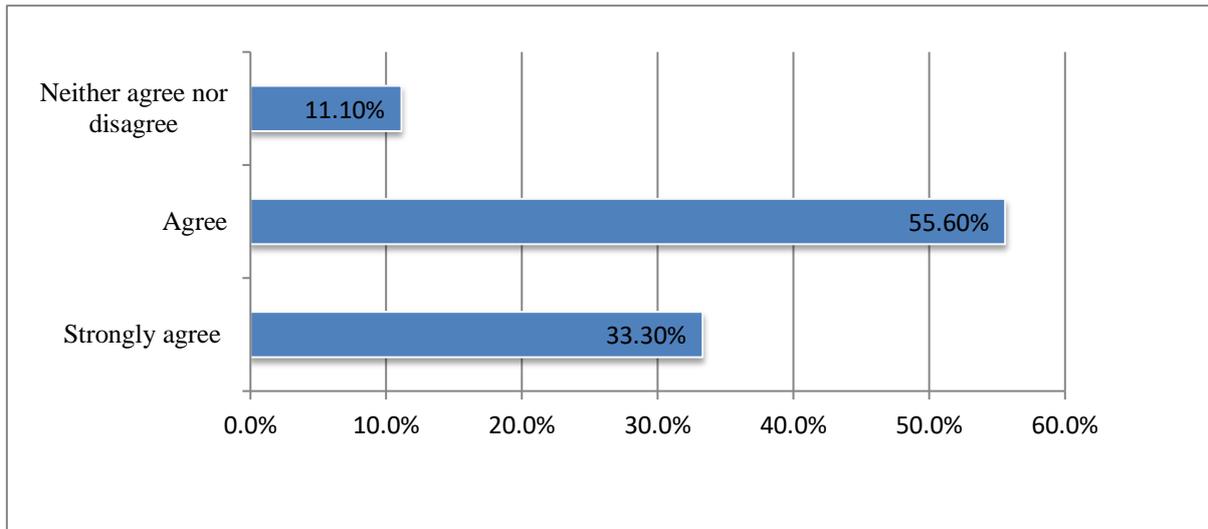
Figure 5: The procedure of business registration was simple and short. Please, indicate from "1" meaning "strongly agree" to "5" meaning "strongly disagree"

The next three questions asked respondents to rank statements related to the tax burden on the scale of "1" meaning "strongly agree" to "5" meaning "strongly disagree". The results are indicated in Figure 6. 67% of experts disagreed with the notion that the taxes the businesses have to pay are not high. In correspondence with this "inverted" question respondents almost in equal proportions agreed with statements that the number of taxes the small businesses have to pay is high and that overall tax burden hurts their business. Most of the respondents (over 55%) also considered that the tax calculation and payment procedures were complicated.
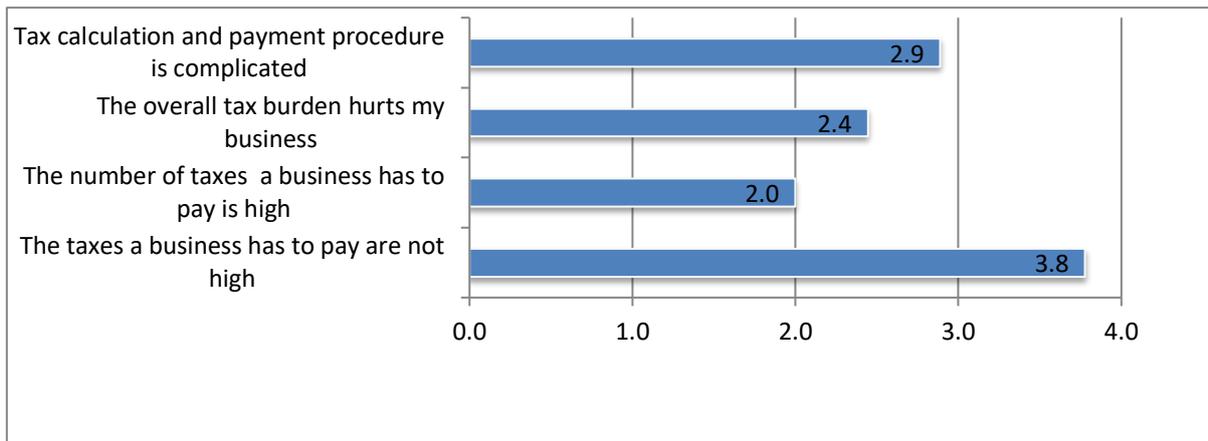
Figure 6: Please, evaluate the given statements by indicating "1" meaning "strongly agree" to "5" meaning "strongly disagree"

In order to get a more specific indication on the burden of tax accounting respondents were asked how many hours on average they spend to calculate and pay their taxes. The answers vary by type of the business. An owner of the individual enterprise indicates that on average it takes from 10 to 20 hours to calculate, declare and pay taxes for a tax period. Persons engaged in business activity with certificates indicate that it takes them from 5 to 10 hours to do their taxes. Answers provided by experts on joint-stock companies varied from "5 to 10" hours to more than 30 hours. (See Figure 7).
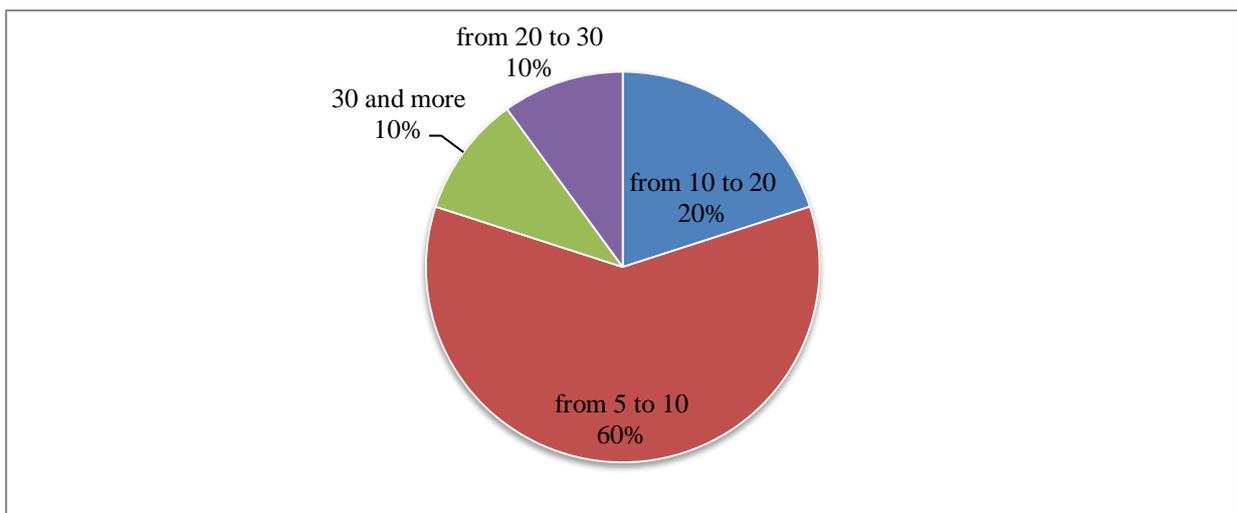

Figure 7: On average how many hours do you spend to calculate, declare and pay your taxes for a tax period?

The aim of the next three questions was to evaluate the accounting burden experienced by small firms and sole proprietors. On the scale of "1" meaning "strongly agree" to "5" meaning

"strongly disagree" respondents were asked to rank statements related to accounting requirements. The results are presented in Figure 8.
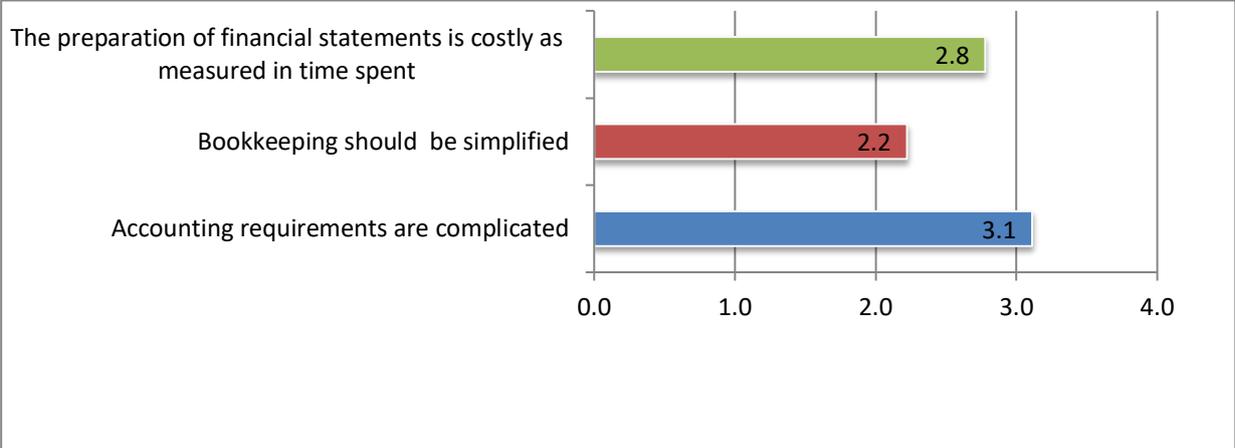

Figure 8: Respondents' ranking of statements related to accounting requirements.

Only 30% of respondents agreed that accounting rules were complicated but the overwhelming majority agreed that bookkeeping should be simplified. The majority also agreed that it takes much time to prepare financial statements. The results may be interpreted that though accounting rules are not complicated, the preparation of reports is time consuming.

Finally, in order to disclose whether formal regulation burden is considered an important barrier for the formation and performance of small business two general statements were formulated. Respondents were asked to rank the importance of regulatory burden for the successful development of small business relative to importance of economic conditions in general. As indicated in Figure 9, majority of the respondents agree that the regulation burden is high and hinders the formation and performance of small business. Opinion was split on whether or not the overall economic conditions like infrastructure, purchasing power of consumers, and the availability of the qualified labor force were more important for the development of small business than the reasonable regulation burden.
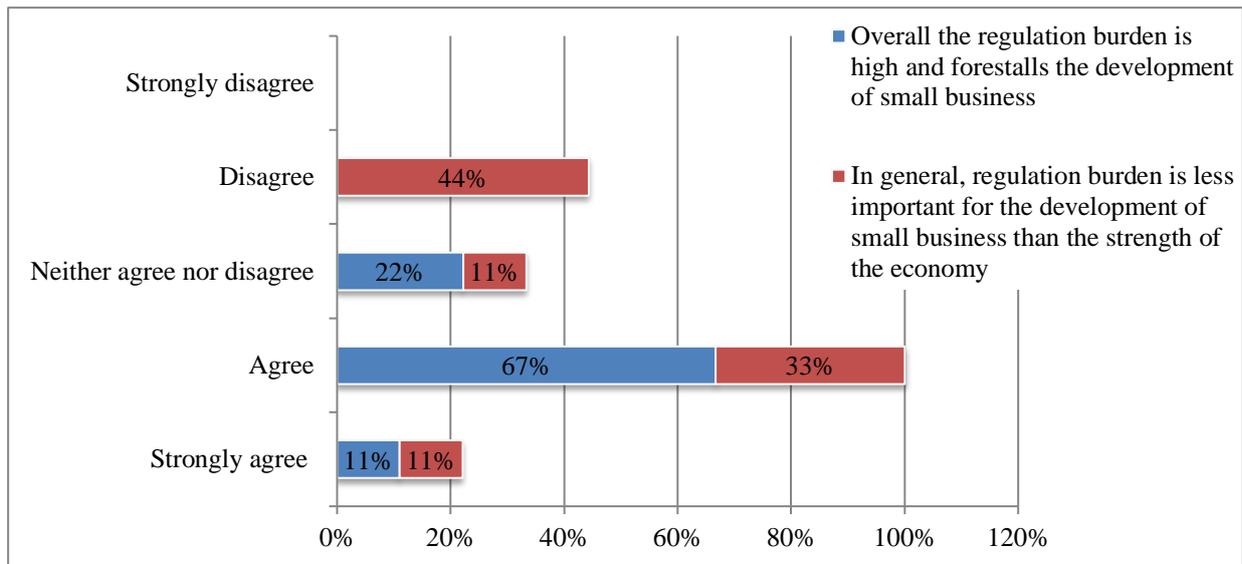
Figure 9: Respondents' evaluation of the relevance of regulation burden versus economic conditions for successful small business development

It follows that experts admit that sound economic environment is a factor that influences the formation of a strong small business sector, however the reduction of regulatory burden is equally if not more important. The respondents were given an opportunity to write comments about the experience managing small businesses. The experts provided the following recommendations:

- Currently each tax imposed on businesses (social insurance tax, health insurance tax, profits tax, personal income tax) is paid separately. In order to save tax payers' resources and time it should be made possible to pay all taxes by a single transfer. Currently separate tax returns (declarations) are filed for each tax though the tax base is often the same. A single tax form (declaration) should be prepared so that all parties engaged in tax administration would receive the information necessary for tax administration purposes in a single form. This would mean filing a single tax return and making a single payment.

- Newly created businesses (up to two years) should be given tax breaks and allowed to keep simplified accounting.

- The social insurance tax rate should be reduced. The calculation and declaration of personal income tax and value added tax should be simplified.

- Reduce taxes on labor, reduce the number of reports required to submit to various government institutions, simplify financial accounting rules.

6. CONCLUSION

Results of the research provide evidence that formal barriers hinder the development of small business in Lithuania. Overall high taxation level, complicated tax calculation rules and time-consuming accounting requirements are perceived as significant burden on small businesses. Although other conditions like infrastructure, the purchasing power of consumers, and the availability of the qualified labor force are recognized as important factors for the successful entrepreneurial activity, the regulatory burden may contribute to high small business failure rates. Businesses in Lithuania are given several options to legally register and carry on their activities, but none of them offer simple and fair taxation rules or relieve from quite burdensome accounting requirements. Though some forms of legal business organization may be more favorable for small businesses than others, the total array of rules and regulations seem confusing for all but very few experts.

Given the predominance of small businesses in the industrial-commercial structure of Lithuanian economy, the policy makers should make more effort to remove the remaining formal barriers to entrepreneurial activity. Fewer taxes and simpler accounting rules would make the whole regulatory system more transparent and amenable to business.

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