Present State and Perspectives of Entrepreneurial Financing in Bosnia and Herzegovina

Bahrija Umihanić, Meldina Kokorović Jukan, and Amra Nuhanović

Abstract Financing start-up firms and small-and-medium enterprises (SMEs) is a challenging task. The main reason for the inability of entrepreneurial firms to finance their business lays in the fact that conventional financing sources (such as commercial bank credits, bond issuing) are not always available for entrepreneurs because there is no available credit history, which are necessary for financial institutions to finance their clients' business operations.

Entrepreneurship development and increase of its overall impact on employment through entrepreneurial activities can be observed from the data of "The Executive Report" of Global Entrepreneurial Monitor (GEM) from 2007. The data shows that in some countries 25 % of the population is employed by starting their own firms (e.g., Peru and Thailand). Due to the fact that entrepreneurial activities are becoming an important driver of economic development in both developed and developing countries, new financial institutions and innovative financing instruments are being created to address the growing need for financing entrepreneurial activities.

This chapter focuses on the examination of different types of financial resources available to financing entrepreneurial firms in the countries with a developed tradition of entrepreneurial thinking and in the countries where entrepreneurial activities are becoming a new trend in economic development. At the same time, we are focusing the research of the impact of the recent financial crisis on the availability of the above-mentioned resources to entrepreneurs. The main incentive for conducting this research is the fact that the financial sector of Bosnia and Herzegovina (BiH) is considered as bank-centric with banks holding more than 80 % of assets within the financial sector. Other financial institutions, microfinance institutions, investment funds, and insurance companies hold less than 4 % each, of the total assets. This means that entrepreneurs are largely dependent on the financial products (credits and loans) from the banking sector. Having in mind that banks perceive entrepreneurial firms as the most risky clients due to the lack of credit history, it raises the issue of how to overcome the gap between banks and

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entrepreneurial firms and what might be the role of the state (and government) in bringing these two sides closer.

The main goal of the research is to identify the degree of development in different types of financial sources available to entrepreneurs in developing countries, with an emphasis on the present state and perspectives of entrepreneurial financing in Bosnia and Herzegovina. In order to conduct the relevant research, we proposed the scientific hypothesis that financial resources available through different types of financial institutions in BiH are not adequately structured to the needs of entrepreneurs starting new businesses.

Methodologically, this research was conducted in two stages. In the first phase, desk research was conducted in order to identify and enlighten the theoretical aspects of entrepreneurial financing. In the second phase, a specific questionnaire was sent to financial institutions in BiH in order to investigate the degree of development of available financial products for entrepreneurs. It further served as the basis for providing recommendations for more usable financial products for financing new businesses.

This chapter is divided into three parts. In the first part, the theoretical background on financing entrepreneurial activity is presented. Using a growth cycle theory, different types and sources of financing available in different stages of entrepreneurial firm life cycle are discussed. In the second part of this chapter, previous research on entrepreneurial financing is discussed. The third part discusses present state and perspectives of entrepreneurial financing in BiH. First, an overview of the BiH financial system is presented, followed by a discussion of empirical finds on BiH financial institutions' lending practices to entrepreneurs. The main focus is on the banking and microcredit sector, government grants and subventions, and venture capital financing perspectives.

1 Theoretical Background on Financing Entrepreneurial Activity: Growth Cycle Paradigm Versus Pecking Order Theory

Facing a problem of high unemployment rates, in most developing countries and countries in transition self-employment through seeking business opportunities and starting new businesses is becoming a major source of creating new work places. According to *The Executive Report* from the Global Entrepreneurial Monitor 2007 (GEM), entrepreneurial activities have profound impact on employment. In some developing countries, a quarter of the population is employed through business start-ups.

By signing the European Charter for Small Enterprises, Bosnia and Herzegovina (BiH) made a commitment to promote and develop an entrepreneurial climate, which is the most important strategic goal for reducing high unemployment.

According to the Agency for Statistics of BiH, in January 2014 there were 557,474 registered unemployed persons. Based on the findings of GEM reports for BiH (Umihanić et al. 2010, 2013), financial and productivity problems are the most common reasons for business discontinuance in BiH in general.

In this chapter, rather than focusing on entrepreneurial firms' perceptions regarding financing, we analyze the factors perceived by financial institutions and government as drivers and obstacles to financing entrepreneurs. Since financing is a key precondition for developing new businesses, the first step in assessing the entrepreneurial climate and its development perspectives is to assess development of financial infrastructure supporting new businesses, measured by the number and types of different financial institutions supporting entrepreneurs.

Furthermore, in order to discuss financing challenges of entrepreneurial firms, it is necessary to make a distinction between entrepreneurial firms (entrepreneurial enterprise) and small-and-midsized enterprises (SMEs). The main difference taken into consideration in this paper is the age of enterprises. We consider that the entrepreneurial firm is a firm in the early stage of entrepreneurial activity. In accordance to the GEM methodology, the early stage of entrepreneurial activity is defined as a period of the first 3.5 years or 42 months of operating a business. This time frame is considered to be the turning point for establishing successful business or discontinuance of entrepreneurial activity. Entrepreneurial firms can be classified to the category of SMEs by defining parameters of SMEs, such as the number of employees and total revenues.

The age difference between entrepreneurial firms and SMEs is a key parameter for distinguishing types of external financial sources available to these enterprises. Even though SMEs have limited options for financing their needs, entrepreneurial firms face a greater problem, which is related to the lack of information regarding the business. This problem is more pronounced when it comes to traditional financial sources (bank loans, initial public offerings—IPOs, and securities emissions).

As it was observed by Denis (2004: 310) entrepreneurial financing situations are characterized by two fundamental problems. First, there are large information asymmetries between entrepreneurs and investors. For example, it is difficult for outside investors to ascertain the quality and potential value of technological innovations. By contrast, entrepreneurs who are often the innovators themselves understand the quality of the innovation. Secondly, there is a potentially serious moral hazard problem. Once entrepreneurs have raised funds from outside investors, they have the incentive to misallocate these funds by spending on items that benefit themselves disproportionately. For example, an entrepreneur/scientist might choose to invest funds in research activities that bring notoriety to the scientist, but for which there is little return for the investor.

Entrepreneurial financing problems caught the attention of the academic circles in the early 1990s, with a boom of entrepreneurial ideas in the high tech, information, and bio-technology areas in the USA. Financing entrepreneurship activity (as well as SMEs) differs from corporate financing, due to their unique characteristics such as size, age, ownership structure, risks related to new technologies development, and, mostly, due to the informational opacity. Unlike large firms, small firms do not enter into contracts that are publicly visible or widely reported in the press; contracts with their labor force, their suppliers, and their customers are generally kept private (Berger and Udell 1998: 616). These characteristics, in large, determine the availability of different types of financial resources.

According to the relevant academic literature, two main streams of theories on entrepreneurship (small business development) can be observed. The first theory is based on the financial growth cycle paradigm disused by Berger and Udell (1998). The second theory discussed in the academic literature is the pecking order theory developed by Myers (1984).

The Financial Growth Cycle paradigm proposes that entrepreneurial firms need different types of financial sources in different phases of a life cycle. The second theory, the pecking order theory, originally devised to examine the financing of large corporations, suggests that the capital structure decisions of a firm are a function of the firm's age. As postulated by this theory, internal sources of funding are prioritized, while use of external sources is delayed until the internal sources are exhausted. As such, when seeking funds, a firm prefers internal equity to external debt, short-term debt to long-term debt, and external debt to external equity (Abdulsaleh and Worthington 2013).

The theory of financial growth is generally accepted in academic research papers and text books, and provides a general idea of which types of financing are available (and appropriate) throughout the life cycle of entrepreneurial firm. Figure 1 shows a general scheme of financing entrepreneurial firms throughout an entrepreneurial firm life cycle focusing on the early stage of entrepreneurial activity.

The developing (seed) phase of entrepreneurial activity is the most risky one, where many businesses do not survive to the next phase, and therefore financial sources are limited. Cash flow in the developing phase is negative due to the existence of different costs associated with product development, legal and tax consultant services, business plan creation, and lack of revenues. Entrepreneurs depend on their own capital and capital which can be borrowed from family and friends, as well as on their ability for bootstrapping. In some cases, providers of external sources are business angels and venture capital funds, which are more commonly connected to the start-up phase.[1] It is important to underline that the role of venture capital funds is not just in providing financing for the new business, but providing managerial assistance as well.

In the start-up and survival stages, which are stages of introduction of the product to the market, the most important providers of financial sources are venture

[1] Business angel or angel investor is usually a former entrepreneur or professional who provides starting or growth capital to promising ventures, and helps also with advice and contacts. Unlike venture capitalists, angel investors usually operate alone (or in very small groups) and play only an indirect role as advisors in the operations of the investee firm. On the other hand, venture capital fund or venture capital firm is a government, semi-government, or private firm that provides start-up or growth equity capital and/or loan capital to promising ventures for returns that are higher than market interest rates (www.businessdictionary.com).

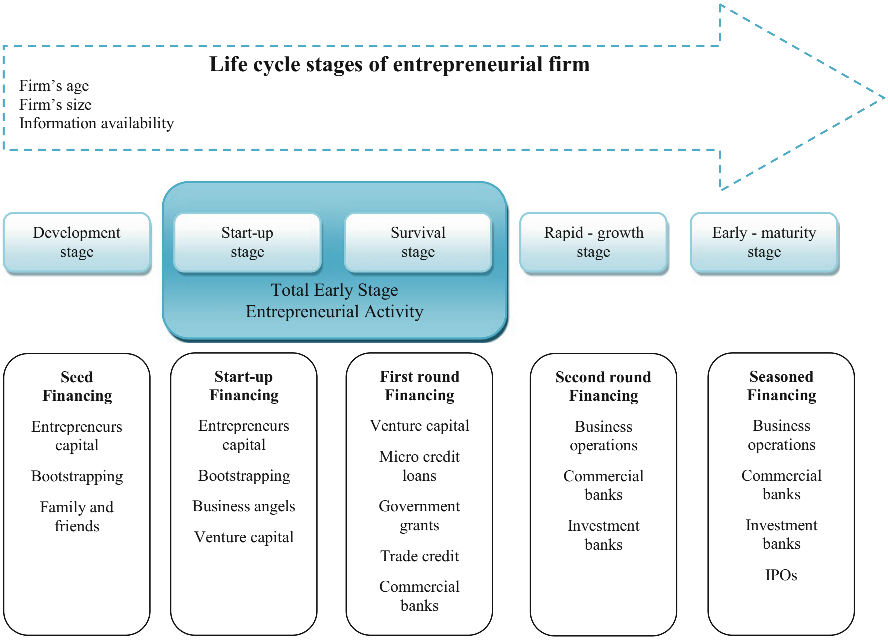

Fig. 1 Types and sources of financing through the life cycle stage of entrepreneurial firm. *Source*: Adapted from Berger and Udell (1998, p. 623), Leach and Melicher (2012, p. 24) and Xavier et al. (2013, p. 13)

capital funds, government grants, as well as a commercial or micro finance institutions loans, depending on the development phase of a national financial system. In the later phase (rapid growth stage) cash flow of the business is positive with a potential of rapid growth, which is a precondition for debt financing. Therefore, in this phase more conventional (traditional) financial sources are becoming available, such as investment loans or financing through securities issuing.

According to Barringer and Ireland (2010), types of financial sources for entrepreneurial firms can be also connected to the riskiness of entrepreneurial activities. In this context, three types of entrepreneurial activity based on the risk associated with the activity can be identified: highly risky activity with uncertain return, low risk activity with less uncertain return, and activity with high return. The most adequate financial sources for highly risky activity with uncertain return (characterized by low cash flow, high debt rate, low to moderate growth, and inexperienced management) are personal capital and capital borrowed from family and friends combined with bootstrapping methods. For low risk activity with a less uncertain return, which is characterized by strong cash flow, low debt rate, revised financial statements and proper management, debt financing is the most appropriate source of financing. IPO and security issuing are methods appropriate for financing activity with a high return, characterized by a unique business idea, high growth market niche, and well-established management.

2 Previous Research

As indicated in the previous part, one of the first research in financing small business (and therefore, entrepreneurial firms) can be found in early papers of Berger and Udell (1998), Helwege and Liang (1996), Kimhi (1997), following Cassar 2004; Hartarska and Nadolnyak (2007), La Rocca et al. (2011), Wu et al. (2008), etc. The early research made by Berger and Udell (1998) provides an insight to a number of facets of small firm finance, the investors and intermediaries that provide it, and the private equity and debt markets in which they function. They argued that the degree of informational opacity is a key feature that drives the financial growth cycle and distinguishes small business finance from large business finance. Information opacity (lack of information on the specifics of business operations, lack of (audited) financial statements and repayment and profitability history, inadequate collateral, etc.) is a key obstacle of entrepreneurial firms to obtain external financial sources for financing their business projects.

Cassar (2004) investigated the relationship between the size of the start-up company and a company's asset structure in the structure of financing. This research shows a strong correlation between size and tangible assets in terms of the possibility to use debt financing. The larger the start-up the greater the proportion of debt, long-term debt, external financing, and bank financing. Firms with a relative lack of tangible assets appear to be financed through less formal means, where nonbank financing, such as loans from individuals unrelated to business, plays a more important role in the capital structure of start-ups (Cassar 2004: 277).

The most important factor governing the ability of start-ups to raise sufficient capital for their projects is the depth of the local capital markets, according to Kerr and Nanda (2009). They found that more developed financial markets, measured by the number of different financial institutions, provide numerous financing opportunities for companies. Furthermore, developed financial markets are characterized by the existence of different types of financial instruments, which help financial institutions reduce risks associated with lending to non-financial firms. On the other hand, emerging financial markets are characterized by a lower number of financial institutions and financial instruments available to financing the non-financial sector. Since entrepreneurial activity is risky in the early stages, entrepreneurs starting their business in economies with developing markets are facing greater constrains related to external sources of financing.

As it is shown in the reviewed literature, financing entrepreneurial activity is a more challenging task in developing countries with an underdeveloped financial system. Financial systems in developing countries are more oriented towards well established companies with credit history (bank oriented financial system) and often do not provide more sophisticated forms of financial support to entrepreneurial companies, such as venture capital, factoring, forfeiting, or leasing.

As the research of the Financial Inclusion Experts Group shows, access to finance is, and remains a key constraint to SMEs as well as entrepreneurial development in emerging economies. Comprehensive data on the SME finance gap is still to be more consistently collected and monitored over time. However various data sources and studies indicate that small firms rely on internal financing much more than large firms do, and that the likelihood of a small firm having access to a bank loan in low-income countries is about a third of what it is for a medium-sized firm, and less than half of what it is for a larger firm. Furthermore, other sources of SME finance, such as leasing and factoring, are also less developed in emerging countries (IFC 2010).

Several attempts to analyze access to financing by entrepreneurs in BiH can be found in the papers by Hartarska and Nadolnyak (2007), Welle-Strand et al. (2010), which are oriented towards examining the role of the microfinance sector in financing entrepreneurs, SMEs, and the poor. Hartarska et al. applies the financing constraint approach to the study whether microfinance institutions improved access to credit for microenterprises in BiH. According to this approach, microenterprises with improved access to credit rely less on internal funds for their investments.

Furthermore, the Global Entrepreneurship Monitor,[2] which has monitored entrepreneurial activity for BiH since 2008, provides a more systematic approach to covering the issue of entrepreneurial financing, but focusing on entrepreneurs and experts' perceptions of the quality and accessibility of financial sources within the BiH financial system. Experts from BiH, surveyed in the 2012 GEM Report, perceive financing as an unfavorable condition for entrepreneurship development with less equity funding available to new and growing firms compared to the previous years (Umihanić et al. 2013: 10). Moreover, GEM reports show that there are no sufficient government incentives to new and growing businesses, as evidenced by the fact that continuous growth of budget revenues in the last years was not in the function of business.

Now we turn our attention to the analysis of the present state and problems of financing entrepreneurial activities in the BiH bank-centric financial system by focusing on the demand of financial products/services offered by different types of financial institutions.

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[2] For more detailed information on GEM reports see http://www.cerpod-tuzla.org/index.php/bs/gem/gem-izvjestaji and http://www.gemconsortium.org/

3 Entrepreneurial Financing in Bosnia and Herzegovina

3.1 Overview of the Financial Sector in Bosnia and Herzegovina with the Focus on Financial Institutions Supporting Financial Needs of Entrepreneurs

In order to examine and analyze the types of financial products/services offered by the financial institutions to entrepreneurs in BiH, an overview of the financial industry and key financial institutions is provided here. The financial sector of BiH is dominated by commercial banks. On the other hand, nonbank financial sector is relatively underdeveloped with the following financial institutions operating within the sector: microcredit organizations, leasing companies, investment funds, and insurance companies. The BiH financial system is bank-centric, where a dominant role is played by the commercial banks. As Fig. 2 shows, commercial banks account for 84 % of the total financial assets within the BiH financial system, while the remaining financial institutions account for 5 % or less of the total assets.

Data on the BiH financial system show that total asset value of the financial institutions in BiH supporting entrepreneurs increased during the last several years (as shown in Table 1).

According to the data provided by the banking agencies of the Federation of BiH and of Republic of Srpska, stability and security of the overall banking sector is adequate. In 2012, the capital adequacy rate of the banking sector, as the most important measure of banking sector performances, was 16.4 %, which is substantially above the regulatory minimum of 12 %. Regardless of the financial crisis, the financial system of BiH remains strong in terms of its ability to provide financial support to the non-financial sector (companies and households).

On the other hand, statistical data shows that credit activity of banks decreased during 2012, where 51.6 % of the total credits (approximately 16 billion BAM) was granted to nonfinancial companies (public and private), 42.6 % to households, and 5.2 % to the government. In the same period, microcredit financial institutions in the Federation of BiH (FBiH) granted only 2 % of the total credits (400 million BAM) to companies and 98 % to households. According to the Annual Report for 2012 of the Central Bank of BiH, there were 28 licensed banks in BiH, of which 18 operated in FBiH and 10 in Republic of Srpska (RS). There were 19 microcredit financial institutions (13 in FBiH and 6 in RS), where 15 of them are organized as microcredit foundations and 4 as microcredit organizations.[3] Leasing companies

[3] One of the main differences between microcredit foundations and microcredit institutions is related to the maximum sum of granted credit. Microcredit foundations can grant a credit up to BAM 10,000 (some 5000 euros), while microcredit organizations can grant a credit up to BAM 50,000 (some 25,000 euros).

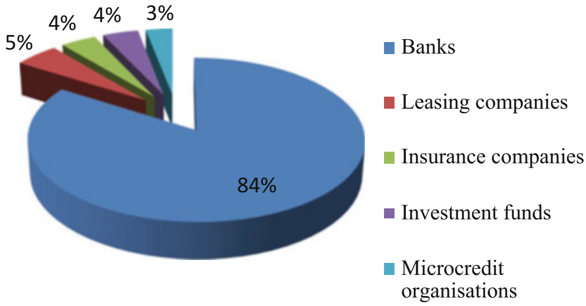

Fig. 2 Structure of financial institutions of the BiH financial sector in 2012. *Source*: www.cbbih.ba

Table 1 Total asset value of financial institutions in BiH

	2012		2011		2010	
	Value in (mil BAM)	%	Value in (mil BAM)	%	Value in (mil BAM)	%
Banks	21,187	86.3	20,923	86.0	20,416	85.6
Leasing companies	716	2.9	767	3.2	744	3.1
Microcredit organizations	681	2.8	752	3.1	853	3.6

Source: www.cbbih.ba

are less developed financial institutions with only nine being licensed for providing leasing contracts (seven in FBiH and two in RS).

Furthermore, capital markets in BiH are not used to their full potential. Organized capital markets exist within two securities exchanges (Sarajevo Stock Exchange and Banja Luka Stock Exchange), but the annual turnover at these exchanges is rather symbolic. The structure of the securities exchanges turnover shows a lack of foreign investors and a dominance of government debt securities. Private companies do not use securities exchanges to raise capital funds through stock or bonds issuing or initial public offerings. Therefore, since microcredit organizations and banks provide a major source of financing to entrepreneurs, these financial institutions are further analyzed.

3.2 *Research Data*

The assessment of the present state and conclusions on future perspectives of entrepreneurial financing in BiH is based on a survey conducted among banks and microcredit organizations as they are the major supplier of external financial resources to entrepreneurs. For the purposes of the survey a specific structured questionnaire was designed and sent to the above mentioned financial institutions in FBiH.

The questionnaire included 12 questions and addressed three main issues as follows: (1) the extent of financial institutions' involvement with entrepreneurs, (2) learning about motives of financial institutions' financing to entrepreneurs, and (3) determining obstacles of future involvement in financing entrepreneurs. Furthermore, key personnel of financial institutions were interviewed in order to provide better insight into financial institutions' operations.

The response rate was rather low, due to the fact that banks and microcredit organizations are known as non-transparent financial institutions. The response rate among banks was 50 % (9 out of 18 banks operating in FBiH in 2012, according to Banking Agency of Federation of Bosnia and Herzegovina (2013a), returned the questionnaire). The response rate among microcredit institutions was 23 % (in absolute terms 3 out of 13 microcredit financial institutions operating in FBiH in 2012, Banking Agency of Federation of Bosnia and Herzegovina (2013b) returned the questionnaire), but the microcredit institutions that returned the questionnaire account for more than 50 % of the total assets of the overall microcredit sector in FBiH.[4]

Furthermore, using available secondary data, we addressed the issue of government involvement in financing entrepreneurs through grants and subventions. Since venture capital market practically does not exist, we assessed the current state and future perspectives of venture capital financing in BiH by analyzing perceptions of entrepreneurs (who are starting or have established their own business) towards using venture capital.

3.3 Present State and Future Perspectives of Banks and Microcredit Organizations' Involvement in Entrepreneurial Sector

The survey data shows that commercial banks and microcredit organizations are increasing their involvement in financing entrepreneurial activities and entrepreneurial firms, where the involvement of commercial banks is in most cases linked to the survival stage of total entrepreneurial activities. Moreover, several leading banks in BiH have established separate departments to deal exclusively with entrepreneurs, which is a strong indicator of increased awareness among banks about the profitability of this segment of clients.

Financial institutions' exposure to entrepreneurs, measured as a ratio of entrepreneurs' loans to the total outstanding private sector loans, is higher among microcredit organizations (ranging up to 25 %), than among commercial banks,

[4] As the response rate was rather low for microcredit financial institutions (MFIs), more detailed information on the present state and perspectives of their future involvement in entrepreneurial sector were obtained through the interviews with representatives of MFIs who returned the questionnaires. In that respect, results presented in the following parts of the chapter are rather descriptive than quantitatively presented.

where this ratio ranges from 0.9 to 13 % for the banks surveyed. A low percentage of commercial banks' involvement in the entrepreneurial sector is expected, due to high credit risk associated with the lack of credit history of entrepreneurial firms. On the other hand, the survey shows an unexpectedly low involvement of microcredit financial institutions in financing entrepreneurs. In informal communication with the key personnel of microcredit financial institutions, it was determined that the majority of entrepreneurs do not have adequate education about available financial products/services offered by the microcredit sector and therefore, they do not use this type of the financial support to its full potential. Furthermore, entrepreneurs find microcredit products (loans) rather expensive since interest rates are approximately 3–4 times higher than the ones calculated on commercial banks' loans.[5]

In terms of the financial product types that banks and microcredit institutions use to engage with entrepreneurs, bank lending products (loans) are mainly short-term, while microcredit institutions offer mid-term and long-term loans. The most important lending products among banks are short-term loans (revolving credits) and overdrafts. These loans are used for financing current asset purchases or maintaining liquidity. Besides short-term loans, banks offer a number of different financial services to entrepreneurial firms, such as checking and savings accounts, services related to payment system, e-banking, etc. (see Fig. 3).

Microcredit institutions, on the other hand, offer long-term loans up to 5 years to prospective entrepreneurs, which are used for long term investments, such as buying equipment for production and other non-current asset. When it comes to collateral requirements for granting a loan, the surveyed banks and microcredit institutions reported using movable property, backer or bills of exchange as instruments for hedging credit risk (collateral) with entrepreneurs. Several banks indicated that they accept guarantees from other business entities for reducing credit risk, since entrepreneurial firms usually do not own significant material goods.

In order to understand motives for financial institutions' involvement in the entrepreneurial sector, banks and microcredit institutions were asked to determine the significance of different factors, using the following scale: "not significant", "significant" and "highly significant". The financial institutions were offered to assess the following factors: (1) entrepreneurs are perceived as a profitable client segment, (2) high competition among financial institutions for large corporate clients (regardless of the ownership structure), (3) high risk exposures to other client segments (households, SMEs and large corporate clients), (4) possibility to

[5] According to the statistical data on the banking sector and microcredit system published by the Banking Agency of FBiH, the average effective interest rate on commercial bank loans was 7.35 % and on microcredit loans it was 25.29 % in 2013. Furthermore, the effective interest rate on short-term loans of commercial banks was 6.8 %, while that of microcredit organizations was 26.89 %. The effective interest rate on long-term loans of commercial banks was 7.95 %, while that of microcredit organizations was 24.82 %. (Information on the banking sector of FBiH as of Dec 31, 2013, p. 48 and Information on the microcredit system of FBiH as of Dec 31, 2013, p. 22.)

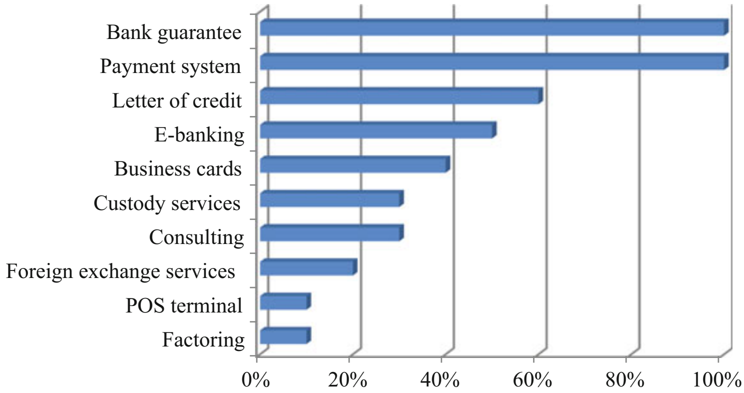

Fig. 3 Other banking services offered to entrepreneurial firms. *Source*: Authors' research

obtain information about prospective clients from the existing ones, and (5) Other factors (specify).

Microcredit institutions highlighted the following three factors as highly significant: profitability of entrepreneurial client segment, possibility to obtain information about prospective clients from the existing ones, and motivation to promote new job openings, and production increase. All the surveyed banks indicated that profitability of entrepreneurial clients segment and high competition among financial institutions for large corporate clients (regardless of the ownership structure) are significant factors for their involvement in entrepreneurial firms, while only one bank indicated the possibility to obtain information about prospective clients from the existing ones as a highly significant factor.

Regarding perspectives of future involvement in entrepreneurial clients segment, all of the surveyed banks and microcredit organizations reported that they intend to increase their involvement in this segment of clients. Moreover, we assessed the degree to which this involvement is affected by certain obstacles. Financial institutions were offered to assess the following obstacles to future increase of involvement in entrepreneurial firms as follows: (1) entrepreneurial specific factors, (2) competition in entrepreneurial client segment, (3) macroeconomic factors, (4) regulations, (5) legal and contractual environment, (6) lending technology, (7) lack of adequate demand (8) bank specific factors, and (9) other factors (specify).

All the surveyed banks and microcredit institutions indicated entrepreneurial specific factors and regulation as the most significant obstacle to further involvement in the entrepreneurial sector. Macroeconomic factors, lack of demand, and bank specific factors were perceived as not significant. None of the surveyed financial institutions indicated highly significant obstacles for their future involvement with entrepreneurial clients, which may lead to the conclusion that a better regulation within the entrepreneurial sector and better understanding of particular entrepreneurial entity (or an entrepreneurial idea) will help to increase the involvement of financial institutions with entrepreneurs in the future.

Since improper regulation is regarded as the most significant obstacle to stronger relation between entrepreneurs and the financial sector, the surveyed financial institutions were asked to indicate concrete measures and possible areas in which government actions could help enhance institutions' incentives to increase their involvement with entrepreneurs. Their responses can be summarized in the following actions:

– creating a positive business environment,
– tax system reform focusing on tax exemptions or deductions for entrepreneurial firms,
– greater government subventions and grants for entrepreneurial projects,
– interest rate subventions for employment and production, and
– reform of the legal and judicial sectors.

Concrete measures at the level of financial institutions and government are moving towards a joint approach of financial institutions and different levels of government (state, entity and cantonal) in supporting entrepreneurial activities.

3.4 Government Grants and Subventions to Entrepreneurs

When it comes to government support to the entrepreneurial sector, government financial support to entrepreneurs in BiH is implemented through grants and subventions at several government levels (entity, canton and local level). According to the available statistical data, the amount of grants and subventions at the federal level was less than 0.5 % of the total annual budget of FBiH for the last several years. Table 2 shows a more detailed breakdown of subventions and grants disseminated through the Federal Ministry of Development, Entrepreneurship and Crafts.

According to the data of the Federal Ministry of Development, Entrepreneurship and Crafts, most subventions and grants are granted for different purposes, such as:

– building entrepreneurship infrastructure,
– support for entrepreneurship associations,
– subventions of interest on loans,
– women entrepreneurship,
– youth entrepreneurship, etc.

Financial sources are granted through public announcements on an annual basis and in accordance with the national program of measures for development of small businesses. Due to inadequate regulations, financial sources available to different private sectors (and therefore, entrepreneurial firms) are ten times smaller than those available for public enterprises. Statistics show that, just before the economic crisis in 2008, financial sources provided for the public sector amounted to 100 million BAM (around 50 million euros, while for small and midsized companies this amount was 10 million BAM (around 5 million euros. This treatment of public

Table 2 Financial support to entrepreneurship and agricultural and rural development from the Budget of FBiH

Year	2009		2010		2011	
Total budget of FBiH	1,988,877,738		1,734,227,815		1,645,041,660	
Sector	Entrepreneurship			Agriculture and rural development		
% provided from Budget in BAM	up to 2			from 2 to 6		
Allocated sources from Budget in BAM	2009	2010	2011	2009	2010	2011
	4,100,000	8,005,000	6,308,330	49,198,591	56,237,203	51,931,974
Percentage of subventions and grants from Budget	0.21	0.46	0.38	2.47	3.24	3.16
Percentage of employed in the sector in the total amount of employed persons in BiH	56			20		
Percentage of GDP of FBiH	50			5		

Source: Audit office for the institutions of FBiH (2013)

enterprises put non profitable and poorly managed companies in a better market position than the private sector (Martinović et al. 2012: 342).

3.5 Venture Capital and Venture Capital Funds in BiH

Venture capital is a major and the most important source of external financing in the total early entrepreneurial activity. Therefore, entrepreneurial activity is dependent on venture capital market development. The venture capital market in Europe started developing in the early 1990s and showed steady growth up to the financial crisis in 2008. The financial crisis in 2008 followed by the European sovereign debt crisis had a profound impact on the investments in venture capital funds, which can be observed from Fig. 4.

Figure 4 shows a steep decline of venture capital fundraising activity in European venture capital market in 2009 and 2010 with short-term recovery in 2011, following another decline in 2012.

In Western Balkan countries, venture capital funds are relatively new financial institutions. The first association (South Eastern Europe Private Equity Association—SEEPEA), promoting industry of venture capital in South Eastern Europe was established in 2005. There have been some positive developments it the

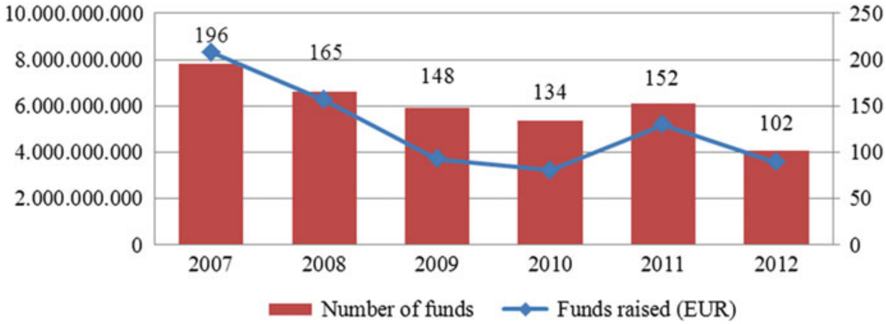

Fig. 4 Fundraising activity in Europe. *Source*: EVCA

Western Balkan region indicating the overall increase in the venture capital activity. This type of financing is becoming more common across this region, including BiH (Kozarević et al. 2013: 442). Croatia and Serbia have established an institutional framework for venture capital. Furthermore, in the above-mentioned countries, associations for promoting venture capital, as well as business angles networks have been established. On the other hand, the venture capital market in BiH can be characterized as nonexistent. One business angle network was established in 2013, but the network does not pursue significant activities. According to the Venture Capital and Private Equity Country Attractiveness Index, BiH was on the second place among Western Balkan countries and 73rd on the global rankings.

As for perspectives of venture capital market development in BiH, it is important to support and stimulate an entrepreneurial culture. In other words, it is necessary to develop a functioning market where innovative businesses can grow. In order to implement this complex task it is important to have in mind that the venture capital market needs three types of subjects: innovative entrepreneurs, investors (with liquid funds and aspiration to long-term investing) and specialized financial intermediaries (Softić 2013: 85–86). BiH Herzegovina lacks specialized financial intermediaries, while there is a growing entrepreneurial culture and investors with sufficient funds to invest in entrepreneurial ideas.

Furthermore, it is important to point out that the results of an empirical study conducted in BiH clearly indicate that the local companies have a very limited understanding and knowledge about financing options through venture capital funds. This highlights the need for proper education and informing in this area. While there is a strong aversion to equity sharing (ownership dilution), entrepreneurs are aware of the benefits associated with the financing through venture capital funds. Therefore, better education and stronger knowledge of venture capital funds would help reduce the predominantly negative perception about this type of fund raising in this particular region (Kozarević et al. 2013: 442).

4 Concluding Remarks and Further Research

The overall conclusion of the research can be summarized in the fact that financial infrastructure supporting entrepreneurship in the total early stage of entrepreneurial activity in BiH is underdeveloped. The most important structural part of this infrastructure namely venture capital market is still practically nonexistent. The following reasons might explain undeveloped venture capital market: poor entrepreneurial culture and infrastructure in BiH and lack of adequate practical government support for promoting entrepreneurship (legal documents in form of action plans do exist, but implementation of the defined measures fails).

The financial sector of BiH is bank oriented. The banking sector, together with the microcredit system, is the primary source of financing for entrepreneurs. However, financial products/services offered by these financial institutions are expensive for young and growing businesses often suffering from low and irregular cash-flow. Moreover, commercial banks offer mostly short-term loans, which are not adequate for financing long-term projects and development plans of entrepreneurial firms. It is positive that commercial banks and microcredit finance institutions accept guarantees from other business entities as the collateral on loans for entrepreneurs, which is of great help to entrepreneurial firms when seeking for long-term financial solutions.

Government support exists in the form of grants and subventions to different interest groups supporting entrepreneurship. Still, the percentage of the budget disseminated for entrepreneurship is low. Based on the information from the financial institutions in BiH, the following measures need to be implemented by the government bodies in order to further develop financial infrastructure for entrepreneurs: creating a positive business environment, tax system reform focusing on tax exemptions or deductions for entrepreneurial firms, greater government subventions and grants for entrepreneurs projects, interest rate subventions for employment and production, and reform of the legal and judicial sector.

Furthermore, research shows that the majority of entrepreneurs are not educated about the available financial products offered by the microcredit sector and therefore do not use this type of financial support. Similar conclusions can be made for venture capital financing, where entrepreneurs have strong aversion to venture capital and ownership dilatation associated with venture capital. Banking financial products, on the other hand, are becoming more available to entrepreneurs. Banks perceive the entrepreneurial segment as profitable due to the lack of profitable opportunities related to large clients (large companies) and the SME sector. The banking sectors' greater involvement in the entrepreneurial sector is evident through the changing organization of banks, where major banks in BiH are creating separate departments, which exclusively support entrepreneurial clients and offer specific products created to aid entrepreneurial firms.

In that respect, further research should address a more in-depth analysis of entrepreneurs' perception of financial sources available for businesses operations. This research has provided two main contributions. One is to help in better understanding of entrepreneurs' needs for external financial sources, as well as for other financial services. The other benefit is to help financial institutions create better-tailored financial products for entrepreneurs, which will increase financial institutions' presence in the entrepreneurial sector.

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