

# European Union Integration Impact on Romanian SMEs Performance

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**ABSTRACT** Since SMEs are the most important entities of the national economy we can say that their performance is the locomotive of performance at the microeconomic level. The present material is not limited to measuring the performance of SMEs in Romania for a given period, but aims to analyze what impact did the European integration of Romania had on the performance of SME within the development regions. For this we took from the annual edition of White Paper of SMEs for the period 2004-2011 the values of eight indicators used to quantified performance (net result, turnover, return on equity, commercial rate, rotation rate of own capital, overall autonomy rate, labor productivity and overall solvency ratio), we explained the choice of these indicators, we applied the model of unobserved components and established a global performance index of SME development for each region separately. With this index we could determine whether Romania's EU accession had an influence on the performance of SME development in the regions and we could compare this influence with the influences of economic crisis manifested in the analyzed period on the same performance indicators.

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**KEYWORDS:**

Performance; European integration; Small and medium enterprises (SMEs); Model of unobserved components

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## 1. Introduction

Small and medium enterprises (SMEs), by their large number, have a significant share in the market structure, diminishing through their high number the influence and monopoly of large companies on market prices. The importance of SMEs within the national economy is crucial, representing the *backbone* of the national economy, idea underlined also by Peter Drucker. The author considers that “small businesses are the main catalyst of economic growth” (Drucker, 1999 cited in Vasilić, 2006). Through their activity SMEs contribute to the goals established for the national economy, ensuring economic growth and social development. SMEs are “the main generator of economic activity and the largest private sector employer group (Carey, 2015). SMEs not only hold a majority share in the total number of active companies in Romania (99.7% in 2013, according to Fundația Post-Privatizarea FPP, 2013), but they have a significant contribution to job creation (according to the aforementioned report 65.7% of the Romanian employees are working in SMEs).

The SME sector has attracted the attention of policy makers both in developed and developing countries. In developed economies the attention was focused on the new number of SMEs and their development, because they are expected to provide a greater number of jobs and contribute to economic development and innovation process. In developing economies the SMEs sector is perceived as a source for providing indigenous economic development (Dalrymple, 2004).

In the European Union was outlined over time the importance of SMEs development for the European economy. Adopted in 2008, the Small Business Act reflects the importance and centrality of SMEs for the European economy (European Commission, 2014).

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SMEs are therefore an important factor for the growth and prosperity of an economy and play an essential role in development, research and innovation. Former vice-president of the European Commission, Günter Verheugen, confirms the importance of SMEs for national economies considering that “Entrepreneurs are the economic DNA needed to boost competitiveness and innovation in Europe” (Ciochină and Cebuc, 2013).

In this context SMEs performance is, especially for developing countries, a concern for both practitioners and academicians. Moreover, the current economic climate is in a permanent change that creates uncertainty, which determines economic entities in general, and SMEs, in particular, to focus on constant improvement of internal processes in order to survive in the market. So, they are forced to constantly monitor performance (Raymond et al., 2009; Bahri et al., 2011).

In this paper we try to identify the impact of Romania’s European Union (EU) integration on the financial performance of Romanian Small and Medium Enterprises. On 1 January 2007 Romania became a member state of the European Union, fact that generated both obligations and rights, all resulting from European legislation. The status of EU member state has attached a number of advantages such as: development of disadvantaged areas in particular through access to European funds, the creation of new jobs, protection of employees, openness to new business opportunities, stability at the legislative level, etc.. In the case study we analyzed the evolution of a complex financial performance index, developed for SMEs in Romania, for a period of eight years (2004-2011) in order to capture the impact of accession (1 January 2007) on the performance index. Although initially we wanted to do this analysis only on six years, three pre-accession (2004, 2005 and 2006) and three post-accession (2007, 2008 and 2009), because the national economy (including SMEs too) was strongly affected by the economic crisis in 2008 and 2009 so that we extended our calculations for the next 2 years, namely 2010 and 2011.

## 2. The concept of performance and its assessment on Romanian SMEs

The concept of performance is suitable to a variety of definitions that can refer to various functional perspectives or contexts. Anthony (1965) defined performance dividing this concept in two primary elements, namely, efficiency and effectiveness. The literature review further this definition (Yachtman and Seashore, 1967; Mărgulescu, 1994; Lorino, 1997; O’Donnell and Duffy, 2002; Albu and Albu, 2003; Mathews, 2007; Danzinger, 2007) found that many of performance definitions focused on the *efficiency* size of the concept, considering the financial results as the primary measures of performance (Pintea, 2011).

The *efficiency - efficacy* couple is also supported by performance definition of Niculescu and Lavalette (1999) that consider that “performance is a state of competitiveness of the company, reached by a level of effectiveness and efficiency (productivity) which provides lasting presence on the market”, opinion resumed by Bouquin (2008).

The financial performance of an economic entity has long been seen through the prism of accounting results obtained, which could take the form of profit or loss. We consider that this limitation provides a truncated economic entity’s financial performance image, as only presenting absolute size of the accounting result is insufficient. In the present conditions imposed by economic development the interests of the stakeholders cannot be satisfied just by knowing the accounting result. This result should be connected with its determinants by calculating financial indicators that capture the multidimensional nature of performance (Pintea, 2011). “The performance of a company is not limited to the size of the outcome of the exercise, in other words performance is defined by the users of financial statements according to their own goals, and as such performance is not reflected solely in profit and loss” (Bătrâncea et al., 2010).

Therefore, in assessing the financial performance of an economic entity the consecrated elements are the indicators. The complexity of economic processes and phenomena that take place at the level of an economic entity make impossible the use of a single indicator for the assessment of financial performance, which is why the solution is either to develop a system of indicators of performance or to develop a comprehensive index of financial performance.

In literature the question raised by the utilization of multiple indicators of performance was regarding on which indicators capture the best the financial performance. Shashi and Goldschmidt (1974) were the first authors who presented a model of financial performance of the economic entity

using the following indicators: profit margin, return on shares, return on capital, capital rate of exploitation and activity rate, indicators that capture each dimension of economic entity's financial performance. The first two are indicators of profitability (direct measure of the performance of the entity) and the last three are financial, indicating that its position is a function of past and present performance.

Anthony Hopkins and Merchant (2003) divided the financial indicators in the following categories: overall performance indicators, profitability indicators, indicators on asset management and financial situation indicators.

Helfert (2006), starting from the most important stakeholders, namely managers, investors/shareholders and creditors, it outlines a clear structure of performance indicators used in financial analysis. For each of the three categories considered (management, investors / shareholders and creditors) Helfert (2006) grouped the indicators into two subcategories performance indicators as follows:

- management: indicators of operational analysis and resource management indicators;
- investors / shareholders: indicators regarding investment profitability and indicators on the use of profit;
- creditors: indicators of liquidity and financial leverage indicators.

The need of alignment across all economic entities, be they large companies or SMEs, of performance measurement systems to their strategic objectives was highlighted over time by various authors (Kaplan, 1983; Gregory, 1993; Darlymple, 2004). Over time were developed various systems to assess the performance of economic entities, such as: Return on Investment and Return on Equity models and their derivatives placed before the 80s; SMART (Strategic Measurement and Reporting Technique) Pyramid developed by Lynch and Cross 1991; Matrix of outcomes and determinants of Fitzgerald et al. (1991); Morin, Savoie and Beaudin Model developed in 1994; Atkinson, Waterhouse and Wells Performance Model, developed in 1997, Balance Scorecard developed by Kaplan and Norton (1992, 1996) - the most popular performance evaluation system; Performance Prism developed by Neely et al. (2001) and others.

If Cohen (1994) considered profit, gross operating profit, treasury profit and cash-flow the key financial performance indicators, Clarke et al. (2004), points out that the following seven financial measures are used by the majority of economic entities: turnover, costs, gross margins and net working capital, cash flow and net income per share.

Although there is a variety of systems for measuring performance, most of them, even if they were validated theoretically do not surprise SMEs perspective, these having several characteristics that distinguish them from larger companies, reason for which the use of these performance evaluation systems to SMEs has not had the expected results (Turner et al., 2005; Wiesner et al., 2007; Hudson-Smith and Smith, 2007; Ates et al., 2013). So, the obvious conclusion that can be drawn from these results is that a fair adoption of performance measurement systems in SMEs needs to consider the specific features of SMEs and in-depth understanding of these characteristics.

Hudson, Smart and Bourne (2001) revealed several features that distinguish SMEs from large companies, namely: customized management with reduced transfer of authority, severe limitations of resources both at management level and in terms of financial dependency, small number of customers, development of activity on limited markets, the existence of flexible structures, high innovation potential and, not the least, the existence of a reactive mentality.

Ates et al. (2013) identified eight main features interdependent influencing management practices in SMEs: short-term priorities, internal operational focus and lack of external orientation, tacit knowledge, flexibility, low managerial skills, entrepreneurial orientation, control culture and limited resources. These features have been highlighted by other authors such as Laverty (2004) that pointed out that SMEs strategic planning is done at a low level and there is a lack of structured decision-making processes. Day and Schoemaker (2005) showed that successful SMEs are those that are constantly concerned with the conditions in the economic environment in which they operate, technological developments in relation to their capabilities and competitive position in the marketplace. O'Regan and Ghobadian (2004) stressed that internal orientation is a prerequisite for improving short-term performance, while the external orientation of a SME provides improved long term performance. Aloulou and Fayolle (2005) highlighted as key features of SME flexibility, responsiveness, creating opportunities and taking risks.

Also, practice has shown that SMEs invest less in training and development of managers compared with large companies (Curran et al., 1996), and SMEs' managers rely on personal relationships to obtain information without realizing the need for well-defined structures of performance management (Bititci et al., 2006).

Hudson, Smart and Bourne (2001) have attempted to develop and apply a strategic performance management system suitable for the SME sector, but their attempt was not brought to completion because they have concluded that there are "substantial barriers in development of strategic performance management system in SMEs".

Based on the literature mentioned above and of the information provided by the White Paper of SMEs for the period of eight years from 2004 till 2011, we chose eight economic indicators for financial performance evaluation of SMEs in Romania, namely: net result, turnover, commercial rate, return on equity, equity rotation rate, global autonomy rate, labour productivity and overall solvency ratio. The selection of these indicators was intended so that they cover the following categories: overall financial performance indicators (net result, turnover), profitability indicators (commercial rate, return on equity), activity indicators (equity rotation rate, labor productivity) and solvency and autonomy indicators (overall solvency ratio, overall autonomy rate). The choice of these indicators was based on their use over time in various models for performance evaluation, among which are some mentioned in Table 1.

**Table 1.** Financial indicators in the literature

Indicator	Authors
Net result (RNE)	Cohen (1994), Gheorghiu et al. (2002), Helfert (2006)
Turnover (CA)	Gheorghiu et al. (2002), Clarke et al. (2004), Bătrâncea et al. (2010)
Commercial Ratio (RRC)	Glăvan (2009), Helfert (2006)
Return on Equity (RRF)	Mereuță et al.(1994), Anthony et al. (2003), Trenca (2005), Glăvan (2009)
Equity Rotation Ratio (RRCP)	Anthony et al. (2003), Helfert (2006)
Overall Autonomy Ratio (RAG)	Mereuță et al.(1994), Helfert (2006)
Labor Productivity (PRODM)	Atkinson, Waterhouse and Wells (1997), Morin, Savoie and Beaudin (2001), Helfert (2006)
Overall solvency ratio (RSG)	Cohen (1994), Bătrâncea et al. (2010)

Primary indicators from financial statements used for developing financial performance indicators are: net result, turnover, equity, total assets, total liabilities and number of employees. The net result and turnover are two of the most used indicators of financial performance. The commercial rate and the return on equity are excellent indicators in assessing the profitability of economic entities.

The first is calculated as the ratio between net income and turnover therefore the decisive elements are the two most used measures of financial performance, and the second rate is calculated as the ratio between net income and equity, highlighting the contribution of equity to the net result. Equity rotation rate, calculated as the ratio between turnover and equity, and labor productivity, calculated as the ratio of turnover and number of employees, are indicators that quantify the contribution of the most important resources, equity and human resource, to the achievement of entity's financial results.

Any meaningful analysis of the overall financial performance of an economic entity, especially SMEs, cannot ignore the indicators of financial autonomy and solvency indicators. It is essential to know the degree of financial independence of a company because it also reflects the need to resort to borrowed capital; the indicator considered during the case study is calculated as the ratio between equity and total assets. Regarding the capital borrowed, overall solvency ratio (the ratio of total assets and total liabilities) is the indicator that best reflects the real possibilities of an entity to cover liabilities incurred.

### 3. Quantifying the impact of integration on the Romanian SMEs performance

Empirical research conducted used the total values of the selected indicators for the eight development regions of Romania: North East (NE), South East (SE), North West (NW), South-West (SW), South (S), Western Region (W), Centre (C) and Bucharest-Ilfov (BI). Data were collected from SMEs White Paper for 2004-2011. We consider relevant to do a regional analyse of Romanian SMEs performance as between the regions there are differences in development accumulated over time and reflected best by the density indicator number of SMEs per 1,000 inhabitants calculated at the end of 2012 (Table 2).

**Table 2.** SMEs density of development regions

Region	BI	NW	C	W	SE	SW	S	NE
Density SMES/1000 inh	50.23	24.4	23.5	23.46	21.54	16.4	16.1	15.12

(Source: based on Fundația Post-Privatizarea FPP, 2013)

The research conducted have sought to emphasize if Romania's integration in the European Union with all the benefits attached (most important from the perspective of SMEs are the access to EU funding and stability law) influenced the performance of SMEs, by region. The proposed model in this paper is an unobserved components model, in which specific observed variables are assumed to depend on a single unobserved variable and an error term (Goldberger, 1972). Such a model is useful because by estimating the unobserved component one could explain part of the relationship between the composite and its components. In the unobserved components model the obtained weight will be set in such a way to minimize the total error associated with the composite (Goldberger, 1972). This model closely resembles an ordinary regression analysis, an important distinction between the two consisting in the fact that in the unobserved components model the dependent variable is unknown and in the regression model the same variable is known (OECD, 2008).

In this paper we consider *performance* ( $r$ ) the un observed performance to be measured. The observed data consist in an array of  $k=1, \dots, K(r)$  indicators, each measuring an aspect of *performance* ( $r$ ). We also consider  $r=1, \dots, D(r)$  are the development regions covered by indicator  $k$ . According to the proposed model the observed score of development region  $r$  on indicator  $k$ ,  $I(r,k)$  can be written as a linear combination of the unobserved performance and an error term,  $\varepsilon(r,k)$ :

$$I(r,k) = \alpha(k) + \beta(k)[\text{performance}(r) + \varepsilon(r,k)] \quad (1)$$

where  $\alpha(k)$ ,  $\beta(k)$  - unknown parameters mapping *performance*( $r$ ) on  $I(r,k)$  (Kaufmann et al., 1999).

Also we consider that the error term reflects two main sources of uncertainty associated with the proposed model, namely measurement errors and errors determined by the imperfect relationship between the composite and its components (Goldberger 1972). Considering these facts, we assume the error term  $\varepsilon(r,k)$  as having a zero mean,  $E(\varepsilon(r,k))=0$ , and the same variance across development regions within a given observed variable, but a different variance across observed variables,  $E(\varepsilon(r,k)^2)=\sigma_k^2$ ; it also holds that  $E(\varepsilon(r,k)\varepsilon(i,j))=0$  for  $r \neq i$  or  $k \neq j$  (Kaufmann et al., 1999). Furthermore we assume that the error term is independent across observed variables, by considering that each specific indicator is measuring a particular aspect of performance independent of others.

*Performance*( $r$ ) is considered a random variable with mean equal to zero and variance equal with one, and the observed variables are normalised using the minimum-maximum method in order for them to take only values between zero and one (OECD, 2008). Finally, in order to simplify the estimation of the level of *performance*( $r$ ) in development region  $r$  we assume that both *performance*( $r$ ) and  $\varepsilon(r,k)$  are both normally distributed (Goldberger, 1972). We use the mean of the conditional distribution of the unobserved component to estimate *performance*( $r$ ) in development region  $r$ :

$$E[\text{performance}(r)/I(r,1), \dots, I(r, K(r))] = \sum_{k=1}^{K(r)} w(r,k) \frac{I(r,k) - \alpha(k)}{\beta(k)} \quad (2)$$

$$\text{where weights are : } w(r,k) = \frac{\sigma_k^{-2}}{1 + \sum_{k=1}^{K(r)} \sigma_k^{-2}} \quad (3)$$

According to equation (3) the weight,  $w(r,k)$ , depends solely on the variance of indicator  $k$  and on the sum of the variances of the all the other individual indicators, including observed variable  $k$  (Kaufmann et al., 1999). In order for the weights to be region independent it is necessary that the set of indicators to be equal (number of indicators) for all development regions (OECD, 2008). The variance of the conditional distribution is given by:

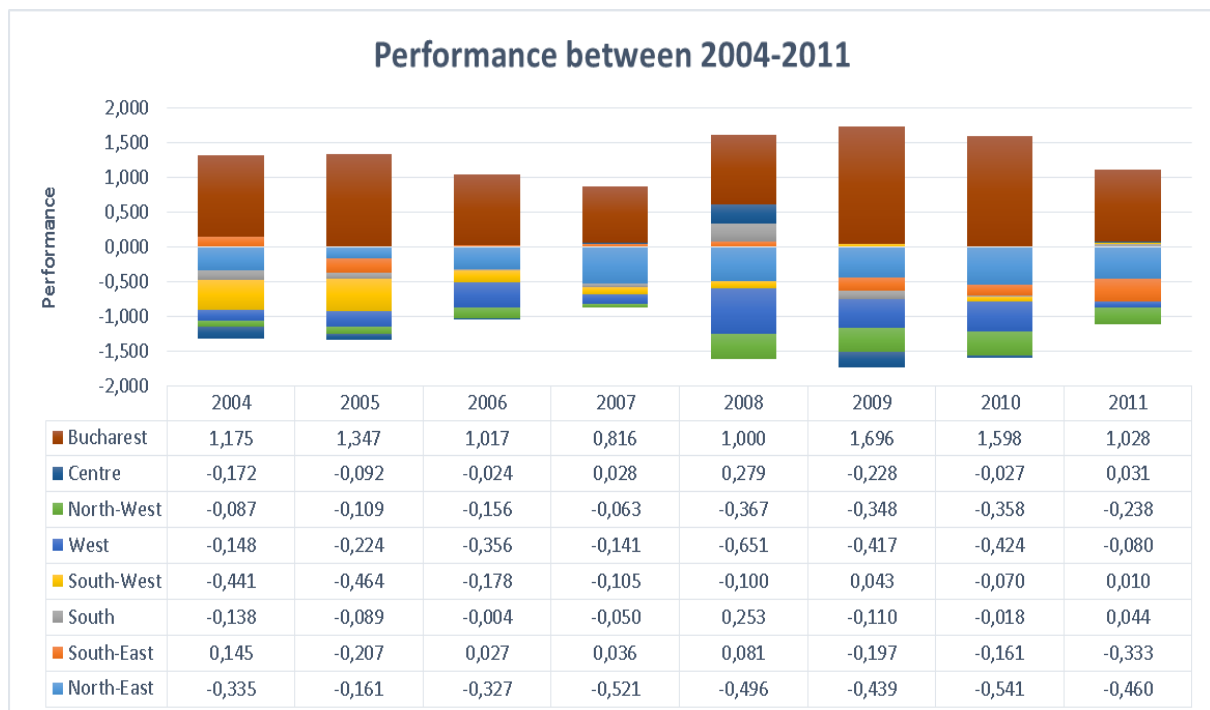
$$\text{variance}[\text{performance}(r)/I(r,1), \dots, I(r, K(r))] = \left[ 1 + \sum_{k=1}^{K(r)} \sigma_k^{-2} \right]^{-1} \quad (4)$$

This variance can be used as a measure of the precision of the composite (Goldberger, 1972). The unknown parameters to be estimated in the unobserved components model are  $\alpha(k)s$ ,  $\beta(k)s$ , and  $\sigma_k^2s$ . These parameters are estimated with the likelihood function of the observed data based on equation (3) (Goldberger, 1972) by maximising it with respect to  $\alpha(k)s$ ,  $\beta(k)s$  and  $\sigma_k^2s$ . Once estimated, their values are substituted in equations (2) and (3) (Kaufmann et al., 1999) to obtain the composite indicator (performance) and the associated weights for each observed variable (OECD, 2008). Using the maximum-likelihood method the unknown model parameters are estimated in Table 3.

**Table 3.** Parameter estimates

	$\alpha(k)$	$\beta(k)$	$\sigma_k^2$		$\alpha(k)$	$\beta(k)$	$\sigma_k^2$		$\alpha(k)$	$\beta(k)$	$\sigma_k^2$
Year 2004				Year 2005				Year 2006			
RNE	0.236	0.294	0.086	RNE	0.204	0.303	0.092	RNE	0.219	0.300	0.090
CA	0.240	0.294	0.086	CA	0.213	0.301	0.091	CA	0.211	0.302	0.091
RRC	0.403	0.320	0.103	RRC	0.408	0.280	0.079	RRC	0.434	0.337	0.113
RRF	0.403	0.284	0.080	RRF	0.309	0.298	0.089	RRF	0.530	0.350	0.123
RRCPP	0.389	0.308	0.095	RRCPP	0.484	0.415	0.173	RRCPP	0.508	0.340	0.116
RAG	0.351	0.318	0.101	RAG	0.359	0.358	0.128	RAG	0.535	0.311	0.097
PRODM	0.174	0.314	0.099	PRODM	0.164	0.318	0.101	PRODM	0.162	0.318	0.101
RSG	0.584	0.344	0.119	RSG	0.745	0.304	0.093	RSG	0.618	0.350	0.122
Year 2007				Year 2008				Year 2009			
RNE	0.213	0.302	0.091	RNE	0.388	0.272	0.074	RNE	0.152	0.321	0.103
CA	0.206	0.303	0.092	CA	0.205	0.303	0.092	CA	0.190	0.308	0.095
RRC	0.531	0.317	0.100	RRC	0.500	0.314	0.098	RRC	0.207	0.304	0.092
RRF	0.428	0.320	0.102	RRF	0.407	0.307	0.094	RRF	0.298	0.286	0.082
RRCPP	0.458	0.302	0.091	RRCPP	0.597	0.398	0.158	RRCPP	0.598	0.389	0.151
RAG	0.414	0.379	0.144	RAG	0.339	0.291	0.085	RAG	0.350	0.283	0.080
PRODM	0.159	0.319	0.102	PRODM	0.158	0.320	0.102	PRODM	0.165	0.318	0.101
RSG	0.696	0.299	0.089	RSG	0.439	0.285	0.081	RSG	0.380	0.349	0.122
Year 2010				Year 2011							
RNE	0.178	0.312	0.097	RNE	0.221	0.299	0.089				
CA	0.205	0.304	0.092	CA	0.219	0.300	0.090				
RRC	0.288	0.292	0.085	RRC	0.491	0.257	0.066				
RRF	0.357	0.334	0.111	RRF	0.488	0.339	0.115				
RRCPP	0.613	0.402	0.162	RRCPP	0.567	0.362	0.131				
RAG	0.318	0.296	0.088	RAG	0.309	0.297	0.088				
PRODM	0.180	0.313	0.098	PRODM	0.220	0.302	0.091				
RSG	0.409	0.307	0.094	RSG	0.498	0.293	0.085				

By substituting the parameter values presented in Table 2 in equations (2) and (3), we obtain for each year estimates of performance. Results are presented in Figure 1.



**Figure 1.** Estimates of Performance between 2004 - 2011

As it can be observed from Figure 1 the performance composite for each development region varies considerably in time. One could argue that there is no stable trend for the composite, but on closer inspection two distinct time intervals can be distinguished. The first one, spanning the years 2004 to 2007 is characterized by a reduction of amplitude between underachieving development regions performance wise and overachieving regions. In contrast the second one, spanning the years 2008-2011, is characterized in the first two years by a sharp amplification of differences between regions followed by a reduction in amplitude for 2010 and 2011.

We propose as an explanation for these trends the fact that 2007 represented the year in which Romania joined the EU and the time period prior to this event was characterized by a sustained effort from the part of the Romanian government in harmonizing the economic development of the various regions of the country. This effort was cut short after 2007 by the global financial meltdown and the subsequent economic recession that also hit Romania. The worst years of the crisis, 2008 and 2009, generated a sharp reverse in harmonization of economic development across regions which are reflected in the performance composite estimated in this paper.

After an macroeconomic stabilization effort undertaken by the Romanian authorities in 2010 and 2011 one can observe a return to smaller differences, performance wise, across regions but at a higher level than prior to the economic recession.

#### 4. Conclusion

Even if improving the SMEs performance depends largely on macroeconomic developments, taking measures to improve the business environment for SMEs at national and European level plays a fundamental role in ensuring SMEs the necessary conditions for them to benefit from sustainable macroeconomic growth. Although SMEs are undoubtedly extremely important to maintain strong economic growth, supporting their performance in the long term is a challenge for any economy, especially for the developing economies such as Romania.

The SMEs' dependence of domestic market, coupled with the drastic decline of the national economy caused by the global economic crisis has influenced the performance of SMEs in Romania, as evidenced by the results obtained. The economic crisis has not only caused a drastic reduction in consumption and adverse developments in macroeconomic indicators, but also had effects in the depth of business environment, with consequences on the entrepreneurship and on the main SMEs resource, the human resource.

The financial performance of SMEs cannot be reduced to financial indicators from financial statements, they should be the starting point in building financial indicators that capture all dimensions of financial performance: its overall size (the appropriate indicators are net income and turnover, they are indicators that reflect the size of the activity performed by entity), the return of processes conducted at the entity's level (commercial rate and return on equity surprise on the one hand entity's profitability from the main activity carried out and, on the other hand, the contribution of equity to the achievement of financial results) and use of resources (suitable indicators are indicators capturing how the main resources are used namely own capital through rotation rate and human resources through labour productivity). An analysis of financial performance is not complete without indicators of the financial situation that reflect on the one hand the autonomy of the economic entity (overall autonomy rate) and second the solvency (overall solvency rate), this information being required by all categories of stakeholders.

The applied model, even if overlapped with a period of crisis, allowed us to point out that Romania's EU integration has influenced the performance of SMEs in Romania, the influence manifested both in terms of measures taken in the pre-accession and in the period immediately after accession. During the 2004 - 2006 period we observed a trend to reduce disparities between development regions through SMEs' performance, a trend that was accentuated in 2007, which indicates that pre-accession measures (2004-2006) and measures taken in 2007 positively impacted the SMEs performance, since 2007 is characterized by the smallest differences between development regions in the considered period. The crisis years 2008 and 2009 have eliminated most favorable aspects generated by European integration on the performance of SMEs, increasing again the differences between developing regions. The development regions could be grouped into two categories: on the one hand the Bucharest-Ilfov, North -West, Central and South - with higher performance and, on the other hand, the other regions (West, South-West, South- East and North East) - with lower performance. In 2010 and 2011 the tendency to reduce disparities between regions regarding the performance of SMEs returned, but has not reached the values recorded in 2007, which may indicate that, if we take into consideration only the European integration and crisis the impact of the latter on the performance of SMEs was higher than that of Romania's EU integration. However, we can say that Romania's EU integration significantly influenced positively the performance of SMEs, revealed by the trend of leveling aspect of the SMEs performance in the development regions, trend manifested both until 2007 and beginning with 2010.

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