Small and Medium Enterprises in the Western Balkans: Development, Challenges, and Prospects

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Abstract

This study examines the development of small and medium enterprises (SMEs) in the Western Balkans, the challenges they encounter, and their prospects amid regional economic transformation. Using a systematic literature review of research published between 2018 and 2025, we focus on six countries: Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia. Key findings indicate that SMEs form the economic backbone of the region, yet face persistent barriers including limited access to finance, complex taxation, institutional inefficiencies, and skills shortages. Recent insights suggest that streamlined tax systems and increased institutional trust positively influence SME growth. The paper concludes that policy reforms, particularly in regulatory simplification, financial access, digitalization, and governance, are essential to enhance the resilience and competitiveness of SMEs. These measures are critical not only for inclusive development but also for preparing the SME sector for integration into the European Union.

***Keywords**: SMEs, Western Balkans, entrepreneurship, taxation, institutional trust, economic development*

Introduction

Background and Context

Small and medium enterprises (SMEs) play a crucial role in the economies of the Western Balkans, which include Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia. Since transitioning from socialism in the '90s, these countries have experienced strong SME-led private sector growth (Alite et al., 2024). SMEs currently account for 99% of all firms in the region, contributing 60–65% of value added and about 75% of private employment (Batrancea et al., 2024). This mirrors or exceeds EU averages. However, the region still lags behind the EU in GDP per capita and productivity, making SME development essential for socio-economic convergence (European Commission, 2024). Beyond their role as drivers of employment and innovation, SMEs in the Western Balkans are closely connected to broader debates on global inequality and the inclusive economy (Bykovskaya et al.,2025). Given the region's persistent development gap with the European Union, strengthening SMEs can act as a mechanism to narrow disparities and promote convergence. In this sense, the growth and resilience of SMEs are not only a matter of regional development but also part of the global agenda for reducing inequality and building more inclusive economic systems.

Relevance of the Topic

The performance of SMEs in the Western Balkans is highly relevant for both research and policy. These firms are vital for employment, innovation, and social cohesion, accounting for over two-thirds of private sector jobs and a substantial share of the region's value added. Yet, the business climate remains challenging, marked by complex regulations, weak rule of law, and underdeveloped infrastructure (OECD, 2022). Inherited structural issues, such as high unemployment and brain drain, further exacerbate constraints on SME development (OECD, 2024). Understanding SME dynamics is essential because these firms are not only adaptive and innovative but also vulnerable to institutional weaknesses and external shocks.

Purpose and Objectives

This study aims to (1) review SME development in the Western Balkans, (2) identify the main challenges faced by SMEs, and (3) evaluate future opportunities and the role of policy interventions to support the sector. The goal is to inform evidence-based strategies for sustainable SME growth.

Scientific Contribution

The paper synthesizes diverse academic and policy sources to provide an integrated view of SME development in the Western Balkans. While past research often focused on isolated factors like finance or taxation, this study links firm-level constraints with broader institutional dynamics. Particular attention is given to emerging themes such as institutional trust and digitalization.Accordingly, the research is guided by the following questions:

Research Questions

RQ1: What has been the trajectory and contribution of SMEs in the region?
RQ2: What are the main challenges to their growth and competitiveness?
RQ3: What opportunities and policy strategies can enhance SME performance?

Literature review

A growing body of literature has examined various aspects of SME development in the Western Balkans. Collectively, these studies highlight the critical economic role of SMEs as well as the multifaceted challenges they face in the region's transitional context (Bartlett & Prica, 2017). According to data reported by the OECD (2022), SMEs in the Western Balkans and Turkey account for 99% of all firms, generate around 60–65% of value added, and about 75% of total employment. This confirms that SMEs are not only numerically dominant but also essential to economic output and job creation.

In the context of post-transition economies, SMEs act as key drivers of structural transformation and private-sector dynamism. They are essential not only for absorbing labor displaced from state-owned enterprises but also for fostering entrepreneurship and regional competitiveness (World Bank, 2023). However, compared to EU member states, SME productivity in the Western Balkans remains significantly lower—partly due to limited access to finance, weak integration into global value chains, and underdeveloped innovation ecosystems (EBRD, 2022).

Financial constraints remain one of the most frequently cited barriers. Bank lending to SMEs is limited, collateral requirements are high, and alternative financing instruments—such as venture capital, leasing, and crowdfunding—are underdeveloped (Rehman et al., 2019; OECD, 2022). The persistence of high interest rates and informality further exacerbates these constraints, resulting in

the underutilization of entrepreneurial potential. Moreover, the regulatory and administrative environment remains burdensome. Complex business registration procedures, frequent tax changes, and inconsistent enforcement of regulations discourage firm formalization and growth (European Commission, 2023). The informal sector continues to account for a substantial share of economic activity, distorting competition and eroding the tax base (Rehman et al., 2019).

Labor market inefficiencies also constrain SME productivity. The productivity and long-term growth potential of small and medium-sized businesses (SMEs) in the Western Balkans are consistently hampered by labor market inefficiencies. The mismatch between the skills that businesses require, particularly in technical and digital industries, and the abilities that the labor force provides is one of the most important problems. The ability of SMEs to compete in increasingly digitalized marketplaces, enhance operational efficiency, and adopt new technology is severely hampered by this mismatch. Evidence suggests that the region suffers from systemic challenges in skills development. According to the European Training Foundation (2023), only 41% of employees in the Western Balkans receive job-related training, compared to 62% in the EU-27. This indicates a substantial gap in continuous professional development, particularly in the area of digital skills (ETF, 2023). Furthermore, research by Bartlett and Uvalić (2022) emphasizes that many university graduates in the region—particularly in ICT—lack the practical and advanced digital competencies required by SMEs, resulting in underemployment and qualification mismatches. The emigration of skilled labor ("brain drain") has further reduced human capital availability, especially among younger cohorts (ILO, 2021). Additionally, SMEs tend to invest less in employee training and technological upgrading, perpetuating a low-innovation equilibrium (Bartlett & Prica, 2017).

The COVID-19 pandemic further exposed these vulnerabilities, though SMEs demonstrated resilience in bouncing back post-crisis. Studies conducted in particular countries provide these conclusions in more detail. Rehman et al. (2019) identify labor productivity barriers, including finance gaps, high tax burdens, corruption, informal competition, and skill mismatches. These findings are echoed in other surveys and show the systemic nature of constraints SMEs face. Moreover, informality and emigration of skilled labor intensify these challenges. Moreover, informality is still a pervasive issue. The "Hidden Employment Index" in the six Western Balkan countries varies from 36% to 76%, depending on the nation, according to a policy brief titled "The Hidden Economy in the Western Balkans in a Time of Crisis" (Institut Alternativa, 2022). This indicates that hidden employment is still substantial. The competitive climate for formal SMEs was undermined during the epidemic by the rise in informal practices brought on by lax regulation and emergency support measures.

The institutional environment also plays a pivotal role. While first-generation reforms (e.g., liberalization) progressed, second-generation reforms (e.g., capital market development, institutional quality) lag. Vučković et al. (2023) demonstrate that institutional and interpersonal trust improve SME outcomes by reducing uncertainty and costs, suggesting social capital's impact on entrepreneurship. Similarly, the EBRD Transition Report (2022) notes that countries with higher levels of institutional trust and legal predictability tend to exhibit stronger SME investment activity.

Taxation is another recurring theme. Batrancea et al. (2024) show that smart tax policies—not just low taxes—can foster entrepreneurship. High startup costs deter firm creation, but this can be offset by effective tax relief. Their findings underline the need for targeted fiscal strategies to stimulate SME growth in transitional contexts like the Western Balkans. Moreover, fiscal policies that reward innovation, green investment, and employment creation can enhance long-term SME resilience. For example, the EU's Small Business Act and the Green Agenda for the Western Balkans provide frameworks for aligning regional policies with EU best practices (European Commission, 2023). Yet, the uneven implementation of these initiatives across countries reflects varying institutional capacities and political commitment.

As the Western Balkans advance toward EU integration, SMEs face both opportunities and pressures. On one hand, the accession process stimulates regulatory convergence, investment in infrastructure, and access to EU funds for innovation and competitiveness (Bartlett, 2020). On the other hand, increased competition from EU firms may challenge domestic SMEs with limited technological capacity or managerial expertise.

Overall, the literature suggests that the region's long-term prospects depend on deepening reforms in three key areas: (1) strengthening financial intermediation and access to alternative finance; (2) enhancing institutional quality and rule of law; and (3) accelerating digital and green transitions (OECD, 2022; World Bank, 2023). Coordinated regional cooperation—through initiatives such as the Common Regional Market—could further promote trade integration and innovation spillovers (RCC, 2023).

Identification of Knowledge Gaps

Existing research is often fragmented, either country-focused or lacking a dynamic, time-sensitive perspective. Few studies compare Western Balkan countries to extract best practices. Additionally, research on digital transformation and trust is still emerging. Further investigation is needed to explore how institutional quality and policy design interact with entrepreneurial outcomes in the region.

Based on the literature, we propose the following hypotheses:

H1: Lower startup and tax burdens correlate with higher SME growth.
H2: Institutional improvements and trust enhance SME performance.
H3: Innovation and digitalization capacity are increasingly critical for SME competitiveness.

These hypotheses guide the analysis in the following sections.

Research methodology

This study is a systematic literature review aimed at synthesizing existing knowledge on SMEs in the Western Balkans. Rather than collecting primary data, we analyze findings from academic research and institutional reports to understand key trends, challenges, and policy impacts.

Data Sources and Search Strategy

We consulted major databases, including Scopus, Web of Science, and Google Scholar, along with reports from institutions such as the OECD, World Bank, and European Commission. These sources offer both peer-reviewed insights and practical policy evaluations relevant to SMEs in the region.

Keywords Used

Search terms included: SMEs, Western Balkans, entrepreneurship, taxation, institutional trust, corruption, finance, innovation, and digitalization. Searches were limited to English-language publications from 2013 to 2025, with a focus on recent developments post-2018.

Inclusion Criteria

Focus on SMEs in at least one Western Balkan country, were published in peer-reviewed journals or as official institutional reports, used clear methodologies (e.g., econometrics, case studies), and contributed insights relevant to our research questions.

Exclusion Criteria

Studies unrelated to the region, overly technical in narrow sectors, or opinion pieces without empirical evidence were excluded. We prioritized final published versions over working papers.

Data Extraction and Synthesis

We extracted data on SME performance, challenges, and policy effects. Findings were grouped under themes like finance, regulation, taxation, and institutional trust. A narrative synthesis compared results across studies, highlighting both consensus and contradictions.

Limitations

This review depends on the quality and coverage of existing literature. Country-level imbalance, outdated data, and qualitative rather than meta-analytic methods are limitations. However, we minimized bias by cross-referencing data from recent and diverse sources.

Analysis and Findings

SME Development and Economic Role: SMEs represent approximately 99% of all businesses in the Western Balkans and account for around 60% of gross value added and 75% of private-sector employment. In Albania, for example, SMEs generate over 76% of value added and employ over 80% of the workforce. Despite disruptions such as the COVID-19 pandemic, the sector demonstrated resilience, with SME density per capita increasing in the following years.

Key Challenges Identified

(1) Access to Finance: SMEs face difficulties obtaining affordable credit due to high collateral requirements and underdeveloped financial instruments. Alternative financing (e.g., venture capital, fintech) remains limited. The banking sector continues to dominate SME financing, while alternative sources—such as venture capital, angel investors, fintech lending, and crowdfunding, are still at an early stage of development (World Bank, 2024). According to recent OECD data, more than 60% of SMEs in the Western Balkans report finance as a major obstacle to business expansion. The problem is particularly severe for startups, innovative firms, and women-owned enterprises, which face additional barriers related to risk perception and limited collateral. Tmava et al. (2009) demonstrates that there is a substantial association between firm age, business strategies, and availability to bank loans in Kosovo, while Gashi Ahmeti & Fetai (2021) demonstrates that small and young enterprises face more financial challenges than larger and more consolidated firms.

(2) Taxation and Regulatory Burden: Complex tax administration and burdensome procedures hinder SME growth. Studies show that simplified tax systems and business-friendly reforms can stimulate entrepreneurship. The tax and regulatory framework in most Western Balkan countries is characterized by complexity, unpredictability, and administrative inefficiencies. SMEs report that frequent changes in tax legislation and high compliance costs increase uncertainty and discourage formalization (European Commission, 2023). In some economies, firms spend over 200 hours annually on tax-related procedures, double the EU average (World Bank Doing Business, 2020). Batrancea et al., 2024 suggest that simplified tax regimes, one-stop-shop services, and digital filing systems can significantly improve compliance and encourage entrepreneurship. However, implementation remains uneven across the region. For instance, North Macedonia and Serbia have made progress through e-tax platforms and reduced start-up fees, while Albania and Bosnia and Herzegovina continue to struggle with administrative fragmentation and overlapping jurisdictions.

(3) Corruption and Weak Institutions: Corruption and low institutional trust discourage business expansion and formalization. Trust in courts, however, is associated with better firm performance and reduced costs. Transparency International's (2023) Corruption Perceptions Index places most Western Balkan countries below the EU average, reflecting persistent governance challenges.

(4) Skills Shortage and Labor Market Mismatches: SMEs struggle to recruit skilled workers despite high unemployment. Brain drain exacerbates skill shortages, while education systems often fail to meet market needs. The mismatch between education outcomes and labor market needs is a persistent challenge (ILO, 2021). Many graduates lack practical skills, while vocational and technical education remains underdeveloped

(5) Competition from the Informal Sector: According to estimations, between 25 and 35 percent of all economic activity takes place outside of the formal sector, demonstrating the pervasiveness of informality (OECD, 2022). By avoiding taxes, labor laws, and environmental regulations, informal businesses unfairly compete with legitimate SMEs and weaken the foundation of the economy. Both opportunity and need considerations contribute to the survival of informality: small business owners are driven into it by complicated legislation, lax enforcement, and a lack of trust in established institutions. When implemented methodically, formalization tactics—like lowering registration fees, providing short-term tax breaks, and enhancing inspection transparency—have demonstrated benefits (OECD, 2024).

(6) Digitalization Gap: For SMEs in the Western Balkans, digital transformation poses both a difficulty and an opportunity. Digital tool usage was sped up by the pandemic, but development is still unequal. Less than 10% of SMEs in the area use cutting-edge technology like cloud computing or data analytics, and less than 20% of them participate in e-commerce (European Commission, 2023; OECD, 2024). Low digital literacy, a lack of internet penetration, particularly in rural regions, and restricted access to financing for technological investments are some of the obstacles. According to the Competitiveness Outlook 2024, Albania, Kosovo, and Bosnia and Herzegovina fall short of EU averages in terms of digital maturity, while only Serbia and Montenegro have made moderate progress.

Tax Policy and Institutional Measures

Evidence suggests that well-designed tax incentives (e.g., reduced startup costs, simplified tax regimes) contribute to increased SME formation. Conversely, tax hikes without compensatory measures discourage formal entrepreneurship. Internationally supported programs (e.g., credit guarantee schemes) have shown promise in easing financing constraints. Institutional Trust and Firm Outcomes: Higher trust in judicial institutions correlates with lower transaction costs and greater investment willingness. Strengthening the rule of law and ensuring fair enforcement are crucial to enabling SME growth.

Positive Developments and Prospects

Despite persistent constraints, some countries (e.g., Serbia, Bosnia and Herzegovina) have seen strong performance in the IT and startup sectors. Post-pandemic recovery was supported by public measures. Moreover, EU accession processes have spurred reforms aligned with the Small Business Act, with new EU-backed initiatives targeting digitalization and competitiveness. SME development is anticipated to be further supported in the future by more integration with EU standards and access to regional markets, especially if these developments are coupled with ongoing investments in institutional capacity, infrastructure, and skill development. This course presents encouraging opportunities for the Western Balkans to become more resilient and economically diversified.

Interpreting the Findings

Our review confirms that SMEs are vital for the Western Balkan economies but operate in a challenging environment marked by institutional weaknesses and transitional market inefficiencies. While SMEs are commonly acknowledged as

engines of growth, in this region, their potential is often constrained by structural barriers—such as limited access to finance, regulatory burdens, and skill mismatches—consistent with the "transitional convergence" problem (OECD, 2022).

Comparative Literature Insights

Our findings reinforce prior research, such as Rehman et al. (2019), who identified finance, corruption, and skills as persistent challenges. We add recent dimensions, such as the growing digital gap and the role of institutional trust (Vuĉković et al., 2023; Batrancea et al., 2024) support our conclusion that a supportive tax environment—e.g., simplified procedures and fiscal incentives—stimulates entrepreneurship. Bartlett et al. (2016) and Alite et al. (2024) likewise emphasize skill mismatches and emigration, which remain unresolved.

Post-COVID Dynamics: The resilience of SMEs during the pandemic was notable. Government interventions (e.g., tax deferrals, loan moratoria) helped firms recover, as noted in OECD (2022). These experiences suggest that targeted support, when timely and well-designed, can have a lasting impact on SME survival and growth.

Policy Implications

(1) Holistic Reform: Governments must coordinate improvements across taxation, finance, regulation, and education.
(2) Finance Access: Expanding credit guarantee schemes (e.g., Western Balkans Guarantee Facility) has proven effective in unlocking SME lending.
(3) Governance: Judicial reform and anti-corruption efforts build trust, which improves firm performance (Vuĉković et al., 2023).
(4) Skills Development: Align vocational education with labor market needs and engage the diaspora in knowledge transfer (Bartlett et al., 2016; Alite et al., 2024).
(5) Digitalization: Expand programs like "Go Digital in the Western Balkans," improve broadband access, and support tech upgrades.

Entrepreneurial Implications

SME owners should leverage available support schemes, engage in training, and form networks to increase resilience and competitiveness. Regional cooperation (e.g., via the Common Regional Market) also offers new market opportunities.

Regional Comparison and Prospects

Compared to Central and Eastern European countries (e.g., Poland), the Western Balkans lag behind due to a slower post-conflict reform process. However, accelerated EU integration and donor support provide a path forward. Initiatives such as the EU guarantee fund (€60 million) and the EBRD-EU digitalization program are already showing results.

The analysis also reveals that SMEs in the Western Balkans are positioned at the intersection of regional development challenges and global inequality. Limited access to finance, weak institutions, and the digital gap reinforce structural disadvantages that mirror global asymmetries between core and peripheral economies (Mahmood et al., 2024). Yet, if effectively supported, SMEs can function as engines of an inclusive economy by generating opportunities for youth, women, and marginalized groups, thereby reducing inequality both within and across countries.

Conclusions

Main Findings: SMEs are the backbone of Western Balkan economies, comprising the vast majority of firms and a large share of employment and output (Alite et al., 2024). Despite growth in number and resilience during the COVID-19 crisis (OECD, 2022), challenges persist—particularly limited access to finance (Rehman et al., 2019), burdensome taxation (Batrancea et al., 2024), weak institutions and low trust (Vučković et al., 2023), skills gaps (Bartlett et al., as cited in Alite et al., 2024), and digital under development (OECD, 2022). These challenges are interconnected and hinder SME competitiveness and formalization.

Policy Leverage Points: Policy reforms have had positive effects. Regulatory simplification, tax incentives, and digital support have contributed to new business formation (Batrancea et al., 2024). Improved institutional trust is associated with better SME performance (Vučković et al., 2023). EU-supported initiatives like guarantee funds and innovation grants are also bridging gaps in finance and technology (OECD, 2022).

Limitations: This review depends on available literature and may underrepresent success stories or smaller economies like Montenegro. Our scope is broad, and we have not conducted primary empirical testing.

Recommendations

(1) Finance Access: Expand credit guarantees and alternative funding (e.g., venture capital), leveraging EU and international institutions (Rehman et al., 2019; OECD, 2022).
(2) Regulation and Tax Simplification: Cut red tape, implement "one-stop shops," and maintain predictable tax regimes (Batrancea et al., 2024).
(3) Fight Corruption: Introduce ombudsman systems and digitalize procurement; establish commercial courts to improve trust and enforceability (Vučković et al., 2023).
(4) Skills Development and Retention: Align vocational training with SME needs; incentivize diaspora return; offer upskilling programs (Bartlett et al., as cited in Alite et al., 2024).
(5) Digitalization: Support SMEs with grants for technology, digital skills training, and broadband access (OECD, 2022).
(6) Regional and EU Integration: Use platforms like the Common Regional Market; prepare SMEs for EU programs such as Horizon Europe and Erasmus for Entrepreneurs (OECD, 2022).

Future Research

Future studies should explore SME performance at the sectoral level (e.g., agribusiness in Albania), assess long-term impacts of donor interventions, and analyze entrepreneurship culture among youth. Research on green transformation readiness is also recommended to align with the EU Green Deal.

In conclusion, we emphasize:The SME sector in the Western Balkans holds both significant challenges and vast potential. Addressing the critical constraints—finance, governance, skills, and innovation—requires coordinated reforms and sustained support. If current momentum and EU integration paths are effectively utilized, SMEs could become powerful drivers of inclusive and sustainable development in the region (Alite et al., 2024; Batrancea et al., 2024; Vučković et al., 2023). From a policy perspective, supporting SMEs in the Western Balkans extends beyond growth-oriented reforms; it represents a strategy for fostering an inclusive economy that mitigates inequality. Measures that enhance access to finance, digitalization, and institutional trust not only strengthen competitiveness but also contribute to bridging socio-economic divides. Aligning SME policies with the broader framework of inclusive and sustainable development can thus situate the Western Balkans more firmly within the global movement toward reducing inequality

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