SMEs and European Integration

Analysis of the internationalisation of Small and Medium-sized Enterprises in Europe

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Introduction

In a globalizing economy, firms are frequently operating and competing on an international level. Nowadays, internationalisation increasingly affects small and medium sized enterprises (SMEs), progressively more involved in cross-border activities such as import, export and international collaborations. Internationalisation is considered a necessary condition for firms to grow in the long term and increase their productivity, but there are considerable risks and costs of this process.

SMEs are more vulnerable to the effects of internationalisation barriers compared to large enterprises: big companies have the resources to mitigate the risk associated to internationalisation by diversifying their operations and strategies, creating economies of scale and lobbying for favourable regulations. On the other hand, SMEs tend to possess a limited amount of resources to overcome the sunk cost of analysing and overcoming the challenges of cross-border activity, thus they often may have to bypass a market opportunity abroad (remaining susceptible to increasing import pressure in the domestic market) or may operate internationally under unfavourable conditions, limiting the firm’s international commitment.

The aim of the European Single Market is to drive economic integration towards a single EU-wide economy: even though the creation of the Internal Market is one of the core objectives of the European Union, it is still an ongoing process. In this process, facilitating the internationalisation of SMEs through the implementation of the “Think Small First” principle is at the heart of the action.

In this report, internationalisation of SMEs is approached as an essential part of a firm’s strategy. In the first chapter, is presented the state of the art of the integration process from the point of view of SMEs, including a quantitative measure of their involvement in cross-border operations across Europe.

In the second chapter, it is analysed the behavioural perspective of the internationalisation process, trying to identify the strategic options for small business to accomplish a process of internationalisation.

Chapter three explore the underlying driving forces of internationalisation, starting from the link between international activities and firm performance and the rationales leading European firms towards the different modes of cross-border operations.

In chapter four, on the other hand, we present the barriers perceived by small businesses while operating outside their domestic market (but always within European boundaries), differentiating between internal and external barriers from the point of view of the firm.

Finally, chapter five draws some policy conclusion, in order to achieve a more SME-friendly environment.
1. The Internal Market and SMEs

The European Single Market, the project to mould Europe into a single economy, represents one of the most significant policy objectives of the European institutions. The primary aim of the creation of the European Single Market is to guarantee the free movement of goods, capital, services, and people (the so called “four freedoms”) across national boundaries of European countries.

The European Single Market is the world’s largest economy in terms of GDP, encompassing over 500 million people: therefore, European integration allows firms to operate on a bigger unified market, generating economies of scale, and creates the possibility for goods and workers to move to the area where they are mostly valued, improving the efficiency of the allocation of resources.

For these two reasons, to achieve an effective European Single Market without internal borders or regulatory barriers and accessible for every firm is a key priority the innovative potential of the European economic system, creating the environment to achieve higher productivity and generate more jobs.

As shown in figure 1, the volume of intra-EU trade almost doubled in less than 15 years, despite the deep financial crisis of 2008. In a globalizing world, firms are progressively forced to play a role in international markets, through import, export, supply chain relations, international R&D collaborations or foreign direct investments. The changing business environment influences also SMEs, which nowadays are more internationally active. Nevertheless, the internationalization of small businesses is often limited and circumstantial, rather than based on a strategic positioning process. For this reason, SMEs still have an unfulfilled potential to flourish exploiting the opportunities of internationalization and European integration.

![Figure 1 – Intra EU-28 trade in EUR billion, by month](image)

Traditionally, SMEs are considered local economic actors, whose activity is restricted to their domestic market (Pleitner, 1997), thus the large part of the literature regarding internationalisation is focused on specificities of large enterprises. Operating at the international level, within a unified European market, represents an advantage for firms increasing their scale of their operations and market shares, but is also a potential threat for firms unable to afford the sunk cost of internationalisation, typically SMEs, which are exposed to an increase in the level of competition coming from large enterprises.
Being SMEs the backbone of the European economy, facilitating the internationalisation of small businesses has been included within the objectives set out by the European Commission (Small Business Act, 2008) for the development of the European Single Market\(^1\).

Yet there is still a very long way to go in order to enable SMEs to operate in a European integrated market, rather than primarily on the domestic market and only marginally within EU. Figure 2, drawing on input-output tables, shows that the large part of SMEs (particularly micro enterprises) operates in industries with a low or very low export intensity, while in contrast the value added is concentrated in sectors featured by a higher level of exports. This figure suggests that exposure to export markets is important in realising the growth potential of firms: the literature shows how exporting leads to a dynamic competition in which productive resources flow toward firms which can use them more profitably so, thanks to scale effects and access to additional knowledge, exporters tend to grow faster than non-exporters.

![Figure 2 – Distribution of number of enterprises and value added across levels of export-intensity\(^2\)](image)

While the number of internationally active SMEs is growing steadily, there are still barriers limiting the volume of cross border operations for small businesses. As reported in figure 3 (next page), the half of European exporting SMEs still relies on the domestic market for over 75% of their sales, while only 28% of exporting SMEs sells the majority of its production outside national borders. This means that SMEs are not yet fully involved in the Single Market. Despite the improvements in Member State SMEs’ environments, the policy action is still inhomogeneous, restricting the scope of small companies. It is thus necessary to act synergistically at the European level, in order to effectively create a European Single Market for SMEs.

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\(^1\) As stated in the Treaty on the functioning of the EU, Article 173, The European Union and its Member States shall ensure “an environment favourable to initiative and to the development of undertakings throughout the Union, particularly small and medium-sized undertakings”.

Otherwise, the “Think Small First” principle, stating that all governmental actions should take into account the needs of small business, should be considered as not comprehensively implemented.

Figure 3 – Percentage of sales from domestic market

The analysis of company characteristics illustrates that there is a positive correlation between firms’ dimension and international exposure. Respectively, 35% and 29% of micro enterprises have been involved in import or export activities, while the percentage for small and medium sized firms is significantly higher. When looking at the decomposition by sectors, it is possible to notice that manufacturing SMEs are considerably more involved in international trade, and can exploit the opportunities related to the Single Market, while less than 20% of service companies operate in cross-border activities.

Figure 4 – Distribution of number of enterprises and value added across levels of export-intensity

<table>
<thead>
<tr>
<th></th>
<th>Imported from another country</th>
<th>Exported to another country</th>
<th>Used a subcontractor based abroad</th>
<th>Worked as a subcontractor for a company based abroad</th>
<th>Worked with a partner based abroad for R&amp;D</th>
<th>Invested in a company based abroad</th>
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<tbody>
<tr>
<td>EU28</td>
<td>36%</td>
<td>30%</td>
<td>14%</td>
<td>11%</td>
<td>6%</td>
<td>2%</td>
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<td>Company size</td>
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<tr>
<td>Micro</td>
<td>35%</td>
<td>29%</td>
<td>14%</td>
<td>11%</td>
<td>6%</td>
<td>2%</td>
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<tr>
<td>Small</td>
<td>50%</td>
<td>43%</td>
<td>19%</td>
<td>14%</td>
<td>8%</td>
<td>5%</td>
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<tr>
<td>Medium</td>
<td>61%</td>
<td>59%</td>
<td>33%</td>
<td>26%</td>
<td>16%</td>
<td>13%</td>
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<td>Sector^5</td>
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<tr>
<td>Manufacturing</td>
<td>53%</td>
<td>55%</td>
<td>17%</td>
<td>17%</td>
<td>8%</td>
<td>5%</td>
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<tr>
<td>Retail</td>
<td>52%</td>
<td>39%</td>
<td>15%</td>
<td>9%</td>
<td>6%</td>
<td>2%</td>
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<tr>
<td>Services</td>
<td>20%</td>
<td>21%</td>
<td>15%</td>
<td>13%</td>
<td>7%</td>
<td>2%</td>
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<tr>
<td>Industry</td>
<td>21%</td>
<td>11%</td>
<td>9%</td>
<td>9%</td>
<td>3%</td>
<td>1%</td>
</tr>
</tbody>
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2. Behavioural models of internationalization


^4 Source: Eurodev (2015), *Flash Eurobarometer 421: Internationalisation of SMEs*, pg: 27. Question 2: in the last three years, has your company done any of the following activities inside the EU?

First of all, it should be noted how internationalization is a multidimensional phenomenon, regarding inward, outward and cooperative operations (Korhonen, 1999). Nevertheless, the large part of the studies focuses only on the outward dimension of internationalization, because it is the one with higher impact on firms’ innovation, skill development and productivity performance.

Since Adam Smith (1776)\(^6\), traditional international trade theories explain the cross border exchange of goods and services in terms of comparative advantage. The comparative advantage à la Ricardo derives from differences in productivity, while the Heckscher-Ohlin notion of comparative advantage resides in differences in goods’ factor intensity and cross-country differences in factor endowments.

More recently, the focus shifted from countries and industries to firms and products. The literature, however, mainly deals with mature multinational companies, whereas SMEs gained attention from scholars only in the last decade. It has been argued that international trade theories does not take into account the specificities of SMEs, and thus cannot adequately explain the internationalization of small businesses.

While no single model can draw an unambiguous and unquestionable internationalization strategy working for every SME, it is possible to view the internationalization behaviour of SMEs as a holistic process, combining elements pertaining to the different theories.

2.1 Stage theory

The stage model views the process of internationalization as evolutionary, consisting in incremental stages (Johanson and Wiedersheim-Paul, 1975). According to the so called Uppsala model, firms develop international activities by small steps: businesses are more likely to accept the risk of operating into a different market as they gain expertise, gradually increasing their international commitment over time.\(^7\). Therefore, SMEs start exporting to countries featured by small geographical and cultural distance, reducing the perceived risk, and expand their geographical range in a cumulative way thanks to a learning-by-doing process (Quinn, 1980).

From an operational perspective, Johanson and Vahlne (1990) theorized a stage process, starting from sporadic export activities, and then involving independent agents and sales subsidiaries until, in the last stage of expansion, firms eventually duplicate their manufacturing activity in the foreign country.\(^8\)

The stage theory generally holds for SMEs, considering that their lack of resources with respect to big firms implies a higher level of risk aversion. Although empirical research provides support for the Uppsala model linked to SMEs, some criticisms have emerged: also within small enterprises, incrementalism is not always the most appropriate way to deal with international activities. Reuber and Fisher (2002) demonstrated that small firms endowed with internationally experience human capital often avoid the first two stage of the Uppsala model. An extreme case regards firms operating in global niches, which often “born global” and do not follow the stepwise expansion process at all (Oviatt and McDougall, 1994).

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\(^6\) Smith, A. (1776), The wealth of nations: “If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage. The general industry of the country, being always in proportion to the capital which employs it, will not thereby be diminished ... but only left to find out the way in which it can be employed with the greatest advantage”.

\(^7\) In Welch, L. and Luostarinen, R. (1993), Internationalization: evolution of a concept, internationalization is defined as a “process of increasing involvement in international operations”.

\(^8\) Johanson, J. and Vahlne, J.E. (1977), The internationalization process of the firm: a model of knowledge development and increasing foreign market commitments: “Typically, firms start exporting to a country via an agent, later establish a sales subsidiary, and eventually, in some cases, begin production in the host country”.
2.2 **International entrepreneurship theory**

As the stage theory fails to recognize the fast pattern of internationalization followed by a number of firms, a new literature strand about international new ventures emerged\(^9\). This kind of companies are often found in innovative and volatile markets, driven by cheap and fast communication technologies and the increasing trend of homogenization of national markets.

This framework underlines the importance of the entrepreneur in the process of strategy formulation (Miesenbock, 1988): it is possible to see firms “international by design”, even without having acquired national experience or resources from the external environment (in clear contradiction with the Uppsala model), when an entrepreneur sees a potentially profitable market opportunity. In that way, the entrepreneur becomes the main variable in SME’s internationalization.

Madsen and Servais (1997) found that international new ventures mostly regard high technology sectors in large economies, while in smaller countries they are more widespread among sectors (due to the smaller market dimension). In technology intensive industries, in fact, internationalization is an essential requirement for firm survival, as firms have to maximize sales before their technology becomes obsolete.

The main concern for early internationalizing firms is the so called “liability of newness”: international new ventures lack experience and organizational routines to ensure market success abroad, implying higher exposure to failure. This risk is even higher for SMEs, because their scarcity of resources to face risks.

Despite the growing evidence about this strand of literature, the large part of new ventures remains within national borders. In addition, new firms are proved to be more subject to entry barriers than established firms (Acs, 2005). Therefore, even the international entrepreneurship theory fails to successfully predict the export behaviour of SMEs.

2.3 **Network theory**

Since SMEs often have insufficient resources and skills to overcome the barriers associated to entry in a foreign market, an effective strategy to ensure successful internationalization process could be to establish relations with partners overseas, to join effort and resources (mass effect), or with foreign entities, exploiting their country-specific expertise.

The starting point of network theory is that firms with complementary competitive advantages can leverage their resources not only to benefit the firm itself, but also its business partners. This strategy implies a loss of independence compared to a common FDI, but requires a smaller amount of time and resources, making the risk of internationalization affordable also to SMEs.

The resource-based view of internationalization focuses on costly-to-copy capabilities that a firm can develop over time, but also forming a coalition with other entrepreneurs: competitors cannot easily imitate a synergistic relationship, turning into an economic rent for the firm.

The central construct of the network perspective rests on experimental learning and the way in which tacit knowledge can spread across separate entities, increasing the stock of resources of a firm and leading to increased market commitment. To make a network approach really effective, the components of the coalition should act under a proper balance between competition and cooperation.

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\(^9\) Oviatt, B. and McDougall, P. (1994), *Toward a theory of international new ventures*, defines the category as “business organizations that, from inception, seek to derive significant competitive advantage from the use of resources and the sale of outputs in multiple countries”.

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Looking at the limitations of the network approach for the specific case of SMEs, Hobday (1994) argues that a dynamic network can be effective only in its first phase, in approaching the external market, because small businesses lack the scale-intensive process capabilities and the absorptive capacity to fully capture the benefits generated by the expansion.

3. **Drivers of internationalization**

The increasing globalization emphasises the relevance of firms’ export competitiveness. For SMEs, several studies report a strong positive correlation between international activity, growth and innovation (Golovko and Valentini, 2011): European internationally active SMEs, for example, grow more than twice as fast as the non-internationally active counterpart. A growing body of research has proven that exporters are more productive, capital intensive and active on the job market (Bernard and Jensen, 1999), but the central issue is the direction of the causality between export and firm performance: looking at post-export data, exporters consistently outperform non-exporters, but the study conducted by Bernard and Jensen found that the differences in term of performance are present even before those firms started to export: in other words, the more productive firms usually self-select into export markets.

This result does not mean that international activity is not per se a benefit for firms, but rather that firms confronted with fierce global competition have to be more productive and consequently expand their market abroad: therefore, progressing into the process of European integration can lead to a more competitive economy, generating growth prospect also for European SMEs.

Looking at the composition of SMEs’ international activities within the European Single Market (figure 5, next page), nearly a half of the companies (49%) reported to be active only in their domestic market, reflecting on the one hand the local nature of the sectors in which SMEs are most present, but on the other hand this result underlines also the fact that small enterprises are still suffering from internationalisation barriers (a detailed analysis in the next section).

The most common form of internationalisation for European SMEs is represented by import activities: more than one third of the companies have imported from another EU countries, while 30% are involved in export activities. More than a SME out of ten reported to have used foreign subcontractors (14%) or have worked as a subcontractor for a company based abroad (11%).

Finally, the survey reports an uncommon for a SME to get involved in cross-border projects for research and development (6%) or investments in foreign companies (2%), implying that these activities require an amount of technical and financial resources that exceeds the usual endowment of SMEs.
SMEs with a focus on economies of scale can be motivated to internationalise in order to gain access to larger markets or cheaper sub-suppliers, thus international activities are to be considered closely linked to the maximization of returns and minimization of costs in purchasing, production and sales.

For most of European SMEs, as shown in figure 6, the main determinant of internationalisation is market seeking, perceived as important for over three quarters of outward internationalised SMEs. On the other hand, businesses with a higher focus on inward dynamics are aimed at strategic assets seeking, so they have cross-border relationships in order to access know-how and technology not available on the domestic market. Less importance is given to resource seeking: the highest value is assigned to firms looking for lower production costs abroad (more than 40% of importing firms), while additional production capacity, capital and labour are least often mentioned as important drivers for internationalisation.

10 Source: Eurodev (2015). Flash Eurobarometer 421: Internationalisation of SMEs, pg: 21. Question 2: in the last three years, has your company done any of the following activities inside the EU?

11 Source: European Commission (2004), ESNR Enterprise Survey. Sum of “very important” and “important” for every motive.
4. Export barriers

The lower involvement of SMEs in international activities, compared to bigger firms, can be attributed to the perception of internalisation as irrelevant for business strategy, as well as several barriers deriving from the individual firm, the industry, the country or European trade and investment policy.

It is noteworthy that a considerable group of SME founders do not have any ambition to grow beyond a certain size or the domestic market: for example, even in a small country such as Luxembourg, a study on the craft sector indicates that 42% of the sample does not internationalise because the national demand is too high. On the other hand, SMEs take the costs of the internationalization process as the highest one and for this reason the dynamics of barriers to cross-border activities should be carefully monitored.

In figure 7 are reported the barriers encountered by European SMEs when exporting.

![Figure 7 - Company activities within the Internal Market in the last three years](image)

Over a half (52%) of exporting SMEs indicated that the administrative procedures are too complicated, with 24% of firms claiming that red tapes are a major problem. The second most common barrier is the high delivery cost (49%), followed by the problem of identification of business partners abroad (45%) and the large entity of the financial investment compared to firms’ resources (42%).

For 20% of the sample, the resolution of cross-border complaints represents a major problem (a problem for 38%), while the difference among different taxation systems represents a barrier for 39% of SMEs. Instead, language skills and country-specificity of the products seem to not represent a problem for exporting firms.

The evidence base on the enabling factors and barriers for SMEs exporting activities are often divided among internal (e.g. skills, finance etc.) and external (e.g. national market conditions, institutions etc.).

4.1 Internal barriers

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12 Chambre des Métiers du Grand-Duché de Luxembourg (1992), *Investigation into the export activity and the participation in national and international fairs of companies belonging to the craft sector.*

13 Source: Eurodev (2015), *Flash Eurobarometer 421: Internationalisation of SMEs*, pg: 48. Question 5: for each of the following difficulties that may present itself when exporting, tell me if it has been a major problem, a minor problem or not a problem at all.
Typically, smaller firms are said to take advantage from flexibility, while on the other hand large firms gain benefits from scale and the availability of specialist resources: therefore, it is possible to conclude that in terms of internal capabilities the relative strengths of big businesses are material, while small businesses have behavioural advantages.

**Skill constraints.** The research literature extensively treated the linkage between the availability of skilled personnel and exporting activity: in fact, different skill sets are necessary for the firm to adopt different exporting strategies. At SME level, firms’ performance is highly dependent on the abilities and market perceptions of owners and management.

A study conducted on Spanish SMEs highlights the importance of experience and workers’ skills in the internationalisation process, but it seems to not figure among the most problematic points for European SMEs: the survey reported in figure 7 depicts a situation in which SMEs do not perceive a problem of insufficient skills among their staff; moreover, European companies appear to benefit from the external “skill ecosystem”, through networking activities. Despite the small dimensions of firms, SMEs can leverage external knowledge through B2B partnerships, supply chain relations or collaborative support measures.

**Financial constraints.** An internal factor raising a higher level of concern is the availability of investment finance: in order to enter the export market in a continuous and structured way, firms have to bear sunk costs arising from preliminary important operations like exploration of market potential and product/service development. The availability of internal investment capital is thus very important in the internationalisation process, but SMEs are generally featured by internal resource limitations.

If 20% of respondents defined the financial investment a major problem is because small firms often face problems in accessing external finance for early stages of export development: potential finance providers see high uncertainty due to the low liquidity endowment of the company, leading to high turn-down rates. Therefore, there is clear evidence of a market failure, implying the necessity of institutional intervention to sustain SME exporters to overcome the initial sunk cost of entry into export markets. According to a survey conducted by the European Commission in the framework of the Flash Eurobarometer 421, the first among the supportive measures requested by SMEs regards “grants, subsidies or low interest loans”, testifying that what small businesses are lacking is the financial possibility to afford their internationalisation plans.

### 4.2 External barriers

External export barriers comprise macro-economic, political, social, cultural and physical characteristics obstructing international activities and performances, upon which an individual exporter cannot influence.

SMEs are generally more vulnerable than large companies to the effects of external barriers, since big businesses have the necessary resources to face more easily this kind of barriers (Hollenstein, 2005).

**Tariff barriers.** A very important determinant of internalisation decisions is the accessibility of the foreign market. This kind of barriers includes tariff and non-tariff barriers: since the introduction of the European Single Market, trade among different Member States is exempt from tariffs, so non-tariff barriers have become the most prominent barriers within the Internal Market.

**Regulation.** Standards are pervasive in modern economies, acting as a way to define minimum quality levels for products and services, as well as fostering the interoperability between different products by
reducing their variety. On the other hand, dealing with misaligned standards among different countries represents a huge trade barrier, forcing firms to duplicate their productive structures.

Also the establishment of common standards at European level can be burdensome for SMEs: small businesses, according to a study conducted by EIM (2006) claim to be not sufficiently considered. Many SMEs consider international standards as created by large enterprises for large enterprises, especially because the higher cost connected to compliance, which can exclude small firms from the market.

However, SMEs are in favour of a European standardisation process aimed at the creation of clear and easy comprehensible standards, referring to technical solutions instead of general concepts.

Another important burden for small businesses is the compliance with regulation and administrative procedures: red tapes and administrative stumbling blocks complicate the management of international relations and discourage firms, such as SMEs, with only a marginal involvement in cross-border activities. Therefore, policy measures should aim at reducing these barriers through simplification, rather than further increasing the administrative burden SMEs already have to deal with.

**Taxation.** Among SMEs, a diffused opinion is to consider taxation as one of the most burdensome policy area affecting them at the international level: while large enterprises can exploit the advice of taxation experts, SMEs have many difficulties in optimising the compliance with separate taxation systems among the different national economies: referring to the survey reported in figure 7, this issue represents a barrier for 39% of SMEs. Although the homogenisation of taxation among European countries is hard to be achieved in the medium term, an important policy priority to effectively create a SME-friendly environment is to homogenise the different taxation system, in order to control and reduce the compliance costs for enterprises.

**Law and internationalisation.** Transparency and rule of law at international level have always been one of the primary focuses of the globalization. While this still represent a major trade obstacle with respect to developing countries, within the European Internal Market only 20% of SMEs considers the resolution of cross-border disputes as a major problem and 15% of the companies claims international payments to be unsafe. Also the enforcement of property rights nowadays represents a minor issue within Europe.

**Informational and contact barriers.** A wide range of national programs are available to support SMEs internationalisation, providing market analyses at institutional level in order to help firms to overcome information asymmetries while entering a foreign market: in this area, European member states are proving to act as successful “bridging” intermediaries. Only 11% of SMEs has major problems in finding information about the target country, within the European framework.

Recent surveys, instead, are reinforcing the importance of the inability to contact potential overseas customers for SMEs: for example, a Swedish study (Rundh, 2007) highlights the difficulty of local firms in gaining access to suitable distribution channels in international market. The problem of the identification of suitable business partners abroad is a considerable barrier for 19% of SMEs.

**Cultural and language barriers.** A widespread assumption of the literature is that countries sharing the same language or culture are more likely to trade, because of the greater accessibility of information and because of cultural affinities generate bilateral trust. However, even in a context characterised by a huge number of languages such as the European Union, this kind of barriers is not representing a problem for the large majority of SMEs (only 8% report language as a major barrier).

5. **Policy implications**
Based on the problems experienced by European SMEs, it is possible to deduce the need for SME targeted policies in order to achieve an environment in which small businesses can afford the cost of internationalisation, contributing to the recovery of European economy.

Therefore, our policy recommendations, to achieve a complete European integration in compliance with the “Think Small First” principle are:

- to promote access to finance, leaving more scope for investments in cross-border activities;
- to create a system of common technical standards;
- to drive different Member States through a more uniform direct and indirect taxation;
- to support skills upgrading within SMEs;
- to improve the environment for businesses with effective administration;
- to encourage cross-border networking initiatives;
- to reinforce the institutional role in overcoming information barriers with a support to SMEs in identifying potential partnerships and projects abroad.

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