

**The United Nations University**

**WIDER**

**World Institute for Development Economics Research**

**TRANSITION TO A MARKET AND ENTREPRENEURSHIP.  
THE SYSTEMIC FACTORS AND POLICY OPTIONS**

by

**GRZEGORZ W. KOLODKO**

**Visiting Professor, Department of Political Science, University of Rochester**

Paper for the UNU/WIDER project „Small and Medium Enterprises: How Does Entrepreneurship Develop in Postsocialist States”. Presented at the conference in Helsinki, Finland, 18-19 June 1999.

\*\*\*

Published in: Communist and Post-Communist Studies, 2000, Vol. 33, No. 2, (June), pp. 271-293.

## Contents

	<b>Page</b>
<b>Abstract .....</b>	<b>2</b>
<b>Summary.....</b>	<b>3</b>
<b>1. Introduction .....</b>	<b>4</b>
<b>2. Transition and the entrepreneurship .....</b>	<b>5</b>
<b>3. The legacy of reformed vs. unreformed economies for the SME development .....</b>	<b>7</b>
<b>4.Shortage removal and the demand factors .....</b>	<b>9</b>
<b>5. Property rights, institutional arrangements and microeconomic efficiency .....</b>	<b>12</b>
<b>6. Interest groups and the formation of a growth lobby.....</b>	<b>18</b>
<b>7. The policy conclusions .....</b>	<b>20</b>
<b>References .....</b>	<b>24</b>

## **Abstract**

Fundamental argument in favor of transition is a supposition that it must improve efficiency and standard of living. It is believed that the shift of property rights to private sector must quickly facilitate such an improvement. Yet in the majority of cases the economies have not returned yet to the path of sustainable growth. The countries that focus their strategies not only on privatization, but also on the entrepreneurship and competitiveness are doing better. Especially the grass-rooted development of small and medium enterprises contributes to overcoming the transitional depression and then to recovery and growth. Yet to accomplish such a sequence specific systemic and policy conditions must be met and of special importance here are proper institutional arrangements. Thus liberalization is a prerequisite of growth of the SME sector in transition economies, but is not a sufficient condition. The crucial factors involve the institutional building.

## **Summary**

The political and ideological concerns aside, the fundamental economic argument in favor of postsocialist transition to a market system has been a supposition that it will improve allocative efficiency and thus the competitiveness of the industries and standard of living of households. It is believed that the shift of property rights from the state to private sector must quickly facilitate such an improvement. Yet in the majority of cases, even after the first decade of transition, the economies have not returned to the path of sustainable growth. The countries tackling the issues of recovery and growth relatively better are these which were able to focus not only on de-nationalization of the state assets, but mainly on the development of venture entrepreneurship. The grass-rooted development of especially small and medium enterprises has contributed significantly to overcoming the transitional depression and then to recovery and fast growth. Yet to accomplish such a sequence specific systemic and policy conditions must be met. To facilitate such a path of development proper institutional arrangements must be executed by the governments, legal framework must be established and the government policies ought to support the rise and competitive performance of the small and medium enterprises (SME). Liberalization is a prerequisite of growth of this sector in transition economies, but is not a sufficient condition. The crucial factors involve the institutional arrangements.

## 1. Introduction

The political and ideological concerns aside, the fundamental economic argument in favor of postsocialist transition to a market system has been a supposition that it will improve allocative efficiency and thus the competitiveness of the industries and standard of living of the households. It was believed that the shift of property rights from state to private sector must facilitate such an improvement fast. Yet in the majority of cases -- even after the first decade of transition -- the economies have not returned to the path of sustainable growth. In 1999 a quarter of transition economies of East Central Europe (ECE) and the former Soviet Union (FSU) are still in or have returned to contraction.

The pre-transitional 1989 level of GDP has been recovered only in Poland in 1995, in Slovenia in 1998 and in Slovakia in 1999. In the remaining 25 countries of ECE and FSU as well as in Mongolia the output is still below the pre-transition level and on average for the whole transition economies region it is at a low 75 percent of the output registered in 1989 (EBRD 1999). In two biggest postsocialist countries, Russia and Ukraine, it remains around half and one third, respectively, of the pre-transition level. Still worse, it appears likely to continue shrinking in 1999-2000.

Such a meager outcome from the early phases of transition stems much more from the fundamental mismanagement of the process of postsocialist changes than from the over-emphasized 'legacy of the past' (Kolodko 1999a).

Neither the governments of the countries involved, nor the international community assisting the process of postsocialist transition assumed at any stage of the endeavor that the process would go along such an awkward way. After ten years of transition for majority of them it is a rather bitter surprise.

The policies implemented in the ECE and the FSU emerging markets have been based to a great extent on the early Washington Consensus.<sup>1</sup> It presupposed -- though was designed in the first place to address the structural crisis in Latin America, and not in the region of the formerly centrally planned economies -- that liberalization-cum-stabilization, together with fast privatization, if only supported by financial policy, must bring soon recovery and later sustained growth. Such a prognosis took for granted that this course of changes will secure improvement of allocative efficiency and automatically wipe out wasteful allocation typical for the distorted socialist economy. Yet for a number of reasons it has not occurred. The crucial cause for such disappointment has been the negligence of the institutional arrangements necessary for the successful performance of postsocialist economies (Poznanski 1996, Kolodko and Nuti 1997, North 1997, Stiglitz 1998, 1999).

The countries that are dealing more successfully with the issues of recovery and growth are these which were able to focus not only on de-nationalization of the state assets, but also on the development of venture entrepreneurship, mainly on the small scale. The grass-rooted development of especially small

---

<sup>1</sup> The Washington Consensus describes the policies response agreed at the turn of 1980s and 1990s toward the debt crisis in Latin American economies. Under its popular name it was first presented and discussed in Williamson 1990.

and medium enterprises has contributed significantly to overcoming the transitional depression and then to the recovery and fast growth. Yet accomplishing such a sequence requires that specific systemic and policy conditions must be met. Just the policy of liberalization-cum-stabilization and de-etatization is not sufficient. To facilitate the required path of development a proper institutional arrangements must be executed by the governments, a legal framework must be established and the government policies must support the rise and competitive performance of the SME. Liberalization in the broad sense of opening up market processes, is a prerequisite for the growth of this sector in transition economies, yet itself is not satisfactory.

In this paper we discussed some of the fundamental features necessary for the take-off of SME in postsocialist economies in transition. The second section presents the conceptualization of the transition process, within which the SME development is discussed. In third section, the meaning of the legacy and the structural, as well as institutional and behavioral, characteristics inherited from the past are considered. Fourth, the significance of the removal of shortages, economic (price, trade, in-out business, capital flow) liberalization for entrepreneurship development and the demand factors are presented. Fifth, the role that the change in property rights plays in development of the SME is examined and the meaning of the legal measures and the new institutional arrangements are discussed. Sixth, the role that an emerging 'growth lobby' may play for the expansion of the SME is examined. And last, the policy conclusions which support the sustainability of development are drawn.

## **2. Transition and the entrepreneurship**

Transition to a market economy must be seen as a historical process of complex changes leading from the centrally planned economy based upon the dominance of bureaucratic coordination and state property to an open economy based upon market coordination and dominance of the private property. From such an angle the crucial factor in establishing of the market economy -- after the statist economy of the socialist, centrally planned type is abandoned -- is the development of the private sector. Yet privatization is far from sufficient to accomplish such a target.

Transition consists of three parallel processes (Kolodko 1992). First, liberalization-cum-stabilization, second, institution building and, third, the microeconomic restructuring of the existing capacity.

Considering the point of departure towards a free market, i.e. a largely distorted price structure and financial disequilibria at the late stage of centrally planned economy, the liberalization process initially caused further financial destabilization, mainly initiating an inflationary process. Since inflation was repressed under the socialist economic regime, liberalization at first leads to acceleration of price (open) inflation and therefore calls for thorough stabilization policy. This in turn, requires though financial and monetary policies, what has particular implications for further structural reforms associated with transition to a market system.

Second, the core of transition is the process of institution building. The market does not mean just a liberal regulation (or de-regulation) and dominance of private property expanding fast due to ongoing privatization, i.e. de-nationalization of the existing assets. The market means both private

property and liberal regulation AND the building of institutions. The institutions are the rules of the economic game and the organizations facilitating these rules as well as the links between them (North 1997). Thus the establishment of appropriate institutional arrangements is indispensable for the birth and growth of a market economy. The more this is the case in the postsocialist countries, where the old institutional regime is being dismantled and the new one must be developed almost from the scratch. Unlike liberalization-cum-stabilization, which may be (if the political circumstances permit) executed in a less or more radical manner, institution building in each case must be a gradual process.<sup>2</sup> It takes time and calls not only for new law and organization framework but also for lasting process of learning by doing.

Transition to a market makes sense only if it leads to the improvement of efficiency and thus relatively better overall economic performance. Hence, microeconomic restructuring, tied to the liberalization-cum-stabilization, on the one hand, and to the new institutional arrangements, on the other, must be seen as another indispensable part of the whole transitional endeavor. This process needs not only time, but first of all the capital, new investment and retraining as well as re-deployment of the labor. It is also very costly in the terms of both financial resources and the social costs. The new economic structure resulting from these changes contributes to upgrading industrial capacities and thus to higher competitiveness and, at the end, to rising standard of living. Microeconomic restructuring is linked to both the streamlining of existing capacities and to the creation of entirely new units facilitating the processes of producing the goods and delivering the services.

Within such conceptual framework transition always is a gradual process. It can be managed better or worse, it can last a shorter or longer time, but in its complexity it is and must be by its very nature a gradual process. In these lights even in the countries most advanced in transition, e.g. these that have already joined the OECD or are negotiating their accession to the EU, the transition is far from over.

Therefore, the development of entrepreneurship in the postsocialist countries in transition should be seen through the prism of this three-dimensional gradual process. It also ought to be interesting to examine the systemic and policy implications for the development of the SME from such an angle.

One may claim that the main purpose for the whole transition exercise is the creation of entrepreneurship. Undoubtedly, liberalization and privatization are unleashing the entrepreneurship, yet these two processes are not sufficient to turn emerging activities in manufacturing, trade, financial and other services into a constructive force. As much as the final success of postsocialist transition in ECE and FSU and the reforms of the socialist system in China and Vietnam depend on the expansion of

---

<sup>2</sup> Institution building, that is the creation of the rules that serve the market economy, also encompasses the behavioral aspect. Thus even in the case of the late GDR -- despite the legal framework was indeed introduced in a radical manner (actually overnight on 1 July 1990) -- the institution building is a gradual process. The rules have been adopted radically, but securing the ability to comply with these new rules is a process that must be learned and, if necessary, enforced by the law and relevant organizations.

entrepreneurship in all sectors of the economy, the development of sound entrepreneurship is due to the proper design of certain other processes, firstly institution building.

Only the appropriate institutions can channel the emerging activities in postsocialist countries in such ways, that the new market-based entrepreneurship will contribute to growing competitiveness and sustained growth. Otherwise, it can turn against long-term growth and development, as it has happened, unfortunately, in some of transition economies, including Russia, the most important and the largest of them all.

### **3. The legacy of reformed vs. unreformed economies for the SME development**

Leaving aside the agriculture sector in some countries -- especially in Poland where as much as 80 percent of farm land was not neither nationalized nor collectivized -- and some positive examples, though only with minor meaning, from the service sector (e.g. retail trade, construction, transport, housekeeping, etc.) there almost were no SME in the old system. This single fact has the most significant implication for their expansion during transition period, since in majority cases they must be developed from the beginning. Yet there are some systemic and real differences between the countries under discussion.

The point of departure to postsocialist transition ten years ago was different in particular countries. On the one hand, we have had traditional, soviet-type, rigid economies of the FSU and some rather orthodox ECE. On the other hand, we have had reformed economies of ECE, especially Hungary, Poland and the former Yugoslavia. Yet among the remaining centrally planned economies of the ECE region there were from this point of view not negligible differences, too. Whereas in the GDR and to some extent in Bulgaria, there was a little bit more of a room for the SME, in countries like Albania and Romania the SME simply did not exist.

Typical feature of the development in the statist centrally planned economies was reliance on heavy industry. From the beginning of so-called 'socialist industrialization', that is from the 1950s in ECE, the heavy industries were provided with true priority as far as resources allocation was concerned. Such a pattern of development was based upon the long lasting and prevalent across the region conviction that the expansion of heavy industries in the long-run would be decisive for the economic efficiency and thus political supremacy. Later, even if such ill-advised conviction had evaporated, the way the industries had been managed facilitated the concentration of production. As long as there was centrally planned allocation of scarce resources there was also a natural inclination to concentrate the production within the large units. Actually, often according to the rules 'the larger, the better'.

So, there was not enough room for the development and performance of the SME. Even if they were allowed to function (formally true in most cases) and even if from time to time (when a reform-oriented mood was gaining momentum) they tried to fill the vacuum left by the large companies, there were to some degree actually discriminated against. A lack of proper supply of the means of production and limited access to other resources, often in short supply, made their existence still more problematic. If – as it had occurred periodically – there were the attempts to facilitate the development of SME, it did not last long and in the real struggle for the centrally distributed resources there were always the losers.

The legal framework, which intentionally was introduced to support this part of the production and service sectors, was not strong enough to secure the smooth performance of SME, which were always pushed into the shadows by big industrial units, that were much easier to be managed from the top of the state bureaucracy.

Of course, the particular situation differed from country to country, yet such a course of evolution was rather typical for all of them. However, in those with lasting communist orthodoxy, the room for private SME performance was always a very narrow one, including the periods where in other countries there were certain attempts to exercise more flexible approach towards this sector.

Indeed, the way the management over the state sector in socialist economy was exercised was of a paramount importance for the evolution of the economic structure toward the concentration of economy into a few yet rather very large units. If it was quite understandable in the case of, say, steel mills or ship yards, it was a rather bizarre exercise in the instance of the factory making buckets or ropes. Yet even in the later cases – if it was difficult to organize the production just under one roof – special organizational units were created to bring the process of production and distribution under some form of the control of central bureaucracy.

In countries that tried to reform their institutional set-up and adjust the legal system towards the needs of a more flexible economy the SME did much better. In Hungary, Poland and the former Yugoslavia – somewhat like China in the 1990s – the sector of small companies employing just a few workers performed well together with the large firms. Yet the core problem was not the size of companies as such. What really mattered was the character of the property. Since they were socialist economies, they relied on state property and there were ideologically motivated constraints imposed upon the expansion of the SME. Whereas the state sector was inclined towards big units, since it was then easier to compete for centrally distributed means of production, the private sector's expansion was strictly limited. The small sector was doomed to remain indeed small, since there was a political limit imposed on its size. And not because of the concern about efficiency, but because of the general features of the old system.<sup>3</sup>

These orthodox limitations were somehow eased in the reform-oriented countries. Therefore, these economies were able to shift more resources and employment to the SME sector, which by the same time happened often to be the private one. The private sector was exclusively small, because there were not at all any private units among the large companies. The SME were allowed to perform especially in the light industries, agribusiness and traditional service sector. Later, the existence of such companies had an important meaning for the transition process for three reasons.

First, small and medium scale of production was more flexible and therefore, at the instant the liberalization had come, the supply response from the SME was much faster and better facilitating the market needs than the response from the more rigid large companies.

Second, the SME under the old system were mostly private enterprises, so it was the true root for the growth of private capital. Many SME, if only they were able to concentrate, invest and form new

---

<sup>3</sup> This was true to some extent in China too, since the expansion of a purely private SME did not really come until after the 1992/93 ideological benediction.

capital, become larger companies, thus contributing to sooner accomplished recovery and growth. This is an important part of the explanation why the transitional recession lasted several years less in Poland, Hungary or Slovenia - the only former Yugoslav republic that was able to escape the misfortune of the local military conflict, or its direct consequences as e.g. mass migration.

However, there was many SME which had perished 'a day after' the economic liberalization arrived. A number of them was able to survive under the communist regime and accompanying it shortage environment, yet there were not able to manage at a free market. A bulk of the SME performing in the previous system was efficient, yet their management did focus mainly on procurement of the means of production, raw materials and other assets, and, of course, securing a labor. When the real market mechanism had begun to be introduced, the main difficulty became to sustain profitability when the market clearing mechanism was set in motion due to the price liberalization. This time the difficulty was to sell an output, not to acquire an input. Hence, many SME were not up to this challenge and had been wiped out of the emerging market.

Third, the skills of the managing staff of the SME was relatively more adequate for the needs of the emerging market economies. Despite the fact that the managers of these small units were far behind the qualifications of managers in advanced market system, they were more flexible and better prepared to undertake the risks that the operation at market economy has brought. Yet they were also oriented with their traditional skills, inherited from the old system, to manage the firm under the environment of the shortages. So, when the shortages were eliminated many of them were not ready to meet the new challenge brought by the transition, because their 'fine art' of management was rather the knowledge how to acquire the scarce goods than how to sell a plenitude of them. However, the fact is that in those countries, which enjoyed the SME sector under the previous regime -- owing to the market reforms introduced before the transition took off -- the process of structural adjustment went much smoother. The institutional building was going faster, the recovery came sooner, the growth has become more robust.<sup>4</sup>

#### **4. Shortage removal and the demand factors**

The common feature of the distorted socialist economy was the phenomenon of shortage. In addition to all its implications for the allocation of capital and behavior of the households sector, it had also an influence upon the SME. Even in the countries that did not introduced market oriented reforms prior to the systemic transition, e.g. Albania or Romania, in some sense there were SME as long as there

---

<sup>4</sup> For instance, in Poland -- the economy with the largest private sector among all ECE and FSU countries, reaching about 20 percent of GDP already in the 1980s also had the largest SME sector -- the transitional recession lasted 'only' three years (mid-1989 until mid-1992). Nonetheless, even during this relatively short period the GDP contracted by as much as 20 percent, mainly due to the mistakes of the policies carried out at the initial stage of transition (Kolodko and Nuti 1997).

was also an informal sector in the economy. Owing to the short supply, various economic activities had been undertaken in the 'shadow economy'.

Mostly it occurred in service sector but also in manufacturing at small scale in the industries not requiring either the scarce raw materials or sophisticated equipment. Such informal activities were exercised firstly in labor-intensive production, for example in garment industry in urban areas, or in food processing industry in rural areas. Depending on the attitude of the governments there were more or less restrictions imposed upon these types of activities. Yet in all cases -- as long as it was from the official point of view the informal sector -- neither the flow of output from these unit, nor their overall numbers were registered. Thus we know that there were some SME under the economy of shortage, yet we don't know how actually big such a sector was.

A driving force behind the SME functioning under the shortage economy was the short supply of the goods and services, especially sought by the household sector at the consumers market. Therefore, the first feature of this activity was that the supply was addressed basically at the consumers market. Hence, these SME were able to sell their product in the shadow economy, which was linked entirely to the 'private' economy, i.e. to the households sector. They hardly operated in the investment or heavy industry sectors at all.

The second fundamental feature of the SME under the economy of shortage was the syndrome 'easy sell, difficult buy'. Where the goods and services were in short supply, it was extremely easy to sell the products at the parallel market, since always -- and it was a systemic characteristic -- the aggregate demand was in excess over the aggregate supply (Kolodko and McMahon 1987). But for the SME it was also difficult to buy the means of production, since they were also -- owing to the same systemic factors -- in short supply. Since such SME were often informal, so the transaction of acquiring the raw materials, procurement goods, labor, etc., were often quasi-informal. Thus to buy inputs was difficult and to sell output was easy.

These foundations had changed significantly at the onset of transition. On the one hand, the SME that had operated up until then in the shadow economy emerged into the surface and tried to meet the new challenge and opportunities in the formal sector. On the other hand, the SME that were already performing in the formal sector, from then on had to meet another challenge, because instantly they found themselves in competition, a feature they were not familiar with. It explains why in reformed economies, e.g. Poland or Hungary, the pace of growth of SME was much higher than in non-reformed centrally planned economies. In countries with a relatively liberal financial regime, or even where the centrally planned allocation was actually abandoned during the reforms of the 1970s and 1980s, there were more SME in both the formal and informal sectors before the transition.

The paradox of this legacy for the expansion of the SME at the early stages of postsocialist transition was that in some cases (the best example is Poland) the shortage economy, together with the reforms aiming at limited liberalization, did contribute to faster expansion of the SME. If shortages were vast (as indeed was the case in Poland during the 1980s) and simultaneously the shadow economy was tolerated -- even if not facilitated by the actual government policies -- there was a greater potential accumulated for the take-off of the SME at the day true liberalization eventually arrived. And on the contrary; when the shortages were vast, but yet the supply response from the SME acting in the informal

sector was repressed by the government policies – as, for instance, it occurred in Romania in the course of the 1980s – then the conditions for the SME growth at the onset of transition were very limited too.

Thus, when the process of transition was set in motion at the beginning of the 1990s the biggest chance for expansion came from the overall liberalization of economic activities and the cessation of numerous bureaucratic constraints imposed for a number of reasons under the previous institutional arrangements. The biggest challenge, in turn, stemmed from the fact that the end of shortages removed as well the easy way of being able to put the products and services on the market, disregarding their quality. It became necessary to compete not for access to the inputs, but for the sale of the output. Thus new expertise was needed, firstly the marketing skills and the ability to take care of the quality of output. The ‘quantity drive’ must be abandoned, the ‘quality drive’ was just born.

Yet one more paradox of development of the SME has emerged. Despite the removal of short supply of the needed inputs for the SME, which could be bought now in the liberalized markets, and despite de-regulation coming as an indispensable part of transition, the shadow economy persists. Moreover, in a number of the countries, especially those of the FSU that are less advanced in the transition, the parallel sector is much greater than ever before. Leaving aside the pathologies – like organized crime activities in Russia, that take a large share of all resources and creates a large part of the informal sector, and especially operates in the large companies and big business (Satter 1998, Ermarth 1998, Economist 1999) – usually the informal sector is composed basically of the SME.

Yet this time the cause is not the shortage, since this malaise of the centrally planned economy has been removed together with the entire old institutional set-up. This time the reason is a temptation to avoid taxes. The reluctance to pay due taxes, even if not necessary the highest ones, is quite strong in the emerging markets. It is not only a matter of weak tax administration, which must be streamlined in a gradual way as transition process progresses, but also the matter of the lack of proper fiscal culture and underdeveloped institutions in the postsocialist economies (Tanzi 1992).

Another feature of the SME which stems from the shortage-removal effect is their real structure in the transition economies. To a much larger degree than in the developed countries and advanced market economies, the SME in ECE and FSU perform mainly in trade. Trade liberalization and the hunger for consumer goods, including the imported ones, have contributed to the mushrooming of SME in the trade sector, especially in retail trade. It happens – at least at the early stages of liberalization - that it is much easier to establish a small scale endeavor in retail trade than in manufacturing.

From this perspective any evaluation of the number of so-called SME must be analyzed carefully, since it is obvious that these numbers are simply the function of the magnitude of the country and the number of its population, on the one hand, and of the manner the trade is organized, on the other hand. Later – when the process of concentration is coming also to the private business in the trade sector and the SME in retail trade are being replaced by the system of super- and hyper-markets – the number of the SME starts to decline. This is simply the result of the technological progress in the trade industry.

Therefore, both the range and the characteristics of the reforms of the centrally planned economies, as well as the specific features of the shortage economy, have had a significant impact upon the development of the SME during transition to a market system. If the quantity and the quality of this sector of emerging postsocialist economy at the onset of transition was given by the legacy of the outgoing system, its evolution and contribution to the performance of the postsocialist economies was

basically resulting from the policies executed already during transition. Both liberalization-cum-stabilization policy and the policy of institutional building, i.e. systemic policy, do matter a lot for the expansion and performance of the SME sector.

If the combination of these policies has been a fortunate one and its design has addressed the specific needs of the SME in an appropriate way, then this sector has not only expanded faster than the large companies, but also has been integrated deeper into the formal economy. Since its output is registered, it shows better results as far as the recovery and growth are concerned, too. Yet it is not only a statistical point, since these small firms not only have begun to operate at the formal, registered market, but also they did expand -- and sometimes significantly -- the range and scope of their activities.

There is also a link between the aggregate demand's shifts and the supply response that has been delivered by the SME sector. Initially -- owing to the stabilization attempts following liberalization -- the aggregate demand was contained by a significant margin. Thus, it caused transitional contraction, which lasted in certain countries for several years. Later, when the economies have been put back on the path of recovery and growth, the growing aggregate demand was another driving force behind the expansion of the SME. This time, due to liberal regulation and easy access to freed markets, they were able to react and there was a positive supply response to increasing demand of both the households and the firms sectors.

Yet in certain cases and periods it has occurred that the aggregate demand was on the decline again. The resurgence of recession in some countries (e.g. Czech Republic in 1997-1999, Russia in 1998-99, Albania in 1997-98), or remarkable slowdown in some others (e.g. Poland in 1998-1999<sup>5</sup>) had led also the slowing down the process of expansion of the SME. Whatever was the actual cause of triggering the policies aiming at the containment of the rate of growth -- was it a concern about too fast and too much growing current account deficit, as for instance in Estonia and Hungary, or was it the reaction for the fallout from the Russian crisis, as for instance in Slovakia and Moldova -- the resulting downward shift in aggregate demand must led to slower than otherwise expansion of the SME sector.

## **5. Property rights, institutional arrangements and microeconomic efficiency**

Essentially, there are two major ways to expand output. First, this is the improvement of efficiency of the existing companies. Second, is the growth of the number of the companies operating in the market. In real economic life both ways are occurring, yet at some specific stages of development they may play a different role. This is also the case during postsocialist transition to a market system, especially if the high rate of growth of the numbers of SME is concerned. Yet, it must be remembered

---

<sup>5</sup> It is worth to stress that in this particular case, that is in Poland after 1997, the pace of growth of the SME sector has slowed down significantly, because of the wrong policy measures. The excessive attempts of the fiscal and monetary policies to contain the aggregate demand have caused a sort of squeeze at the markets and, in result, several SME have been driven out of the business owing to shrinking demand for their products and services.

that this phenomenon occurs only one time. After initial take-off -- owing to overall liberalization and the shortage-removal effect -- the number of SME is growing fast.<sup>6</sup> Later, after some degree of satiation is achieved, it stabilizes. The structure and particular samples are changing, since now there is both free entry to business and free exit from it, but beyond some point the quantity of SME ceased to increase fast, if at all.

Yet there are relatively few SME in the transition economies, far below other economies with similar GDP levels. There are two reasons for such a feature. First, the SME are born gradually through the growth of micro-enterprises (less than five employees), of which there are too many in transition economies, resulting in a dualist population of large and micro-enterprises. Second, through founding by large enterprises, which are busy re-structuring for the time being, and are impeded by large interest costs. Thus they do transfer some assets and labor to the SME they create for the sake of providing services and supplying them in some particular goods.

As a good example here, the case of the SME mushrooming around the big shipyards or coal mines can be brought to the fore. They use the same as before, i.e. where they were still large state-owned units, assets and the same labor -- at least at the initial period of their existence -- but since the restructuring have taken place, they are managed in a different way. From the formal viewpoint, they are independent SME (most often already privatized), yet initially they perform the same functions as these units did while they were still the part of the large company, a demand of which they satisfy now. Such type of restructuring has been also an important means of privatization. A bulk of previously state-owned assets has been transferred -- often just for a fraction of their real value -- into the private hands. In the longer run it could contribute to both growing number of the SME and increasing efficiency, thus it facilitates the overall growth ability.

This makes a great difference if compared with advanced and developed market economies, where there is rather a smooth spectrum of the companies seen from the viewpoint of their size. The scale goes gradually from the micro-enterprises through small and medium companies, to large and very large firms, unlike in transition economies. In the latter, such a continuum is broken, especially as far as medium-like companies and the small business employing the labor within the range of 50-500 persons are concerned.

The SME sector in postsocialist economies is of a dual nature. On the one hand, this is the continuation of existing SME functioning earlier, under the socialist economy, in both formal and informal sectors. If these SME were owned by the state prior to transition, a bulk of them had been quickly privatized, mainly through selling the assets to managers and employees of the small companies, often below the market clearing prices and rather in an insider trading manner.

In the socialist economy there were two dominant forms of ownership, i.e. the state and the cooperative property. As for the SME, they were basically the domain of the latter. A chain of SME -- for instance in dairy products procurement, or in local taxi transport facilities -- had been organized

---

<sup>6</sup> Actually, it must be remembered that in some cases such a growth was in part an illusory one, since it was resulting simply from the SME coming into the official economy out of the unregistered so far activities.

under the tutelage of the cooperatives. Therefore, it was easy to exercise specific 'socialist corporate governance' over such units and to keep them under though limited, yet true control of the government bureaucracy. Self-dependency of these type of cooperatives was always an issue in the era of centrally planned economy. Thus it was enough to dismantle the bureaucratic umbrella spreading over small production and service units and to de-centralize the management of the units belonging to such cooperatives.

In the aftermath, a bulk of 'new' SME had emerged. That was the case, *inter alia*, in the late Czechoslovakia, the former GDR, or Hungary and Poland. Such sequence explains a kind of myopia towards the development of the SME. Actually, a part of them existed already under the socialist regime. And the more the system had been reformed, the more such units was there. Thus, from a technical viewpoint, a number of SME did exist before, yet they were not counted as a such unless the legal decentralization occurred. This systemic factor, together with bringing many SME from the informal to the formal sector, explains the mushrooming of the SME in Hungary and Poland at the beginning of 1990s.

On the other hand, the new ventures have been vastly established owing to liberalization. The liberalization is reflected not only in freeing the prices and trade, but – what is most important from the viewpoint of the SME expansion – in free entry to and exit from the business. In the SME sector, much more than in the big business, both entry and exit are less restricted. Especially exit is indeed very free, if the business turns out not to be a profitable one. So, in the SME, due to overall liberalization and de-regulation, there is a dynamic process of establishing the new entities and retiring from the business, if it happened to be not a successful endeavor.

The core of postsocialist transition is the process of privatization. Yet there are many 'privatizations'. It has been assumed – and still this is the fundamental supposition justifying privatization – that de-nationalization of the state assets must soon bring the growth of microeconomic efficiency. But, unfortunately, it has not been the case so far, since the continuing financial distortions and especially weak institutions evaporate the gains that the shift of the property rights from government towards the private sector could bring in the short and medium terms.

More visible is the progress of efficiency in the SME sector. It is almost fully owned by the private sector, but as far as microeconomic efficiency is concerned its superiority over the large companies is stemming rather from the very size of the companies than from the fact that the SME belong entirely to the private sector. If the other part of the private sector, i.e. the just de-nationalized large companies, are less efficient, this is the result of more complex structure of the latter. It is also more difficult to exercise competitive management over the larger units. Moreover, they require a more complex institutional environment than the SME, which are much simpler to put on a competitive basis and are more flexible in adjusting to the market signals.

Undoubtedly, the property rights revolution, which has arrived together with the postsocialist transition, has made the expansion of the SME possible. However, their further development and relative meaning within the whole economy depends on the overall institutional arrangements as well as the specific institutional and legal set-up facilitating just the SME. Additionally, the government policies can assist the growth and competitiveness of SME, or on the contrary -- if designed inappropriately, it can hamper its performance and development.

That is very much the case of Russia where liberalization meant institutional chaos and free choice meant *de facto* acceptance of illegal and criminal economic activities (Economist 1999). Thus in the pathological case of Russia – due the nightmare of neither plan nor market syndrome, and following the collapse of the previous system creating an institutional vacuum – the SME sector must function within the corrupted system, that is to quite an extent controlled by the organized crime.

In Russia, as in several other emerging markets of the FSU (especially in the larger countries), the weak record of the SME development stems from both the legacy of the past and the mismanagement of the early phase of transition in the course of the 1990s. Neither was there a favorable point of departure, as for example in Hungary, nor there was the real attempt to create a proper legal framework to support the development of the SME sector from the scratch. Additionally -- following bungled price liberalization and the resulting wild inflation -- the ill-advised stabilization policy, had led to extremely high interest rates, discouraging the growth of the SME. Furthermore, it caused also the collapse of aggregate demand and severe friction and disturbances within the normal payments mechanism.

Crucial for the success of the SME development is the property rights protection. In postsocialist economies it is secured by the law, often written into the new constitutions. However, the protection of property rights needs also a mature judiciary system and proper organizations that can serve the needs of the rise and the expansion of the SME. It also calls for decency and proper market culture that always is a product of the long-term developments. Protection of property rights means too that the system is relatively free of bribery, extortion, racketeering and government corruption. None of these conditions is met so far in Russia. Thus, in this largest postsocialist country, contributing about one third of total GDP of all 28 countries of the ECE and the FSU, the SME sector is a minor contributor to the output, employment and government budget. Not surprisingly, the output is shrinking, unemployment growing and the fiscal system is in dire straits.

Sound economic and social performance of the postsocialist economy needs the same institutional arrangements facilitating the SME sector as the large companies. Yet it is not sufficient, considering the specific characteristics of the latter. Being always in the shadow of ‘big business’ they do need some special solutions, means of policy measures and organizational support. It is so, since their lobbying power is hardly on the par with the big companies. They must rely most often on the short-term commercial credit. They can not afford their own marketing branches. Their access to market information and analyses is limited and their ability to process the otherwise accessible data is limited, too.

Therefore, the SME sector needs some special support. This is not against the rule of an equal treatment of all enterprises, but rather an attempt to alleviate the existing chance to compete in the emerging, open market economy. Hence, these and other systemic factors, specific for the SME sector, justify certain institutional arrangements to enhance the SME ability to perform within the competitive environment.

First, the SME must have the right to organize themselves in trade, commerce and industrial chambers. Being indeed small and medium as far as the scale of production and provided services are concerned, these units should have a forum to express their views and opinions on the legal system as well as on the governments and monetary authorities policies as though they are a big and important

partner. Indeed they are, but only if properly organized and if their lobbying is managed in an adequate way. The law must establish the rules for such SME self-governing bodies and representation on the local, region and country scale. The rules governing such organizations of the SME must be transparent and negotiated with these sector.<sup>7</sup>

Second, the development of SME requires special financial facilities and intermediaries. The lines of micro-credit must be provided and thus special banks, operating among the SME, should be created, mostly with the capital participation of the SME. Considering the legacy and the structure of SME in transition economies – especially relatively larger importance of agriculture and traditional services – there is a room for financial cooperatives and small regional banks specializing in providing financing for the SME.

Third, under some circumstances, the commercial credit for the SME should be supported by the government subsidies to ease the burden of interest rates which are often too high in the real terms, owing to the by-effects of the stabilization attempts during the period of high inflation. However, always such assistance must be based upon the conditionality that the credit is used for a profitable endeavor and that the flow of assisting capital must only add to one's own accumulation. Such a policy can be exposed for a risk of mismanagement, yet if regulated and monitored suitably, should be transparent and well-performing.

Fourth, there are many particular cases where a special regulation is needed. For example, the SME sector can provide employment for disabled people, which is not a domain of large business. Thus, such projects must be furnished with the institutional and financial assistance of the government, including directed government transfers. In particular instances, special government semi-financial organization are established to manage and support these policies.<sup>8</sup>

Fifth, the governments must create special semi-banks and government agencies supporting particular expansion of the SME, meeting the needs of structural and industrial policies. Taking into consideration the structure of the real economy, there may be the need to create and capitalize initially by the government money (sometime with the help from foreign donors, e.g. from the EU) special

---

<sup>7</sup> The regulations *vis-à-vis* this aspect of SME organizations vary from country to country, and in some of them is still neither clear, nor stable. For instance, in Poland the membership in the chamber of commerce is voluntary, whereas in Slovenia it is mandatory, and in Ukraine it is not regulated yet. Of course, it has a meaningful implications for the position and lobbying strength of these bodies and thus their ability to influence the policies' and institution's matters of the SME performance and development.

<sup>8</sup> Fine example of such a scheme is the Fund of Rehabilitation of Disabled and Handicapped People established in Poland. If the SME investor is keen to sign a contract and to secure the employment of such persons, then is provided with soft credit by the government agency. Of course, it involves a transfer of the taxpayer money through the state budget. Yet, at the other end, it reduces the pressure on this same budget to provide otherwise necessary financial allowances for the disabled and handicapped people, who would be idle and jobless otherwise.

organizations facilitating restructuring of the agricultural sector, constructing reasonable quality houses and apartments for the poor part of the society, or supporting specific R&D in various industries.

In the longer run such agencies are supposed to be self-financing and privately owned, but at the initial stages of transition they must be boosted both in organizational and financial terms by the government.<sup>9</sup> However, there are many examples from different countries at different level of development and institutional maturity that such organizations can perform well as the government agencies, too. Hence, in the transition economies also they may remain in the hand of the state and under the government management as long as they are contributing firmly to the accomplishment of their aims.

Sixth, yet while there should be one comprehensive government policy towards the development of the SME, there are as well many regional aspects. In some regions special development agencies, supported by the local governments, should be created. Their role is to provide technical assistance and advice for the new SME, which most often are aiming at the local markets. Such development agencies may be streamlined through central government financial transfers. Later, they must rely on their own commercial activities and participation as well as on the fees collected from the SME from their region.

Seventh, both the central and local governments ought to take care of training the cadres needed for the SME growth. Managing SME is basically a process of learning by doing, by considering the legacy from the past – especially in the unreformed socialist economies – it is wise policy to teach basic business and managerial skills to the business owners-to-be. Especially marketing, accounting and financial engineering as well as the knowledge how to prepare the feasibility studies and applications for credits and other financial arrangements are important here.

Eight, as long as trade is the gist of the business, in the case of SME the governments must initially facilitate regional and country commodity exchanges. They must be regulated by the law and at the beginning supported logistically and financially by the government. Later, after being established on the sound basis and being well-regulated, they may be also privatized, yet in several cases they can work well while being still owned by the government. Sometimes it is just necessary that the state, or the local government and the municipalities, remain acting as the owners and the managers -- and not only their regulators -- of such organizations. Otherwise, they can overlook and neglect the needs of some entities, including relatively weaker SME, and may make them unable to stand the pressure of better organized competition of the large units, often at the cost of the customers. Even in the most advanced countries there is many cases like these, e.g. Pike Place in Seattle, or the Paris markets.

---

<sup>9</sup> There are many examples of such exercises in particular countries. In case of Poland, for instance, several government initiatives did contribute significantly to the development of the SME. The Agency for Reconstruction and Modernization of Agriculture (ARMR) contributes to the creation of new job opportunities in the rural area, however mainly outside agriculture, e.g. small food processing factories, hard infrastructure development, agri-tourism and eco-tourism, various services, etc. The Agency for Technological Development (ART) assists the SME projects by industrial policy, research and development. The Agency for Industrial Restructuring (ARP) operates as a soft-lending financial intermediary and helps, on the basis of carefully examined feasibility studies and guided conditionality, to co-finance projects linked to the introduction of new technologies and high-tech know-how.

Hence, the best advice one may give to the policymakers as far the development of entrepreneurship, in general, and *vis-à-vis* the SME sector, in particular, is *primum non nocere*. It seems to be wise to support this self-sustaining process through proper legal framework and institutional set-up. The SME sector has the ability to expand itself in the long-run, but at the initial stages of the functioning of the emerging postsocialist system such an ability can be wisely enhanced with the proper engagement of the government-led policies.

## **6. Interest groups and the formation of a growth lobby**

An evolution in interest groups is of the greatest importance in the formation of the public support required for the development of entrepreneurship and thus, in the long-run, for sustained growth. In view of their origins, characteristics and dynamics, the interest groups inherited from the socialist system are quite different from those needed for the expansion of the new system, including its SME component. One should not wait to see what sorts of interest groups emerge from the chaos of the transition, but appropriate actions aimed at shaping new and influential groups representative of society should be taken quickly.

The appearance of a ‘growth lobby’ should not be made to depend on the assumption that certain groups will spontaneously begin vigorously supporting positive measures to expand the economy. This should be a matter of policy. Although liberalization and privatization did automatically set in motion the creation of some groups acting in favor of growth, the process ought also to be a deliberate one. Workers, farmers, academics, and the bureaucracy are not all able to join naturally together to take part in the growth lobby. The emergence of a special group of development leaders must be fostered during the wide-ranging restructuring of society and the overhaul of old institutions. The leaders of the SME sector naturally do belong to such a group.

It is necessary to intervene because interest groups are themselves in transition. Moreover, there is a great deal of interaction between the shifts experienced by these groups and ongoing economic and political change. In extreme cases, either a new growth lobby will emerge to act as a decisive interest group, or the old bureaucracy will continue to lead economic events. In the worst case, a new political elite with close ties to organized crime will come to exercise a significant role in the informal institutional set-up and thus in policymaking (Kolodko 2000, Satter 1998, Stiglitz 1998, 1999).

It may be thought that a growth lobby will emerge on its own out of the new middle class, including the SME owners and managers, arising from liberalization and structural reform. Yet, if this process is to occur in a sensible and speedy way, there must be strong and determined political leadership. The growth lobby in a transition society consists initially of entrepreneurs, investors, managers, and reform-oriented politicians and economists. The legacy of the centrally planned regime – with its institutional, behavioral, and cultural dimensions – represents a hurdle for the appearance of the new lobby, since the market environment is fundamentally different.

The formation of a growth lobby is a slow and complex process which should be assisted as much as possible. Because it is linked to the fall of the old elite and the rise of a largely new one, it is also a conflict-prone process. First, the old elite seek to remain in control and to become ‘the new’ elite.

Second, the process takes place in the context of a series of sensitive privatizations and the restructuring of financial intermediaries, and this generates lively public debates about the best ways to realize the policies. Third, the process is also tied to and influenced by the democratization of political life and the emergence of democratic institutions. There is thus interaction between the economic power and the political position of particular individuals, groups, and parties, and this has an impact on the creation of interest groups.

Among those involved in such groups, be they entrepreneurs, managers, bankers, investors, politicians, trade unionists, civil servants, economists, lawyers, or journalists, some will act in favor of growth, but others will seek to bulldoze events toward their own particular ends, even at the cost of growth, that is, at the cost of society as a whole. Especially if the institutional environment is weak, some of these people will act against the law, will not respect the market rules, or will try to evade taxes, thereby undermining the potential for expansion. Their logic seems to be, the less they pay to the Treasury, the more they will be able to save and then spend including, of course, on their own affairs. They are not concerned that this behavior has a negative effect on the fiscal balance by reducing the resources available for financing the public expenditures indispensable for sustaining growth, also for the institutional and financial streamlining of the SME development.

If the entrepreneurial spirit is oriented mainly toward capital formation, investment, export expansion, the generation of new jobs, and fair competition, then the growth lobby can be strong. But if this spirit is directed toward the redistribution of existing capital, mergers and acquisitions, tax evasion and tax avoidance, the exploitation of labor, and unfair competition, then there is a sort of 'capitalist populism', and the important lobbies tend to be 'anti-growth'. In the case of emerging SME sector in transition economies both tendencies -- the favorable and unfavorable -- can be observed. Their ultimate balance will be a function of the commitment of the government and the policy interventions.

The challenge for the political leadership is to enhance the emerging growth lobby and to coordinate policies, both macro and micro, in such a way that the groups desirous of real economic expansion will be able to check populist tendencies and limit the power of the conservative bureaucracy, while not becoming too strong themselves. Hence the coordination of transition and development policies involves passing between the Scylla of populism and the Charybdis of expansionism. While populism stresses too heavily the importance of income distribution and consumption without proper attention to efficiency, expansionism emphasizes too much the significance of capital formation and growth without sufficient consideration for equity (Kolodko 1999b, 1999c).

Entrepreneurs and investors are taking the places vacated by the old party activists, the statist bureaucrats, and the directors of state companies. These are the people who are now expected to bear the risk and to take responsibility not only for their own decisions, but for the consequences on others of those decisions. Entrepreneurship and the readiness to take risks in investment are features of a certain sort of personality and reflect a certain kind of knowledge and technical skill. Whereas character traits and attitudes are a given, the expertise must be acquired. The government must therefore also foster technical and professional training among business people. Even if these people believe that they already know how to solve the mounting problems in risk assessment, marketing, and management, the state should not cease seeking to upgrade these precious abilities. The greater these abilities are, the greater also will be the rate of expansion, including the growth of the SME.

For several years subsequent to the onset of transition, before the older staff members begin to retire and are replaced by a new generation, the majority of the executives running the privatized and newly market-oriented companies are recruited from the old guard among the directors of former state enterprises. This is less true for the SME enterprises, since they most often are run either by their bosses from the previous system, yet within a new institutional environment, or they just have been established by the real market entrepreneurs. Yet not all these people are able to change old habits easily or to the degree necessary for business management in the market, which is so different from the old system. Transforming the director of a state enterprise who has functioned for so long within a closed statist economy into a manager of a private company operating on open competitive markets can be as difficult as converting an old-style politician into a new-era leader or a central planning zealot into a capitalist fanatic. In fact, the latter metamorphoses are much less difficult.

While some managers are quick to devote themselves to expansion and are eager to take up the competitive challenge represented by the open market, others are keen to insist on the maintenance of the state tutelage which is so familiar to them. While progressive managers are ready to shoulder risks and lobby on behalf of fair competition, deregulation and growth, others act conservatively and lobby only for subsidies and allowances, which influence the redistribution of income and cause distortions in market signals and consequently in allocative efficiency. Nevertheless, such an attitude is more typical for the managers of the large companies, since those that are associated with the SME have proved to be much more flexible and indeed more efficient for business expansion.

To be sure, in the long-term the more deregulated the economy, the bigger the voice of profit-oriented managers and of the growth lobby. However, there is also a danger of going too far in this direction. Likewise, if it is too far-reaching and poorly designed, state involvement in economic matters, especially the supervision of corporate governance and microeconomic policy, can weaken the growth lobby. Yet the SME is a natural ally in such a lobby, which in turns facilitates the rise and development of entrepreneurship in emerging market economies in transition countries.

## **7. The policy conclusions**

Considering the outcome of the first decade of transition, i.e. the widespread fall of output and lasting great 'transitional depression' of 1990-99, it is obvious that the policies have not generated the anticipated results. This judgment suggests the need to search for alternative measures. As the postsocialist markets have emerged, so have fresh issues, problems, and concerns. The reactions to these have differed, and new approaches have been evolved. But if one wants indeed the proper legal framework, institutional arrangements and supportive policies for the development of the SME sector, one must look from a wider perspective for the implications for policies of sustainable growth. Ten major policy conclusions can be identified here.

First, institutional arrangements are the most important factor for the accomplishment of durable growth. They should be established through a process directed by government (by design) rather than spontaneously (by chance). In those nations in which government has been committed to this approach, recovery has come sooner, growth has been more robust, and there are more prospects for sustainable

development. Those countries in which government has relied on the spontaneous appearance of new institutions have not been able to manage this complex process adequately and are lagging behind in the transition.

Second, the size of government is less important than the quality of government policies and the manner in which the change is realized. In transition economies a profound restructuring of the public finance system is more important than is a downsizing of the government. Fiscal transfers should be redirected from non-competitive sectors toward institutional building (including behavioral and cultural changes) and investments in human capital and hard infrastructure. Attempts to downsize government through expenditure cuts can do more harm than good in terms of recovery from transitional recession and the achievement of sustainable growth. Additionally, it can affect in a negative way the aggregate demand, thus causing first growing capacity underutilization and, later, decreasing ability for the output expansion, including its part coming from the SME sector.<sup>10</sup>

Third, institutional building must be a gradual process. The effects of specific inputs in this process must be constantly monitored, and policies must be regularly adjusted and corrected. One should not depend on the experiences in distorted market economies, but should understand the special features of the emerging postsocialist markets. This is especially true in privatization and the development of capital markets, but also in enhancing the development of the SME sector.

Fourth, if institutional arrangements are neglected and left to spontaneous processes and liberalized market forces, then there arises a systemic vacuum and 'informal institutionalization' occurs. Spreading corruption and organized crime are extreme examples of informal institutionalization. These are the two principal diseases in countries in which liberalization and privatization have taken place under weak government.

Governments may sometimes be too weak because they are too big, but in transition economies they are often too weak because they have been downsized too soon, before the emerging market was able to take over relevant functions of the state. Even if the aim of the downsizing is to reduce the scope of fiscal redistribution so as to encourage capital formation and hence investment and growth, one must not overlook the fact that the struggle against informal institutions is costly in fiscal terms, too.

---

<sup>10</sup> That was, for example, the case in Poland in 1998-99. The faulty government policy -- intentionally aiming at bringing the soaring current account deficit under control through the containment of aggregate demand -- has led to growing underutilization of the capacity, including SME. In some sectors, e.g. wholesale and retail trade, the absolute number of the SME declined significantly and later was taken over by the large units (mainly foreign capital), which were able to stand longer against the odds of such policy. On the one hand, the target of diminishing the current account deficit was not met, since it even increased from only 3.2 percent of GDP in 1997 to about 6.5 percent in 1999. On the other hand, the rate of growth of GDP was brought down from 6.4 percent, on average, in 1994-97 to about 2 percent in the first half of 1999. And, unfortunately for the prospects for regaining the high-quality growth typical for the period of the implementation of "Strategy for Poland" in 1994-97, the expansion of the SME has been put on hold.

A prematurely or too thoroughly downsized government may not be strong enough to lead in this struggle, and the market may quickly expand within the informal sector, while the difficulties are mounting in the official economy. Thus, profits will accrue to the informal sector, while revenues drop in the official sector. Profits are thereby 'privatized', while losses are 'socialized' in a politically unsustainable process full of negative consequences for the budget and for social policy.

Fifth, in transition economies policies must aim at transforming and streamlining the legal system so that it can serve the market economy. The establishment and development of new laws – trade and tax codes, capital market regulations, the protection of property rights, antitrust regulations, banking supervision, consumer protection and environment protection – are extremely important and ought to be addressed before or simultaneously with the process of the state assets privatization. The establishment of a legal framework which is appropriate for the market economy should be much higher on the agenda of international financial organizations. It must be a more urgent and important issue than liberalization and privatization, since these latter can contribute to sound growth only if the former has been assured.

Sixth, a shift in functions from the central government to local governments is necessary for deregulation in the postsocialist economy. Such deregulation facilitates the growth of the SME, too. This means that some decentralization must be undertaken in the public finance system and that local governments must be given more fiscal autonomy. The process of taking functions away from the central government must be matched by reinforcing local governments. Both levels of government must be seen as two parts of a single entity which is essential for gradual institutional building. If local governments are not strengthened as the central government is reduced, then healthy market forces cannot be supported by new institutional arrangements, and liberalization and privatization are less likely to improve capital allocation and raise efficiency.

Seventh, the development of non-governmental organizations must be accelerated. More significant international technical and financial assistance must be channeled into the effort to empower non-governmental organizations. Along with the private sector and the state, these organizations are an indispensable pillar of the contemporary market economy and civic society. A wide range of non-governmental organizations active in various areas of public life is needed to ease the constant tension between the state and society. The expanding private sector cannot adequately fill this gap. Certain areas of public life can rely neither on the state, nor on the business-oriented private sector. Without the institutional infrastructure provided by non-governmental organizations, successful systemic change and high-quality growth become more problematic, the infant market economy and democracy in postsocialist nations cannot evolve properly, and the transition will remain incomplete. The non-government organizations ought to be also a natural ally of the SME, since they too operate closer to the people and the local- or regional-level needs.

Eighth, income policy and equitable growth are very important for the success of the transition. Because increasing inequality is unavoidable during the initial years of transition, the government, through fiscal and social policies, must play an active role in managing income dispersion. Beyond a certain limit, income disparities inhibit the expansion of economic activity, stunt economic growth, and delay recovery. Substantial inequities hamper crucial institutional and structural reforms and start to act against the

expansion of the SME sector, which relies to a great extent on the development and well-being of the emerging middle class.<sup>11</sup>

Ninth, the postsocialist transition to the market is taking place in a context of worldwide globalization. Hence integration with the world economy is an indispensable part of the process. This must be managed carefully. Special attention must be paid to short-term capital liberalization, which must be monitored and controlled by fiscal and monetary authorities and supported by international financial institutions. It is better to liberalize capital markets later rather than sooner. Institutional building must first be sufficiently advanced, and stabilization ought already to be consolidated into stability. Only then should financial markets be liberalized in a gradual manner. Otherwise the populations in the young and emerging democracies will not back the introduction of market mechanisms or integration with the world economy and may even become hostile to these steps.

Tenth, international organizations should not only encourage regional integration and cooperation, but should insist upon them. Rapid and durable growth requires export expansion, which depends on strong regional linkages. In turn, this calls for institutional support through import-export banks, commodity exchanges, credit insurance agencies, and so on. This should be the main focus of the institutional building effort of the EBRD through its direct lending and technical assistance. This sort of market infrastructure is now underdeveloped in transition economies, and regional trade and direct cross-country investment are lagging behind in the process of change. What should be a driving force behind sustainable growth, is actually now one of a major obstacles.

---

<sup>11</sup> The case of Russia -- with its political pathologies, crony capitalism and vast capital flight -- is the most spectacular illustration of this phenomenon. Not the lack of the capital for the development of the SME, but the overall mismanagement of the transition process and long lasting international tolerance for mounting corruption and continuing capital flight have caused that this sector by all means remains significantly underdeveloped. In turn, it hampers the prospects for the overall growth later, when the recovery at last will come. For too long too much the policy's attention -- domestically and internationally alike - has been focused on huge firms, as Gazprom or Lukoil, with disregard of the issues of the SME expansion (Kolodko 1998).

## References

EBRD (1999), Transition Report Update, London, European Bank for Reconstruction and Development (April).

Economist (1999), "Crime without punishment", *The Economist*, August 28: 17-19.

Ermarth, Fritz M. (1998), "Seeing Russian Plain: The Russian Crisis and American Intelligence", *The National Interest*, (Spring): 5-15.

Kolodko, Grzegorz W. (1989), "Reform, Stabilization Policies and Economic Adjustment in Poland", WIDER Working Papers, 51, Helsinki, The United Nations University, World Institute for Development Economics Research/WIDER (January).

\_\_\_\_ (1992), "Economics of Transition. From Shortageflation to Stagflation: The Case of Poland", in Armand Clesse and Romuald Tokes (eds.), *Preventing a New East-West Divide: The Economic and Social Imperatives of the Future Europe*, Baden-Baden, Nomos Verlagsgesellschaft, pp. 172-81.

\_\_\_\_ (1998), "A Plan for Russia", *The Harriman Review*, Special Issue: "The Russian Economy in Crisis", Columbia University, New York, December, pp. 24-27.

\_\_\_\_ (1999a), "Ten Years of Postsocialist Transition: the Lessons for Policy Reforms", Policy Research Working Paper, No. 2095, Washington, DC, The World Bank (April).

\_\_\_\_ (1999b), "Equity Issues in Policymaking in Transition Economies", in Vito Tanzi, Ke-young Chu and Sanjeev Gupta (eds.), *Economic Policy and Equity*, Washington, DC, International Monetary Fund, pp. 150-88.

\_\_\_\_ (1999c), "Income Policy, Equity Issues and Poverty Reduction in Transition Economies", *Finance & Development*, September: 32-34.

\_\_\_\_ (2000), *From Shock to Therapy: The Political Economy of Postsocialist Transformation*, Oxford University Press (forthcoming).

Kolodko, Grzegorz W. and Walter W. McMahon (1987), "Stagflation and Shortageflation: A Comparative Approach", *Kyklos*, Vol. XL, No. 2: 176-97.

Kolodko, Grzegorz W. and D. Mario Nuti (1997), "The Polish Alternative. Old Myths, Hard Facts and New Strategies in the Successful Transformation of the Polish Economy", *Research for Action*, 33, Helsinki, The United Nations University, World Institute for Development Economics Research/WIDER.

North, Douglass C. (1997) "The Contribution of the New Institutional Economics to an Understanding of the Transition Problem", WIDER Annual Lectures, 1, Helsinki, The United Nations University, World Institute for Development Economics Research/WIDER (March).

Poznanski, Kazimierz (1996), *Poland's Protracted Transition: Institutional Change and Economic Growth*, Cambridge, UK, Cambridge University Press.

Satter, David (1998), "The Rise of the Russian Criminal State", Prism, Washington, DC, The Jamestown Foundation, (September 4).

Stiglitz, Joseph (1998), "More Instruments and Broader Goals: Moving toward the Post-Washington Consensus", WIDER Annual Lectures, 2, Helsinki, The United Nations University, World Institute for Development Economics Research/WIDER (January).

Stiglitz, Joseph (1999), "Wither Reform? Ten Years of the Transition", paper prepared for the Annual Bank Conference on Development Economics, Washington DC, World Bank, 28-30 April.

Tanzi, Vito (1992), Fiscal Issues in Economies in Transition, Washington, DC, International Monetary Fund.

Williamson, John (1990), "What Washington Means by Policy Reform", in John Williamson (editor), Latin American Adjustment: How Much Has Happened?, Washington, DC, Institute for International Economics.