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**LA MICROFINANZA NEI PAESI EX-COMUNISTI:  
IL CASO POLACCO**

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**MICROFINANCE IN POST COMMUNIST COUNTRIES:  
THE CASE OF POLAND**

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# ***INTRODUCTION***

During my staying in Warsaw in autumn 2002 I used to hang out in one of the biggest malls in town: Galeria Mokotów. Looking around I could find all the best international shop-chains and goods and the unfailing American fast-foods. If I hadn't already spent there some time and talked with many Polish people and hadn't seen the reality of grey soviet blocks grown like mushrooms in the Warsaw suburb or travelled in the boundless Polish country-side, I could have thought I was finding myself in Milan, Paris or London: malls are the same everywhere. But luckily I had the pleasure to converse with different Poles and find out, for instance, that their average salary was almost a half of ours, while prices of non-food goods in malls were about the same as in Italy. As time went on, I made a little progress with Polish language and started going for shopping in the typical "bazars", very popular open markets where I could buy food and clothes almost for nothing. I realised that malls were not places for everyone in Warsaw, but only for foreigners and for the better-off Polish citizens who could afford more than just window-shopping in Galeria Mokotów.

As it is clear from the title of this work, I'm not going to write a thesis about malls in Warsaw, but rather on the development of microfinance in transition countries and, in particular, in Poland. My experience with malls was however enlightening. It showed me that I can't extract any phenomenon from its environment, from its past and present and from the reality of people related to it, if I want to get the right idea of it.

The present work will be markedly split in two parts, with the intention of investigating extension, structures and performances of the microfinance industry first of all in the more general context of transition countries of Central and Eastern Europe (C&EE) and the New Independent States (NIS) and only subsequently in Poland, where a peculiar network of microfinance institutions (MFIs) has been recently developing. To remain faithful to my previous observation, each of the two parts will be introduced by a chapter delineating first the historical and then the economical and social evolution of the areas under study. These two chapters, apparently not concerning the main theme of the work, are not aimed at depicting all the manifold features of the transition process indiscriminately. In both parts, almost specularly, only those issues related to the development of microfinance will be discussed. These aspects concern the impact of reform processes implemented with different methods and speeds by governments to switch from a centrally-planned to a modern market-driven system; the increase of poverty and inequality which has occurred to various extents in all transition countries; the changes in the labour-market and the emergence of a new phenomenon, unemployment. Later on, it will be taken into account the attempt of governments to

balance the negative effects of the transformation and to compensate losers through social allowances, as well as the efforts of privatisation of former state-owned enterprises. A considerable attention will be given to the birth and growth of private business activities in transition countries and in Poland and, in particular, to the role of small and medium enterprises (SMEs) in the development of a renewed sound economy capable of generating benefits for all layers of population. Also the various obstacles hindering SMEs' expansion will be stressed. These are i.e. the period of economic recession and falling demand started in 1998 and not yet recovered; the high level of social insurance drawings on salaries (the so called Z.U.S. payments); the cash-flow problems for many companies; the lack of marketing and business knowledge and experience; the problems of underdeveloped rural areas; the mentality of people, not yet used to a market economy and the problem of access to finance from the banking system for entrepreneurs who want to start their own activity or expand their businesses. The subsequent paragraphs will be therefore devoted to considering the evolution of the banking system in transition countries and Poland and to the study of the critical problem of lack of financing for emerging SMEs, to which microfinance tries to give an answer. Finally, but only in the more general part dedicated to all transition countries (chapter 1), the need for an appropriate legal environment in a situation of diffuse corruption and state-capture will be examined. The section about Poland (chapter 4) will be on the contrary closed by a special paragraph about the difficult living conditions in rural areas.

Once dealt with all these background themes, the central issue of microfinance will at last come on the scene in both parts. I have chosen to focus my thesis on this subject and its application in transition countries, because I think microfinance can play a significant role in the building of a new social and economical environment not just in the developing world, but also in this peculiar reality. It can be seen in fact as an attempt, in principle rising from the "bottom", to instil self-confidence and trust in their own creative and entrepreneurial skills to the inhabitants of that region. The expected result consists in the encouragement of self-employment and in the birth of micro-enterprises after the collapse of the plan-system, the closing of many state-owned enterprises and the loss of any economic security, however miserable it was.

Chapter 2 will concentrate on the typical traits this newly born industry assumes in transition countries. The high demand for its services will be highlighted, its functions in the transition process will be enumerated and the four main institutional models will be described in depth, together with their strengths and weaknesses. As a matter of fact, institutions providing micro-lending services in transition countries can take the form of Credit Union, of Non-Governmental Organisations, of "downscaled" commercial banks and of greenfield microfinance banks. Chapter 2

will end with a paragraph entirely devoted to the problem of regulation and supervision of MFIs, which is so ardently debated by microfinance practitioners at present.

The following chapter (chapter 3) will consider the surprising performances of such a young industry. A first section will focus on the fundamental work of research, information exchange and network building of the MicroFinance Centre for C&EE and the NIS, located in Warsaw, and on one of the most recent and complete study about microfinance in transition countries carried out by the research department of MFC. The attention will then be diverted on the current achievements of microfinance institutions in the area, analysing them according to two different criteria: by institutional type and by sub-regions. The fifth paragraph of this chapter will be then dedicated to the controversial matter of relieving the living conditions of the poorer layers of population through microfinance services and the important indicator of “depth of outreach” will be used to try to quantify the attainment of this goal. The subject of poverty reduction through micro-loans will be again considered in the successive section, where the financial results of MFIs in transition countries will be reported. The central issue will concern the difficult commitment of many MFIs to reach the poorest people, attaining, at the same time, financial or, at least operational sustainability. The chapter will conclude with a comparison between the outcomes of the MF industry in C&EE and the NIS area and those of other regions where microfinance operate, exploiting the benchmark activity carried out by the MicroBanking Bulletin under the “MBB Standards Project”.

The state of the microfinance industry in Poland will be finally discussed in chapter 5. Here institutions providing microfinance services will be classified into three groups: 1) Credit Unions; 2) “classical” MFIs; 3) Loan Funds and Guarantee Funds. The most important topics concerning each of the three approaches to microfinance will be then discussed, such as the most representative institutions operating on the Polish territory, their mission, their products, their clients, their social and financial outcomes and their impact on the local communities where they are active. Differently from the previous three descriptive paragraphs of this same chapter, the fourth and last one will try to ideally delineate the factors which can turn a former state-farm worker into a microfinance client and a potential successful entrepreneur.

The last, conclusive chapter (number 6) will try to briefly sum up the manifold contribution microfinance institutions are giving to the Polish development and to the solving of the problems underlined in the previous chapters, especially of unemployment. This contribution takes place on two sides: the economic-financial one and the likewise important cultural one. Consequently, it will come to surface also what microfinance is not made for; that is to say, the impediments it can not overcome and towards which more efficacious policies must be implemented and a concerted effort by all levels of society is necessary.

## THANKS

I can't avoid thanking all those people, who have so helpfully and patiently contributed to my work and supported me personally during these months of intense and fruitful work. I read a great deal of paper, but people were the ones I learnt mostly from.

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## *CHAPTER 1*

# **Current regional situation for microfinance.**

When approaching the study of Microfinance in Central and Eastern Europe and the New Independent States, it must be always kept in mind the peculiar context in which this newly born industry has been developing. The aim of this first chapter is depicting the most salient traits of the environment surrounding Microfinance Institutions operating in the region, in order to better understand their mission, their operating models and the troubles they have to face in their activity. A first, brief paragraph will try to summarise the most important changes occurred during the - not yet ended - process of transition from totalitarianism to democracy, on the political level, and from a centrally-planned economy to an open-market one, drawing also a sketch of the current situation. The following part will take into account only those themes directly implied with the development of the Microfinance industry in the area, namely the dramatic growth of poverty and inequality, the changes in the labour-market, the compensation policies undertaken by governments, the re-birth and the role of the private sector and especially of micro- and small business units, the re-building of a sound and efficient financial system and the legal and regulatory environment which disciplines and constrains the entire economic and especially financial sectors.

### **1.1. Legacies of a recent past.**

#### **1.1.1. The way it was: the socialist system.**

“In June 1989, Communist regimes in Europe (including the U.R.S.S.) ruled more than 24 million square kilometres of territory, or 17 percent of the world’s land area, and about 420 million people, or approximately 9 percent of the world’s population.”<sup>1</sup>. All these people lived in the Soviet Union, in six Eastern European allied countries, and in two independent communist regimes: Yugoslavia and Albania. In none of these countries a genuine opposition was tolerated; elections, when held, were just a plebiscite in favour of the regime; secret police worked underground spreading fear and disrupting everyday trust-relationships and the party ruled on every aspect of political, economic, social, cultural and religious life in various degrees, according to the typical traits of a totalitarian domination.

Economy was a state-matter too, being the major means through which the communist ideology turned into reality. The core assumption of socialist economy was in fact the “social

ownership of means of production”, under which only labour-income was considered as legitimate and free, competitive markets were condemned as wasteful and inefficient ways of co-ordinating economy<sup>2</sup>.

**Table 1.1. State Employment as a Proportion of the Labor Force, 1988, (percent)**

<b>Country</b>	<b>Share</b>
<i>Socialist average</i>	<b>90.0</b>
<b>Czechoslovakia</b>	98.8
<b>URSS</b>	96.3
<b>Romania</b>	95.2
<b>German Democratic Republic</b>	94.7
<b>Hungary</b>	93.9
<b>Bulgaria</b>	91.5
<b>Yugoslavia</b>	78.9
<b>Poland</b>	70.4
<i>OECD average</i>	<b>21.2</b>

Source: MILANOVIC “Income, inequality and poverty during the transition from planned to market economies”, W.B. (Regional and Sectorial Studies), 1998, p. 12.

Marx’s vision wished that an harmonious non-market co-ordination could have been achieved without centralisation, but the complexity of economy necessarily called for state-ownership. As a matter of fact, one single huge enterprise characterised the whole socialist economy, because the many yet existing state-owned companies were in reality no more than administrative agencies led by bureaucrats appointed by the party-state *nomenklatura* and subject to

<sup>1</sup> See i.e. MILANOVIC B. “Income, inequality and poverty during the transition from planned to market economies”, W.B. (Regional and Sectorial Studies), 1998, p.1.

<sup>2</sup> See BALCEROWICZ L. “Socialism, Capitalism, Transformation”, Central European University Press, Budapest, 1995, p. 23-25.

central orders.<sup>3</sup> The state, as owner of economic activities, acted far differently from any private manager, above all being subject to a political (not profit-oriented) system of incentives, and cared more about popular support rather than about profitability, rationality or efficiency. Besides, government enjoyed a monopoly on the creation of money and on legislation and could subsidise enterprises in an inflationary way while creating an adequate legal framework for further protecting them.<sup>4</sup> Capitalism was not only temporarily suspended, as in post-war Germany, or distorted, like in many Latin American states, but completely *destroyed*, repressing any private activity (with few exceptions, like Polish farms) and limiting private ownership of assets to saving deposits and part of the housing stocks.<sup>5</sup>

Economic structure saw an over-dimensioned heavy- and machine-industry coping with and underdeveloped and highly constrained service-sector, particularly concerning distribution and trade of goods. Markets of goods, in fact, didn't play any role in influencing demand or supply, but were only a passive instrument for distributing the production, which was always insufficient and generated a constant excess demand. Prices, as well as production, didn't respond to this powerful demand, but were subsidised, arbitrary and anachronistic, administratively set by the central government, not even in a rational, co-ordinated way. Enterprises, on their side, were not only working-places, but the fulcrum of the entire life of workers, granting both a low, but sufficient and guaranteed wage, and a series of complementary benefits ranging from health-care to education services for children, to lodging and sometimes a small plot of land for the employees. Employment was assured by government itself, at the cost of overstaffing firms and further increasing their inefficiency, which was however supported by a fictitious banking system, accumulating hoards of bad, unrecoverable debts. Trade patterns were constricted into the network of countries belonging to CMEA (the Council for Mutual Economic Assistance) and countries were permanently dependent on the Soviet economy for exports and imports of gas and oil. Widespread but repressed inflation, a flourishing black market for Western goods and currencies and, in some cases, foreign debts completed the picture of socialist economies. They were nonetheless able to reach a growth of 4.2% in industrial output and a trade surplus of US\$ 12 million in 1988, virtually without unemployment, with generally stable prices<sup>6</sup> and respectable, though far from the Western, standards of living.

### **1.1.2. “Antirevolutionary- revolution”**

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<sup>3</sup> See CHILOSI A. “L’economia del periodo di transizione: dal socialismo di tipo sovietico all’economia di mercato”, edited by A. Chilosi, Il Mulino, Bologna, 1992, p.22 and following.

<sup>4</sup> More about the different conduction of enterprises between state and private managers in BALCEROWICZ L (1995), p. 94-104.

<sup>5</sup> See BALCEROWICZ (1995), p. 203-205.

<sup>6</sup> Except for Yugoslavia, Poland and Hungary where inflation rate reached respectively 180, 60 and 15,7 percent. Source: CHILOSI (1992), p.17-18.

“The events of 1989 were profoundly antirevolutionary, so they cannot be called revolutions. Yet they were also clearly not part of the routine of politics the way “reforms” are. They were more dramatic, radical, and involved changes too deep for this simple category of ordinary policy to be applicable”<sup>7</sup>. As a matter of fact, a first surprising feature of this moment of extraordinary politics was its lack of violence: negotiations usually preceded the fall of a regime which seemed not to oppose a strong resistance to its demolition<sup>8</sup>. Needless to say, the process of transition required a different time-table for its manifold layers and didn’t follow the same patterns everywhere. Ralf Dahrendorf identified in 1990 three different areas, each with its own predicted implementation timing: six months for reaching political democracy and the rule of law, six years for the conversion to a market economy and sixty years for the emergence of a civil society<sup>9</sup>. No matter if his esteemed periods were effectively respected or not, he was however right when he sequenced the process of transition in three steps and ordered them correctly: political, economical and social changes happened almost everywhere following the same order, although with different results. **Central European countries** were generally the most advanced in reforming all layers of society: parliamentary democracy was established as “the only game in town” with the creation of a constitutional framework, legitimate political institutions and a stable party system. Market-oriented reforms were suddenly implemented (even under the form of “shock-therapy” as in Poland) with “more than half of the gross product produced in the private sector and over three-quarters of trade now [that is, in 2000] conducted with Organisation of Economic Cooperation and Development countries”<sup>10</sup>. Also civil society didn’t take much time to flourish again both on the economic and non-governmental levels, following the tradition of reform and opposition movements which managed to emerge and remain active even under totalitarian regimes in different countries<sup>11</sup>. Even within this apparently homogeneous group of countries a clear contrast turned up between those embarking on radical reforms (such as in Poland or Hungary) and those choosing gradualism or

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<sup>7</sup> Extract from SOLTAN K. “1989 as a rebirth” in “Between past and future: the revolutions of 1989 and their aftermaths” edited by Sorin ANTOHI and Vladimir TISMANEAU, Central European University Press, 2000, p. 30.

<sup>8</sup> Two clarifications need to be done. First, former Yugoslavia and some countries of Central Asia (like Azerbaijan, Georgia, Tajikistan and Russia itself) saw war and civil strife on their territory and represented a remarkable exception which affected approximately 50 million people, with half a million of them being killed and 8 million becoming refugees or displaced persons. Source: MILANOVIC (1998), p. 3-5. However, the main reason for such conflicts cannot be ascribed to the resistance of the communist regime, but often to inter-ethnic hates or claims to independence. Second, as Leszek Balcerowicz sustains: “[negotiations] would not have come about if the members of the old elite had felt physically threatened or even if they had not believed that they would be free to seek favourable positions in whatever new system would emerge. In this sense one can speak of a tacit political pact.”. Source: BALCEROWICZ (1995), p.150.

<sup>9</sup> See DAHRENDORF R. “Essay on the Revolution in Europe”, Chatto, London, 1990.

<sup>10</sup> Extract taken from RUPNIK J. “On the two models of exit from communism” in ANTOHI and TISMANEAU (2000), p. 15.

<sup>11</sup> Solidarity movement, which operated in Poland since the early ‘80s, was for sure the most recent and famous one, but the supporters of Hungarian revolution in 1956 and the Czechoslovak reform movement in 1968 witnessed even earlier a still alive civil society.

directly postponing market reforms and privatisation (such as Bulgaria and Romania).<sup>12</sup> Results stand however clearly in favour of the formers, whose GDP in 2002 reached 144% of the 1990 level for Poland and 109% for Hungary, while that of Bulgaria and Romania swung around 81-82%.<sup>13</sup>

**Table 1.2. Recession and recovery in transition countries.**

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<sup>12</sup> See RUPNIK J. (2000), p. 17.

<sup>13</sup> World Bank data available on the web-site.

<b>Country</b>	<b>Consecutive years of output decline</b>	<b>Cumulative output decline (percent)</b>	<b>Real GDP, 2002 (1990=100)</b>
<b>Central Southern Europe and the Baltics</b>	<b>4</b>	<b>23</b>	<b>107</b>
Albania	3	33	110
Bulgaria	4	16	81
Croatia	4	36	87
Czech Republic	3	12	99
Estonia	5	35	85
Hungary	4	15	109
Latria	6	51	61
Lithuania	5	44	67
Poland	2	6	144
Romania	3	21	82
Slovak Republic	4	23	105
Slovenia	3	14	120
<b>CIS countries</b>	<b>7</b>	<b>51</b>	<b>63</b>
Armenia	4	63	67
Azerbaijan	6	60	55
Belarus	6	35	88
Georgia	5	78	29
Kazakhstan	6	41	90
Kyrgyz Republic	6	50	66
Moldova	7	63	35
Russian Federation	7	40	64
Tajikistan	7	50	48
Ukraine	10	59	43
Uzbekistan	6	18	95

*Source: World Bank data available on the web-site.*

The **Balkans** represented, on the contrary, the most extreme case of a “derailed” transition, because the first prerequisite of a democratic transition, that is the territorial framework, was still to be defined, together with the role of the state in countries such as Albania. Statistics for the whole region of Central Southern Europe and the Baltics show nonetheless a general positive trend with a recovery from an average of 4 consecutive years of crisis and a cumulative output decline of 23%. Average GDP in 2002 is in fact 107% of 1990.<sup>14</sup> The area is attracting more and more foreign investments, having received more than US\$ 21,000 million in the triennium 1992-95 (0.5% of total GDP), over US\$ 50,500 million (3.3% of GDP) in the period 1996-99 and registering growing FDI’s quotas in more recent years.<sup>15</sup>

On the contrary, **former Soviet Union** was the region which most suffered from the crisis and still lags behind in the reform process. Immediate outcome of the fall of the Soviet Empire was the collapse of the entire political and economic systems, only partially softened by the policies for a growing economic democracy implemented under the leadership of Gorbachov between 1987 and the end of 1989. The republics united under the Soviet Empire had never been an homogeneous group, nor were the steps they undertook in the transformation process. In countries such as Uzbekistan the process implemented was gradual and peaceful; others, like Kyrgyzstan adopted a market-oriented strategy, but serious problems paved its road; Russia and Ukraine underwent a long-term crisis and saw a dramatic increase in social stratification; only the Baltic states (Latvia, Lithuania and Estonia) have recently achieved adequate living standards and economic development, after gradually extricating themselves from the crisis that followed the sparked armed clashes with Moscow after they gained independence.<sup>16</sup> CIS countries, after experiencing on the average 7 years of economic depression (with Ukraine bearing 10 consecutive years of output decline), in 2002 reached only 63% of their 1990 GDP with the impressive negative peak of Georgia not even attaining 30%.<sup>17</sup> These data are worrying, given the recent period of growth facilitated by a competitive currency and high oil prices, which may be only temporary. A greater economic diversification and productivity is surely needed to sustain growth.

Reforms towards competitive market-economies had to be exceptionally comprehensive, given the already mentioned large role played by the economic system under totalitarian communist regimes. Three main types of transitional economic policies were implemented: 1<sup>st</sup>, macro-

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<sup>14</sup> Besides Poland and Hungary, leaders of the transition process with only 2 and 4 years of recession respectively, other well performing countries are Slovenia (reaching in 2002 the 120% of the GDP of 1990), Albania (with a recovery of 110%), the Slovak Republic (105%), and the Czech Republic (99%). Source: WB data available on the web-site.

<sup>15</sup> Most important receivers are once again Poland, the Czech Republic and Hungary with about US\$ 17,000 million, 10,000 million and 7 million respectively in the triennium 1996-99. Source: WB data available on the web-site.

<sup>16</sup> See GORNIAK “Poverty in transition: Lessons from Eastern Europe and Central Asia” in UNDP report “Choices for the poor: lessons from national poverty strategies”, March 2001, p.145-146.

<sup>17</sup> WB data available on the web-site.

economic stabilisation policies; 2<sup>nd</sup>, liberalisation policies, aimed at removing the various restrictions imposed by the state; and 3<sup>rd</sup>, institutional restructuring, which concerned i.e. privatisation of state enterprises, reforming of tax-systems and the building up from scratch of stock-exchanges<sup>18</sup>. Each countries accomplished them following a different combination and timing and starting from different initial condition, a pattern that goes beyond the aim of this work describing. What really needs to be stressed is the common attempt of creating an environment which, at the same time, encourages entry and growth on the market of new private firms (especially small- and medium-sized ones) while disciplining remaining, large and inefficient enterprises through the imposition of hard budget-constraints and the strengthening of legal and regulatory institutions. The aim is that of overseeing management and governance of old enterprises and forcing them to release assets and labour which are then potentially available to restructured and new enterprises. Of dramatic importance for less advanced reformers is “breaking the political economy equilibrium of partial reforms”<sup>19</sup> redistributing, through fiscal policies, a part of the reform dividend to those who would otherwise only bear its costs.<sup>20</sup>

The ten most advanced countries of Central and Eastern Europe are nowadays taken up with the challenge of entering the European Union, a chance that will turn into reality in 2004 for Poland, Hungary, Czech Republic, Slovakia, Slovenia and the three Baltic States, while Romania and Bulgaria will have to wait at least until 2007. Big efforts have already been made by EU accession countries, especially in the restructuring of their economies and in complying with the legislative and regulative *acquis communautaire*, but a huge work remains to be done because of the many residual inefficiencies and the deficit in state-budget generated by the high costs of such a process. Keeping pace with the current EU members will be easier for Slovenia, whose GDP is already 69% of the EU average, but more demanding for countries such as Poland, Lithuania and Latvia, which hardly get to a rate of 40%. Transition process is not yet over too: the development of sound financial markets, the building up of a spread network of medium enterprises and the improving of infrastructure are only three of the main priorities to be implemented as soon as possible.<sup>21</sup> All the same, the contribute of Eastern Europe to the Union will be considerable: 20% of the entire population, 5% of total GDP, 23% of territory and 9 new languages besides the 11 already spoken from current members will be “annexed” to EU by candidate countries<sup>22</sup>.

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<sup>18</sup> More in BALCEROWICZ (1995), p.145 and followings.

<sup>19</sup> From “Transition: the first ten years”, WB, (2000), p. xxvii.

<sup>20</sup> More about the interrelation between discipline and encouragement policies in “Transition: the first ten years”, WB, (2000).

<sup>21</sup> From an interview with Willem Buiter, Chief Economist of EBRD, in “Il sole 24 ore”, 12th December 2002.

<sup>22</sup> Data from “Il sole 24 ore” 12th December 2002.

## **1.2. The rise of poverty and inequality.**

The process of transition required as a first step to dismantle a centrally-planned system which had openly showed all its fallacies: it was stagnant, inefficient, poorly and bureaucratically managed and produced unsustainable shortcomings of goods (just to mention the most evident defects). As a consequence, reform efforts focused primarily on transforming this sick economic system into one thought to be more sound, which would increase efficiency, competition, production and consequently incomes. Higher and well-distributed incomes were therefore to be secondary goals, which should result from the systematic changes taking place, as aftermath of the policies of liberalisation and privatisation implemented. Being not primarily targeted, poverty and inequality got out of control soon after the collapse of the regime, also because former governments were not accustomed to recognise and face such problems and the new ones inherited the same approach. In the following sub-paragraphs, the old, more egalitarian distribution of income will be examined and the emergence of poverty and inequality will be firstly described in quantitative and qualitative terms and then analysed in its causes and falling on the different layers of population. (Often belated) state attempts to compensate the generation of such “inconveniences” with social benefits will be considered in the fourth paragraph, after the exam of the changes occurred in the labour- market of transition countries.

### **1.2.1. Income level and distribution in socialist economies.**

Various eminent scholars agree on the assertion that income distribution in centrally-planned economies was more egalitarian than the one in the current post-communist era<sup>23</sup>. On the other side it doesn't seem hasty to sustain that “one of the main causes of the post-socialist revolution in the Central and Eastern European countries stemmed from the people's conviction that income distribution was unfair and unequal, contrary to political claims and the system's ideological foundations”<sup>24</sup>. So, it is perhaps a good method starting with the description of the “ideal” socialist income distribution and then move on the empirical ground, trying to trace those ideological features in the reality of communist society.

According to Milanovic (1998)<sup>25</sup> the three specific features of the distribution of income in socialist economies were: 1) a smaller share of income derived from economic activity (labour, capital and entrepreneurship) if compared to market or developing economies; 2) social benefits

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<sup>23</sup> See MILANOVIC (1998), p.15. See also: KOLODKO G. W. : “Income policy, equity issues and poverty reduction in transition economies”, Villa Borsig Workshop Series, 1999, available on the web-site:

[www.dse.de/ef/poverty/kolodko.htm](http://www.dse.de/ef/poverty/kolodko.htm). (D.S.E. stands for “Deutsche Stiftung für Internationale Entwicklung”, German Foundation for International Development), p.1. and “Transition: the first ten years.”, WB, 2000 , p.xiv.

<sup>24</sup> From KOLODKO G. W. (1999) , p. 1.

<sup>25</sup> MILANOVIC (1998), p. 12-19.

were more relevant, accounting for 19% of composition of gross income and in particular child benefits were much more substantial; 3) direct taxes were much lower (only 3% of gross income, compared to 20% in market-economies), but state revenues were collected directly from the employers and counted for 24% of gross income. Being proportional to (centrally established) wages, tax had virtually no re-distributive effect, but were “flat”, using a current terminology. All the same, total taxation in socialist countries turned out to be 4% lower than in capitalist ones<sup>26</sup>.

Other three “stylised facts” were also generally accepted: 4) income distribution was more egalitarian, with subsidies targeted on the poorest layers of population, even considering fringe benefits and privileges accorded to the representatives of the party-*nomenklatura*; 5) cash social transfers, pensions and family allowances, were distributed almost equally (with the former slightly pro-rich and the latter mildly pro-poor, compensating each other); 6) where private agriculture was allowed, it was practised either by poor households as a help to survive or by few successful and rare entrepreneurs<sup>27</sup>. All these features originated from the application of some socialist ideological underpinnings. Among the most common: a) the necessary dominant position of the State in labour allocation<sup>28</sup> and in the general conduction of economy, which was meant to lead to a growing efficiency and industrialisation; b) the twofold view on income distribution: on the one side, against excessive differences in income and, on the other, trying to reward the most deserving people, following Marx’s teaching that workers should be paid according to their work; c) the more positive evaluation of manual workers on intellectual ones<sup>29</sup> (which was reflected in the respective salaries); d) the abhorrence of private wealth accumulation, contrasted through collective consumption of public goods and in-kind income; and e) the equal contribution of men and women to the building up of the communist society, facilitated by the provisioning of family allowances and free kindergartens and schools.

Inequality, not officially measured but nonetheless concretely felt by the population, was therefore based not on monetary income distribution, but on a series of privileges accorded to politically well-connected people. Since a chronic excess demand was the rule and “cash itself did not give a simple command on goods – the supply of which to individuals was frequently subject to constrained availability at controlled prices”<sup>30</sup> - real privileges consisted i.e. in the access to shops

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<sup>26</sup> Data taken from MILANOVIC B. (1998), p.14.

<sup>27</sup> *ibid.* p.12-19.

<sup>28</sup> State employment represented, on the average of socialist countries, 90% of the total labour force. Source: MILANOVIC (1998), p.12.

<sup>29</sup> See FLEMMING J. and MICKLEWRIGHT J. “Income, distribution, economic system and transition.” Innocenti Occasional Paper, Economic and Social Policy Series n. 70, May 1999, p.8. See also BOERI T. “Structural change, welfare system and labour reallocation: lessons from the transition of formerly planned economies”, Oxford University Press, New York, (2000), p.57-61.

<sup>30</sup> From FLEMMING J. and MICKLEWRIGHT J (1999), p.4.

where goods were more readily available, in waiting longer for consumer durables, in access to good education, health services and housing.

As a conclusion, we can affirm that socialist countries were on the one hand, according to conventional measurement, more equalitarian<sup>31</sup> because of the central wage setting, because of more consistent and generalised social allowances and because of high female participation rates; but on the other imbued with inequality because of the preferential position of manual workers and because of in-kind favours and advantages conceded to the party-members on different degrees<sup>32</sup>.

Poverty, inequality and unemployment, though actually existing, were however taboo-issues and “attempts to conduct serious surveys of living conditions were forbidden and considered nationalistic propaganda”<sup>33</sup>.

### **1.2.2. How much, where and why did poverty and inequality increase?**

Some growth in poverty rates were expected by politicians charged with the hard task of reforming the former communist countries, but the scale on which this phenomena presented itself was heavily underestimated. Many have been the attempts of measuring the breadth of this phenomenon, but, for the sake of simplicity, only a few will be referred to in this work. According to the World Bank statistics, the rate of population living on less than US\$ 1 a day in Eastern Europe and Central Asia moved up from 1.5% in 1990 to 5.1% in 1998, thus increasing more than three times<sup>34</sup>. “In 1998 an estimated one out of every five people in the transition countries of Europe and Central Asia survived on less than US\$ 2.15 per day. A decade ago fewer than one out of 25 lived in such absolute poverty.”<sup>35</sup> Proportions change again when considering a conventional, relatively high, poverty line of \$PPP 4 per capita per day (or the equivalent of \$PPP 120 per month), which is however below the “accounting” social minimum lines for most of Eastern European countries. It is actually estimated that the total number of poor in former communist countries increased about twelve times: from nearly 14 million before transition (4% of the population) to 168 million in 1993-95 (approximately 45% of the population)<sup>36</sup>. The regional

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<sup>31</sup> In the late '80s the Gini coefficient in centrally-planned systems were mostly around 0.23-0.24, on the average 0.6 points lower than in Western Europe countries. Source: KOLODKO G. W. (1999), p.1.

<sup>32</sup> See also FLEMMING J. and MICKLEWRIGHT J. “Income, distribution, economic system and transition.” Innocenti Occasional Paper, Economic and Social Policy Series n. 70, May 1999, p.32-36. On page 36 we find the following conclusive sentence: “Social benefits in kind, subsidies and fringe benefits certainly do alter the light in which income data under socialism should be viewed.”

<sup>33</sup> See GORNIK J., March 2001, p.147.

<sup>34</sup> Data from “Transition: the first ten years.” WB, 2000, table 1.6 on page 8.

<sup>35</sup> From “Making transition work for everyone: poverty and inequality in Europe and Central Asia”, WB, Washington DC, (2000).

<sup>36</sup> Data from MILANOVIC (1998), p.67-69.

distribution of poverty growth varied considerably: in Central Europe<sup>37</sup> (excluding Poland) poverty headcount rose of only 3%, but in other areas such as the Slavic Republics<sup>38</sup> and Central Asia<sup>39</sup>, the growth reached impressive rates around 50%. Slavic Republics alone, passed from 3.5 million poor people in 1987-88 to 112.1 million in 1993-95. Transitional poverty has been defined as “shallow”<sup>40</sup>, meaning that the average income of poor people was not greatly under the poverty line, but, if this is true for the Balkans, Central Europe and the Baltics, where the shortfall as a percentage of poverty line (of \$PPP 4 per day) remains within 35%, it is more dubious for the Slavic Republics and Central Asia, where the correspondent data are respectively 39 and 47%<sup>41</sup>.

Such an extraordinary increase in poverty was brought about by the conjunction of various factors deeply entangled among each other. The first evident destabilising factor was the disintegration of the old economic system of production and of the consolidated trade paths. The consequent need for restructuring, necessary to adjust to the competitive demand of Western economies, brought to a dramatic economic depression and to significant changes in the labour-market<sup>42</sup>. In 1990 all the Eastern European and the former Soviet Union countries showed a decline in GDP rates, which reached peaks of –14.7% in 1991 for the Eastern European and –16.1% for the latter. On the average the first group of countries (Eastern European’s ones) experienced four consecutive years of depression (1990-94), while the countries belonging to second one (former Soviet Union’s countries) in 1996 still hadn’t inverted the negative trend<sup>43</sup>. In some regions like Eastern Europe (excluding the Czech Republic) adjustment on the labour-market took the form of a huge release of superabundant workers, while others, like the former Soviet countries, were less struck by unemployment but the decrease in real wages was strong enough to make most of the population fall under the poverty line<sup>44</sup>. Besides, relative prices increased more than the indexed wages and workers’ purchasing power fell in a brief time. Increasing masses of low-income population couldn’t even count on the state any more for public services to satisfy basic needs or for price reduction or subsidies on critical goods<sup>45</sup>, because many of these services had been privatised or were no more bound to the working-place.

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<sup>37</sup> Including Czech Republic, Hungary, Slovakia and Slovenia. Poland was omitted because of its abnormal poverty growth of 14%.

<sup>38</sup> Including Belarus, Moldavia, Russia and Ukraine.

<sup>39</sup> Including Kazakhstan, Kyrgyz Republic, Turkmenistan and Uzbekistan.

<sup>40</sup> See MILANOVIC (1998), p.76.

<sup>41</sup> *ibid.* p. 68-69. A shortfall of 47% as a percentage of poverty line (of 4 \$ a day), means that poor people in Central Asia survived with slightly more than 2 \$ a day.

<sup>42</sup> Unemployment problems and the labour-market of transition countries will be analysed in the following paragraph.

<sup>43</sup> Data from MILANOVIC (1998), p.25.

<sup>44</sup> See MILANOVIC (1998), p.28-30.

<sup>45</sup> see GORNIJAK J, March 2001, p.148.

Country	Poverty headcount (%)		Total number of the poor (millions)		Shortfall as % of poverty line	Total poverty deficit as % of GDP
	1987-88	1993-95	1987-88	1993-95		
<b>Balkans &amp; Poland</b>	<b>5</b>	<b>32</b>	<b>3.6</b>	<b>22.4</b>	<b>28</b>	<b>2.2</b>
Bulgaria	2 <sup>b</sup>	15	0.1	1.3	26	1.1
Poland	6	20	2.1	7.6	27	1.4
Romania	6 <sup>b</sup>	59	1.3	13.5	32	5.4
<i>Central Europe</i>	<b>&lt;1</b>	<b>2</b>	<b>0.1</b>	<b>0.4</b>	<b>25</b>	<b>0.1</b>
<b>Czech Republic</b>	0	<1	0	0.1	23	0.01
<b>Hungary</b>	1	4	0.1	0.4	25	0.2
<b>Slovakia</b>	0	<1	0	0.0	20	0.01
<b>Slovenia</b>	0	<1	0	0.0	31	0.02
<i>Baltics</i>	<b>1</b>	<b>29</b>	<b>0.1</b>	<b>2.3</b>	<b>33</b>	<b>3.1</b>
<b>Estonia</b>	1	37	0.02	0.6	37	4.2
<b>Latria</b>	1	22	0.03	0.6	28	2.3
<b>Lithuania<sup>c</sup></b>	1	30	0.04	1.1	34	2.9
<i>Slavic Republics</i>	<b>2</b>	<b>52</b>	<b>3.5</b>	<b>112.1</b>	<b>39</b>	<b>4.8</b>
<b>Belarus</b>	1	22	0.1	2.3	26	1.2
<b>Moldova</b>	4	66	0.2	2.9	43	7.0
<b>Russia</b>	2	50	2.2	74.2	40	4.2
<b>Ukraine</b>	2	63	1.0	32.7	47	6.9
<i>Total without Central Asia</i>	<b>3</b>	<b>43</b>	<b>7.2</b>	<b>137.2</b>	<b>31</b>	<b>3.1</b>
<i>Central Asia</i>	<b>15</b>	<b>66</b>	<b>6.5</b>	<b>30.7</b>	<b>47</b>	<b>9.8</b>
<b>Kazakhstan</b>	5	65	0.8	11	39	9.2
<b>Kyrgyz Republic</b>	12	88	0.5	4	68	64.4
<b>Turkmenistan</b>	12	61	0.4	2.4	40	25 7.7
<b>Maldives</b>	24	63	4.8	13.3	39	12.4

**Table 1.3. Estimated poverty headcounts and poverty deficits in 1987-88 and 1993-95.**

*Source: MILANOVIC, "Income, inequality and poverty during the transition from planned to market economies", W.B. (Regional and Sectorial Studies), 1998, p.68-69.*

Poverty factors can be divided into two groups: external and independent from people's willing and internal and personal causes. The first group includes unemployment, low salaries, late, partial or in-kind payments for salaries, high costs of public utilities, hyperinflation, banks' collapse, inadequate child benefits, low market prices for agricultural production and governmental incompetence or indifference to the population's wellbeing. On the other side, personal factors often derive from customs developed under the Soviet period and difficult to get rid of. These are a deeply rooted attitude of dependence, passivity and apathy, or the harmful vice of alcoholism.

Yet "poverty increased not just because of the fall in output, but because of greater inequality in the distribution of income"<sup>46</sup>. Once again, inequality, like poverty, followed different paths of extension and depth. It increased almost everywhere, but most strikingly in current CIS country, where, on the average, the Gini coefficient sharply grew of 0.18 points from 1987-90 to 1996-98, with the highest peaks reached in Armenia, which passed from 0.27 to 0.61, followed by Ukraine and the Russian Federation where the same coefficient increased of more than 0.2 points in both countries. Central, South Europe and the Baltics (CSB) suffered from a lower increase in inequality, but all the same the average growth rate of the Gini coefficient in the same period was 0.1, with the highest value reached by Bulgaria with an increase of 0.18 points.

Causes of increasing inequality were deeply analysed by many scholars, but there isn't an univocal vision about them. A simple and reasonable explanation is given by the World Bank's experts: causes of inequality differ according to the considered region. If, for the more developed CSB (Central-Southern and Baltic) countries the main causes were the rising returns to education, decompressing wages and emerging returns to risk-taking and entrepreneurship, for the CIS area explanations are different. Most of the inequality emerging during the transition process resulted from three main causes: 1) a widespread corruption and rent-seeking; 2) "the capture of the state by narrow-vested interests", which have hindered the completion of the transition process, limiting competition, concentrating economic power in their hands and stripping former state-owned companies of their more valuable assets, thus profiting by the results of partial reforms; 3) the imprisonment of workers in their old, low-paid (sometimes not even paid) jobs, while the creation of new ones was hampered by the artificial lack of competition and network of corruption<sup>47</sup>.

Summing up the current composition of income, we can say that the share of wages has declined in all countries, reaching around the 50% of the average income for Former Soviet Union

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<sup>46</sup> See "Transition: the first ten years." WB, 2000, p.8.

<sup>47</sup> See "Transition: the first ten years." WB, 2000, p. xiv.

(FSU) countries and slightly less for Eastern European ones; non-wage private income share has formidably increased in FSUs, overcoming the quota of Eastern Europe; pensions have much grown their share in FSUs passing from 8 to 18% of average individual income and increasing their share in Eastern Europe too; while non-pension social transfers have increased everywhere except for Russia, reaching, for all countries a share of 7-8%. Overall the income composition of Eastern Europe, on the one hand, and Russia and Latvia, on the other, is much more similar after the transition than before, with wages accounting for a half of individual gross income and non-wages private sector income and cash social transfers equally composing the other half. Considering the starting point of the two regions, Russia and CIS countries felt more dramatically the impact of transition on income distribution<sup>48</sup>. After considering these and more analytical data, Milanovic (1999) comes to the conclusion that “ the change in the composition of income has had very little to do with increased inequality”, but “[...] higher concentration coefficients of wages (in all countries) drove the overall Gini coefficient up. It was the most important factor behind the increase in inequality.”<sup>49</sup>

**Table 1.4. Changes in Inequality during the Transition, Various Years**

<i>Countries</i>	<i>Gini coefficient of income per capita</i>			<b>Growth 1987-98</b>
	<b>1987-90</b>	<b>1993-94</b>	<b>1996-98</b>	
<b>CSB</b>	<b>0.23</b>	<b>0.29</b>	<b>0.33</b>	<b>0.10</b>
Bulgaria	0.23	0.38	0.41	0.18
Croatia	0.36	-	0.35	-0.01
Czech Republic	0.19	0.23	0.25	0.06
Estonia	0.24	0.35	0.37	0.13
Hungary	0.21	0.23	0.25	0.04
Latvia	0.24	0.31	0.32	0.08
Lithuania	0.23	0.37	0.34	0.11
Poland	0.28	0.28	0.33	0.05
Romania	0.23	0.29	0.30	0.07
Slovenia	0.22	0.25	0.30	0.08
<b>CIS<sup>a</sup></b>	<b>0.28</b>	<b>0.36</b>	<b>0.46</b>	<b>0.18</b>
Armenia	0.27	-	0.61	0.34
Belarus	0.23	0.28	0.26	0.03
Georgia	0.29	-	0.43	0.14
Kazakhstan	0.30	0.33	0.35	0.05
Kyrgyz Republic	0.31	0.55	0.47	0.16
Moldova	0.27	-	0.42	0.15
Russian Federation	0.26	0.48	0.47	0.21
Tajikistan	0.28	-	0.47	0.19
Turkmenistan	0.28	0.36	0.45	0.17
Ukraine	0.24	-	0.47	0.23

Source: “Transition: the first ten years”, WB, 2000, p. 14.

<sup>48</sup> See MILANOVIC B. : “Explaining the increase in inequality during the transition”, WB, Policy Research Department, Washington DC, 1999, p.18-20.

### 1.2.3. Who are the “new poor”?

The emergence of poverty in former communist countries has been shocking for the population not only for its material implications, but mostly for its psychological ones. “Normal life” and the accustomed social patterns have been destroyed and people fallen into poverty express their distress that the knowledge, skills and formal and informal competencies they acquired in the former system have become irrelevant and useless. “Their sense of personal failure, together with the loss of respected social roles and identities, has frequently given way to a paralysing sense of shame and depression”<sup>50</sup>.

However, the identification of winners and losers from the attempts of reform is much dependent on the degree reached by the process in each country. Some general statements can be all the same expressed. State-sector workers are the ones most struck by the closure or restructuring of state-owned companies and farms, especially if of older age and lacking skills to enter the emerging private enterprise sector, because they feel upon themselves the powerful effects of unemployment, higher prices and lower provision of subsidised social services by their former employers. Potential winners are, on the contrary, all those people endowed with the skills required by the new competitive market, who will gain the major benefits only with the fulfilment of the reform process, with the complete removing of trading and productive barriers, with the liberalisation of prices, the privatisation of state-controlled sectors, but also the imposition of a sound discipline on the economic system. Their potential success will be made more difficult to reach by all those short-term winners, capable of influencing political decisions and willing to preserve the old system’s distortions as long as possible, enjoying benefits from the no man’s land of liberalisation without discipline<sup>51</sup>.

A more precise definition of the social classes mostly stricken by poverty is given by Milanovic (1998)<sup>52</sup>, comparing the relative poverty rates of five social categories: workers, farmers, pensioners, self-employed and unemployed. Results of this study show that groups most at risk of being poor are farmers (especially in Estonia, Romania and Hungary) and unemployed (particularly in Poland, Bulgaria and Hungary), with Polish unemployed nearly four times more at risk than the average. Workers are those less at risk, while pensioners are usually under the average except for Estonia; no clear evidence is showed for self-employed. Unemployment<sup>53</sup> seems therefore to be one of the most significant factors related to poverty growth, but different degrees of risk can be traced

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<sup>49</sup> Ibid. p.24.

<sup>50</sup> From “Making transition work for everyone...”, WB, (2000), p.2.

<sup>51</sup> More about the trap of partial-reforms, long- and short-terms winners and losers from transition in: “Transition: the first ten years.” WB, 2000 , chapter 9.

<sup>52</sup> See MILANOVIC (1998), p.92 and following.

<sup>53</sup> More about the connection between poverty and unemployment and about the changes in the labour-market of transitional countries in the next paragraph.

also within the broad category of unemployed people. Most likely to be poor are the households with long term unemployed or with more than one jobless component, especially if the household-head is one of them<sup>54</sup>. Long-term unemployment<sup>55</sup> is particularly correlated with long-lasting poverty: a persisting absence from the labour-market can drive to a more and more passive attitude and to the development of a dangerous “welfare dependency syndrome”<sup>56</sup>.

The presence of full-time working people in the household is however no more indicative of a better-off situation in the family, especially in CIS countries where labour adjustment have taken the form of sharp wage reductions. “Working poor” are often people who work in non-competitive jobs (especially in the budgetary-sector where wages are still centrally-set and substantially eroded by inflation) and have to support other members of the family<sup>57</sup>. Typical are the cases of Russia and particularly of Ukraine where average wages didn’t even reach two times the poverty line income from 1993 to 1996<sup>58</sup>, while average per capita income went under the same line in 1995. Thus, “a dual-income couple earning the average wage cannot be sure of staying above the poverty line in Ukraine, and barely manages to do so in Russia.”<sup>59</sup>. Single-parents households, especially those headed by single mothers, and families with a higher than average number of dependants (old people and children) are at risk too<sup>60</sup>. Children are, as a matter of fact, one of the most poverty-hit groups among all ages in almost all of the analysed countries, reaching, for some of them, an impressive possibility of being poor (even 70%)<sup>61</sup>. Infants’ poverty is a very dangerous event which is likely to protract in adulthood and to permanently deprive children of key opportunities in life. As a matter of fact, the lack of sufficient means of poor families often prevents their children from regularly attending school or from moving to towns in order to receive more than a primary education degree; this missing higher education remains a burden for the rest of the child’s life<sup>62</sup>. People with only an elementary level of education are usually more than 1.5 times more likely to fall under the poverty line. Only secondary education reduces the probability to about half the average<sup>63</sup>.

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<sup>54</sup> For instance: in Hungary households with long-term unemployed are more than three times more at risk than the average, while those with more than one employed reach poverty rates five times higher. Source: MILANOVIC (1998), p.95.

<sup>55</sup> the statistical definition of long-term unemployment includes all persons who have been continuously unemployed for 12 months or more. Source: EUROSTAT.

<sup>56</sup> See GORNIAK, March 2001, p.148.

<sup>57</sup> Ibid. p. 161.

<sup>58</sup> to be noticed is that “approximately 60% of workers normally earn less than the average wage”. Source: MILANOVIC (1998), p.97-98.

<sup>59</sup> From MILANOVIC (1998), p.98.

<sup>60</sup> See GORNIAK J., March 2001.

<sup>61</sup> Data from UNDP (1998) confirm that 73% of Russian families with three or more children were impoverished.

<sup>62</sup> See GORNIAK J., March 2001, p. 157-158.

<sup>63</sup> Data from MILANOVIC (1998), p.105.

To summarise, we can say that three are the major risk factors: employment status, age and location. Unemployed people (even more so if low-educated), children and inhabitants of rural areas run the highest relative risk of being poor, though other elements, such as the level of wages, influence this possibility.

### **1.3. The changing of the labour market.**

Even though, during the communist regime, the term “labour-market” was never officially used, only a small share of job was centrally allocated, while “employees were free to choose their job, skill or profession, as well as the region where they worked”<sup>64</sup>. It was the setting of wages to be centrally planned and tending to favour all those jobs involving muscle power (such as mining or heavy engineering) or higher responsibilities, to detriment of physically less demanding positions i.e. in medicine or education sector, providing monetary and in-kind incentives similar to those of a market economy. But wages, besides being quite low and egalitarian, were much more flexible since “workers’ paycheques were not necessarily convertible into immediate consumption, but were often saved and earmarked for durable goods with five to ten years delivery time.”<sup>65</sup> Other remarkable differences during the Soviet era lay on two aspects: 1) a much higher female participation (usually in non-manual and thus less remunerated works) and 2) a very much lower recorded unemployment or a generalised full-employment situation which led to overstuffed and inefficient state-owned companies. This could happen thanks to the cheap credit that firms could use to finance the new employment and because the generalised scarcity of materials made it advantageous to have adequate and on-hand staff when finally deliveries arrived.<sup>66</sup> On the workers’ side no great choice of labour-participation was left since “inactivity was stigmatised or downright illegal.”<sup>67</sup>

#### **1.3.1. Labour-adjustments in Central and South Eastern Europe.**

During the early transition period impressive labour adjustments took place as a result of the upsetting restructuring of the entire economy, but they were not uniform in all the countries implied. Four were the main events connected with labour-markets in Central and South Eastern Europe: 1) a substantial increase in unemployment; 2) sectorial shifts in employment; 3) a rapid

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<sup>64</sup> quotation from MARNIE (1992), p. 38-39. in FLEMMING and MICKLEWRIGHT (1999) p.7. It must be added that, on the other side, mobility was reduced under socialism by the bureaucratic mechanism concerning the allocation of housing, which was strongly connected with the employing enterprise.

<sup>65</sup> From BOERI T., BURDA M. C. and KOLLO J. “Mediating the transition: labour markets in Central and Eastern Europe” Forum Report of the Economic Policy Initiative n. 4, edited by Ambrus-Lakatos and Schaffer, 1998, p. 2-3.

<sup>66</sup> Ibid. on p.2.

<sup>67</sup> Ibid. on p.3.

growth in the private sector; 4) rising returns to education and skills<sup>68</sup>. Wages decreased as well as employment, but the former of only of one-fourth between 1987-88 and 1994 (not a huge decrease if compared to the average for the FSU countries where wages decreased of half their value), while unemployment reached peaks of –15% in the same period.<sup>69</sup> A dramatic reduction in demand for labour was the first result of the collapse in output originated by both supply and demand problems. On the one side, firms, once lost the old clients, had to find new ones and to adapt to the new quality, efficiency and competition standards of Western countries, while they were no more able to rely on state-banks for financial help or to count on soft-budgets constraints. As a consequence they started shedding unwanted, excess workers first by attrition, then through mass layoffs and plants closures. On the demand side, overall spending decreased sharply and consumers' taste turned on Western-style goods, thus making import grow constantly, also as a consequence of a repressed demand for product variety completely lacking in the former system<sup>70</sup>. The only potential solution to the problem of growing unemployment, that is new job creation through the flow to self-employment or thanks to newly established business units couldn't reach the scale of job-destruction by old restructuring firms. The resulting unemployment rates were not so severe for all CEE countries, but the most dramatic peaks were reached in Poland (around 16% in 1993-94) and Bulgaria (between 16 and 14% in the same years)<sup>71</sup>. Other countries in the same region, such as the Czech Republic, could boast an surprising low unemployment rate of 3.2% in 1993, while at the same time its former companion, the Slovak Republic, reached a rate of 14.4%<sup>72</sup>.

Greatest release of workers took place in the sectors of agriculture, especially in Poland, (-417 thousands workers between 1994-95) and Romania (-240,000), of mining, particularly in the Czech Republic, and of manufacturing, where Romania again was the most hit one.

Since, as above mentioned, unemployment didn't reach the same magnitude in all CEE (Central-Eastern Europe) countries, a most common trait in the region was instead the surprising decline in employment rates<sup>73</sup>, affecting women more than men. Outflows from unemployment tended to be dominated by exit from the labour force, rather than by the entrance into employment which remained low. Most willing to retire from work were two categories: 1<sup>st</sup>) women, pushed by the increasing costs of child care facilities and limited part-time jobs opportunities and 2<sup>nd</sup>) those older workers with deteriorated abilities and some retirement provisions already put aside, often the first to be dismissed in case of restructuring. If, on the one hand, this willing flow into inactivity

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<sup>68</sup> See FLEMMING and MICKLEWRIGHT (1999) p.53 and following.

<sup>69</sup> Data from MILANOVIC (1998), p.29.

<sup>70</sup> See BOERI T. (2000), p.3.

<sup>71</sup> Data from GORNIAK J. "Poverty in transition...", in UNDP report "Choices for the poor: lessons from national poverty strategies", March 2001, p.161.

<sup>72</sup> Data from BOERI T., BURDA M. C. and KOLLO (1998), p.18.

<sup>73</sup> that is the fraction of working-age population actually employed in whatever job.

reduced labour supply and was positive for younger workers entering the labour-market, it was, on the other hand, deleterious for state-budget, already put under severe pressure by the high, almost unbearable costs of unemployment benefits. Net state revenues had to be increased in order to cover the growing burden of the social security system and the costs of this process entirely fell on paid employment. Higher payroll taxes, rendering labour much more expensive, couldn't but once again foster unemployment slowing down new hiring, and stimulating tax evasion through informal or underground labour allocation. Moreover, unemployment benefits (sharply reduced as the years passed) and above all social assistance schemes (potentially open-ended though lower than unemployment's ones) discouraged job search and led many people on the way to the "poverty and unemployment trap".<sup>74</sup> Another important constraint to a reduction of unemployment in CEE countries was the heavy presence of structural unemployment in some regions, especially rural ones where the only large employer was forced to downsize or went bankrupt.<sup>75</sup> The threat of the emergence of impoverished rural enclaves could have been avoided only by regional mobility on the side of workers or enterprises. This solution was but hampered by the sharply increasing costs of housing and transportation and by the uncertainty about the concrete possibility of getting a more remunerative job in another region, while costs of commuting everyday were usually unsustainable.

Nowadays, individuals mainly struck by unemployment are the same as the most vulnerable in OECD countries. Their distinguishing characteristics are a lower, usually primary or vocational level of education and a young age. Vocational training, once pride of the socialist regime for the specificity of its taught skills, has revealed itself a trap for its attendants who, currently overspecialised in one skill, are now unable to cope with such a situation of dramatic change in the labour-market<sup>76</sup>. More and more cut out from the labour market are long-term unemployed people, because of the skill depreciation effect, their decreasing motivation and the more negative signal firms receive the longer the inactivity period lasts. The only certain conclusion is that "education is the single most important factor affecting employment probabilities"<sup>77</sup>.

### **1.3.2. Wage-adjustments in former Soviet Union countries.**

The countries formerly belonging to the Soviet Union regime were less hit by unemployment but still strongly hurt by different adjustments in the labour market trends were<sup>78</sup>. As

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<sup>74</sup> See BOERI T., BURDA M. C. and KOLLO (1998), p.3-17.

<sup>75</sup> It is estimated that up to 40% of unemployment in CEE countries belongs to this kind. Source: *ibid.*, p.20. More about structural unemployment also in GORNIAK J. "Poverty in transition...", in UNDP report "Choices for the poor: lessons from national poverty strategies", March 2001, p.162.

<sup>76</sup> See BOERI T. (2000), p.55.

<sup>77</sup> See GORNIAK J. "Poverty in transition...", March 2001, p. 28.

<sup>78</sup> Actually, in 1995, of all former Soviet republics, only Latvia registered an unemployment rate of more than 5% of the labour force, while the same rate for Russia was 3.2%. Source: MILANOVIC (1998). For the sake of truth,

already hinted at above, in this region the large fall in output and the unfavourable changes in terms of trade primarily influenced the value of real wages which declined between 40 and 60%<sup>79</sup>, while short-time work was also undertaken to minimise lay-offs during that period of turbulence<sup>80</sup>. An anomalous situation of employment without earnings caused by wage arrears was widespread too. Russian Longitudinal Monitoring Survey (RLMS) data showed that “by late 1996, a half of all working age adults were owed money by their primary employer, with this delinquent payments being equal, on the average, to one months expenditures for an average household”<sup>81</sup>. Most suffering from wage cuts and delays in wage payments were people working in the budgetary sector where wages were still set from the state and whose indexation was periodically carried out increasing the value of the minimum wage only partially. Just to get the idea of the erosion occurred in wages, we can consider the value of minimum wage, which, in the period 1991-94, dropped from about 25% to 8% of the average wage. As a conclusion, only few workers of this examined sector were actually paid at the level of the minimum pre-transition.<sup>82</sup> Workers from former state-owned enterprises, privatised after 1992, were on the average more lucky. Here managers were finally free to decide the level of wages, having to cope only with some limited workers’ unions influences. The final outcome mostly depended on the nature of the business carried out by the company: natural monopolies, such as energy extraction and supply, saw a growth in the level of wages, but other sectors, like light manufacturing, undergoing sharp fall in demand, reduced the pay of their workers. It was instead the emerging private sector, especially in the fields of trade and financial services, which reported the greatest rise in salaries, which, on the average, were about double those in state-owned enterprises. Such a flexible wage system couldn’t but increase inequality in income distribution of former Soviet countries.

### **1.3.3. Recent labour-market trends for Central European countries<sup>83</sup>.**

In 2000, more than ten years after the beginning of the transition process, Central European countries are still striving to reach a balanced economic structure of employment similar to that of OECD countries. Some gaps are still to be filled, especially concerning the still over-manned agricultural sector and the still underdeveloped service-sector. As a matter of fact, statistical results

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FLEMMING and MICKLEWRIGHT (1999) affirm that “[...] data undoubtedly understate the true level of unemployment in many former Soviet Union republics, where the incentive to register as unemployed has often been low”, p.53-54.

<sup>79</sup> See MILANOVIC (1998) p.29 and FLEMMING and MICKLEWRIGHT (1999), p.53 and following.

<sup>80</sup> See FLEMMING and MICKLEWRIGHT (1999), p.60.

<sup>81</sup> quotation from: *ibid.* p. 60.

<sup>82</sup> *Ibid.* p.60 and following.

<sup>83</sup> This group of countries includes Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Romania, Slovenia, Slovakia and it is usually referred to as CEC-10 by Eurostat’s statistics.

for the year 2000<sup>84</sup> show a still sizeable primary sector, employing 21.2% of working people, a still to grow tertiary one, employing a percentage of 47.4%, and the secondary sector falling in between with a share of 31.4%. Even going more in depth and taking into account the NACE classification<sup>85</sup> of economic activities, the outcome is similar, but some interesting remarks can be made all the same. Manufacturing, with its rate of employment of 21.4%, is the sector offering the greatest number of jobs in all the considered countries with the exception of Romania. The highest share of employment in this sector is reached in Slovenia (30.3%), while also the Czech Republic, Slovakia, Hungary, Bulgaria and Estonia lie above the average. Agriculture, with a share of 21.5% of all employed, constitutes the largest single sector in the CEC-10 countries. However, this relatively high share can be attributed almost exclusively to Romania where 44% of people live on farming or cattle-breeding, while the countries with the next biggest shares (Lithuania and Poland with 18-19% and Bulgaria and Latvia with 13-14%) are already below the average, though possessing a sizeable agricultural sector. The third major sector in the CECs is that of trade and repair with a share of 12.4%, which, except for Lithuania, Poland and Romania, ranks second behind manufacturing. Noteworthy, these three dominant sectors also represent the primary, secondary and tertiary levels of economic activities. Results show Romania as the farthest away country from a modern economic structure and Poland clearly second to last.

As far as the educational level for each sector is concerned, the situation is quite similar in all the examined countries, with agriculture workers having the lowest and people working in the education sector having the highest level. Below the average are mining, manufacturing, construction and hotels & restaurants sectors, while neatly above the mark are finance & insurance, real estate & business, public administration and health spheres. To be underlined is that the educational level of sectors does not always match with their employment perspectives, since i.e. the employed in a highly developing sector like that of hotels & restaurants possess a below average education.

Coming to consider the gender of employed people, once again the most remarkable differences are observed among sectors but not among countries. Predominantly male sectors are those implying physical strength such as construction and mining (respectively employing 90% and 85% of men) or, slightly less, electricity, gas & water supply, transport and communication

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<sup>84</sup> All data and tables of this paragraph are taken from the EUROSTAT report "Employment and labour market in Central European countries", European Community, 2001.

<sup>85</sup> The Statistical Classification of Economic Activities (NACE Rev.1) divides the economy into 99 micro-sectors, grouped into 17 macro-sectors. These are: A. agriculture, hunting and forestry, B. fishing, C. mining and quarrying, D. manufacturing, E. electricity, gas and water supply, F. construction, G. wholesale, retail trade and repairing, H. hotels and restaurants, I. Transport, storage and communication, J. financial intermediation, K. real estate, renting and business activities, L. public administration and defence, compulsory social security, M. education, N. health and social work, O.

(between 78-73% of men employed); while dominated by women are the sectors related to health and education (employing 81-77% of women) and, to a lesser extent, finance & insurance and hotels & restaurants (67-62%). Most remarkable is that all the declining sectors are mainly male, while sectors in which woman predominate have good perspectives for the future. The only exception is the real estate & business sector, which, though mostly male-dominated, can nevertheless expect future employment growth.

Poland has accounted for more than half of the overall CEC rise and Lithuania has reported the highest relative increase almost doubling the number of jobless people for more than one year. Not differently from the recent past situation analysed, most at risk are men, especially in the last decade of their working life, endowed with a lower educational level and previously working in skilled manual occupations. People belonging to this category are doubly disadvantaged: first, because of the lack of work and the related income and second, because most of them have lost the right to access unemployment benefits and are without any basic financial support.

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other community, social and personal service activities, P. private households with employed persons, Q. extra-territorial organisations and bodies.

Table 1.5. Sectoral structure and characteristics of Central Eastern European economies.

	BG	CZ	EE	HU	LT	LV	PL	RO	SI	SK	CEC-10	
<b>Employment by sector 2000</b>												<b>Employment by sector 2000</b>
Agriculture	13.2	5.2	7.0	6.5	<b>18.4</b>	14.4	18.7	<b>45.2</b>	9.6	6.9	<b>21.5</b>	Agriculture
Manufacturing	<b>23.5</b>	<b>27.4</b>	<b>23.0</b>	<b>24.2</b>	<b>18.6</b>	<b>18.5</b>	<b>19.8</b>	<b>18.6</b>	<b>30.3</b>	<b>25.8</b>	<b>21.4</b>	Manufacturing
Trade & repair	<b>14.1</b>	<b>12.9</b>	<b>12.8</b>	<b>14.5</b>	<b>13.7</b>	<b>15.3</b>	14	8.3	<b>13.4</b>	<b>12.5</b>	12.4	Trade & repair
Education	7.4	6.4	7.8	8.2	12.1	9.0	6.9	4.0	6.4	7.8	6.5	Education
Construction	5.9	9.4	7.8	7.0	5.9	6.0	7.4	3.7	5.4	8.0	6.5	Construction
Transport & Communication	7.5	7.9	10.4	8.1	6.8	8.5	6.2	4.5	6.7	8.2	6.5	Transport & Communic.
Public administration	6.8	6.6	5.6	7.0	5.4	7.8	5.3	3.9	6.0	7.7	5.5	Public administration
Health	5.8	6.1	4.8	6.5	6.6	5.0	6.5	2.9	5.2	7.0	5.4	Health
Real estate & business	3.2	5.7	6.8	5.4	2.8	4.9	3.5	1.2	4.8	4.1	3.4	Real estate & business
Other services	3.1	3.7	5.7	4.4	3.9	4.7	3.6	2.2	3.9	3.7	3.4	Other services
Hotels & restaurants	5.0	3.4	3.0	3.5	1.8	2.3	1.7	1.1	3.8	3.0	2.2	Hotels & restaurants
Electricity, gas & water	2.0	1.6	2.1	2.0	2.6	2.1	1.8	1.8	1.1	2.2	1.9	Electricity, gas & water
Finance & insurance	1.1	2.0	1.5	2.2	1.0	1.2	2.5	0.9	2.4	1.8	1.8	Finance & insurance
Mining	1.5	1.6	1.7	0.6	(0.3)	.	2.1	1.6	0.8	1.2	1.5	Mining
TOTAL (1000)	2857	4671	604	3807	1525	968	14518	10898	888	2083	42818	

Sector by average age, CEC-10, 2000

Sector	AB	C	D	E	F	G	H	I	J	K	L	M	N	OPQ	All
CEC-10	41.8	39.4	38.4	41.6	38.9	36.8	<b>35.0</b>	39.8	38.3	39.8	39.2	<b>42.0</b>	40.8	39.0	39.4

Sector by sex, CEC-10, 2000

Sector	AB	C	D	E	F	G	H	I	J	K	L	M	N	OPQ	All
Female	44.8	15.5	41.1	22.2	9.7	53.8	62.4	27.2	67.8	45.0	43.2	<b>77.1</b>	<b>81.3</b>	51.3	45.9
Male	55.2	<b>84.5</b>	58.9	77.8	<b>90.3</b>	46.2	37.6	72.8	32.2	55.0	56.8	22.9	18.7	48.7	54.1

Unemployed and employed by sector of (previous) economic activity, CEC-10, 2000

Sector	AB	C	D	E	F	G	H	I	J	K	L	M	N	OPQ	All(1000)
Unemployed	7.0	1.6	<b>33.3</b>	1.3	12.2	17.2	4.2	4.7	1.2	2.6	4.6	2.4	3.6	3.9	3599

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Employed	<b>21.5</b>	1.5	21.4	1.9	6.5	12.4	2.2	6.5	1.8	3.4	5.5	6.5	5.4	3.4	42818
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*Source: Eurostat: "Employment and labour market in Central European countries", p.24-25*

## 1.4. Attempts to compensation.

To varying degrees, all the countries in the region are struggling to address the sudden impoverishment of large segments of the population. They are doing so in a context in which jobs are being eliminated at alarming rates, public services have been curtailed and fiscal revenues are extremely limited. Another constraint is that most governments lack the knowledge and tools required for devising effective policies targeted at people in need: anti-poverty strategies are often too general to lead to a rational series of concrete actions, while implementation conditions and budgetary implications are often left out of consideration<sup>86</sup>.

A key to solving the emergence of poverty growth in the countries entering market-economies lies for sure in encouraging a stable economic growth and creating new jobs (substantially redeploying labour from the former state-owned sector to the emerging private one), but, since these goals require a long time and a great effort and ability to be achieved, governments have often opted for more short-term solutions which don't eradicate the problem but only try to reduce its manifestation. The real task of governors in the early stage of the transition process didn't call for the entire building up of a new system from scratch, but for courageously implementing comprehensive reforms of the social security system in a moment in which the changes and efforts required would have been accepted by the population because felt as unavoidable and necessary. This opportunity has been instead lost and a complex mixture of provisions and cash transfers have replaced the indispensable reforms guaranteeing an excessive number of benefits of low, often trifling amounts to an excessive number of beneficiaries<sup>87</sup>, without much consideration of further potential future costs.

Social safety net in transition countries should be designed "to ensure that labour shed by contracting enterprises and other losers from reform do not fall into poverty, while not eroding these workers incentives to find employment in new enterprises"<sup>88</sup>. Three are the pillar of state social security networks: 1) labour policies (both active and passive); 2) pension systems; 3) social assistance. Each of them has its primary target, respectively: unemployed and school leavers seeking for their first job; elderly people outflowing from the labour market; poor, vulnerable, destitute people, especially children, invalid, physically and mentally ill persons.

**Central European countries** and former Soviet Union republics followed two different strategies in allocating state revenues through these three mentioned branches of social security. The

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<sup>86</sup> More about anti-poverty programs in the various transitional countries in GORNIAK, March 2001, p. 163-170.

<sup>87</sup> See BOERI T. (2000), p. 7-9. Interesting is the apparently contradictory version given by the same author and others (1998) when affirming that "unemployment benefit systems [...] allowed for nominal replacement rates as generous as in many OECD countries" but going on saying that "Over time, chronic inflation and incomplete indexation of ceilings eroded unemployment benefits to level close to the minimum wage...", p.74.

<sup>88</sup> From "Transition: the first ten years", WB, 2000, p. xvii. But see also BOERI T., BURDA M. C. and KOLLO J (1998) where the authors state that "one of the greatest challenges facing the CEE countries is to develop a system of social insurance that guarantees basic needs of the population without impeding labour mobility necessary for a successful transition.", p. 71.

former group of countries focused its efforts on generous (often even *too* generous) unemployment benefits having sometimes unlimited duration (like in Poland) and generating at least three considerable by-products: a) a sharp decrease in employment rates; b) a longer duration of unemployment period; c) an unbearable social security burden on active population with all its discouraging effects on labour demand, new-job creation and regular tax payments. Following the fiscal crisis of the early '90s a deep tightening on this social transfer system was required<sup>89</sup>. The outcome was doubly ruinous: on the one side the burden of helping jobless people and their families was only shifted from unemployment insurance to social assistance and, on the other, no growth in the inflow to the labour-market, as a result of the cut to unemployment benefits, was registered<sup>90</sup>. Besides, most hardly hit were long-terms unemployed, who preferred not to register any more in labour-offices and enter the non-participation category<sup>91</sup>.

Many and different have been the explanations for such “bad” policies implemented<sup>92</sup>. There is no doubt that they were designed to soften the social impact of unavoidable unemployment and to ensure an on-going support to the reform process from a population not at all accustomed to cope with lack of job, previously furnished by the state itself. The burst of unemployment was considered inevitable and taken as a good proxy for the speed of the transition process, but its scope was for sure underestimated: the most pessimistic esteems for Poland spoke of a maximum of 200,000 unemployed, while actually in 1994 lack of job stroke 3 million Polish citizens. Tito Boeri (2000) puts forward his own interesting explanation for such blunders in the choice of the right labour policies which sometimes even brought to the implementation of social schemes with higher administrative costs than the total amount of the cash-transfers involved. He sustains and demonstrates that “factors other than employees’ resistance to staff cuts were seriously obstructing the restructuring of state enterprises”<sup>93</sup>. Three were, in his opinion, the pressures politicians had to face while designing the demanded policies. The first pressure came from the managers of state enterprises who asked for high unemployment benefits to “buy-out” workers and obtain more flexibility in their restructuring attempts, thus substantially getting rid of their social responsibilities for the needed lay-offs. It’s not clear whether managers were conscious or not of the expensive implications for public finance; what is self-evident is that the subsequent rapid cuts to non-employment benefits were of great relief for them, preventing payroll taxes from exploding and labour costs from rising beyond the limits. The second reason for the

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<sup>89</sup> “The maximum duration of unemployment benefits was halved in the Czech and Slovak republics and in Hungary, and a maximum duration of one year was set in Poland. Gross statutory replacement rates were also decreased in Bulgaria, in the former Czechoslovakia and in Poland [...] in the Czech and Slovak republics regulatory changes were enforced retroactively...”. Source: BOERI (2000), p.86.

<sup>90</sup> See BOERI (2000), p.87.

<sup>91</sup> See BOERI T., BURDA M. C. and KOLLO J (1998), p.75.

<sup>92</sup> One explanation different from the following ones is given by FLEMMING J. and MICKLEWRIGHT J (1999) when stating that “In practice, intervention in labour-market was directed more to the restraint of inflation than to the support of employment.”, p. 44.

undertaken policies was of political kind and deeply connected with the particular attitude towards unemployment inherited by public opinion from the previous regime. Differently from Western countries, unemployment became the decisive factor influencing political preferences and the providing of long-lasting cash social transfers substituted the previous state-allocation of work as a mechanism for controlling the electorate. The third pressure came from the lobbying groups composed by the large and redundant mass of bureaucrats who needed a certain high degree of complexity in state institutions to justify their presence in the new system<sup>94</sup>. Needless to say, the more complex and bureaucratized the system would be and the lower the salaries (and the related costs of losing one's job when caught out), the more space for corruption would have been allowed.<sup>95</sup>

Employment-fostering policies comprehend not only unemployment benefits, but can be much more active in their facilitating the integration of groups which dominate long-term unemployment. The so called "Active Labour Market Policies" (ALMPs) include three main practices: 1) *job intermediation*, aiming at improving information exchange between labour-demand and supply about vacancies, mostly required qualifications and future prospects; 2) *training measures*, designed to improve workers' skills; 3) *job creation schemes*, the largest component of ALMPs, aimed at increasing the demand for labour and reducing the discriminations against long-lasting joblessness. Data concerning the expenditures for active and passive labour measures implemented by some significant CEE countries confirm the negative opinion about governors' labour policies given at the beginning of this paragraph. While in 1996 Hungary was spending 2,27% of its GDP for passive labour policies, only a meagre 0.67% was used for active ones; the same happened in Poland where 1.82% of national GDP represented the total passive spending, but only 0.36% was utilised to cover active measures' costs; the situation was not much different in Slovakia and Slovenia, whereas only the Czech Republic dedicated more resources to ALMPs rather than to passive measures<sup>96</sup>.

Quite different was the reaction to unemployment and the other negative consequences of the transformation in the **former Soviet Union countries**. Here no floor to wage setting was established (thus permitting a sharp decrease in the salaries to occur) and practically no new insurance system against job loss was introduced (thus eliminating any incentive to register as jobless in public labour offices). The role of the state in reducing poverty and inequality and promoting social cohesion was therefore residual, while huge stocks of wage arrears in the budgetary sector were the norm<sup>97</sup> and the transfer system put up before the collapse was only partially indexed, leaving inflation erode the real value of those minimal public cash-supports. Furthermore, data show that in Russia and Ukraine

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<sup>93</sup> See BOERI (2000), p.69.

<sup>94</sup> Worth noticing is that "At the end of 1996 the employment share of public administration was almost 4%, from about 2.5% in 1990." Source: BOERI (2000), p.185.

<sup>95</sup> These three hypothesis for explaining policy mistakes are taken from BOERI (2000), p.66-69, p. 174 and following.

<sup>96</sup> Data from OECD "Employment Outlook", 1996.

<sup>97</sup> See BOERI (2000), p. 10-11 and p.165.

unemployment benefits, though very low, were badly targeted and received by better-off rather than poor families<sup>98</sup>. The shrinking social budget was moreover concentrated on pensioners rather than on still potentially active actors, rendering the incidence of poverty for households headed by pensioners much lower than for other social groups<sup>99</sup>. “The outcome was less labour reallocation and a more downward wage adjustment than in other transitional economies”<sup>100</sup>.

Reasons for such different political choices are not difficult to be found out: first, it must be borne in mind that the influence of Western European countries and of their protective and comprehensive welfare systems was more direct and stronger on CEE countries than on FSU ones. The appealing prospect of accession into the EU was for Central European countries a further spur to uniform their social security systems to those of EU members (in the end resembling those of Southern European countries, with all their connected problems). The second explanation for such differences is of financial nature: FSUs had great problem with tax collection and very restricted state budgets to cover the expenditures for any adequate public social net. Last but not the least was the matter of foreign capital inflows, which permitted to finance abundant social expenditures in CEE countries, but were not sufficient to do the same in other regions<sup>101</sup>.

Still to be examined are the remaining two pillars of public social security networks: the pension system and social assistance. While the first lies outside our study, because not directly connected with the development of the microfinance industry in the region, the second issue will be briefly described hereafter.

Social assistance is sometimes considered as a means of last resort: who cannot benefit from other forms of revenues turns to social assistance for some cash or in-kind transfer in order to survive. And in fact “social assistance benefits should be more focused on the poor than any other kind of transfer, because they are the only transfer whose function is specifically poverty alleviation”<sup>102</sup>. A real problem in accomplishing this difficult task is that of targeting, because the concession of this benefit implies a great discretionary power, which can be supported by means- (and hence family-) testing. The “mixed bag” of social assistance comprehends cash or in-kind payments, but also other heterogeneous supports such as education grants, free health care, expenditures on nursery homes for aged people, mental institutions, free meals and so on. Once again the distribution of such assistance differed in CEE countries and FSUs ones. In Central Europe and the Baltics more resources were allocated for alleviating poverty through social assistance, while CIS countries preferred “indirectly protecting employment by not imposing hard-budget constraints on old enterprises and by maintaining subsidies

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<sup>98</sup> Data from concentration coefficients of unemployment benefits in MILANOVIC (1998), p.110.

<sup>99</sup> See “Transition, the first ten years...”, WB, 2000, p.82.

<sup>100</sup> From BOERI (2000), p. 10.

<sup>101</sup> Reasons for the difference between CEE and FSU countries were found in BOERI (2000).

<sup>102</sup> From MILANOVIC (1998), p. 111.

on housing and utilities”<sup>103</sup>: their expenditures in social assistance were therefore highly reduced. As a consequence of the deep fiscal adjustments CEE countries as well as former Soviet republics had to impose severe cuts on educational expenses thus putting at risk the development of competitive skills in the younger generations and shifting educational costs on families<sup>104</sup>. Not even health care was spared from budget-cuts, notwithstanding the growing threats of HIV/AIDS and drug-resistant tuberculosis. Low salaries of health-workers brought to a growing and sometimes inevitable request for under-the-table taps, forcing poor families to borrow money and fall into bad debt. Georgia, Azerbaijan and Tajikistan don’t even reach 2% of GDP in health expenditures, with the former not even reaching 1%. But CEE countries like Bulgaria and Romania are not much far from them with a meagre percentage under 4%, while, as a comparison, Germany’s level is over 8%<sup>105</sup>.

Coming back to the problem of targeting, concentration coefficients indicate that in all countries social assistance is less well targeted than unemployment benefits, especially for Latvia, the Slavic Republics and Russia, where, on the average, the contribution of social assistance is paradoxically pro-rich. “If, for the sake of simplicity, the poor – that is, those whom policymakers want to reach – are assumed to occupy exactly the bottom quintile, and only the bottom quintile, than little over one-fourth of expended social assistance in transition economies can be said to reach them”<sup>106</sup>. Public social assistance has been clearly not sufficient to alleviate poverty since the onset of transition.

## **1.5. Private sector development and the role of SMEs and micro-enterprises.**

The well-know scholar Anne O. Krueger wrote in the early period of the transition process: “Focus seems to be upon privatisation of existing assets, which is obviously a contentious and difficult issue. It is politically important because the existing assets now belong to the state, and people feel that those assets should be returned to the people in a “fair” manner. The difficulty is that there is no such thing as “fair”, and searching for the least unfair process will inevitably be time-consuming and divert attention away from the more important problem of creating new earning streams.” And here was her alternative receipt: “Creating an open foreign trade regime, which will in itself provide some much needed competition to state-owned industries, supporting small entrepreneurs as they seek foreign markets, preventing anti-competitive practices among domestic producers of non-tradable goods, and providing improved infrastructure in support of economic activity, are the major challenges facing the governments of Eastern European countries”<sup>107</sup>. Following her suggestion, this paragraph will try first

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<sup>103</sup> From “Transition: the first ten years”, WB, 2000, p.83.

<sup>104</sup> World Bank data for 1998 speak of public expenditures on education in Armenia, Georgia, Poland and Tajikistan hardly reaching 20% of GDP, source: *ibid*.

<sup>105</sup> Data from the World Bank’s World Development Indicators database.

<sup>106</sup> From MILANOVIC (1998), p.113-114.

<sup>107</sup> From A. O. KRUEGER “Institutions for the new private sector” in “The emergence of market economies in Eastern Europe”, edited by C. CLAGUE and G. C. RAUSSER, Blackwell, 1992, p. 221-223.

to briefly depict the various efforts undertaken by authorities for privatising formerly state-owned companies, efforts which every government considered the “fairest”, according to the particular national environment. Afterwards, the re-birth of private enterprises and their contribution to the new, open market economies will be analysed, focusing on SMEs and on micro-businesses; finally the policies to spur their development and the major obstacles entrepreneurs had, and still have to face, will be investigated.

### **1.5.1. Efforts of privatisation and their results.**

Privatising state-owned companies was not only a matter of fairness towards citizens, but primarily a matter of efficiency and a part of an overall strategy made up of discipline (upon the old, stagnant sectors bound to restructuring) and encouragement (of new entrepreneurship and competition). The nominal change in the ownership, from the state to whatever possible private owner, wouldn't be enough to increase the soundness and productivity of firms: the superiority of a private company critically depends on the degree of competition present in capital markets, on the incentives incorporated in the different organisational models and on the efficacy of regulatory policies adopted to correct market-failures, rather than on the ownership itself<sup>108</sup>. All the same, after the fall of communist regimes, all governments decided to get rid of the heavy burden of state-companies as soon as possible, but did it following different strategies. Privatisation was in fact expected to solve different crucial issues like getting the state out of enterprise management, creating a broad support for reforms, arresting the “spontaneous privatisation”, tunnelling and asset-stripping from former managers, imposing hard-budget constraints and promoting restructuring, creating demand for stronger property rights and institutions of corporate governance.<sup>109</sup>

***Formerly state-owned small and micro business activities (retailers, restaurants, hotels and other business units in the fields of trade, distribution and tourism) were almost everywhere the first to be sold to private owners, often by simple methods based on auctions. This decision revealed itself as the easiest and most correct one. Real problems turned out with the core of large-sized socialist firms (500 in Poland, 5000 in the URSS, just to get an idea)<sup>110</sup> accounting for the bulk of industrial output. They were usually more vertically integrated than their counterparts in market economies, especially in the sectors of mining, shipyards, petrochemistry plants and their privatisation process was characterised by great delays. Various reasons accounted for these postponements and***

<sup>108</sup> See M. VISCONTI “L’impatto dei processi di privatizzazione sulla realtà finanziaria aziendale” in “Finanza, imprese e sviluppo locale: casi di paesi europei in transizione”, edited by M. VISCONTI and D. GRBAC, Giuffrè Editore, 2001, p. 180.

<sup>109</sup> See “Transition: the first ten years”, WB, 2000, p. 71.

<sup>110</sup> See S. FISCHER “Privatisation in Eastern European Transformation” in C. CLAGUE, G. C. RAUSSER “The emergence of market economy in Eastern Europe”, Blackwell, 1992, p. 233.

**difficulties: 1) the presence of obsolete technologies and capital stocks which discouraged potential buyers; 2) the high occupational weight of such companies with all the social and economical implications of any attempt of restructuring.<sup>111</sup>; 3) the burden of large liabilities and contingent liabilities such as debts, pension obligations, severance pay promises, prior ownership claims etc; 4) the scarcity of domestic savings with which to buy equity shares of former state-owned enterprises; 5) the need for establishing an effective ownership control over privatised companies.<sup>112</sup> Among the manifold methodologies implemented in the privatisation process (special privatisation agencies for small units, financial intermediaries, liquidation through direct selling or auction of assets, renting, management/employee “buy out/in”, direct sell to foreign investors, divestiture by leasing to workers cooperatives, returning to original owners, mass privatisation through vouchers), the real choice was between conceding the ownership to a concentrated group of effective owners or spreading the ownership among insiders (workers or managers) or outsiders (granting vouchers to all citizens). The first choice revealed itself as the one mostly contributing to restructuring, while the latter, though seeming the most transparent and fair, often brought to a dead-end point in the process of renovation and to the surviving of non-viable enterprises. Vouchers schemes were universally adopted in Russia and Czechoslovakia, while Armenia, Azerbaijan, Georgia, the Kyrgyz Republic, Lithuania and Moldova used them as the principal method of divestiture; they were all the same a secondary privatisation methods for several other countries such as Poland, Bulgaria, Estonia, Latvia and Slovenia.<sup>113</sup> Poor results showed up very early: the highly risk-averse population often preferred to get rid as soon as possible of their shares selling them below cost, causing a depression in their prices and negative consequences for the new market structures<sup>114</sup>. Furthermore, in Russia and current CIS countries, insiders ended up owning larger shares than intended (on the average 66% of the shares of privatised enterprises for Russia); significant asset stripping was the rule and insider-groups constituted a strong opposition to the drawing up of an effective legal and governance framework. In former Czechoslovakia, where the transfer was fast and massive, investment funds were created to consolidate the diffuse ownership, but, due to the lack of resources and skills to drive restructuring and to the weak surveillance by creditors, budget constraints were further softened and extraction of assets by enterprise and fund managers was the outcome. Some hypothesis were made by World Bank experts to explain the ineffectiveness of diffuse or insider ownership: the first element lacking was, in their opinion, an adequate institutional**

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<sup>111</sup> See VISCONTI (2001), p.177.

<sup>112</sup> See FISCHER “Privatisation in Eastern European Transformation”, in C. CLAGUE, G. C. RAUSSER p. 290-295.

<sup>113</sup> See “Transition: the first ten years”, WB, 2000, chapter 7.

<sup>114</sup> See VISCONTI (2001), p.184-185.

**framework capable of efficaciously monitoring insiders and creditors, of protecting minority shareholders, of solving conflicts of interests and including accounting, auditing and disclosure standards as well as take-over, insolvency and collateral legislation. Also missing was the owners' ability to provide capital to modernise enterprises and the market-experience needed to manage a firm in a competitive environment. An important factor was also a very limited contribution of foreign capitals especially in former Soviet Union countries, which reduced the possibility of direct selling of equity shares and prevented the transfer of more advanced Western technologies and experiences.**

Table 1.6. Private Sector Growth since 1990.

<i>Countries</i>	<i>Percentage of GDP</i>		
	<b>1990</b>	<b>1994</b>	<b>1999</b>
<b>CSB</b>	<b>11</b>	<b>50</b>	<b>68</b>
Czech Republic	12	65	80
Estonia	10	55	75
Hungary	18	55	80
Romania	17	40	60
<b>CIS</b>	<b>10</b>	<b>20</b>	<b>50</b>
Armenia	12	40	60
Belarus	5	15	20
Russian Federation	5	50	70

*Source: "Transition: the first ten years", WB, 2000, p.6.*

The role of foreign investors (and all the connected positive by-products) was on the contrary crucial in countries of Central Europe and especially in Hungary. In this country, central planning had been already abandoned before the collapse of the regime and the real problems came from managerial groups leading the independent but still formally state-owned companies and stripping off their assets. An impressively high state debt, together with the presence of corrupted insiders, led to a privatisation to strategic investors and a process entirely open to foreigners which was encouraged by substantial progresses in bank- and bankruptcy- regulation and by the working out of large stocks of bad loans in the banking system. Poland was instead the country which simultaneously implemented the largest variety of methods: mass privatisation through vouchers of some 400 public companies, "privatisation through liquidation" selling or leasing the assets and selected liabilities of other 1000 medium-sized enterprises, setting up of joint ventures with foreign capitals and so on.<sup>115</sup> But the real key of its success lay in the imposition of hard-budget constraints and the effort to restructure and privatise banks and address the bad loan problem.<sup>116</sup>

<sup>115</sup> See VISCONTI (2001), p. 189-192. More about the Polish privatisation process in chapter 4.

<sup>116</sup> See "Transition: the first ten years.", WB, 2000, p.77-78.

Summing up, while CIS countries, and to some extent South-eastern European too, “[have] tended to protect rather than discipline old enterprises through subsidies granted through the budget, energy consumption, and the banking sectors”<sup>117</sup>, thus favouring asset stripping, broad violations of property and shareholders’ right and a diffusely corrupted economic environment; those countries (such as Hungary and Poland) implementing more rapid reforms (especially if transferring assets to concentrated groups of strategic, often foreign, investors) obtained the most successful results.

**Table 1.7. main recipients of Foreign Direct Investment, 1992-99.**

Countries	1992-1995		1996-1999	
	US\$ millions	% of GDP	US\$ millions	% of GDP
<b>CSB</b>	<b>21,091</b>	<b>0.5</b>	<b>50,558</b>	<b>3.3</b>
Czech Republic	4,821	2.9	10,104	4.6
Estonia	647	3.9	1,050	<b>5.2</b>
Hungary	9,399	<b>5.7</b>	6,979	3.8
Poland	2,540	0.6	17,096	2.9
	<b>8,272</b>	<b>1.0</b>	<b>22,001</b>	<b>2.5</b>
<b>CIS</b>				
Azerbaijan	237	4.2	3,222	20.9
Kazakhstan	2,357	2.7	4,971	6.4
Russian Federation	3,965	0.3	8,412	0.7
Turkmenistan	427	3.5	334	3.0

Source: World Bank staff estimates and country statistical office data in “Transition: the first ten years”, WB,2000, p.7.

These successes took the form of a more rapid recovery from the original fall in output, a higher share of private sector in GDP (around 80% in 1999 for Hungary and the Czech Republic, just to mention the leading countries), a larger quota of FDI (more than US\$ 17 million for Poland and more than US\$ 50 million for the entire CSB region in the years 1996-99) and a growth of exports to industrial countries reaching the impressive rate of 94% for Bulgaria and 81% for Hungary.<sup>118</sup>

### **1.5.2. The growth of new companies and the role of small and medium enterprises.**

It’s high time to come back to A. O. Krueger’s statement and finally spend a conspicuous part of our research on what she called “the problem of creating new earning streams”. As a matter of fact, the explosion of new small- and medium-sized firms started after 1989<sup>119</sup> severely calls for our

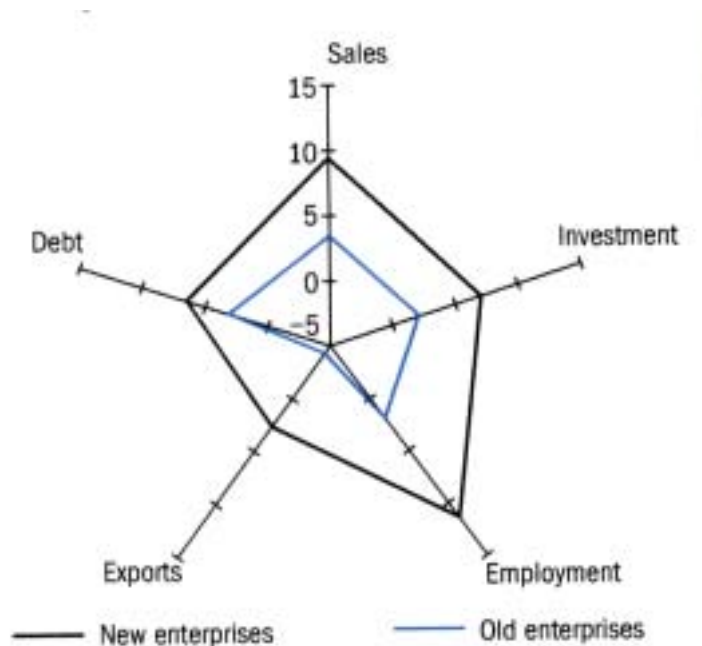
<sup>117</sup> Ibid. p. xvii.

<sup>118</sup> Ibid. from various tables.

<sup>119</sup> It is estimated that only during the year 1995 around one million new firms were registered in each of the three most important countries of Central Europe: Poland, Hungary and the Czech Republic. Source: VISCONTI (2001), p. 238.

attention because they outperformed both state-owned and privatised units not only in their contribution to job creation, but also in much lower job-destruction rates. Their contribution to the building up of a new, sound open market-market economy didn't limit itself to the field of employment (whether in the absorption of the released labour force from restructuring firms or in the generation of new workplaces), but concerned output too: the introduction of new products tended in fact to be concentrated in new firms which could fill the market niches and exploit investment opportunities opened by the transition process.<sup>120</sup>

**Chart 1.1. Old and new enterprises compared.**



Source: BEEP survey 1999, available on the web-site: [www.worldbank.org.ru/survey/front2.htm](http://www.worldbank.org.ru/survey/front2.htm)

Besides a large support to unemployment reduction and a high power of innovation, small and medium enterprises (SMEs henceforth) in transition countries are characterised by other features too. The Business Environment and Enterprise Performance (BEEP) Survey<sup>121</sup>, jointly conducted in 1999 by the European Bank for Reconstruction and Development and the World Bank, pointed out the major strengths of new SMEs if compared with old (though restructured and privatised) enterprises. New companies once again outperformed old ones in sales, export, investments, besides the already mentioned employment category. Furthermore, World Bank reports attribute a great importance to the growth of new small enterprises since they are characterised by higher labour productivity and a larger

<sup>120</sup> See BOERI (2000), p. 63-65, where the author also states that “Overall, various pieces of evidences, including those of anecdotal type, suggest that improvements in firms’ performances are mainly associated with the development of new goods, rather than with the downsizing of overmanned state-enterprises and their privatisation.”

<sup>121</sup> The BEEP Survey was conducted together by EBRD and WB experts on about 3,000 firms in 22 Eastern European countries in 1999. Main goal was studying the perception entrepreneurs themselves had on the two issues of governance obstacles to business and state capture components and being able to put forward recommendations for governments and make comparisons among the different countries. Questionnaire and database of results are available on the web-site: [www.worldbank.org.ru/survey/front2.htm](http://www.worldbank.org.ru/survey/front2.htm),

contribution to value added and to employment shares.<sup>122</sup> But the simple presence of a small number of highly productive small enterprises is not enough to ensure a sustainable growth, “a threshold of about 40% for the shares of small enterprises in employment and value added needs to be crossed for new enterprises to absorb the resources released by the old sector [...] and to develop the critical mass to lead aggregate economic growth”<sup>123</sup>.

**Table 1.8. SMEs shares in total employment and value added, 1998.**

<b>Countries</b>	<b>SMEs</b>	<b>Share of total employment</b>	<b>Value added (total)</b>	<b>Value added (per employee)</b>
Belarus	37.7	15.9	-	-
Czech Republic	97.0	48.7	53.5	109.9
Georgia	88.6	39.6	39.3	99.2
Hungary	96.1	54.9	<b>63.6</b>	115.8
Kazakhstan	88.6	15.6	22.4	143.6
Latria	91.2	45.5	50.4	110.9
Lithuania	<b>97.4</b>	<b>55.1</b>	55.3	100.4
Poland	92.1	45.7	54.4	118.9
Russia	56.3	18.6	23.0	123.7
Ukraine	69.2	16.9	30.0	<b>177.5</b>

*Source: World Bank database on SMEs as reported in “Transition: the first ten years”, WB, 2000, p.42.*

Emblematic are the examples of Russia and Ukraine, whose small firms, not even reaching 20% in employment share and hardly reaching 30% (for Ukraine) in the value added can’t find the strength to decisively contribute to their countries’ growth. In the majority of cases SMEs are overwhelming trade-oriented and only a small fraction of them is involved in production of goods or services; but most of them are often not familiar with foreign trade and customs procedures or with product liability, quality and consumer protection requirements, in spite of the fact that SMEs generally engage relatively higher skilled employees.<sup>124</sup> The explosive growth of new and small enterprises has been however tremendous: already in January 1995 new firms accounted for 96% of Bulgarian companies, 95% of Romanian and 92% of Slovak ones; small enterprises were over 99% in Romania and Hungary and more than 98% in Albania, Bulgaria, the Czech Republic, Poland and Slovakia<sup>125</sup>. Some of them were however fictitious entities, registered with the only aim of defrauding the state.<sup>126</sup>

### **1.5.3. Obstacles and shortfalls in the development of SMEs.**

<sup>122</sup> In some countries like Hungary and Lithuania the share of employment in small enterprises reached nearly 55% in 1998, while the Czech Republic, Poland and Latvia were by far over 40%. Concerning the share of value added in small enterprises Hungary reached in the same year a rate of almost 60%, while Poland, the Czech Republic, Lithuania and Latvia swung around 53%. Source: “Transition: the first ten years”, WB, 2000, p. 41-42.

<sup>123</sup> From “Transition: the first ten years”, WB, 2000, p. 42.

<sup>124</sup> See UN-ECE document “Characteristics of SMEs in the countries in transition” by Antal SZABO’, regional adviser on entrepreneurship and SMEs, based on ECE document IND/AC.3/1 as of 14th February 1996.

<sup>125</sup> Data from “Transition: the first ten years”, WB, 2000, p.49.

<sup>126</sup> See UN-ECE document “Characteristics of SMEs in the countries in transition”.

The issue of what are the most influencing factors hindering SMEs' development in transition countries can be examined from two points of view: the one of experts and scholars engaged with the study of the SME sector and the one of entrepreneurs themselves through the results of the 1999 BEEP Survey. Many experts point out the need for government to design an attractive investment climate for new entrants (both domestic and foreigner) which concretely means developing laws and institutions to protect investors and monitor managerial behaviour, capable of "enhancing creditors' and shareholders' rights, promoting internationally recognised accounting and auditing standards and enforcing take-over, insolvency and collateral."<sup>127</sup> The problem of an adequate legal and regulatory framework seems therefore to be one of the most urgent, especially under the form of a judicial system effective enough to enforce contracts and protect property rights<sup>128</sup>. Besides, old impediments like stifling administrative barriers to entry, over-regulated labour-markets and tremendous discretion for bureaucrats are still to be demolished while new one are emerging. Most pressing is the problem of overly complex and burdensome, always changing and distortionary tax-regimes, which often push companies to operate in the informal, illegal sector in a surrounding of uncertainty and precariousness which limits growth and investments.<sup>129</sup> Other obstacles identified by World Bank experts are unstable inflation, lack of access to finance, corruption and anti-competitive practices and lack of access to infrastructure services. Much more concerned with the connection between capital- and financial-market and SME growth are instead Visconti (2001) and Boeri (2000) together with the already mentioned official documents by UN-ECE and OECD<sup>130</sup>. All these authors and papers strongly underline the need for "a reallocation not only of labour but above all of capital for small businesses"<sup>131</sup> through the development of small credit banks and credit guarantee institutions to overcome the burden of lack of collateral and expensive (or totally unaffordable) credit for small-business activities. The problem of financing for SMEs is but much more complex and will be better analysed in the following paragraph about the building of a renewed financial environment in transition countries. Remaining potential obstacles are also represented by comparatively high and rigid wage levels (especially if compared to Eastern Asiatic developing economies), the lack of entrepreneurial skills and experiences, a limited access to domestic and foreign production markets, the strong competition from Western and Asiatic markets and the lack of infrastructures especially in the sectors of transportation and distribution.

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<sup>127</sup> From "Transition: the first ten years", WB, 2000, p. xvi.

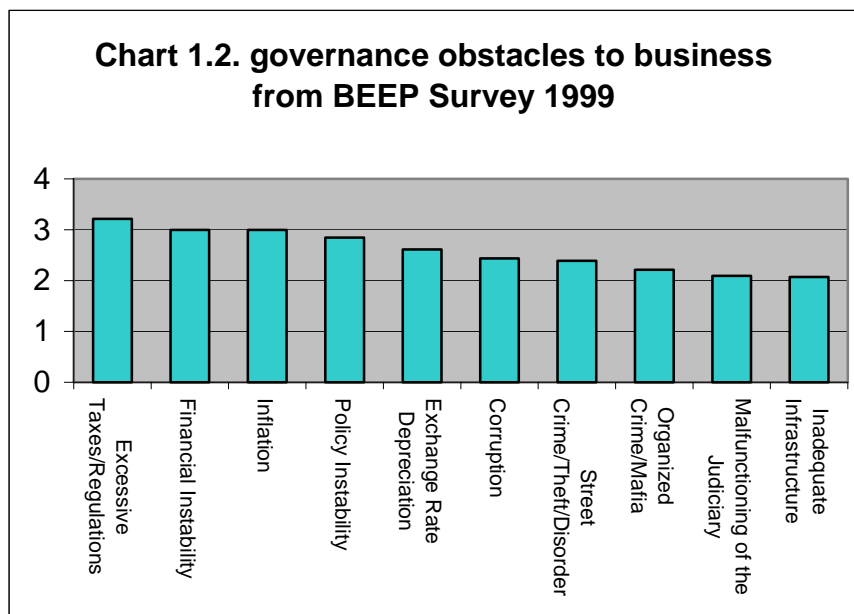
<sup>128</sup> Insecurity of property right is highly influencing in CIS countries, especially in Moldova, Ukraine and Russia, where the problem hits nearly 80% of companies. Source: EBRD data (2000). The legal environment for business activities will be more in depth analysed in paragraph 1.7.

<sup>129</sup> These series of obstacles are taken from "Transition: the first ten years", WB, 2000.

<sup>130</sup> The reference is to the UN-ECE document "Characteristics of SMEs in the countries in transition" and "Development of the SME sector in the Visegrád countries" by the same author and to the OECD document GD(96)40 "Microcredit in transitional economies", Paris, 1996.

<sup>131</sup> From BOERI (2000), p.4.

Coming to take into account the results of the 1999 BEEP Survey, we see how the outcomes are not much different from experts' analysis, but from the analytical data we can get also the intensity with which every governance obstacle is perceived by entrepreneurs themselves. The governance obstacles to business are areas pertaining to the public sphere in which bad performance by the state negatively affects the interviewed firms. Respondents were asked to indicate the degree to which firms performance were affected by each obstacle on a scale from 1 (not at all) to 4 (very much). Thus a higher average value for each item represents a worse performance by the government, and a worse obstacle for business performance.



Source: author's elaboration based on the data of the 1999 BEEP Survey.

The first three ranking perceived impediments turned out to be “excessive tax/regulation system” (with 3.2 average points), “finance instability” and “inflation” (both with 2.9), but “policy instability” and “exchange-rate depreciation” lagged only little behind, always with more than 2.5 score. It seems therefore that the need for a more simple, reliable and stable regulatory system and for a less burdensome taxation is the most utterly felt by entrepreneurs, but also the other items (inflation, policy instability, exchange rate depreciation etc.) point out a general request for stability in both the financial and political environments: ever-changing rules and conditions of the game cannot foster the building of permanently growing businesses.

#### 1.5.4. The peculiar role of micro-enterprises in transition economies.

It is now the turn to analyse the role of micro-enterprises in transition countries, so little considered although broadly diffuse and playing all the same a considerable role. Conventional wisdom has been that small- and micro-enterprises (MSEs) lack both the market knowledge and the capacity to significantly increase exports and internal economic development quickly and efficiently. The

consequence of this assumption is that very few resources have been directed towards their support, especially on the financial level. In transitional economies, however, micro-businesses (both family-run storefront enterprises and single-owner start-ups) have a strong potential for financial viability, because they form the backbone for the distribution of goods and services outside capital cities and are a vibrant and essential part of local communities, especially in rural and smaller urban areas, which constitute most of the territory of Central Eastern Europe. “Home based businesses, petty traders, local retail storefronts, service firms and nascent manufactures are important sources of employment, supplemental income, and local goods and services”<sup>132</sup>, often representing the only way-out for people facing the closure of a city’s sole or major state-owned company. For those poverty-stricken or unemployed individuals the setting up of a micro-activity independently run, provides an alternative or additional source of income and may potentially be a way to soften their transition into the private sector<sup>133</sup>.

There is no official definition of “micro-enterprise” and sometimes this type of business is accounted under the item “small-enterprise”, nor it is possible to estimate the number or units, because a considerable part of them operate in the informal sector and is not registered. It is but generally considered “micro” any activity including informal businesses, self-employed and family-owned firms employing less than 10 individuals, where often the owner-operator does all management tasks and sales.<sup>134</sup> Two are the main characteristics of micro-businesses in transitional economies. First of all, “entrepreneurs tend to focus on short-term profit opportunities, rather than building long-term sustainability”<sup>135</sup>. They seek out the best possible one-time deal regardless of the long-term implications for their activity for two main reasons: on the one side, they lack management experience in the competitive environment of new, open-market economies, but on the other, it is the uncertainty brought about by their illegal position or by the constantly changing government policies to push them to prefer short-term gains. The second feature is their crucial importance for rural areas, where labour mobility is very limited by high costs of transportation and shortage of housing in urban areas and where structural changes in agricultural and traditional rural employment are occurring.

In order to spread and grow micro-enterprises have to face at least four common obstacles on their way. The first is a generalised lack of access to market information deeply hindering their activities and the correct assessment of opportunities especially in such rapidly changing markets as in CEE and the NIS countries. Current and former insiders tend in fact to have a great advantage over

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<sup>132</sup> From OECD document GD(96)40: “Microcredit in transitional economies”, Paris, 1996, p.20.

<sup>133</sup> See also UN-ECE document “Microcrediting small and medium-sized enterprises in countries in transition” by Antal SZABO’, Geneve, 1997 where the author affirms that: “[...] the micro and small enterprise segment (MSEs) is of greater importance because it is considered as the cradle of entrepreneurship, particularly in environments facing high poverty and unemployment rates, and especially where, due to the restructuring of heavy machinery plants, military complexes or the closing of worked-out mines, there is a need for structural and social adjustment. In those districts, MSEs in particular can create jobs, and provide income-generating opportunities to alleviate poverty.”

<sup>134</sup> See OECD document GD(96)40, p. 27.

<sup>135</sup> Ibid. p. 28.

outsiders and potential entrants, because competitors and customers are not always visible and there is little public disclosure of transactions. A second hindrance to a sound growth of micro-businesses is the lack of incentives to turn into formal, registered businesses due to the high tax rates and distrust of government. In CEE and the NIS countries, legal and regulatory rules for small businesses often lag far behind the needs of micro-entrepreneurs for simple, workable and inexpensive organisational forms; the relevant rules are still too complicated and costly to comply with for many needier entrepreneurs left without substantial assistance. And even in the few cases in which rules are clear and costs are reasonable, in practice administrative authorities may find ways to hamper the process adding illegally costs of compliance.<sup>136</sup> The third problem is common to SMEs too, but it is much more marked for micro-activities and concerns the limited access to credit and capital. Formerly unemployed people or all the same many of the people leading a micro-firm have put aside few savings and accumulated too few assets to access formal banking credit: they lack the required collateral, the management experience and an adequate turnover in their business to even aspire to credit eligibility. Besides, even in case they could be considered “bankable”, the high price of credit would be unaffordable for most of them and many wouldn’t even try to apply for a loan because of a generalised mistrust in lending institutions<sup>137</sup>. Last, already mentioned, obstacle, once again common with other kinds of entrepreneurs, is the diffuse lack of managerial skills and marketing-knowledge which often prevents a correct pricing, the rational drawing of competition strategies and a customer service orientation.

## **1.6. The re-building of the banking-system and the problem of financing to private enterprises.**

### **1.6.1. The passive role of the banking system in socialist economies.**

Under central-planning the role of the banking system was substantially passive on both the loan and the deposit sides. On the former side, state-owned banks granted credit to whatever state-owned company had received the permission to undertake an investment or purchase materials: the concession of credit without restraints derived automatically from the state without any need from banks to assess the risk of lending and the credit-worthiness of the borrowing firm. On the deposit side, blocked cash accounts of state-firms increased their value until they were expropriated or companies were allowed from government to use them according to the central-plan. In few words, nor banks were required to accomplish their tasks of selection and monitoring, through the screening of loan applicants, nor enterprises were constrained from bidding for scarce resources and bearing the risk of their investment choices: all investments were thus qualitatively equivalent, that is, risk-free. Sanctions against

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<sup>136</sup> See OECD document GD(96)40 p. 36-37.

delinquent borrowers were weak and above all there was no incentive to hold enterprises on a tight leash because, belonging both to the state, transactions between the bank and the company could be considered a simple accounting exercise. Besides, when central authorities decided to limit the concession of bank credit, enterprises often effectively extended credit to each other.<sup>138</sup> Lack of financial discipline and consequent soft-budget constraints were therefore widespread and hard to demolish during the reforming of the entire system.

### **1.6.2. The establishment of a modern banking-system.**

The shaping of a sound and well-functioning financial system cannot be avoided if governments of transition countries want their renewed real economies to flourish. Capital markets play in fact various crucial functions in the economic environment of a country: they transfer resources from those who have it (savers) to those who can, for the time being, make a better use of them (investors); they agglomerate capital for investments requiring more than just one saver's deposits; they select credit-worthy projects, monitor their on-going and enforce contracts; they share and diversify the risks connected with entrepreneurial activities and finally they record transactions and acquire useful information about loan candidates. Selecting and monitoring are peculiar tasks of capital markets, because there is no need for these two efforts in conventional markets where the item goes to the highest bidder.<sup>139</sup> But no efficient capital market can work without a sound banking system as a base, nor the latter can be established in a legislative vacuum, but requires adequate regulatory and supervisory norms. Three processes of reform were called for on the attempt of creating financial structures to support real economy, especially in providing medium and long term capitals. The first demanded reform was the restructuring of the banking system which consisted in solving different main problems: 1) the creation of a double-level system (an autonomous central bank plus other commercial banks); 2) the decision about the mass of unrecoverable *bad loans* conceded to inefficient *socialist firms* and still weighting on old bank liabilities<sup>140</sup>; 3) the strengthening of bank capitalisation and of risk-evaluation and risk-management procedures; 4) the drawing up of a regulation capable of ensuring safety and transparency of financial operations; 5) the building of monitoring and supervising skills and infrastructures with power of enforcing contracts in case of insolvency.

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<sup>137</sup> A confirm of this highly influencing problem comes from the OECD document GD(96)40 stating that: "the most significant market gaps in these transition economies appear to be (1) small amounts of seed or risk capital for start-up and expansion stage businesses, and (2) small loans for working capital and equipment financing", p.36.

<sup>138</sup> See C. CLAGUE "The journey to a market economy", p. 12, R.I. Mc KINNON "Taxation, money and credit", p. 110-112 and J. STIGLITZ "The design of financial systems", p. 170 in "The emergence of market economies in Eastern Europe" edited by C. CLAGUE and G.G. RAUSSER, Blackwell, 1992.

<sup>139</sup> See STIGLITZ, in "The emergence of market economies in Eastern Europe" edited by C. CLAGUE and G.G. RAUSSER, Blackwell, 1992. p.162-164.

<sup>140</sup> "In 1998 non-performing loans still represented 34% of total loans in Romania, while they were 4% in Estonia, 6% in Hungary, 11% in Poland, and 13% in Lithuania." Source: "Transition: the first ten years", WB, 2000, p.46.

Legislative adjustments were demanded too. These included i.e. the drafting of bankruptcy procedures, the compliance with international accounting and auditing standards; the setting up of Credit Information Bureaus as centralised databases registering financial information on enterprises and of mortgage registers<sup>141</sup>; the strengthening of property rights; the adoption of normative schemes to support the issue of credit to SMEs though i.e. appropriate loan guarantee funds; the adequacy of entry requirements for new banks so that they wouldn't be too liberal (undermining public confidence in financial institutions), nor too strict (reducing competition and generating problems of moral hazard and adverse selection)<sup>142</sup>.

Countries embarking in such a structured and complex reform effort had to move with caution especially in facing the problem of how to reduce the market share of formerly state-owned banks and imposing hard budget constraints on bank, as well as on enterprises. Two were the possible options: a) privatising and restructuring the existing institutions (often failed banks with a large inter-bank exposure and loans to loss-making enterprises)<sup>143</sup> and b) opening the market to the entrance of new private institutions satisfying prudential criteria for capital adequacy and management qualifications.<sup>144</sup> This second choice substantially meant opening the door to foreign financial institutions, given the generalised shortage of domestic capitals characterising transition countries, but implied also the positive importing of managerial and supervisory expertise. Most of Central and Eastern European countries, like Bulgaria, Poland, Hungary, former Czechoslovakia and Romania initially opted for the first choice and subdivided the national state-owned *mono-bank* in a various number of autonomous institutions operating exclusively as commercial banks. They were conceded full operativeness on the model of universal banks, but they were never effectively never able to develop an autonomous capacity of allocating and mobilising savings.<sup>145</sup> Only later foreign and domestic intermediaries were allowed to take part to the issuing of credit on the territory through cooperatives or joint-stock companies controlled by local banks; some countries are currently still entrapped in this phase. Most advanced reformer was Hungary while a more gradual path was followed by Poland and the Czech Republic. The first mentioned country sold off almost all of its commercial banks to foreign investors in the early stage of transition, new external owners managed to impose hard budget constraints on borrowers who were strictly screened and supervised.<sup>146</sup> Poland, after transforming the former centrally-led bank into nine autonomous entities, undertook a real privatisation and restructuring

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<sup>141</sup> The importance of a central registry of liens and ownership is great; without such instruments the same asset might be pledged to multiple creditors without their knowledge.

<sup>142</sup> See IMF working paper "Financial development and poverty alleviation : issues and policy implications for developing and transition countries" by P. HOLDEN and V. PROKOPENKO, October 2001, p. 18-28 and VISCONTI (2001), p.244-247.

<sup>143</sup> See "Transition: the first ten years.", WB, 2000, p. xxxi.

<sup>144</sup> See IMF paper (2001), p. 19-21.

<sup>145</sup> See VISCONTI (2001), p.24-25.

<sup>146</sup> See "Transition: the first ten years.", WB, 2000, p. 66.

process in 1993, while the concrete liberalisation of capital-market had to wait until 1999, thus implementing a substantially national system at least till more recent years.<sup>147</sup> Former Czechoslovakia, on its side, maintained for a long time state-owned and unreformed banks which continued to lend to their traditional non-performing borrowers. Besides, in the early '90s many newly born commercial banks in transition countries, enjoying the legislative uncertainty concerning the banking sector, tried to expand through the issuing of highly risky credits which dramatically increased the amount of bad-loans and the mistrust in banking institutions. Very strong was the reaction of Czech Republic and Hungary where an extreme, even excessive prudence characterised the banking system henceforth.

### **1.6.3. What went wrong? Current problems of enterprise financing.**

It was thought that reducing the scope for state-ownership of financial institutions would result in an increase of private credit which has actually not materialised. “[...] domestic credit to the private sector (as a share of GDP) in the transition economies is generally low in comparison with countries with similar per capita income”<sup>148</sup>. But, if the situation is getting better and better in Central European countries and the Baltic States<sup>149</sup> where a growing important part of credit is flowing to new enterprises, South-eastern Europe and the CIS are still far from the world fitted line. According to IMF experts, one reason for the lack of response from the newly privatised banking sector is that “the state divestiture was not effectively accompanied by the development of the institutional foundation for privately owned financial system”<sup>150</sup>. The judgement is further confirmed by WB researchers who various times recommend that “the pace of privatisation should not outrun the development of adequate supervisory authorities”<sup>151</sup>.

Even richer of implications and still partially unresolved is the problem of assessing responsibilities and facing the problem of *bad loans* and soft budget constraints inherited from the previous system but still full of consequences for the present time. First of all, the decision of liquidating even a failed bank, especially if of considerable dimensions as many of formerly state-run institutes, must take into account the implied costs not only on the employment level but also concerning the systemic risk generated by such a closure and the loss of specialised information on the

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<sup>147</sup> More about Polish financial reforms in chapter 4.

<sup>148</sup> From “Transition: the first ten years”, WB, 2000, p.64.

<sup>149</sup> In Estonia, Hungary and Latvia between two-thirds and three-quarters of total private credit is flowing to new enterprises. Source: *ibid.* p. 66.

<sup>150</sup> From IMF paper (2001), p.21.

<sup>151</sup> From “Transition: the first ten years”, WB, 2000, p. xxxi.

reliability of clients<sup>152</sup>. Secondly, the resistance to changing of socialist firms is still a topical issue: the chronic denial of contractual clauses towards creditors and suppliers is still everyday practice, as well as informal pressures by the enterprises themselves or by governmental authorities in order to avoid a collapse in output and unemployment. In such a circumstance banks (but also private suppliers and the entire productive system) cannot but suffer from constant liquidity problems and financial unbalances. They are thus forced not only to depend on lenders of last resort to cover the eventual withdrawal of their deposits, but also to increase the spread between active and passive interests and to privilege the choice of secure investments in state bonds instead of directing their funds to sound enterprises willing to grow. The consequent credit rationing is deleterious in many ways. On the one side it reduces the possibility of new important investments for enterprises, thus decreasing their potential production and profits and their further saving capacity or drives companies to elevate prices of their output. On the other, the shortage of credit makes its interests rise generating adverse selection problems: in order to obtain highly expensive credit, firms have to undertake highly risky investments to get the adequate returns to pay back their debts. The result is a generalised increased propensity to risk even in sound companies and a short-term vision in the conduction of their activities by entrepreneurs. The limited competition and often the geographic allotment of banks, especially in low-density areas, prevents credit-worthy companies to threat to turn to concurrence for their requests and pushes them to accept current prices of credit or to limit their financial requirements.<sup>153</sup> It is not a surprise therefore that banking financing ranked only second place after self-financing, which constituted 39% of enterprise funds in a Polish research referring to the period 1989-94. Sources other than informal financing (through family and friends) and bank-credit are factoring, leasing and financing by formal authorities or venture capitals, but such non-banking institutions are developed only in most advanced reformers while banking institutes are still predominant in other countries.

Besides the already examined constraints, two more are the problems entrepreneurs have to go through while accessing credit: 1) the neat prominence given by banks during the phase of risk-evaluation to collateral availability rather than to the financial soundness of the client enterprise<sup>154</sup>; 2) the high differential in real interests rates applied by banks. In both cases the aim of banks is clear and

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<sup>152</sup> "A decrease in information not only impairs the efficiency with which funds get allocated; it may also lead to more extensive credit rationing, so that the effective cost of capital is greatly increased." Taken from STIGLITZ in "The emergence of market economies in Eastern Europe" edited by C. CLAGUE and G.G. RAUSSER, Blackwell, 1992., p. 167. The same author tries to explain his personal point of view on the resolution of this problem when stating that: "There is perhaps valuable organisational capital which would be lost if the bank were dissolved. One needs a once-and-for-all capital infusion. Without some method of ensuring that such a capital infusion would not be repeated, again incentives would be distorted. From STIGLITZ in "The emergence of market economies in Eastern Europe" edited by C. CLAGUE and G.G. RAUSSER, Blackwell, 1992, p.172.

<sup>153</sup> Reference for the whole sub-paragraph is VISCONTI (2001), p. 205-210 and p. 25-27.

<sup>154</sup> Usually the ratio value of collateral / value of the loan should swing between 1 and 1.5. The analysis of financing granted by the major banks in Poland, Hungary and Czech Republic, indicates that the request for collateral higher than 1.5 times the value of the loan passed from 17% in 1989 to 44% in 1994. Besides, it can be noticed a gradual increase of this ratio for small and medium enterprises in the same period. Source: VISCONTI (2001), p. 248-249.

not easily contestable: they need to safeguard themselves considering the highly risky investments enterprises are going to undertake and the lack of a reliable credit-history and valuable assets.<sup>155</sup> To these considerations must be added a diffuse uncertainty characterising the entire macroeconomic environment, for instance concerning the inflation level or the volatility of foreign direct investments.

Summing up, “among the major problem for SMEs in transition countries (CIT) is securing the initial capital necessary for access of potential entrepreneurs to initial credit so as to start their operations”<sup>156</sup> SMEs have limited access to sources of finance because:

- ✓ lending to small business implies a great risk because of the high degree of uncertainty faced by them (high failure rate, market changes, economic fluctuation, lack of collateral).
- ✓ Commercial and credit banks of CIT have no previous experience in dealing with SMEs since they were accustomed in dealing with large state-owned companies.
- ✓ Administrative costs of lending to SMEs are high and the usual size of loans can be too small to cover these costs.
- ✓ It still survives a diffuse lack of transparency in evaluating loans and lack of skills of financial institutions in dealing with SMEs.
- ✓ Accounting and auditing standards are still underdeveloped and reliable market information and credit histories are still lacking.
- ✓ SMEs are unable to provide the collateral and/or security demanded by lending institutions.

## **1.7. The legal environment and the problem of corruption.**

### **1.7.1. Law drafting, institution building and state-capture.**

The demand for a political and economic system based on the rule of law always recurred in the sporadic protest movements that arose in post-war Eastern Europe, most prominently in the goals of Charter 77 in Czechoslovakia and of Solidarity movement in Poland. And when the time for a non-violent revolution came in 1989, the rule of law was again at the forefront of popular demands. After the early times of collective euphoria, a central element on the reform agenda was the fundamental change in economic laws and institutions. The effort was much more difficult than in developing countries, busy at the same time with the process of law-drafting and institution building, because the legacy of communist past regime was a lacking education in the concepts of private property and in the firmness of law. An instrumental use of law, the laws ignored, the telephone justice, the settlement of

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<sup>155</sup> See VISCONTI (2001), p. 233-234.

<sup>156</sup> From UN-ECE document: “Microcrediting small and medium sized enterprises in countries in transition” by Antal SZABO”, Geneve, 1997.

economic disputes through an administrative process and a myriad of procedural irregularities had demolished in the population any belief in the justice of law.

But the desire for legal and institutional reforms, though strongly felt, revealed itself too demanding, extensive and unable to show its benefits on the short-term and consequently receded in the background<sup>157</sup>. More newsworthy, quick and simple shock therapies, such as privatisation and liberalisation, took the place of the since far longed institution building measures which were consigned to the future consolidation period<sup>158</sup>. Only in the late '90s a real turn-about took place bolstered by the discouraging results of former Soviet Union and the Balkans and their institutionally poor environments affected by low performing state administrations and corruption. It was clear in the end that the building of market-supporting institutions such as efficacious legislation and impartial courts enforcing contracts, protecting property rights, carrying out mortgage agreements, providing for limited liability corporations and facilitating a lasting and widely used capital market, was a crucial requirement of a successful transition, in order to realise all the potential gains from trade and complex-good production.<sup>159</sup>

In spite of the scarce attention paid to the legal reform process, especially in the early '90s, it cannot be denied that during the former and current decades an unprecedented amount of new laws have been drafted in transition countries. The process started with the wave of democratisation which prompted many countries to adopt new constitutions or to amend old texts, to go on with a comprehensive redefinition of the rules governing economic policies providing a platform to launch major programmes of liberalisation, de-regulation and privatisation. A marked change occurred, for example, in the regulation of foreign investments, previously largely hostile and today welcoming the inflow of foreign funds into national markets. Economic reforms were thus primarily focused on the linkages between national economies and world markets, not considering the alteration they were operating upon the basic state and legal systems. Today's agenda is instead much more comprehensive, including areas such as judicial reform, decentralisation, labour standards, equal opportunities, gender equality, land tenure systems, criminal law and the protection of the environment. But "the task that most national governments face today is to ensure that the law they have so effortlessly enacted are rigorously applied, fairly interpreted and, if necessary, promptly amended"<sup>160</sup>. Another important risk is underlined by the same author: "As the agenda of legal reform expands, there is a serious danger that the institutional framework of many states may deteriorate as a result of the large number of reforms that have to be processed over a relatively short period of time. An overcrowded reform agenda makes

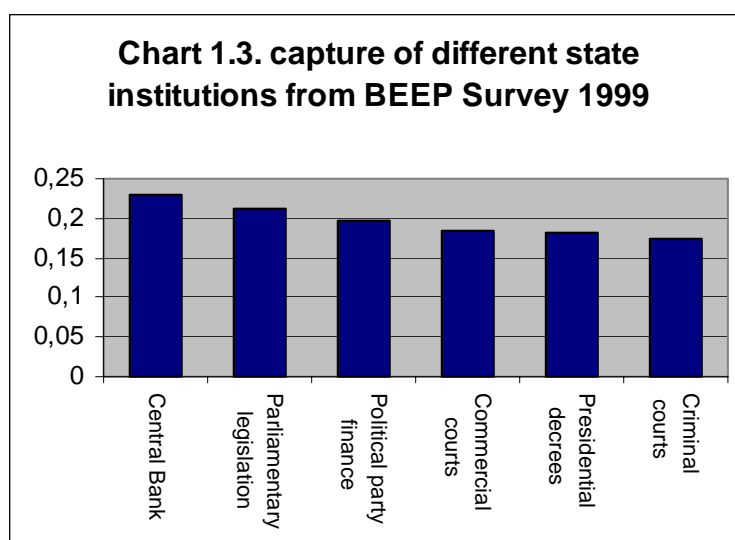
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<sup>157</sup> Reference for this introductory part of the paragraph is CLEMENT C. and MURREL P. "Assessing the value of law in transition economies", P. MURREL Editor, The University of Michigan Press, 2000, p.1-5.

<sup>158</sup> See EBDR, "Transition Report", 1996.

<sup>159</sup> See OLSON M. "The hidden path to a successful economy" in CLAGUE and RAUSSER, 1992, p.65-66.

it difficult for officials in charge of the reform process to spare the time to understand its wider implications.”<sup>161</sup> Furthermore, the processes of lawmaking and institution building cannot but go hand in hand and managers of legal reform projects shouldn’t take a strong institutional framework for granted, as i.e. in the case of Russia.<sup>162</sup> It seems all the same noteworthy that a number of transition countries, notably Hungary and Poland, are quickly adapting their legal and institutional framework, in particular concerning financial legislation, to ensure that they are consistent with European Union directives, while others are engaged in strengthening their supervisory authorities, although the effectiveness of such agencies has yet to be tested<sup>163</sup>. Especially in the Russian Federation and the other former Soviet Union countries imbalances and asymmetries in the reform process<sup>164</sup> have generated a wide range of arbitrage and rent-seeking opportunities for small groups usually closely connected with the government or with existing state-owned sectors.<sup>165</sup> For many decades these enterprises have been characterised by a network of informal relationship and patterns of obligation and reciprocity among management, workers and suppliers, which have persisted and continue to shape their functioning and their connections with formal authorities in non-transparent ways.<sup>166</sup>



*Source: author’s elaboration based on the data of the 1999 BEEP Survey.*

The “state-capture index”, based on the already mentioned 1999 BEEP Survey, is a good proxy measure of such phenomena. The index refers to the efforts of enterprises to influence six institutional components: Central Bank policies, parliamentary legislation, political party finance, Commercial

<sup>160</sup> From FAUNDEZ J. “Legal reforms in developing and transition countries – making haste slowly”, from “Law, Social Justice and Global Development Journal”, 2000, par.2.1.

<sup>161</sup> Ibid. par. 5.1.

<sup>162</sup> ibid. introduction to par. 5.

<sup>163</sup> See the article by KNIGHT M. “Developing and transition countries confront financial globalisation” in the IMF magazine “Finance and Development”, June 1999, vol. 36 n.2.

<sup>164</sup> Such as price and trade liberalisation with continued restrictions on entry, privatisation with soft budget constraints, the rapid creation of banks without a sufficient regulatory framework, the distribution of equity shares without effective laws protecting minority shareholders and so on.

<sup>165</sup> See “Transition: the first ten years”, WB, 2000, p.105.

<sup>166</sup> See WB “Rural environment and social development strategies for the ECA region”, Prague, 2000, p. 34.

Courts, presidential decrees and Criminal Courts. Two are the most evident outcomes from the analysis of the data: 1) “Competitive democracies”<sup>167</sup> (except for Latvia) constitute a group only marginally suffering from state-capture problems, while the average index for “concentrated political regimes”<sup>168</sup> is more than two times higher. “Non-competitive political regimes”<sup>169</sup> register, on the contrary, the lowest state-capture degree. “The concentration of political power appears to be an important determinant of the extent of state capture in transition economies”<sup>170</sup> 2) most captured state components, according to the perception of the interviewed entrepreneurs, seem to be the Central Bank (probably in its power of establishing interest rates and quantity of money in circulation), parliamentary legislation and political party finance. Courts and government appear less corruptible, as confirmed also by a further research by G. Hendrix on Russian courts examining disputes involving foreign companies settled in the country<sup>171</sup>.

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<sup>167</sup> including, according to the WB definition, Slovenia, Hungary, Estonia, Lithuania, Czech Republic, Poland and Latvia.

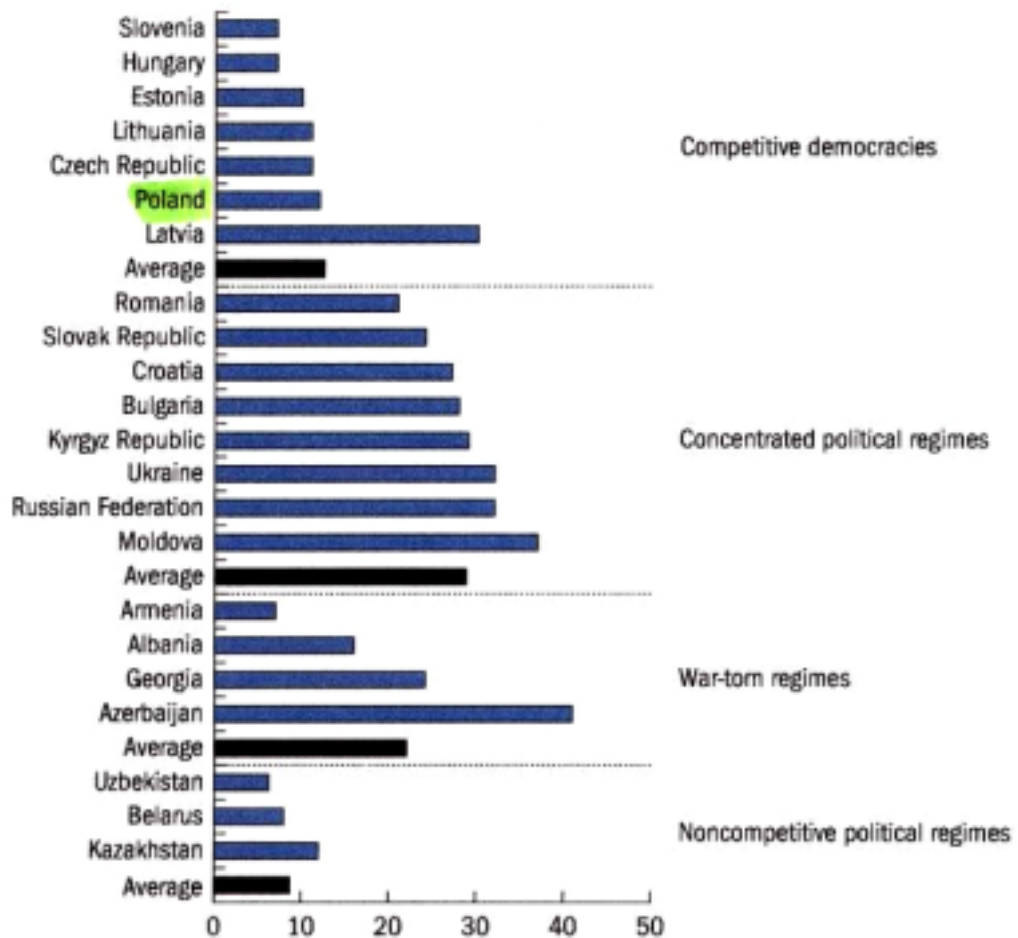
<sup>168</sup> Including, according to the WB definition, Romania, Slovak Republic, Croatia, Bulgaria, Kyrgyz Republic, Ukraine, Russian Federation and Moldova.

<sup>169</sup> Including, according to the WB definition, Uzbekistan, Belarus and Kazakhstan.

<sup>170</sup> From HELLMAN, JOEL and KAUFMANN (2000) “Seize the State, seize the day: state capture, corruption and influence in transition”, Policy Research Working Paper n. 2444, WB, 2000.

<sup>171</sup> The reference is to HENDRIX G. in “Assessing the value of law in transition economies”, P. MURREL Editor, The University of Michigan Press, 2000.

### State Capture Index, 1999



Source: "Transition: the first ten years", WB, 2000, p.106.

As a conclusion, transitional economies appear to be over-regulated and under-regulated at the same time: the over-regulation in some administrative areas is a result of large, inefficient and often corrupted bureaucracies trying to defend their *raison d'être* in the new system and of the effectiveness of many old legal provisions granting broad and intrusive powers to the state<sup>172</sup>; on the other side, the under-regulation, notably in the financial market, does not help to get the confidence of investors and to promote enterprise growth.

#### 1.7.2. Informal economy and corruption.

Unofficial economy is not only a matter of acting against the law in itself, but it impedes a correct economic growth for at least three reasons: 1<sup>st</sup> underreporting output reduces government tax revenues and consequently state capacity of providing useful public goods for the entire society such as an efficient legal system; 2<sup>nd</sup> doing business "underground" generates distortions because some resources must be used to avoid detection and punishment; 3<sup>rd</sup> firms operating illegally cannot make

<sup>172</sup> See FUNK T. and LYMAN T.R. "The legal and regulatory environment for microfinance in CEE and the NIS" DocX971,2000, p.15.

use of market-supporting institutions, such as commercial courts, and might invest too little because of the persistent uncertainty in their activities. Four are instead the main factors which push firms into informal business: a) high statutory tax rates and onerous official regulations; b) predatory behaviour by government officials (but the direction of causation is not so clear: is it bribe-seeking by officials causing hiding or hiding causing bribes?); c) extortion by “mafia” or criminal bands in general (once again the causality can be reversed: on the one side firms might try to conceal their activities both from authorities and from criminal groups, but on the other rackets might prey more on firms that hide than on regularly reporting companies); d) the lack of benefits and public services offered by a state of legality. This last point has to do with the opportunity costs of hiding and must be better explained. The costs of operating underground are manifold: firms cannot appeal to courts to enforce their contracts; they have to deal with a restricted set of trading partners accepting their condition of illegality; it might be also more difficult to raise equity capital or to borrow from a bank. Consequently “firms are more likely to hide output if the economy has underdeveloped market-supporting institutions”<sup>173</sup>.

As a result of the above considerations is not surprising to find out that the size of unofficial economy considerably differs between Eastern European countries and former Soviet Union ones. This statement is confirmed by all most common research methods (household surveys, electricity consumption, direct interviews to entrepreneurs), though the width of the phenomenon might differ according to the different data. For the sake of simplicity, only two researches based on two different methods will be considered: the first relies on electricity consumption data and, though carried out in 1997, can furnish data only through 1995<sup>174</sup>; the second is a survey conveying firm-level data undertaken in the same year in Russia, Ukraine, Poland, Slovakia and Romania on about 300 manufacturing firms for each country<sup>175</sup>.

The first work gives an idea of the magnitude of underreported output, but without investigating the causes. Its results show how the average share of unofficial economy in CEE (Central and Eastern Europe) countries starts at 16.8% of GDP in 1989, to reach a peak of 21.3% in 1992 and fall back again at 19% of GDP in 1995, with the Slovak Republic as best-performing country (only 5.8%). On the contrary, data concerning FSU countries tend to rise more consistently, starting from a share of 12% in 1989 and ending up with a percentage of 34.3% of GDP in 1995, with tremendous peaks around 60% in Azerbaijan and Georgia.

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<sup>173</sup> Reasons and costs of informal activities have been found in JOHNSON S, KAUFMANN D, McMILLAN J, WOODRUFF C. “Why do firms hide? Bribes and unofficial activities after communism” in the *Journal of Public Economics* 76 (2000) p. 495-520. In particular, the reported quotation is on page 501. Furthermore: “[...] countries with inefficient regulatory environments and a great deal of corruption have unofficial activity in excess of 40% of GDP (Schneider and Enste, 1998; S. Johnson, Kaufmann and Zoido-Lobaton, 1998; Friedman et al., 1999)”, p. 496.

<sup>174</sup> The reference is to JOHNSON, KAUFMANN and SCHLEIFER “The unofficial economy in transition” (1997) as reported in JOHNSON and KAUFMANN “Institutions and the underground economy” in “A decade of transition: achievements and challenges”, edited by O. Havrylyshyn and S.M. Nsouli, IMF, (2001).

**Table 1.9. Share of the unofficial economy as a % of GDP (based on electricity consumption).**

<b>Country</b>	<b>1989</b>	<b>1992</b>	<b>1995</b>
<b>Eastern Europe</b>	<b>16.8</b>	<b>21.3</b>	<b>19</b>
Bulgaria	22.8	25.0	36.2
Czech Republic	6.0	16.9	11.3
Hungary	27.0	30.6	29.0
Poland	15.7	19.7	12.6
Romania	23.3	18.0	19.1
Slovak Republic	6.0	17.6	5.8
<b>Former Soviet Union</b>	<b>12.0</b>	<b>31.2</b>	<b>34.3</b>
Azerbaijan	12.0	39.2	60.6
Belarus	12.0	13.2	19.3
Estonia	12.0	25.4	11.8
Georgia	12.0	52.3	62.6
Kazakhstan	12.0	24.9	34.3
Latria	12.0	34.3	35.3
Lithuania	12.0	39.2	21.6
Moldova	12.0	37.3	35.7
Russia	12.0	32.8	41.6
Ukraine	12.0	33.6	48.9
Uzbekistan	12.0	11.7	6.5

Source: JOHNSON, KAUFMANN, SCHLEIFER "The unofficial economy in transition", 1997.

The second survey by Johnson et al. shows not only the extent of underreported sales and salaries (around 40% for Ukraine and over 26% for Russia), but also the main determinants for these results which are the ones presented at the beginning of the paragraph. Managers in Russia and Ukraine (but the result is likely to be similar for other CIS countries), having to face worse bureaucratic corruption, more Mafia extortion, higher taxes and less effective court system and financial institutions, are the ones hiding more of their output and hiring more workers underground.

**Table 1.10. The extent of unofficial economy and its causes (1997).**

	<b>Poland</b>	<b>Slovakia</b>	<b>Romania</b>	<b>Russia</b>	<b>Ukraine</b>
<i>Total firms in sample</i>	303	308	321	269	270
<i>% of sales not reported</i>	5.4	7.4	5.7	28.9	<b>41.2</b>
<i>% of salaries not reported</i>	8.6	7.6	7.6	26.1	<b>37.9</b>
<i>Total regular payments to government as % of sales</i>	19.4	20.2	22.0	29.9	<b>31.4</b>
<i>% who think firms make extra-legal payments for government services</i>	20.0	38.0	20.0	<b>91.0</b>	87.0
<i>% of firms saying that firms pay for "protection"</i>	8.0	14.9	0.6	<b>92.9</b>	88.8

<sup>175</sup> The reference is to JOHNSON S, KAUFMANN D, McMILLAN J and WOODRUFF C (1997) as reported in "Why do firms hide? Bribes and unofficial activities after communism".

% saying <b>courts</b> can be used to enforce an agreement	72.9	67.9	86.9	58.4	<b>54.7</b>
% of firms which received <b>credit</b> in 1996	48.8	27.6	24.1	17.0	<b>13.8</b>

Source: author's elaboration based on S. JOHNSON et al. / *Journal of Public Economics* 76 (2000), p.498, 502-503.

