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**PRIVATIZATION OF THE POLISH ECONOMY AFTER 1989:
OBSTACLES TO FINANCING
THE EMERGING SMALL AND MEDIUM-SIZED ENTERPRISE SECTOR**

by

AMELY A. JURGENLIEMK, B.A.

**A thesis submitted to
the Faculty of Graduate Studies and Research
in partial fulfilment of
the requirements for the degree of
Master of Arts
Norman Paterson School of International Affairs**

**Carleton University
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Maureen Appel Molot

Maureen Appel Molot, Director
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R. Carson

Professor R. Carson, Supervisor

ABSTRACT

Since 1989, private small and medium-sized enterprises (SMEs) have emerged in great numbers in Poland. In transition economies, incomplete financial markets and institutions hamper enterprises' access to investment capital, which impedes privatization and growth of the SME sector. This is identified as a barrier to entry and development.

Attitudes of bankers and entrepreneurs have been conditioned by economic hardship and regulatory uncertainty. Therefore, banks ration credit by demanding higher levels of interest and collateral than would be possible in competitive financial markets. Most entrepreneurs cannot borrow under these conditions. Efforts to overcome these barriers include grant, credit and equity provisions, and loan guarantee funds. Both financial institutions and small businesses need to be supported during the transition period, and it is proposed that public-private collaboration to allocate credit and investment funds would be advantageous.

This thesis is dedicated, with love, to my mother, Gertrud Antoine Barwick, whose strength is a constant inspiration to me, and to the memory of my father, Albert Jurgenliemk.

I gratefully acknowledge the contributions of the many individuals who assisted me, and those on whose scholarship I relied, in the course of this project. Especially, my thanks go to Alicja Wielgus without whose generosity this thesis might never have been completed.

I have noticed that taking on unnecessary work for myself brings out the best in the people dearest to me. To my mother, my brothers, Mike and John, my son, Daniel, to Roberts, to Marie-Andrée, and others unnamed, I owe my deepest thanks.

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LIST OF ABBREVIATIONS

CPE	centrally-planned economy
CSFR	Czech and Slovak Federal Republic
EBO	employee buy-out
IEC	inter-enterprise credit
LDC	less-developed country
LGF	loan guarantee fund
MBO	management buy-out
MF	Minister of Finance
MIT	Minister of Industry and Trade
NMP	net material product
POE	privately-owned enterprise
SME	small or medium sized enterprise
SOE	state-owned enterprise
CEEC	central and eastern European countries

Organizations

CUP	Central Planning Office
EBRD	European Bank for Reconstruction and Development
GEMINI	Growth and Equity through Microenterprise Investments and Institutions
GUS	Central Statistical Office
IFC	International Finance Corporation
IMF	International Monetary Fund
NBP	National Bank of Poland (the central bank)
PAIZ	Polish Agency for Foreign Investment
PARD	Polish Agency for Regional Development (PARR, <i>Polska Agencja Rozwoju Regionalnego</i>)
PHARE	Programme of EU assistance to countries of eastern and central Europe
RDA	Regional Development Agency(ies)
WSE	Warsaw Stock Exchange

Currency

CDN	Canadian dollar
ECU	European Currency Unit (1 ECU = 1.25 USD = 2 PLN)
PLN	new Polish zloty (from 1 January 1995, 1 PLN = 10,000 PLZ)
PLZ	old Polish zloty (to 1 January 1995)
MECU	million ECU
USD	American dollar (1 USD = 2.49 PLN)

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INTRODUCTION

Thesis subject

This thesis presents the findings of an inquiry into the conditions facing Polish entrepreneurs in their search for financial resources, borrowed or invested funds, to start or expand small businesses. It was undertaken to test the hypothesis that the underdevelopment of markets for financial services and resources has been a significant impediment to growth in the small and medium-sized enterprise (SME) sector. In effect, this investigation has focussed on a deficiency of credit markets, an important instance of market failure, in a country whose economy is still very much a hybrid of capitalist ambitions and communist inheritance.

The thesis casts some light on the challenge of building a durable sector of competitive SMEs in Poland. To a great extent, its findings will apply to other post-socialist countries which have undertaken to develop market economies; many of the special financial constraints faced by entrepreneurs in these countries can be linked to shortage of domestic capital, the absence of a financial services industry, outdated legal and regulatory systems, weak corporate record-keeping, and the absence of established relationships between entrepreneurs and banks.

Profound changes throughout the CEECs have exposed, as obstacles to "marketization", the majority of institutions, attitudes and organizational structures inherited from the communist period. These have been a major impediment to effective allocation of financial and material resources and, therefore, to investment. Throughout the world SMEs are relatively disadvantaged bidders for investment capital and in eastern Europe the problems normally faced by small businesses are magnified.

The thesis will show that prevailing legal and institutional conditions hamper both banks and business people from mobilizing financial resources. Also, that

inexperience, scarcity, and generalized economic uncertainty, have made creditors, investors, and borrowers, prudent. In consequence, credit rationing is imposing a powerful barrier to entry for cash-poor entrepreneurs, and forecloses many opportunities for the growth and consolidation of the Polish SME sector.

Importance of the subject

The contributions of SMEs are of broad economic and social consequence which, for the purposes of the present study, must be looked at in two ways. First, from a macroeconomic perspective, economic policies aim to exploit small companies' adroitness in stimulating and supporting economic growth and diversification, employment, and technical innovation. And in varying degrees, governments favour SME' initiatives because they have historically been a source of social stability and cohesion. Secondly, from the perspective of the individual, the right and potential to create wealth, and to make one's own decisions about how to invest and what to consume, exemplify the "pure" meaning of capitalism. Without embarking on a theoretical analysis about the relationship between political and economic freedoms, it can be stated that small businesses are perceived to democratize the economy.

Systemic economic conditions dictate the "comparative degrees of freedom of decision" (Kurczewski 1975) available to society's economic actors, and define the margins which include or exclude sectors of society from the processes and the decisions constituting economic life. Since 1989, citizens of the countries of central and eastern Europe (CEECs) have been expected to make a wider range of decisions; certainly they have been exposed to raw economic facts, to uncertainty, and to risk, in marked contrast to their experience of previous decades. This thesis explores efforts being made to equip Polish citizens with the basic tools to undertake economic activity in the realm of small business. The Polish state's ability to promote productivity at that level is especially important in present conditions of high unemployment and extreme regional

disparities. Concluding that both economic and social conditions necessitate the articulation and practice of clear positions regarding SMEs, the paper highlights obstacles encountered in Poland's stewardship of that sector.

The thesis' point of departure

In Poland, the Balcerowicz stabilization plan of 1990 simultaneously introduced positive real interest rates, dropped most trade barriers and sharply devalued the domestic currency, the *zloty*. The profits of state banks soared briefly and, to escape the rigours of commercial credit, enterprises redoubled their collaboration in a parallel system of inter-enterprise credit (IEC). Subsequently, in the early 1990s, prospects for new businesses were soured when massive loan defaults by large state-owned enterprises (SOEs) and rapid-fire failures of new private businesses caused severe bank losses. Both the major state-owned banks and new, smaller banks were hurt. In 1993, Poland imposed the Financial Restructuring Act, a dramatic measure which placed the onus on banks to clear their portfolios of non-performing loans, and to enforce financial discipline on debtor enterprises and in their own affairs. The banking system in transition has faced adverse conditions, made up both of historic disadvantages and new challenges, which have created disincentives to lend to the private SME sector. Private entrepreneurs are hampered by inexperience, and the consequent vacuum of records and reputation has not inspired lender confidence. These conditions compound commercial banks' well-known reticence toward small business lending.

Also in 1993, Poland's industrial policy asserted that "the construction of a modern structure of industry requires the development of private, cooperative and other SMEs which provide services to industry and work for the needs of local markets." To compensate for the "weakness of the financial and credit infrastructure, SMEs require special protection on the part of national and local government."¹ At the time,

¹ Industrial Policy Objectives, Ministry of Industry and Trade, 1993, 5-6.

establishment of an agency dedicated to SME development was envisaged, as was consolidation by agency shareholders of a credit guarantee fund for SME projects. The Polish government made a commitment to helping emerging private SMEs in June 1995 when the Policy toward SMEs was adopted, and in September the Polish Foundation for the Development of SMEs was inaugurated.

State attention to the needs of the small business sector has produced a variety of initiatives, mostly through the Ministry of Industry and Trade (MIT) where a Department of Small and Medium-Sized Enterprises has been established. The MIT programme for the implementation of SME policy sets out a series of obligations which primarily involve the Ministry of Finance, the Ministry of Justice, the provinces (*voivods*), and the MIT itself. The policy pledges budget resources to the support of fledgling private companies, especially in the form of loan guarantees, and promises the government will continue to explore more innovative and effective ways of satisfying policy objectives.

These comments describe only a limited aspect of an immensely complex process of economic, political and social transformation which is occurring in Poland, in the Balkan and Baltic states, in the newly independent states of the former Soviet Union, and everywhere throughout the CEECs. In 1989, a unique convergence of events launched the reintegration with Europe of the CEECs which were designated the "Soviet Bloc" when the Allies divided the spoils of World War 2. What these countries have in common is that for roughly forty years their domestic production served the command economy of the Soviet Union. How each one has approached the transformation of administrative systems of resource allocation into competitive market systems has been determined in large part by its particular level of international debt, the composition of economic output and the degree of trade openness, the availability of domestic savings and other investment capital, including the quality of the productive infrastructure. The

level of education and technological proficiency of its citizens, popular sentiment, and political will have also been important factors.

Privatization has been a central pillar of adjustment strategies throughout the region, and most often has been purposefully divided into two distinct streams comprising privatization of large state-owned enterprises (SOEs) and privatization by liquidation or leasing of component parts and smaller SOEs. In Poland, the dynamic, spontaneous emergence of new privately-owned SMEs was not a product of privatization efforts. A range of investment assistance programmes delivered by multilateral organizations has played an important role in microeconomic adjustment in Poland, by furnishing training for bank and business personnel, advising on legal and institutional reform, and developing loan guarantee provisions to mitigate banks' lending risks. To prevent over-reliance on foreign direction and loans, these should ultimately be supplanted by self-directed programmes financed with domestic investment capital.

Structure of the thesis

The thesis is divided into five parts. The first familiarizes the reader with the environment for private sector production in the 1980s, and the second develops a foundation of knowledge about the adaptations of the Polish economy to the process of marketization. Part III studies SME policy, examines the particular financial disadvantages of SMEs and offers a diagnosis of conditions contributing to them. Part IV presents a summary and evaluation of financial assistance measures presently in force in Poland, and in Part V alternative approaches are explored.

Part I begins with a succinct history of the private sector in Poland during the 1980s, and the evolution from centralized command toward decentralized administrative control of production. This is followed by discussion of the role and objectives of privatization and a summary of the primary institutional adjustments made by successive Polish governments since 1989. Because privatization is merely one

component of generalized economic transformation strategies, Part II summarizes the theoretical approaches to sequence and timing of the main features of the CEECs' transition paths. The actual progression and incidence of privatization measures in Poland are situated in that context.

It is well known that Poland's "big bang" economic programme front-loaded radical stabilization measures, primarily to arrest inflation which had caused consumer prices to rise by 585% from 1989 to 1990.² It will be shown that the adaptation of legal and financial institutions to support private enterprise lagged substantially behind measures which introduced foreign competition and market pricing. Obstacles to smoothly operating credit markets inhering in the existing legal system and infrastructural foundation are elaborated. It is intended that this discussion will enable the reader to appreciate that Polish banks and private enterprises were compelled to assume commercially-oriented relationships in an ill-suited and sometimes antagonistic regulatory environment.

The following section of the thesis focuses on Polish efforts to assist SMEs in overcoming conditions which impede access to financial credits, and situates the problem in the context of Poland's prospective membership in the European Community (E.C.) The generic rationale for government intervention on the part of SMEs is discussed. Distinct or amplified needs of SMEs are presented as justification for active assistance policies in the CEECs. For small enterprises, complementing own with outside capital generally means borrowing -- assuming and creating debt. For especially promising companies, investment capital may be available. In Part IV, available instruments of financial assistance to SMEs in Poland, including direct grants, credit lines, equity provisions and loan guarantees, are examined. The current emphasis, in Polish public policy, on loan guarantees is evaluated and questions are raised about the

appropriateness of using loan guarantees as a primary instrument to increase the flow of loaned capital to SMEs.

Extrapolating from the presumption that guarantees are unlikely to satisfy the expectations set out in SME policy, the final part of the thesis concludes that the government should take a more direct approach to ensuring investment capital is effectively channelled into sound business projects (that is, within the parameters of available financial resources).

The concept of public-private collaboration is explored, based on the belief that the present value of public investment can be outstripped by future returns. One existing model is explored in some depth, that of the German savings banks, the *Sparkassen*, in which active, direct shareholding by regional or local government authorities introduces public policy considerations into the banks' lending decisions. Other alternatives to a *laissez-faire* approach are discussed briefly. This line of thinking is based on five factors: (i) the perception that the firm reluctance of commercial banks to lend to small businesses is rational in present conditions; (ii) the perception that entrepreneurs' wariness of assuming debt is also rational; (iii) the shortage of own-capital and the slowness of Poland's privatization programme in realizing its distributional objectives; (iv) the belief that a dynamic programme of financial support is necessary to ensure SMEs survive and grow, and can continue to lead the progressive privatization of the Polish economy; and (v) time-constraints arising from reliance on lending and technical assistance of multilateral organizations.

Contribution to knowledge

This thesis' contribution to knowledge in the field of the post-socialist transition economies is constituted in its narrow attention to the SME sector, and the consequences of sequencing and timing decisions regarding institutional reform, especially development of financial intermediation capabilities. It also exposes the difficulties that

transition policies must surmount in accommodating the pressing and legitimately divergent goals of distinct constituencies. The paper suggests such policies should not favour one group's successes over another's.

Recognizing that Poland's national interest embraces the prosperity of banks and businesses, the writer argues that Poland's policy-makers must look harder for ways to finance SME growth without undermining the health of the emerging banking sector or ghettoizing the SME sector. The present situation demonstrates that the risk aversion of banks, in the absence of competition among complementary and substitutable financial services and institutions, is incompatible with the wants of cash-poor entrepreneurs. Risk is inherent in capitalism; during the transition period, SMEs are important but vulnerable contenders whose endurance may depend on the active collaboration of a stronger partner. By studying the methods of SME financing presently in use or which have been proposed, the writer reaches the conclusion that alternate solutions should be explored which temporarily introduce a degree of separation between banks and small businesses, by activating both market and non-market criteria, techniques and resources.

Limitations of methodology

The present text is based on information gathered from a range of sources. Statistical data come from Poland's Central Planning Office (CUP) and Central Statistical Office (GUS), the central bank (National Bank of Poland, NBP) and the Polish Development Bank (PBR), as well as publications of the Ministries of Industry and Trade, of Finance, and of Privatization. The thesis also relies heavily on the scholarly research both of distinguished and less-known students of the transition economies, and of societal change. The various experiences of many countries' financial and small business sectors are considered. Periodicals and international newspapers have also made a significant contribution to the writer's appreciation of a subject so young and dynamic that one cannot afford to "close the book" on new material. Thus,

there are many imperfections and gaps in this exploratory work, many of which arise from the writer's limitations. However, it should be noted that the actual level of bank credit (from commercial banks and the central bank) to the private sector, and more particularly to private SMEs, is not available through any primary sources. These credit flows, the NBP records as balance sheet assets designated "due from the non-financial sector" comprising "personal" and "corporate" debts. Allocations to the private sector have, for limited blocks of time, been calculated by the World Bank and the IMF, whose results are shown in the Appendices to this text. A final cautionary note regarding distinctions between the "personal" and "corporate" sectors would advise that a portion of small business borrowing is certainly composed of personal loans. At present, empirical evidence on the operations of the financial sectors in the CEECs is weak (See Griffith-Jones and Drabek 1995).

A precise knowledge of Poland's SME population is also hard to acquire. The Central Statistical Office (GUS) has adopted the term "*small biznesie*" to describe private companies having fewer than fifty employees. These statistics are complicated by the fact that, among SME owners, 30% are known to draw salaries from regular employment elsewhere. One reads that more than two million SMEs have been created in Poland since 1989, but the number of operative SMEs cannot be established because while registrations are recorded by the courts, company closures are not. One must also keep in mind that aggregated data on firm size account exclusively for the taxed activity of registered firms. With regard to financial data, it has been said that only 58% of all companies comply with legal requirements to disclose it.³ One must allow that compilation of the immense quantity of data which describes the economic and financial activity of the state will take time. In the interim, too much weight should not be given

³ Beata Szumniak, Director of Dun & Bradstreet's Poland Office, cited in Warsaw Voice, 31 December 1995.

to statistical renderings of the state of the corporate sector.

*A SNAPSHOT: Poland's economic status and the SME sector*⁴

Poland is a country of about 38.6 million people. Since 1994, her rapid economic growth has been widely regarded as having "the makings of an economic miracle".⁵ In 1994, Poland was the only CEEC to achieve a positive change in the real rate of growth of gross domestic product (GDP) per capita, as compared with 1985.⁶ And, in 1995, a 6.5% increase in GDP⁷ established Poland as the fastest growing economy in Europe. The private sector now employs 61% of the total work force and produces 39% of the country's industrial output.⁸ Although it remains less profitable than the state-owned sector, the private sector's share of total investment in the economy had grown from 21% in 1992 to 38% in the first half of 1995. In that year, 56.6% of private sector investment was in manufacturing.⁹

A snapshot of the current SME population would look like this: Small and medium sized firms account for 98% of all companies; 90% of companies have fewer than fifty employees, 8% have between fifty and five hundred.¹⁰ Of these companies, 75% employ only the single proprietor or co-owners, with the possible addition of family members.

The number of SMEs began to increase rapidly in 1989, and the rate of growth

⁴ See Table 1 for basic economic indicators for Poland.

⁵ D. Mario Nuti, cited in "Strategy for Poland", printed as a special supplement to the Warsaw Voice, 4 February 1996.

⁶ The real rate of Poland's growth of GNP per capita for the period 1985 to 1994 was 0.9%, as shown in The World Bank Atlas 1996.

⁷ Poland Now, March 1996, 1.

⁸ Ibid.

⁹ Net profit margins for January to September 1995 were 2.21% in the private sector, compared with 2.91% in the public sector. See Tables 2 and 3 for the size of the private sector contribution.

¹⁰ Wprost, 24 March 1996, citing Ministry of Finance figures.

slowed after 1992. The size of the SME population stabilized in 1994-1995, but the velocity of change remained high with SMEs being established at a rate of 20,000 to 30,000 monthly, and closing at a rate of 10,000 to 25,000 monthly. GUS states that twenty percent of Poland's small firms are located in two major cities, Warsaw and Katowice, each having about 100,000.¹¹ It is estimated that one half of SMEs operate in the retail or wholesale trades, and ninety percent are financed with their own resources. In 1995, 4.3% of small firms graduated to medium-size, compared to 3.0% in 1994.

PART I

A. BACKGROUND TO PRIVATIZATION: HISTORY OF THE PRIVATE SECTOR

To understand the role of privatization in the economic transformation which began in 1989, one has to appreciate that Poland already had an active private sector. A representative account of private sector activity would emphasize farming which, in Poland, was not thoroughly collectivized.¹² The scope of this paper, however, excludes agriculture.

At the conclusion of WW2, a tripartite economy of private, state and cooperative sectors was envisaged by the coalition of socialist and communist forces. Until February 1948 when Stalin's system was imposed, some laxity was demonstrated toward the private sector which, in 1946 and 1947, produced 65% to 70% of Poland's net material product (NMP). Subsequently, a massive campaign to expropriate large properties was launched and complete eradication of the private sector by liquidation, confiscation or merger with cooperatives, was decreed. Only in agriculture and small family businesses did the private sector largely succeed in resisting nationalization. Capture of small-scale operations by the State was largely discretionary, based on political decisions and executed without recourse to legal proceedings. This informal nationalization was largely complete by the mid-1960s (Grabowski 1992, 178).

The state's disposition regarding the private sector was capricious for the next twenty years. As early as 1956, there were serious efforts to improve the effectiveness of the command economy in both Poland and Hungary. In Poland, the authors of a 1957 set of economic theses perceived that marrying the principle of centralized production planning with decentralized management would yield economic advantages;

¹² Wladyslaw Gomulka became First Party Secretary in 1956. His opposition to forced collectivization arrested the nationalization of private farms.

those theses put forward the broad strokes of such a marriage.¹³ The 1957 paper recognized that the "centre" could never have sufficient information at hand to plan microeconomic activities capably. It argued that, to compensate for this deficiency, authority and responsibility for enterprise management ought to devolve to on-site managers who could be motivated, by appropriate incentives, to maximize the utility of state resources. No role was identified for a price system or the market. The only enduring aspect of this project was a decision to end the collectivization of agriculture, in which Poland's private producers comprised the largest non-state sector in Eastern Europe throughout the communist era.

This thesis does not examine the communist period in detail, but a summary compiled by Aslund illustrates the inconstancy of the environment for private entrepreneurs: 1956 and 57 were years of dynamic liberalization; 1958 to 1964 were restrictive; a period of cautious liberalization began in 1965 and ended with an attack on the private sector in 1968; haphazard policies prevailed until the state sector faced serious financial difficulty in 1976. Then, the state, under Prime Minister Edward Gierek, began to look to the productive capacity of the private sector for help and permitted creation of unincorporated firms (the "Polonian" companies) owned by persons resident outside Poland. Statistics indicate that in 1980, at the end of Gierek's administration, 350,000 non-agricultural private enterprises (mostly providers of consumer services) employed about 600,000 people and contributed 3% to GNP (Grabowski 1992, 178).¹⁴

Throughout the eighties, the intensifying economic problems created opportunities for the development of private firms. On average, private sector

¹³ The reform paper was commissioned by Prime Minister Gomułka and prepared under the leadership of Oskar Lange.

¹⁴ The author uses GNP, probably as a substitute for net material product (NMP). Most statistics are believed to understate the size of the private sector, due to underreporting of profits and omission of the shadow economy.

production grew 2.7% annually, while public sector production decreased at an annual rate of about 0.2%. The rate of private sector growth accelerated markedly after 1986 until it reached 30.4% in 1989.

By the end of the decade, private sector production accounted for 19.2% of gross NMP, of which one-half originated in farming. The share of private sector non-agricultural production in NMP had almost doubled in ten years, even taking into account declining output over the period 1980 to 1982. Over the same period, employment in that sector almost tripled, while public sector non-agricultural employment decreased 7.2% (Breitkopf 1991, 80).¹⁵ After 1982, most private sector investment shifted to non-agricultural production.

All indices showing the relative importance of private to public sector economic activity rose in the 1980s, but the fundamental relations of production or composition of aggregate output had changed little. In spite of the high rate of growth of the private sector, private non-agricultural producers' total share in NMP had increased by only 4.0%. "Extrapolating the trends in the respective growth rates of the public and private sectors in the years 1985-89, it turns out that the private sector would attain a majority share in the formation of national income in over fifty years' time."¹⁶

The Giersek administration devised a programme for reform of central planning; the plan was to extend managerial autonomy to the firm level, while constraining it by application of a series of economic indices to quantify and rationalize production. Giersek, however, is remembered more for his pursuit of an ambitious economic modernization strategy which was financed by extensive borrowing from international creditors. The scale of debts incurred under his consumption-led growth programme

¹⁵ See Table 5 for growth of the private sector during the 1980s.

¹⁶ Ibid., 20.

contributed to Poland's virtual economic collapse over the years 1979 to 1982, when the country could not raise sufficient foreign exchange even to service the debt. During that period industrial output fell by about 25%. "The economy was effectively developing with neither central accounting nor central five-year plans, since those plans that did exist were not in practice binding upon anyone at all" (Gomulka and Polonsky 1990, 124).

Economic hardship followed these reform efforts. Announced food price increases in 1976 and 1980 provoked intensive labour strikes and demonstrations, from which the Solidarity labour union emerged as the unchallenged popular leader.¹⁷ Concerted civil resistance and the escalation of strikes at the national level resulted in the imposition of martial law by Prime Minister General Wojciech Jaruzelski in December 1981.

Enterprise reform in the 1980s

A reform programme introduced by the Sejm on 25 September 1981 formulated a new set of operational relationships for the administration and management of SOEs. The new programme was based on implementation of a set of indirect administrative controls to replace compulsory production targets with directives for self-management by labour; this development marked the introduction of Workers' Councils, elected bodies representative of a firms' workers, into the management of SOEs. Three main bills were adopted to establish this new system: the State Enterprises Act defined SOEs as "autonomous, self-managed and self-financing units, possessing personality at law"; the State Enterprise Workers' Self-Management Act established a firm's labour force, by

¹⁷ Solidarity was suppressed by martial law under Jaruzelski in 1981, but emerged again in 1989 when its leaders, notably the current President Lech Walesa, were released from prison to participate in the Round Table discussions.

means of the Workers' Council, as a "collective entrepreneur";¹⁸ and the State Enterprise Finances Act.¹⁹

Additional steps were taken to reduce the role of central planning. For example, firms producing consumer goods were allowed considerable freedom in making production decisions, and the planning process was "socialized" to engage the participation of parliament and the Council of Ministers, among others. The early eighties have been tagged a period of "compromised central control" in which managerial latitude was extended without any corresponding financial responsibility (Jorgenson, Gelb, and Singh 1990). During succeeding years, domestic output continued to fall. In 1982, a law permitting operation of non-state cooperatives was passed and private ownership of banks was introduced. From 1985, Poles were able to incorporate firms under commercial law; on average these companies had workforces of fourteen people, more than were typically employed by unincorporated firms. Adoption in 1986 of the Law on Foreign Investment permitted establishment of incorporated firms with foreign capital participation, and permits were granted liberally for new joint ventures. State-owned enterprises were the source both of the small companies' primary clientele and valued connections which supplied rare inputs, goods and services. According to Grabowski (1992, 179):

... SMEs were functioning within the framework of the centrally-planned economy, which was undergoing incremental and experimental modifications. The eventual outcome of this period of structural uncertainty was the growing role of informal relations replacing more structured interactions, and the emergence at the end of the 1980s of a limited market economy in certain sectors. . . These informal relations did not resemble those functioning in the developed market economies where they are treated as an indication of a businessman's credibility. . . . This interplay of favoured access and opportunities is a predominant feature of the private sector in the 1980s.

¹⁸ This expression is from Breitkopf, 1991, p.11.

¹⁹ Although the powers of the Workers' Councils were suspended under martial law from 1982 to 1985, they were reinstalled thereafter.

Thus the private sector was growing in the absence of market competition.²⁰

From 1987 to 1989, the role of central planning was further reduced. In 1987 the State Enterprise Act was amended to permit the State to enter into joint ventures with other bodies, including natural persons.²¹ Centralized allocation of inputs was reduced to only five commodity groups. Many producers were free to set their own prices, and prices of agricultural goods were freed from control. Since agriculture accounted for twenty percent of the national product, with deregulation of agricultural prices, fully fifty percent of the national economy was subject to market pricing. The 1988 adoption of the Law on Economic Activity established the economic equality of persons, natural and legal, giving legitimacy to economic activities undertaken by private entrepreneurs. For many types of activity, registration replaced previous requirements for possession of a licence or permit.

Although developments during the 1980s favoured private sector growth over public, rigid conditions continued to be imposed on private firms. These included application for very specific and detailed business permits²², restricted access to inputs and credit, and fiscal disadvantages. At the same time, the private owner had to contend with administratively controlled input and output prices.

A number of legislative adjustments came into effect in 1989, with the goal of making SOEs more flexible organizations entitled to make economic decisions. For example, they were allowed to lease some parts of their assets to individuals or

²⁰ See Table 4 for relative growth of private and public sectors in the 1980s.

²¹ Formerly, SOEs were permitted to merge only with cooperatives. Pursuant to the amendment, the founding body was responsible for entry and exit decisions, while the general director and Workers' Council could make recommendations.

²² The scope of business activities requiring permission has gradually eased. In 1991, permits were required for the following activities: mining and quarrying, processing and trade in precious stones and metals, manufacture of pharmaceutical drugs and operation of pharmacies, manufacture of spirits and tobacco products, provision of sea and air transport. Discretion could still be exercised to protect the national economy and in the interest of national security. This list is taken from Breitkopf, 1991, p.25.

corporate bodies. Enterprises' primary capital was divided into two parts: the "capital fund" (that is, the share held by representatives of the State Treasury) and the "operating fund" (comprising net transfers from depreciation allowances and net profits). Thus, the assets of a firm were divided nominally into state-held and enterprise-held segments. This division established the obligation for SOEs to pay the state a "dividend" on the assets held in the capital fund. Modelled after the western notion of income derived from property ownership, the "dividend" which is still assessed on SOEs is a tax on the use of state assets. At the time, the founding bodies continued to exercise the authority of the state, whose control was "uninterruptedly maintained over key areas such as the setting up of new enterprises, the definition of fields of activity, the division, merger and liquidation of enterprises, and all substantial changes which could alter their statutory position and form of ownership." (Breitkopf, Gorski and Jaszczynski 1991, 14). Changes consisted in advances along the continuum away from central planning, while centralized control was steadfastly maintained. No discontinuity was recognized between enterprises, as agents of the state, and the administrative centre, and no rights of ownership were embodied in the redefined fiscal and legal relationship between them.

The failure of limited reforms to achieve significant improvements in the system of central planning has been the subject of considerable research and analysis. This literature has an important place in the present debate about the potential effectiveness of partial or gradual reforms in the CEECs. Most views hold that the absence of two elements -- a meaningful price system and effective ownership -- was largely responsible for the unsatisfactory results of partial reform. These arguments begin with the conviction that the process of centralized planning cannot embrace the full range and complexity of economic transactions in a domestic economy because of the volume of information which, to be useful, must be gathered, assimilated and communicated

rapidly. Efforts to streamline the administration of economic activity, according to these arguments, fail to improve economic performance because administrative allocation does not reflect actual or relative economic values. To rationalize the bureaucracy and improve performance requires replacing administrative allocation of resources with allocation according to supply and demand, and that depends on flexible pricing.

In summary, the reforms of the eighties were designed to stay the course on collective ownership. They attempted to influence the manner of economic decision-making without addressing issues relating to ownership. It was hoped that limited price liberalization of the 1980s would cause firm managers to make efficiency-based decisions. But because domestic pricing in CEECs was insulated from the international market, prices neither informed managers about the relative value of their products nor enforced competition. Even had price liberalization been open and complete, and pricing and investment free from distortion, most writers say that the absence of incentives and penalties linked to managerial decisions still would have precluded success. In addition, managerial autonomy was constrained in a number of ways relating to obligations to the Council for Mutual Economic Assistance, bureaucratic supply and distribution systems, and wage and employment rigidity. Thus, the absence of generalized demand pricing ensured (i) that information available to managers was inadequate to promote efficient allocation and (ii) that there was no direct connection between improved performance and financial gain for an enterprise or its manager. The importance of a credible price system is underscored by Kornai's observation that profit had become a fictional concept in eastern Europe: "We no longer know what is expressed by profit or by loss. As a working concept, profit has lost prestige because of the arbitrary nature of the price system; no one can be fully confident that it really reflects efficiency." (Kornai 1990, 86).

B. ECONOMIC TRANSFORMATION: THE THEORIES

There is strong consensus about the essential elements of the economic programme required to mobilize economic forces in the post-centrally planned economies (CPEs) along the lines of a market economy. These include (i) implementation of a legal framework for enforcement of property rights; (ii) liberalization of prices to reflect world prices; (iii) development of financial institutions; (iv) removal of subsidies, and reform and codification of the fiscal system; (v) privatization of State-owned enterprises; and (vi) development of a national social safety-net which will relieve employers of responsibility for societal well-being. On the order in which these elements ought to be introduced, and at what pace, there is considerable disagreement. Every country which anticipates implementing a major economic programme faces the task of identifying specific goals and priorities and selecting economic instruments suitable to its circumstances. Because of the formidable scale of these nation-wide transformations, special care must be taken to tailor reform paths which will be sustainable in the particular conditions of each country. Such a programme must take into account the level of national and international indebtedness, the degree of trade openness, the level of education and skills of the population, the availability of domestic savings or other investment capital, the quality of capital and transportation and communications infrastructure, as well as considerations about the character of popular sentiment and political will surrounding the direction of reform. Decisions must be made about who rightfully owns state-held assets, and further judgements must be made about the desired balance between equity and efficiency.

Notwithstanding the fact that the 1989 revolutions galvanized reform movements in the CEEC economies, one should recall the steady worsening of economic performance over the previous three decades. The major challenge facing CEECs has been to devise feasible strategies to achieve a radically improved allocation of domestic

resources. From the experience of advanced Western economies, this objective can be satisfied most readily by creating an institutional environment which stimulates and rewards savings and investment by citizens, and which sustains an adequate flow of information to ensure that investment behaviour can be well-informed and rational.

The following criteria (identified by Tanzi) are helpful in composing a global picture of the goals that are at the heart of the transformation process. "The economic transformation of the Eastern European countries", he wrote, "will be complete when:

- (a) a large proportion of their total wealth is owned by individuals and not by public sector entities;
- (b) when most prices, including wages, interest rates and exchange rates are free to reflect the opportunity cost of using resources and, thus, to influence decisions;
- (c) when, within limits imposed by legitimate regulations, individuals are free to start and carry out any economic activity they wish;
- (d) when individuals are free to buy and sell any asset (tangible or intangible);
- (e) when savers can choose from a range of financial assets (reflecting different risks and maturity structures) to invest their savings;
- (f) when individuals are free to make the basic decisions on how to allocate their earnings; and, finally,
- (g) when they are confronted by a legally-based and objective tax system which can only be changed by a legitimate legislative process." (Tanzi, 1992, 7)

Using this set of objectives as a guide, one can crudely identify the sorts of mechanisms required to accomplish it. Tanzi's point (a) clearly calls for privatization of a portion of state assets to tip the scales in favour of private ownership of the nation's wealth; (b) calls for liberalization of prices according to world market prices, and therefore includes currency convertibility; (c) and (d) require creation of a legal system which institutes individual property rights and defends individual economic rights; (e) and (f) necessitate development of financial institutions which enable savers and investors to act on decisions regarding the management of their privately-held financial assets; which create

clear fungible incentives, and guarantee the individual's right to the proceeds of savings or investments; and which meet international standards for regulation and accountability of capital and securities markets²³; (g) calls for a rational and coherent legislated fiscal system which, by eliminating bargaining, discretion and favouritism, creates an "even playing field" in which fiscal incentives become effective instruments of a national economic strategy. Given price liberalization, rational pricing would restore the informational function of market prices, promoting improved allocation of resources and stimulating production of goods and services for which there is genuine demand. In such an environment, the aggregate effect of decentralized investment decisions would be to strengthen and enrich efficient producers, stimulate competition and enable the private sector to generate a positive supply response.

The primary implication for reform, arising from the entrenched nature of the centrally-planned economic system in the CEECs, is that any reform must be disruptive on a historically significant scale, leaving few of the conventions and institutions of the communist world unmoved. The systemic logic of the Soviet-type economies cannot be overlooked in efforts to achieve economic objectives. Many writers on the centrally-planned economies transformation process emphasize that such efforts must begin by acknowledging values and relationships inhering in the economic structure being challenged. In developing policies, reformers must penetrate beyond formal economic and administrative structures to see the strategies that people and enterprises have used to acquire, accomplish or protect whatever they valued most highly under the communist regime. This is especially important when predicting microeconomic adjustment efforts.²⁴ For example, the production quota system encouraged workers and managers to cooperate

²³ The effective functioning of competitive markets (in capital, stock or goods) depends profoundly on the existence and availability of adequate, intelligible, and accurate information about products and competitors.

²⁴ The results of research by Wawrzyniak and Bieganski (1991, 1992) are enlightening in this regard.

in misrepresenting cost and production figures. Informational asymmetry between the "centre" and production sites, combined with the difficulty of monitoring plant-level activity, encouraged workers and divisional supervisors to collude to maximize their wages, privileges and security. In such an organization, "the logic of the system requires that initiative be punished, making any attempt to change both personally risky and likely to fail" (Ericson 1991, 22). Such a strategy applied in a market system would have perverse results -- for management, labour and share values.

Although the prevalence of black-market trading in the CEECs has probably contributed an elemental understanding of market relations in those countries, the skills developed by its entrepreneurs are not necessarily compatible with growth of private sector firms. These operators typically faced no overhead or input costs, since their goods were more often pilfered from employers than purchased. Reinvestment behaviour, traditionally absent among black-marketeers, would have to be induced by legislated property rights which would allow entrepreneurs to project returns over a longer time horizon (See Laki 1990).

Enterprises and individuals have been acquiring expertise in competitive strategies which depart sharply from the kind of behaviour which was rewarded under the communist regime. For this reason, training personnel in finance, management, marketing and accounting, geared to the demands of a market economy, is essential to the success of economic transformation. The Poles have historically been reputed to be enterprising and, as Aslund observed "Predictions that people had forgotten how to set up and run a private business have turned out to be completely wrong" (Aslund 1994, 35).²⁵ A more complex dilemma is posed by the current shift in the playing field from dominance of the public sector in both finance and production, to institutions in both areas which are being driven by private sector demands. It can be said that private companies enjoyed a level of

²⁵ His remark applied to the CEECs generally.

privilege and security when their major transactions, those being with SOEs, enjoyed the guarantee of the state purser. After 1989, the business environment rapidly became more dangerous for private and public companies.

Visualizing a market economy

...the ultimate configuration of institutions and interactions is unknowable, a largely unintended consequence of the growth of decentralized agent interaction. Thus a final lesson for successful reform taught by the nature of the traditional Soviet-style system is to abandon the Faustian urge to control, to know in advance, and thus to allow economic outcomes to arise naturally as the unpredictable consequences of market interaction. (Ericson 1991, 26)

The scale and complexity of economic transformation in the post-Soviet countries have confounded recourse to generic solutions; Islam proposed a simple constellation of five points which describes the dynamic elements affecting implementation of a reform strategy: stress, sectoralism, sequence, speed and duration (Islam, Mendelbaum 1991, 189). Islam makes use of a table by Alan Gelb and Cheryl Gray (1991) which illustrates the overlapping phases of various reforms over a ten year period.

Capitalism takes a range of forms in the developed market economies, and all existing forms depart, in character or in degree, from the theory of capitalism articulated by Adam Smith. Distinctions among various developed market economies originate largely in the role played by organs of the state. CPEs are distinguished from market economies on the same basis, but by a magnified degree. In the CPEs, the state is the primary agent of economic decision-making and economic activity, while market economies rely on the private sector to own and determine allocation of resources. In the simplified world of theory, through the lens of neoclassical economics, the perfectly competitive market ensures optimal allocation of resources: capital is perfectly mobile and flows automatically toward investments where returns are maximized, and competition squeezes economic profits to zero. This condition of allocative efficiency allows society to maximize utility while minimizing sacrifice - the desired range of capital and consumer goods is available in

sufficient quantity and quality, and at prices equal to marginal production costs.

Conventional criticisms of centrally-planned economies emphasize their poor informational properties, the absence of provisions for exit and entry, their inability to supply an adequate variety of consumer products and their unwillingness to separate allocative from distributive functions. Some writers say the neoclassical model is an inappropriate guide to understanding the post-Soviet economies (Murrell 1991 and Targetti 1992). For example, post-Keynesian economic literature has explored a variety of "diseconomies": transaction costs, informational asymmetry and the "principal-agent" dilemmas. Murrell pointed out that the weakness of markets in these areas may make the neo-classical model unsuitable for analysis of any major economic transformation.

Economic transition projects normally start with macroeconomic stabilization, followed by internal structural reforms. However, Genberg observed that in Eastern European countries, these two actions are hard to differentiate. He argued that the degree of interdependence within the range of economic reforms in these countries made simultaneous attack on all fronts the only sensible approach. Because of the depth and degree of change required, the economic potential for failure increases directly with the duration of the transformation process. In the vast majority of cases, radical reform initiatives are instituted in response to crisis situations and their costs are front-loaded; in theory, a well-designed reform programme will ensure progressively increasing marginal benefits over time. The potential for success may be improved by implementing a reform sequence whose cost structure, in recognition of social, economic and political costs, favours continuation over abandonment or reversal. Governments' demonstrated commitment to clear and consistent goals invariably contribute to the political viability of reform programmes.

Even in optimal conditions and with careful preparation, the scale, scope and direction of the transformations underway in Eastern Europe are without precedent. The

instability and uncertainty inherent in transition aggravate normal problems of adjustment, as does the relative absence of institutions in the post-Soviet-type economies which guarantee legal and financial security. As it is not clear that the human costs of a shock approach are greater than those caused by gradual transition, no one knows exactly how to revive economic growth with the least possible pain.

Is there an "optimal" sequence of economic reforms?

We can borrow from Genberg to model an optimal sequence of economic reform measures. Macroeconomic stability should be established early to shrink excess demand. In this way, inflation can be contained, and dangerous social, exchange rate and trade effects, prevented. Genberg suggests that the main stabilization instrument should be withdrawal of government subsidies. Subsequent price liberalization would have rational and desired effects in the presence of hard budget constraints, and in a context of liberalized wages, managerial expertise would be rewarded. Governments should focus early on developing human resources: knowledge of market-based institutions and practices, and specialized skills in market-oriented economic behaviour. Simultaneously, a basic social safety net must be established to cushion the effects of lay-offs resulting from bankruptcies and restructuring, and relieve employers of the traditional obligation to provide social services to the community and perquisites to families of employees. This would facilitate emergence of a labour market. In Genberg's analysis, implementation of basic privatization measures should coincide with economic stabilization; such measures ought to begin by removing restrictions on existing private enterprises and be followed swiftly by legislated protection of private property rights. In the absence of such protection, there is little incentive to risk investing in private enterprises and linked reform initiatives become reversible.

A later stage of reform would include development of financial institutions and markets, a comprehensive tax system, and health and social security programmes. Until

an effective regime of controls and accountability of financial transactions was established, Genberg argued that a high degree of state control ought to be maintained. However, disincentives to private enterprise inhering in existing taxation schemes must be eliminated as early as possible in order to level the playing field for private and public sector competitors.

The above framework summarizes Genberg's ideal sequence. This discussion will return later to evaluate the importance and implications of the position of financial sector reform in the overall sequence of economic reforms.

Opinions about where privatization ranks in priority among reform elements diverge sharply. For example, Genberg cites two visions: Hinds' view is that privatization should coincide with monetary and fiscal reforms in order to create an active private sector as rapidly as possible; Fischer and Gelb place privatization later in the reform process, concentrating on the role of market pricing to promote allocative efficiency. Genberg (1991) points out that the latter ordering may be more suitable to privatization efforts in economic environments already dominated by private sector activity, as are found in many less developed countries (LDCs).

The ideal sequence is never within reach, and a second-best solution is often the best available option. Schmieding said that "appropriate sequencing depends on the time pressure. In spite of the theoretical advantages of large-scale ex-ante privatization, it could still be necessary to go ahead with the macro and micro reforms first - and hope that the ensuing economic crisis will put rapid privatization more firmly on the political agenda" (Schmieding 1991, 104).

The role and the rate of privatization

One way to approach the question, "why privatize?", is to ask if a market economy can be achieved without privatizing (Genberg 1991 and Kornai 1992). There are claims that decentralizing the process by which economic decisions are made suffices; some would

seek to achieve a "socialist market" economy in which property is owned collectively and managerial autonomy is promoted by an appropriate incentive structure. Theoretical discussion allows that efficiency goals may be satisfied by reassigning ownership rights without actually transferring property holdings, making privatization unnecessary. But the record of the 1980s, in Poland, is poor in this regard.

There are many proponents of the view that the single most important reason to privatize state property is to get the government out of the economy in order to depoliticize and de-bureaucratize economic decision-making; to liberate capital from liens of loyalty; and to give actual and potential foreign investors a signal that enterprises in Poland are not at risk of being nationalized. There are other compelling reasons to privatize. The state cannot afford to maintain or utilize its productive capacity. Even were Polish policymakers skeptical about the merits of selling state assets, objective financial constraints probably made pursuit of a privatization programme inevitable.

Recalling Islam's five elements of the dynamic of economic reform -- stress, sectoralism, sequence, speed and duration -- , we can examine the issues bearing on the pace of privatization. Stress and sectoralism refer to varying intensity and selective application of policies among economic sectors and geographical regions. His differentiation of the time-based factors -- sequence, speed and duration -- helps us clarify a somewhat complex question. Sequence relates to the order in which reform measures are implemented and, therefore, when privatization should begin. Duration suggests when the process ought to have been completed, and speed, presumably, describes the intensity of privatization activity in the period from beginning to end. But "speed" has both economic and political implications and determinants. To a large extent the speed of privatization is a function of the method used to achieve it. For example, in the Polish case, formal privatization has advanced quite slowly because (i) progress is contingent on successful passage through a resistant and fragmented parliament and (ii) it is based on the voluntary

participation of SOEs' management. So although identifying the desired speed and duration of privatization is important in planning a privatization programme, actual speed and duration are impossible to predict.

It is important to distinguish between formal privatization of large SOEs and proliferation of new, small private businesses. The former will be called "top-down" because it is a process administered by the Polish government, and the latter, "bottom-up". The relatively slow rate of top-down privatization is of great concern because of the immense productive capacity tied-up in the large-enterprise public sector. Bottom-up privatization normally expands rapidly, even in neutral conditions, and sustainability becomes the critical issue. Gelb and Gray characterize the first three of four years of reform as a period of intensive growth in the small, private enterprise sector, while intensive large-scale privatization begins only in the third year of reform and continues for many years.²⁶ This describes the Polish case fairly accurately.

We have seen that the link between stabilization and privatization in the CEECs is the subject of a debate which explores the relative order, duration and intensity of these two important economic programmes. The belief that rapid privatization was essential to supplement stabilization measures in the transformation of the Polish economy was held, most notably, by Jeffrey Sachs who with Balcerowicz designed the "Big Bang" stabilization programme. They intended that the new private sector would lead the nation's economic recovery, and the slowness of large-scale privatization has since been blamed for what was, until 1993, seen to be a lagging supply response to stabilization efforts. Privatization normally requires a long-term horizon which, in the case of the CEECs, must be quite elastic because many of the properties they endeavour to sell find no buyers.

In the CEECs, privatization has generally taken longer than was anticipated; the Czech Republic and the eastern Lander of Germany are exceptions. However, the

symbiotic relationship between stabilization and privatization in transforming economies often leads governments to elaborate ad hoc measures designed to speed up the privatization process and close the gap between the two. Many economists argue that to divorce stabilization from institutional reform diminishes the potential for successful stabilization and wastes stabilization efforts (for example, Rosati 1992, 271).

Let us look briefly at the theoretical arguments supporting rapid privatization and at contrary positions which hold that gradual privatization is preferable. Then we will outline the conditions prevailing for new private SMEs created by bottom-up initiatives. In reading the arguments that follow, one should keep in mind that optimal timing depends on the basic reason for privatization. One should identify the time preference of the seller, and then try to deduce what is possible. We have seen that, in the early years of transition, rapid privatization was clearly seen by Poland's leadership as the superior policy choice. However, it has been demonstrated in Poland that when the seller is a government holding national assets in trust, policy selection is subject to political pressures. Small-scale privatization has been less vulnerable to political impediments.

Rapid privatization has many proponents. Strictly economic reasons for privatizing early in the sequence of reforms include absorbing excess liquidity to reduce inflationary effects of price liberalization, easing demands on budget revenues, and raising revenues from asset sales. We have also seen Sachs' argument that the private sector should be the "engine" of economic growth in transitional economies. Finally, an early start on privatization allows markets to contribute to articulation of a realistic price regime (Blanchard 1991, 32). The optimal relationship between price liberalization and privatization is hard to model. It is doubtful that the desired allocative effects of price liberalization can occur in the absence of a strong private sector, but without market pricing, there are neither incentives nor signals to drive or guide private producers.

A fundamental political rationale for rapid privatization in Poland would have

been to take advantage of the extraordinary momentum and passion for change that was unleashed by the *Solidarnosc* victory. Then, early on, privatization would have produced a constituency of legitimate property owners and entrepreneurs having a personal interest in continuing market reforms. This would have reduced the acceptability of policy reversal and prevented spread of so-called "spontaneous privatization" (privatization of state-owned assets by their managers, for personal gain) which characterized the period of the Mieczyslaw Rakowski administration, from 1988 to 1989. Legitimacy is an important factor in Poland, where the population has learned to be suspicious of political authority and "The verb 'to privatize' in man-on-the-street parlance is very often used as a synonym for another verb, 'to steal' " (Winiecki 1992, 71).

Related to legitimacy is clear government commitment. Swift and resolute action by government demonstrates commitment, as did the Big Bang stabilization programme. Similar determination regarding privatization might have prevented the sustained uncertainty many Polish firms have experienced. Instead, large numbers of enterprises erected and revised successive survival strategies while stalled in the privatization queue. Uncertainty breeds anxiety, attracting workers to their labour associations and citizens to organized lobbies -- prepared to militate for alternative solutions to the problems they face. If the privatization programme includes a distributional element, rapid implementation allows the government to frontload benefits, set capital into circulation and get citizens involved. If distribution stimulates some optimism about the future, it also buys goodwill.

Another option which imitates rapid privatization in some respects is rapid commercialization -- the transformation of SOEs into joint-stock companies, wholly-owned by the state. Commercialization meets none of the economic criteria justifying quick sale, but does offer two benefits; it presents an opportunity to establish a more efficiency-driven management structure and eliminates Workers' Councils. Employees of SOEs are legally empowered to contest privatization proceedings through their Workers'

Councils, but commercialization of the employer divests workers of that authority.

Aslund said "... it is foolhardy to try to be precise, while it is vital to try to be fast and resolute. All government endeavours need to be oriented toward getting the basics right. That is hard enough" (Aslund 1994, 37). Once a goal has been identified, it pays to move in the right direction; some argue that it is better to aspire to an intermediate stage of capitalism in the short-run if mature capitalism is out of reach. Like arguments discussed in an earlier chapter, this one is based on the belief that the costs of delaying ownership changes outweigh the costs of making technical errors of commission. A lot of debate has highlighted the existence of an implied tradeoff between privatizing quickly or privatizing fairly. Those who favour the "quickly over fairly" position, argue that a transforming economy risks eschewing the potential benefits of privatization by delaying it. They maintain that eventual readjustment can correct unfair initial distribution or other negative consequences of sub-optimal privatization methods (for example, Grosfeld 1991).

Most current arguments recommending a relatively slow rate of privatization emphasize harmonization with other policies and institutional developments. There are advantages to slow or gradual privatization. As noted above, less speed may imply more fairness because design of a programme to achieve an equitable and socially just redistribution of assets takes time. Some believe that "Rapid privatization will inevitably be unfair and in time undermine support for economic transition and democratic decision-making" (van Brabant 1992, 283).

A slow rate of top-down privatization may be favoured when firm restructuring is integral to achievement of programme goals. Throughout eastern Europe, restructuring may be undertaken by the government in order to support national or regional industrial strategies (see Murrell 1991 and Wisner 1993), to reduce market concentration, to promote

productive efficiency or to close non-performing units within enterprises.²⁷ Some argue that restructuring should be left to private owners who are motivated by clear and exclusively economic objectives -- as compared with the state which takes social and political factors into account. The problem with this ideal is that large SOEs are generally not in saleable condition and cannot be sold unless they have been restructured. As well, coordinating privatization with macroeconomic "stress" and "sectoral" priorities may prevent bankruptcies which are painful to those involved and costly to the state.

Privatization of large SOEs implies withdrawal of a gamut of practical, social and healthcare benefits previously provided by employers in Poland. It takes time for the government to devise an alternate way of financing and delivering such benefits to citizens in need.²⁸ Other reasons to delay privatization concern the business environment in which private entrepreneurs will operate. Scope for useful decision-making by private entrepreneurs is effectively paralyzed in the absence of operative financial and labour markets. And society may be penalized if privatization is not preceded by demonopolization, when the behaviour of emerging private firms is untouched by competitive forces.

Careful selection of firms slated for privatization contributes to the strength and stability of the emerging private sector. The durability of individual private firms goes a long way toward optimizing conditions for entry of new firms; confidence of lenders and clients in the private sector is cultivated far more effectively by viable firms than by failing firms.

There is yet another factor to be considered in light of the above -- the pace of restructuring. Roland observed that the perception of risks associated with large-scale

²⁷ Among proponents of the view that restructuring should precede privatization is David Newbery. See Newbery in Siebert 1991.

²⁸ Carol Graham suggested that CEECs should use interim models applied in Latin America (Bolivia and Chile) to address short to medium-term social needs in "Safety Nets and Market Transitions: What Poland can learn from Latin America", *Brookings Review* (Winter 1994): 36-39.

restructuring are "probably the most important source of political constraints" (Gérard 1994, 1162). Restructuring implies income redistribution. This is immensely important to citizens employed in the public sector who can neither anticipate nor control which SOEs, in which sectors, will close or lay off workers. Roland's preference is for a programme of incremental restructuring whose successes would publicize the positive achievements of reforms and whose failures would not be of such magnitude that they could not be remedied.

Incidence of the financial burden generated by enterprise failures is profoundly important in the context of emerging financial markets. To oblige banks to absorb the shock of enterprise losses in the transition period (during which one can safely predict a large rate of loan defaults) confers an insupportable burden. This is true irrespective of whether the banks are privately or publicly owned; a portfolio dominated by non-performing loans cannot be sustained in either case. The ideal sequencing of privatization of financial services and enterprises is a complex question and various arrangements have been proposed to address it. For example, van Brabant (1992, 204) favours banking privatization before privatization of the enterprise sector and suggests additional readings. Hinds proposed creation of an entirely new banking system comprising private banks exclusively vested with responsibility for mobilizing deposits, "leaving the old ones as channels for financing, with fiscal resources and in a declining manner, the enterprises still to be privatized" (Hinds 1991, 209). Roland recommended postponing privatization of weak firms so that banks would inherit viable accounts and clients on whom financial discipline could safely be imposed, to mutual and general advantage. The state would retain weak firms and, by limiting access to commercial capital markets exclusively to private firms, be enabled to enforce hard budget constraints. In this way, the banks would be insulated from the debts of SOEs and could elicit maximal performance from their

clients, while SOEs might be provoked to improve performance. In the longer run, Roland observed, a shift of relative bargaining power would develop between the state, a private sector wholly independent of state financing, and a public sector wholly reliant on the state. The state's progressive dependence on tax revenues from the private sector would strengthen the constituency favouring continuing reforms (Roland 1994). The new SME sector escaped consideration in Roland's model. Financial weakness is not limited to SOEs, but broadly threatens the viability of businesses and financial institutions throughout the economy. Calvo and Frenkel observed that importation of macroeconomic policies into the Polish economy, which did not have a responsive financial infrastructure, had serious negative microeconomic consequences; the high interest rates imposed in 1990 suppressed the spontaneous growth of private enterprises and caused SOEs to increase their reliance on inter-enterprise credit (IFC). They emphasized the primacy of well-developed financial institutions to the articulation of development strategies, and recommended bank balance sheets first be cleared of bad debts and, then, system-wide financial accountability should be instituted. Financial sector reforms are the subject of Part II.2.

Even under the best circumstances, obstacles to fast-paced privatization are numerous. There are often severe and intractable financial constraints. Rapid and deep privatization has been achieved in the post-GDR but this was possible only because the Treuhand was in a unique position to decouple "the protection of people from the protection of firms"²⁹. The Treuhand was legally bound to compensate, train and provide alternative employment to laid-off workers, but it relied on West Germany to finance this obligation. Efforts to secure the same guarantees for labour in Poland failed. Although Prime Minister Tadeusz Mazowiecki made an early commitment to paying unemployment

²⁹ In March 1994, in the post-GDR, only 237 SOEs remained from the 14,000 which existed in 1989, and out of about 4 million, fewer than 100,000 employees were still employed in the public "productive sector". Cited in Siebert, 1994, 1361.

compensation at a rate of 70%, the promise was retracted because the Treasury lacked sufficient funds.

In summary, the main elements of arguments favouring fast privatization are (i) absorption of excess liquidity contributing to stabilization; (ii) legitimacy and confidence; (iii) irreversibility; (iv) reduction of state budget costs; (v) earnings from sales; (vi) seeding economic efficiency and exercising leadership in cost-pricing; and (vii) weakening of employees' roles.

Arguments favouring slow or gradual privatization emphasize (i) opportunities to optimize selection -- in support of a macroeconomic strategy or merely to build a durable core group of private enterprises; (ii) equity in redistribution of assets; (iii) postponement of massive unemployment until an effective social safety net has been constructed; (iv) demonopolization and creation of a viable legal and financial business environment; and (v) protection of the banking sector from absorbing voluminous losses from firm bankruptcies.

Privatization in Poland: A sense of timing

It was stated at the opening of this chapter that optimal timing depends on the basic reason for privatization, from which a sense of the possible may be derived. In 1990, Poland's looming debt and trade imbalance made rapid privatization very attractive. The Solidarnosc government launched the privatization programme with a clear objective of bringing a market economy to Poland -- as soon as that could be achieved. The programme of economic transformation was provoked by economic crisis, therefore the top priority of privatization was to revive economic growth by selling the assets of large SOEs. Neither equity nor macroeconomic planning were prominent among its concerns; speed was. In 1990, an extensive slate of legislation supporting privatization was adopted by parliament, with the hope that rapid privatization would (i) improve enterprise efficiency and corporate governance; (ii) reduce the burden on the state budget and public

administration; (iii) stimulate economic growth and (iv) contribute to wide diffusion of ownership.³⁰ The organs of the official privatization programme proliferated and soon a diversity of methods was offered which aimed to attract investors and managerial expertise.

However, sale of large SOEs has advanced slowly; as Islam noted, "privatization (or restructuring or liquidation) of large SOEs - especially the fat and weak ones -- is one area where a lot of stress would yield little speed" (Islam and Mandelbaum 1993, 191). The small enterprise sector expanded almost spontaneously and, among formal methods, liquidation has far exceeded capital privatization in achieving *de facto* ownership change. Individual capital privatization is advancing at a modest pace. The cornerstone Mass Privatization Programme (MPP) took effect in November 1995, after a laborious and complex series of discrete steps taken by successive governments. To date, the most significant distributional achievement of the privatization programme has been accomplished by the preferential sale of shares in commercialized firms to their employees. However, in many of these, there has been no capital inflow from investors and employees are indebted to the state under specialized loan arrangements. In addition to effective political opposition, other reasons which help to explain the slow rate of ownership transformation include the voluntary and case-by-case design of the overall programme, and the inclusion of a restructuring element in most of its components. There is no doubt that, despite its dynamic growth, bottom-up privatization has been impeded by lagging institutional adjustment which hampers the emergence of financial and capital markets. The legal framework, having been inherited for the most part from pre-Stalin Poland, is geared toward defence of capitalist property relations. However, it will be shown that numerous fine-points, anachronisms in the present environment, prevent its effective implementation.

It has become clear that privatization of Poland's large SOEs will take many years, if it can be accomplished. Research has led, therefore, to an appreciation of the leading role of the new private SME sector. This thesis examines the difficulties faced by SMEs in raising capital, which significantly limit the ability of the private sector to generate a supply response, create employment, and stimulate efficiency and growth in the economy.

PART II

A. LEGAL AND ANTI-TRUST REFORMS

The CEECs are acting quickly to develop resources suppressed in the command economy, by erecting (i) legal systems which permit and protect private acquisition, and (ii) systems of financial institutions which promote efficient allocation of savings and investment throughout the economy. Developments also include establishment of competitive stock markets to foster shareholder discipline over managerial prerogatives, and evolution of competitive markets in managerial expertise.

An effective legal system is essential to the development of an economic system based on the entitlement to proceeds from ownership. World Bank legal scholar Cheryl Gray estimated that, although implementation has lagged, an adequate and "admirably flexible" legal foundation dates from pre-War Poland.³¹ According to Gray, the 1933 Law of Obligations, which established many of the core tenets of economic practice under the civil code, corresponds closely to Western standards. The legal system required to support operation of a market economy consists basically of constitutional law, real and intellectual property laws, contract and company laws, and laws regulating foreign investment, competition and bankruptcy. Contract law sets out the terms for transfer of real, personal and intellectual property. Competition and bankruptcy laws ensure that free entry and exit by companies support the market's role in allocation of national resources.

Equal rights of economic subjects was enshrined as a principle of Polish law only in 1988, with passage of the Law on Economic Activity, under which every legal or natural person is equally entitled to undertake and conduct economic activity. A 1990 amendment of the Civil Code took an important step toward implementation of that principle; all provisions of the Civil Code favouring socialized property (including state-owned and

³¹ Cheryl Gray, "Legal Frameworks in Central and Eastern Europe - The Polish Case", Transition, December 1991.

cooperative companies), referring to both material rights and obligations, were dropped, putting private businesses on equal footing with SOEs. Companies must be registered with the local government office in the region where the economic activity will be situated. On 27 July 1990, the Law on Land Ownership and Expropriation established municipal governments as the responsible authorities for its application, and set conditions for property ownership by foreign nationals.

When the state gives up direct control over assets, it must develop instruments of arms-length regulation. In the absence of effective regulation, there exists the risk that private owners will exploit monopoly power, or disregard employee health and safety or environmental standards. In Poland, adoption of the Anti-Monopoly Law and establishment of the Anti-Monopoly Office (UA) preceded privatization legislation by a few months. The Anti-Monopoly Law, adopted in February 1990, defines restrictive business practices resulting from dominance or collusion; these include fixed pricing, barriers to entry, tied selling, and imposition of strong conditions on payment. UA President Anna Fornalczyk interpreted expanding use of IEC as an emergence of "crisis cartels" among SOEs, evading the costs of formal bank credit.

Estrin and Caves identified competition policies as one of the "more conspicuous successes" of transition management in the CEECs. They concluded that of the CSFR, Hungary and Poland, the Polish UA has been most successful in promoting competition. The Polish have given the most authority to the office. Not only is the UA empowered to exact penalties on firms found guilty of infractions against Anti-Monopoly Law, it may intervene directly to break up dominant firms, and participates in evaluation and screening of applications to privatize. The Office also evaluates draft laws for implications regarding competition practice, before they are introduced for first reading. The threshold for market dominance in Poland was increased from 30% to 40% in June 1991, and now conforms with the EC standard. The authority of anti-monopoly offices in countries having

concluded Association Agreements with the E.C. is reinforced by the explicit (and precedent-setting) inclusion in those agreements of competition clauses. The tenets of the Agreements concerning competition policy became mandatory in 1995.³²

³² This obligation comprises instituting legislation aligned with the Articles 85, 86 and 92 of the Treaty of Rome.

B. THE BANKING SECTOR

1. Introduction

Immaturity of the financial system constrains the mobility and volume of financial resources in the Polish economy. For privatization, this has two implications. Poles' inability to draw on a well-established credit regime makes purchase of SOEs difficult, and also hampers establishment of new privately-owned enterprises (POEs) and investment in development of already existing companies. Thus, the absence of a well-developed financial sector hinders the evolution of a strong and durable private sector, especially of a manufacturing sector which, to compete effectively with western imports, must make substantial front-end investments. But does the financial market's youthfulness explain its failure to support SMEs? This thesis finds that systemic weakness provides only a partial answer. Of at least equal relevance is the fact that investment in credit operations for SMEs is an inferior investment choice for Polish banks seeking secure short-run profit margins.

Analysts of the eastern European transformation have sought to identify development models suitable to explain the economic transformation of that region. In one theoretic scheme, John Dunning outlines the post-war "reconstruction" model, the "developing country" model, and the "systemic" model which he defines as an integration of appropriate elements of both the former types. Dunning's systemic model takes into account the macroeconomic, microeconomic and social attitudinal demands particular to a development problem. The model is characterized as systemic because "it suggests that the willingness and ability of foreign (or for that matter, domestic) investors, rests mainly on the speed and extent to which eastern European economies can reorganize both their economic and legal systems, and the ethos of their people towards entrepreneurship and wealth-creating activities" (Dunning 1994, 379). Poland's approach to privatization has

been frankly pragmatic. Successive governments have accepted as fundamental the rights of managers and employees to participate in privatization decisions. Financial provisions were arranged to enable the realization of the desires of employees to become enterprise-owners. A loose construction of alternate routes to privatization was devised to permit advantageous coupling of capital with initiative wherever and however that was possible. The merit of this position will not be debated here, except to ask what effect this succession of choices has had on the disposition of the economic structure and its stewards toward the emergence and survival of SMEs. The Polish government did not proceed from a fixed set of principles for the dispensation of property or rights thereto; in fact, restitution or compensation for nationalized properties has only recently been given serious attention.

The process of cultivating "satisfactory financial markets is a complex alchemy which depends on a mix of economic, monetary, fiscal and social policies. [Ministry of Finance] goals beyond the immediate objective of privatization call for a subtle coordination of the various influences which can have a bearing on financial markets" (Olex 1992, 106). In the course of this chapter we will try to gain an appreciation of how the alchemy of finance, in Poland's peculiar mix of public and private assets, influences the emergence and growth of the small enterprise sector.

2. Background: The banking system 1980-1995

In a market economy, a banking system would ideally fulfill these functions:

- (a) institute incentives which promote saving;
- (b) maximize efficiency of resource allocation among competing investment projects;
- (c) exercise and impose financial discipline on the enterprise sector;
- (d) compile and analyse financial information about enterprises and lead the capital market in risk assessment; and
- (e) develop financial instruments to improve the market's ability to satisfy varied financial needs.

In centrally planned economies, interest rates did not exert an allocative force because consumption decisions were largely the purview of the administration, or were self-regulated by virtue of the shortage of goods. Individuals were infrequent borrowers, and what credit was provided was typically specialized and limited to a particular type of purchase. The role of savings as the foundation for investment capital was not pervasive as citizens of these countries had little need of savings for illness or old age. As far as loans to enterprises went, "the losses of some enterprises were expected to be covered by the gains of some others" (Tanzi 1991, 5), in what has come to be known as the "soft budget constraint". Prior to the 1980s, banks' activities were circumscribed to ensure there was no duplication of services. Regional and sectoral segmentation prevented competition among financial agents but also created concentrated portfolios highly susceptible to risk. Relations between the banks and SOEs were predetermined by the state; enterprises did not select their bankers, neither could they choose a preferred branch. Banks were directed by the central authorities and financed those projects to which they were assigned.

Pursuant to adoption of the 1982 Banking Law and National Bank of Poland (NBP) Statutes, new banks could be established and private ownership of banks was permitted. Notwithstanding, the mandate and scope of operations of all banks remained the prerogative of the Council of Ministers. Although three new banks were created³³, including the Export Development Bank (*Bank Roswoju Eksportu SA*), not a single bank emerged as a result of the "grassroots initiative" the legislation aimed to release. However, the 1982 legislation formally severed the NBP from the Ministry of Finance, making progressive independence of the financial sector from the central authorities possible.

It is not surprising that, under those circumstances, the economic reforms of the

³³ The Export Development Bank was founded jointly by the NBP, the Ministry of Finance and the Ministry of Foreign Economic Relations, Bank Handlowy, Bank PKO SA and a group of foreign trade enterprises. The Economic Initiative Bank (*Bank Inicjatyw Gospodarczych SA*) was created by a group of state enterprises with private capital assistance. Lodzki Bank Rozwoju was the third.

early 1980s had weak results. Subsequent to limited price deregulation, the central bank succumbed to pressure to print money to finance the state enterprise sector. While the soft budget constraints were protected, Poland faced open inflation of over 20% in 1981 and 200% in 1982 (Wyczanski 1992, 12). The system had no mechanism whereby individual banks controlled or coordinated the level of credit they extended, and this situation was aggravated by direct and arbitrary interference from the government in banking practices. The planners held onto their roles as economic regulators and did not envisage a role for market relations in the allocation of financial resources. The reforms had not recognized the role of the central bank in defending the national currency or the importance of the banking system to the success of the economic reform programme. At the same time, the soft budget constraint encouraged hoarding of labour and resources by large SOEs. It was in response to the uncontrolled growth of credit that responsibility for deposit and loan operations was removed from the mandate of the central bank with creation of the State Savings Bank as a separate entity from the NBP. Autonomous banks were expected to exercise more rigorous control over credit, and "the elimination of the bondage between enterprises and banks will make it possible for the latter to arrange relations with the borrowers on equal rights, and that will translate into a departure from the principle of automatic credit" (Wyczanski 1992, 13). The NBP was simultaneously freed to concentrate on defence of the zloty.

A first bank was calved off to specialize in private savings deposits: PKO BP (*Powszechna Kasa Oszczednosci*). PKO BP still dominates household savings, mortgages, small business lending and construction credits; in 1992 it was the fourth largest enterprise in Poland, having over 37,000 employees.³⁴ PKO BP has the advantage of a well-developed and extensive network of branches throughout Poland and strong customer loyalty; it possesses the unique advantage of offering banking transactions in Post Offices.

³⁴ Economist Intelligence Unit, 1993.

In January 1989, the Bank Act and the Act on the National Bank of Poland (*Narodowy Bank Polski*) were introduced simultaneously, and launched a movement toward a two-tiered system wherein the NBP assumed the functions of a central bank. The Act obliged the NBP to give up all commercial activities, and nine commercial banks were created by consolidating several voivodship and county branches. These banks were endowed with modest capital, and assigned to take over savings and loan functions from the central bank. The nine banks were commercialized according to the Law on the Privatization of SOEs, with the aim that they would eventually be privately owned.³⁵ To encourage competition and enable enterprises to choose their bankers, each bank was assigned a majority of branches in its immediate vicinity and also a number of branches in other regions. Although the commercial banks' capital to assets ratios were low at the outset, extraordinary profits earned in 1989 and 1990 soon enabled them to exceed the minimum capital adequacy requirements established by the Bank for International Settlements.

In the radically altered business environment of 1990, the first task of the NBP was to institute monetary policy consistent with the objectives of the Balcerowicz plan, through money supply, interest rate policy and foreign exchange rate policy. In a decisive move, the NBP Act was amended in December 1989 to sharply restrict access to central bank credit by the Government, specifically by limiting purchases of State Treasury Bills. By applying real positive interest rates and sharply devaluing the zloty, the NBP aimed to maintain a stable relationship between the nominal value of GDP and the money supply. The NBP is accountable to the *Sejm* which appoints, and may recall, its President. Elements of an elaborate programme to develop financial systems and institutions was initiated in 1990,

³⁵ Four have been privatized: *Wielkopolski Bank Kredytowy*, *Bank Slaski*, *Bank Przemysłowo-Handlowy*, *Bank Gdanski*.

using the technical guidance and financial participation of several foreign banks.³⁶

The refinancing credit rate set by the NBP played the key role in implementing interest rate policy, whose variations paralleled the changes in consumer price indices, but efforts to diminish the scope of refinance credit as a source of direct credit to banks were initiated. Discount credit operations were reintroduced in 1990, but discount credit had already become unpopular by 1992, because enterprises preferred to circumvent the financial discipline imposed by formal credit by using inter-enterprise arrangements.

The principal goal of restoring bills of exchange was to limit the extent of mutual indebtedness, the so-called 'debt overhang', of most enterprises which more often than not was no fault of their own. As a result, overdue obligations as well as assets kept rising, with the emergence of a whole chain of debtors and creditors, all of them lacking liquid assets (Wyczanski 1992, 45).

The rights vested in the holder of a bill of exchange were expected to be attractive to debtors. This expectation was not realized, partly because most bills of exchange were granted for agricultural payments which limited the potential effectiveness of the bills in reducing inter-enterprise credit. In May 1991, the Ministry of Finance began to sell Treasury Bonds to raise funds for the state budget; these are a liability of the state and not of the central bank.

Based on authority conferred in Article 54 of the Act on the NBP, the President of the NBP issued a series of recommendations (beginning in August 1990) which set out the principles for and practices of granting bank credits. The purpose of these ordinances, compiled in the General Ledger for Banks (BPK 91), was to introduce modern, prudent banking methods and to protect the banking sector from high exposure to risk. They addressed data-sharing to inform risk assessment, concentration of credits within banks'

³⁶ Money markets (Bank of England); interbank settlements (Federal Reserve); banking supervision and prudential regulations (Bank of France); banking school in Katowice (Banking Staff Training Centre, Paris); central bank accounting system (Bank of Austria); banking law amendments (World Bank); diagnostics for commercial banks (international consultants selected by competitive bidding under World Bank coordination); central bank organizational structure (International Monetary Fund); statistical reporting and economic analysis (Bank of Netherlands); foreign exchange operations and economic policy (Deutsche Bundesbank). Source: National Bank of Poland

portfolios, required qualifications of borrowers, computation and maintenance of a solvency ratio (capital adequacy ratio), and measurement of financial liquidity of banks. Banks were instructed to achieve an 8% ratio of capital to risk-bearing assets by 1 January 1993.³⁷ The General Ledger became an important instrument for disseminating information about new methods and imprinting new standards on the Polish banking system. However, Poland's poor communications infrastructure continues to be a serious constraint on the ability of banks to fully exploit the liberalization of banking regulations.

In 1990 the NBP applied liberal criteria in granting of licenses to create new banks: possession of sufficient start-up capital (a lower threshold was demanded for banks using exclusively domestic capital); legally sound articles of association; a viable business plan; secure premises; and appointment of suitably educated officers having no record of fiscal offenses. At the end of 1990, there were seventy-five nationwide banks of which forty percent had majority private ownership, 104 independent cooperative banks and 1,562 small cooperative banks affiliated with the *Bank Gospodarki Żywnościowej*. Licenses were also issued for banks having foreign capital participation.

The General Banking Supervision Inspectorate (GBSI), established in 1990, is responsible for data collection. In exceptional circumstances when a bank's practices threaten the well-being of its shareholders or depositors, or the integrity of the banking system, the GBSI may use its supervisory capacity to intervene directly in banking operations or recommend liquidation of a bank to the NBP President.

The Polish Development Bank (*Polski Bank Roswoju SA*, PBR) was established in early 1991 with the financial participation of France's *Credit Nationale* and *Invest Credit* of Austria, and rapidly became Poland's major development bank involved in modernization, restructuring and privatization. According to its statutes, the PBR provides credit, but

³⁷ Various risk weights were assigned to holdings, ranging from 0% for assets of the NBP and OECD members' banks, and 30% for domestic banks, to 300% for disputed or doubtful credits. The principles for determining the risk weights are revised periodically, and as the range of financial instruments increases.

transfers execution and supervision of those credits to other banks, although it may operate without intermediaries. For this reason, PBR has played a primary role in organizing the inter-bank money market.

The first indication of competition among banks arose when banks began to publicize marginal differences in interest rates on deposits and advantageous conditions for term deposits. There was some innovation in security requirements and speed of processing loan applications, but little competition to offer attractive interest rates on credit. Competition in financial services has been hampered by limitations on the operation of foreign banks in Poland. Following establishment of Amerbank in 1990, six additional licenses were granted to foreign banks in 1991. Like domestic banks, foreign-owned banks were subject to supervision by the NBP, contrary to western convention under which foreign banks are supervised by the financial authorities of the parent country. Then the NBP ceased granting licenses to foreign banks, to resume, at a very modest level, only in September 1994. The NBP policy during that hiatus had been to encourage foreign banks to invest in domestic banks; the NBP Vice-President is quoted to have said "The NBP is eager to grant licenses to banks willing to invest in Polish banks with no chances of survival."³⁸

Main threats to the Polish banking system in 1991 can be summarized as follows:

- (a) risk created by credit exposure to failing enterprises (public and private), and the apparent slow pace of adjustment in the public enterprise sector;
- (b) recession and fiscal crisis provoked by the stabilization measures, contributing to the large share of bad loans in banks' portfolios;
- (c) excessive concentration of credits, especially for small banks;
- (d) imprudent lending practices and failure to maintain minimum solvency ratios and suitable liquidity; and
- (e) financial offenses.

Completion of a major study of companies' indebtedness to the Polish banking system, conducted jointly by the NBP, the Ministry of Finance and the Ministry of

Industry, with the cooperation of World Bank consultants, resulted in new obligations for the major banks in 1991. The largest banks were required to implement a series of measures designed to tighten control over their portfolios. Each of the largest banks was obliged to conduct a professional audit of its credit portfolio, take action to collect credits at risk of default and organize management systems for routine assessment of the credit portfolio and evaluation of restructuring proposals presented by clients. Significant amendments to the Banking Act of 1989 were adopted on 9 April 1992. Pursuant to these amendments, banks were obliged to disclose audited balance sheets, profit and loss statements, and major acquisitions or transfers of shares; to publish interest and fee rates; and to keep the NBP generally apprised of the state of their affairs. Another important element of the amendments was imposition of a limit of 15% on the level of concentration of exposure to clients or groups of interdependent clients.

3. Inter-enterprise credit (IEC)

IEC continues to be an obstacle to transformation of the CEECs' economies and, especially, of their financial institutions. Non-payment of debts enabled innumerable companies, both private and state-owned, to avoid financial crisis and delay adjustment to the new economic conditions. In so-doing, the strategy crowded out growth, starved state budgets and often shifted the burden of accumulated state-sector debts onto new private firms. The existence of an extensive, informal network of deferred payment among firms was characteristic of the 1980s in Poland and has been observed in recent years throughout the CEECs. The ubiquity of this condition in the CPEs was rooted in state ownership of a majority both of supplier and client firms; those outside the state portfolio generally did business with SOEs, and so were also protected. Companies' only need for cash or bank credit was to pay wages, and purchase foreign exchange when needed. In order to conserve liquidity, other expenditures were channelled through IEC whenever

possible. A representative of the Ministry of Finance noted, in 1990, that "Enterprises tend to advance credit spontaneously, since their bilateral relationships are based on monopolistic or vertical links" (Olex 1992, 103). The business environment lacked effective structural disincentives to defaulting; unlike commercial creditors, SOEs and state banks could not impose significant reputational or financial penalties. Firms therefore behaved as though the state budget had an unlimited capacity to absorb bad debt. However, those which chose to grant credit to their customers likely anticipated tight credit policies would be reversed, or eased, and general solvency restored. It has been suggested that such firms raised their prices to protect themselves against inflationary losses owing to delayed receivables, and thus fuelled short-run inflation (Rostowski 1993, 184).

Outstanding domestic credits have been identified as a major impediment to privatization, restructuring, economic recovery and growth. The debt-relay scheme culminates in payment bottlenecks which block potentially beneficial effects of monetary policy, induce inflation and impede investment. The low level of monetization of the Polish economy has also limited the effectiveness of monetary policy (See Table 6). Contracts enforced by well-established SOEs with new private firms may be inequitable; in fact, empirical studies show that, as suppliers, SOEs often demand cash payment upon delivery of goods, while delayed payment or non-payment typify SOEs' behaviour as customers. Thus, private sector producers, usually smaller firms, are forced to subsidize the state sector.

There is another factor to be taken into account. Michal Zielinski observed that one of the main features of monetary supply in 1991 was the increased share of demand for money by the state budget: "the budget joined the enterprise sector in expanding the chain of involuntary credits by delaying payments, mainly to the public services sector. In this way, the budget also initiated creation of additional informal money supply, as institutions dependent on the budget had to postpone their payments to others in the chain of

indebtment." Zielinski calculated that the ratio between the budget deficit and net credit expansion to the enterprise sector nearly doubled in 1991, from 0.26 in the fourth quarter of 1990 to 0.50 in the fourth quarter of 1991 (Zielinski 1993,91)³⁹. The high level of tax arrears signified that SOEs continued to operate with soft budget constraints. It could be argued that interest-free deferral of corporate tax payments in market economies, to reduce corporation's tax obligations, achieves a similarly soft budget constraint for large enterprises (especially when compared with household budgets); in Canada the sum of corporate tax arrears was almost CD 40 billion in 1995.

From another perspective, the effects of IEC may be outlined in this way: the reliance of the public sector on bank credit ensured that banks, at least, received debt service for the share of total lending absorbed by the state. This enabled banks to continue paying interest on deposits. "The deficit is thus a way of providing a safety net for the banking system" (Gomulka 1993, 197).

Inter-firm debt more than doubled from December 1989 to December 1990, and continued to grow at that pace. In 1992, outstanding debt owed by enterprises to the banks equalled PLZ 140 trillion; by enterprises to one another, PLZ 260 trillion; and back-payments owed by enterprises to the Treasury, PLZ 20.6 trillion.⁴⁰ At the end of 1993, overdue debts totalled PLZ 520 trillion⁴¹, more than USD 20 billion. According to Poland: International Economic Report 1993-94, in 1993 the composition of corporate assets included 53.9% receivables and claims. Total enterprise obligations were calculated to have increased by 34.8% over 1992, comprising a 28.6% increase in debts for goods and services and 41.7% increase in debts owed to the central government. That, at 36.6%, the

³⁹ The discussion appears in the context of Zielinski's analysis that monetary contraction was not the major cause of falling aggregate demand.

⁴⁰ Warsaw Voice, 8 November 1992, B4.

⁴¹ Poland: International Economic Report 1993-94 Figures vary; according to this publication, the value of such debts had increased by ZL 156.5 trillion over 1993.

ratio between obligations and receivables remained at the 1992 level demonstrated a level rate of accumulation of arrears. The Report continues: "the structure of these obligations is changing with the proportion of payments due to central government and outstanding social insurance contributions are on the rise",⁴² suggesting that payment priority was being assigned to suppliers or banks, over government.

Although the zloty value of IEC in 1990 and 1991 was more or less equal to the value of total bank credits to the SOE sector (Winiecki 1993, 14), the level of IEC in Poland was neither unique nor especially severe when compared with other post-CPEs. In real terms, IEC fell by 36% in the first six months after implementation of the Balcerowicz plan; in both the Czech Republic and Russia, a real increase in IEC ensued in the months following implementation of their respective stabilization programmes.

Traditionally, Poles have placed deposits with the large state-owned banks because such deposits were protected by Treasury guarantees. However, a new Deposit Insurance Law came into effect in February 1995, which has expanded the scope of deposit insurance to all banks.⁴³ In December 1992, although more than one half of Polish banks were privately owned, the state-owned banks were better capitalized and controlled almost 90% of the credit market (Lamacz 1995, 162). At that time, approximately 4,500 enterprises were deemed by the major banks not to be creditworthy. (See Table 7 and Table 8). In June 1993, results of a study conducted by the Central Planning Office revealed that 90% of banks faced payment bottlenecks. The report, "Banks 1993", commissioned by the Union of Polish Banks estimated the overall level of non-performing loans held by State-owned banks to be 27%, which included 60% of total credits to large SOEs. Enterprise managers normally adjust their creditor ranking to according to the severity of penalties

42 Poland: International Economic Report 1993-1994, 67.

43 Liability is limited to 100% on deposits up to 1000 ECU, with a lower level of coverage applying for larger amounts. GEMINI, 85.

imposed on defaulters. In 1990 when, pursuant to the 1989 Law on Financial Management of SOEs, non-payment of the dividend on capital assets automatically triggered bankruptcy proceedings, enterprises ranked payment of the dividend an absolute priority (Jorgenson, Gelb, and Singh 1990, 170).

4. The Financial Restructuring Act 1993

A decisive measure was enacted on 19 March 1993. The Financial Restructuring Act⁴⁴ set an unusual precedent in giving state-owned banks authority to launch restructuring of SOEs with debts exceeding PLZ 15 billion, or having more than 30% of their debts in arrears. Immediately preceding adoption of the Restructuring Law was a reduction of interest rates calculated to promote borrowing for productive applications. The lower interest rates were accompanied by more exacting criteria for loans, but succeeded in boosting short-term borrowing by 10% over the expected level.

The Restructuring Programme was intended "both to cure the problem of bad debts and to eradicate the main causes that lie behind it." These were its main objectives:

- (a) to assist debtors capable of successful adaptation to the market;
- (b) to eliminate businesses incapable of adapting;
- (c) to improve the overall health of the financial sector by clearing out bad debt;
- (d) to simulate a free-market environment for the provision of financial services.⁴⁵

Polish authorities designed a restructuring strategy which could be applied in a decentralized manner, offering extraordinary authority, influence and discretion to eligible banks in its implementation. At the same time, such banks accepted responsibility for the effective management and correction of their own portfolios. A combination of incentives was designed to stimulate banks and debtors to cooperate in seeking an optimal resolution to their mutual problems and impose financial discipline on all the parties involved. The

⁴⁴ Also called the Law on Debt Reduction for Enterprises and Banks.

⁴⁵ The Financial System in Poland, NBP, 31.

Law provided for *ex ante* recapitalization of banks holding non-performing debts (loans extended before the end of December 1991) and set 31 March 1994 as the deadline for settlement of bad debts. It set out the following new alternative settlement options: conciliation (in the forms specified in the Act), initiation of bankruptcy or liquidation proceedings, open market debt sales, and debt-for-equity sale. Although routine administrative supervision of participating banks is performed by the National Bank of Poland, the Ministry of Finance is empowered to represent the Government. Complaints that the Finance Ministry resorted to coercive measures to impose the programme on banks were likely based on the fact that the Ministry is empowered to exercise shareholders' rights with respect to State-owned banks. If a current package of bills to reform the economic ministries is adopted by the *Sejm*, the Ministry will lose that authority⁴⁶ in an effort to limit the influence of government bureaucrats on the commercial banking system.

To support implementation of the Restructuring Programme, Supervisory Boards, staffed by professionals in law and finance, were established and a system of regular financial audits and analysis, undertaken. Seven twinning agreements with major western banks, financed by the World Bank, were concluded as a vehicle for the transfer of banking expertise and technology. Poland's largest commercial bank, *Bank Handlowy*⁴⁷, had already gained extensive experience in foreign trade as the state's exclusive trading bank and was not deemed needy of a western twin. The Bank has been a major facilitator of foreign credit instruments in Poland.

The banks' eligibility to participate was dependent on satisfaction of the following conditions: at least 50% ownership by the state, having audited financial statements conforming with international standards, separation of a specialized portfolio dedicated to problem loans and creation of a "work-out" department exclusively for their

⁴⁶ The bills were approved by the Council of Ministers on 12 November 1995.

⁴⁷ In 1992, its sales ranked third among Polish companies. Economist Intelligence Unit, 1993.

management. Applications had to be accompanied by restructuring plans. "Work-out" units were required to evaluate the quality of all outstanding loans, assess the ability of each debtor to service the restructured liabilities and develop a restructuring programme to minimize the bank's potential losses while developing the account's future potential profitability. Satisfaction of these conditions entitled banks to be recapitalized. (See Table 9)

Recapitalization was calculated not only to achieve the level of risk-asset ratio (RAR) required by the Bank on International Settlements (BIS), but to exceed it. Anticipating the possibility of sudden change in the economic fortunes of debtor companies, the Ministry increased the minimum RAR from 8% to 12%.⁴⁸ Government Restructuring Bonds issued to the banks are initially non-transferable and reach maturity in fifteen years. Costs are shared by the central government and the Polish Bank Privatization Fund (BPF) which was established in 1992. The Fund was financed by transfer of unused capital from the Zloty Stabilization Fund of 1990,⁴⁹ with an agreement that the central government will service the Restructuring Bonds (principal and interest) for each bank, until the respective bank is privatized. Upon privatization, the Bonds will be serviced and redeemed through the BPF -- a process which is expected to be completed for all the banks involved by 1997.

According to the Polish Development Bank, settlement by individual bank arrangement represents the most important innovation introduced by the Act. Banks had full authority to negotiate with their clients, and could grant partial forgiveness of principal and interest. These conditions improved chances for settlement to be reached without the cost and delay entailed in court bankruptcy proceedings, and without their severe

⁴⁸ All banks established after June 1993 were required to meet capital adequacy ratios higher than 8%.

⁴⁹ The transfer was effected with the agreement of contributors to the currency stabilization fund, and of creditors.

consequences. From the creditor's point of view, the Act simplified existing conciliation provisions. The bank exercises discretion in its response to a debtor's application; it may choose to propose an arrangement and initiate enterprise restructuring or, instead, to sell the loan at a discount and write-off the loss. Having elected to undertake an arrangement, a bank assumes full responsibility for ensuring any other creditor holding claim to at least 50% of the debtor's liabilities accepts the plan and will sustain no injury; on this foundation, the settlement has the force of law.

Banks undertake to sell debts when the enterprise is deemed a poor candidate for restructuring and proceeds from debt sale are expected to exceed potential proceeds from bankruptcy or liquidation. Although the Civil Code provides for transfer of the ownership of debt, prior to implementation of the Restructuring Act, Polish banks were prevented from engaging in the public sale of debt by the confidentiality provisions of the Banking Act (Article 48). The Restructuring Act overrides Article 48, permitting banks to sell loans publicly, at a market price, on the sole condition that the loan is outstanding. This provision was intended to stimulate emergence of broader debt markets for the mutual benefit of debtors, banks and investors, which would lead to the expanded use of debt-for-equity exchange as an efficient method of privatizing weaker firms.

The Act introduced debt-for-equity swaps for SOEs and commercialized companies, wholly-owned by Treasury, with the prospect that encouraging use of the secondary debt market could dissolve some payment bottlenecks created by IEC. The new procedure does not limit debt exchange to debts owed to banks. The Act circumvents provisions of the Law on Privatization of SOEs for employee participation in enterprises' privatization decisions: "A debt-to-equity swap does not require a decision on incorporation of the enterprise by its statutory bodies (Workers' Councils or management) nor by its parent body. Should they wish to retain the current status of the enterprise or utilize a different method of privatization, the only recourse for the aforementioned bodies

is to arrange payment of the outstanding debt, thus removing the substantive basis for claims on the enterprise."⁵⁰

Certain aspects of the Restructuring Programme have given rise to concern about sustained state intervention. Tadeusz Lamacz identified several potential drawbacks arising from the role of the state in these processes. First, the Act could maintain bureaucratic intervention in banking practices; he wrote: "One cannot miss the point that, until the banks are privatized, civil servants from the Ministry of Finance will take a series of steps, including mandatory action to be imposed on the banks and ensure their close monitoring by the Ministry. Thus the independent nature of commercial banking is to be violated and 'banking culture' can only be insufficiently improved in the course of the operation" (Lamacz 1995, 168). Second, Lamacz maintained that meaningful involvement by the state in privatization and economic and financial restructuring implied corruption, which would risk invoking loss of confidence in reforms. Third, as acts of intervention generally lead to repetition, successive budgetary allocations could be called for.

A study by the Gdansk Institute for Market Economy (IBGR) found that 93% of non-performing credits of Poland's seven major state-owned banks⁵¹ had entered a restructuring process: in 84% of cases, settlement was by conciliation, 11% of cases were settled in court and in 4% of cases other methods were used. Only a small number of debt-for-equity swaps were recorded, reportedly because the required procedures are time-consuming and difficult (See Table 10). The IBGR concluded that "the banks are in a position to achieve reduction of the ratio of bad debts in their portfolios to about 8% within two years, from about 30% last year." The actual result by June 1995 was that bank claims on businesses in bad financial standing represented 16.9% of total bank lending to

⁵⁰ The Financial System in Poland, NBP, 35.

⁵¹ Of the seven which were state-owned at the time of the IBGR study, two have been privatized: Bank Przemysłowo-Handlowy SA and Bank Gdanski.

the corporate sector, and 22.2% of total corporate debt to the major banks.⁵² New regulations require banks to maintain strict loan loss provisions: a minimum of 10% for debts up to three months late, and at least 50% for debts six months in arrears.

Cooperative banks also play a major financing role in Poland, providing 90% of loans to the agricultural sector in the first half of 1994; according to the Central Planning Office, the sector's costs were reportedly double the amount of its revenues during the same period. The cooperative banks provide 7.5% of total loan financing to the non-financial sector and hold 8% of the total value of bank deposits. In August 1994, the Chief Banking Supervision Inspectorate declared that 67% of the cooperatives credits should be classified as non-performing.⁵³ This sector is also undergoing intensive transformation.

In the short-term, the Act has had the positive effect of providing participating commercial banks with stable and adequate capital bases. They have also acquired experience in applying sound business decisions and developing constructive relations with clients. A third consequence has been the effective delivery of expert counsel to banks and enterprises, resulting in many instances, in survival and privatization by restructuring of SOEs which might have been shut down with less-active intervention. The conciliatory approach is not unlike that employed by banks in Japan and Germany, where bankruptcy provisions are commonly eschewed in favour of private arrangements between banks and clients. Arriving at such arrangements is time-consuming, and companies may be required to reduce dividend payments or employment levels temporarily. Current levels of investment, research and development spending will be maintained, thus enterprises are assisted not only in surviving but also in overcoming difficulties. "The whole process reduces the likelihood of ultimate failure as well as creditors' potential losses" (Jackson

52 NBP.

53 Warsaw Voice, The Financial Voice August 1994, F1.

1992, 71). It is worth noting also that Poland is not unique among CEECs in having transferred substantial authority to the banks; in the CSFR, almost three quarters of privatization vouchers were acquired by ten investment funds, of which half are owned by banks (Griffith-Jones 1995, 7).

Rostowski identified a fiscal advantage of using the secondary debt market as a profitable way of clearing the obligations of SOEs. "When the market defines a real value of the commercial credit granted to bad enterprises by good ones, this will naturally not change the situation of the latter as far as the cash flow is concerned. But it can significantly alter their financial results and thus the state's budget receipts" (Rostowski 1993, 193).

At year-end 1995, the Pentor Institute for Market Research surveyed more than two hundred bankers. Asked to identify the most favourable development of the past year, 56% named the declining share of bad debt and 35% said banks' improved financial condition. However, 73% named a high rate of private and cooperative banks' bankruptcy as the year's least favourable development.⁵⁴ A current priority of the NBP in 1995 is progressive consolidation of the banking sector by takeovers and mergers of weak small and medium-sized units. The strategy has provoked controversy between the Ministry of Finance and the NBP about how best to achieve the objective, with the Ministry arguing the NBP proposal is too restrictive and could hamper progress. To strengthen Polish banks in anticipation of free entry in 1999 of foreign competitors, the government also consolidated its commercial banking assets in two banking holding companies: one operating through *Bank Handlowy w Warszawie* and the other through *Polska Kasa Opieki* (PeKaO).⁵⁵ If the bill outlining consolidation plans for two large banking groups is adopted

⁵⁴ Warsaw Voice, 31 December 1995.

⁵⁵ It should be noted here that none of the Bank Act, the Commercial Code or taxation law, provide for operation of holding companies.

by parliament, these banks will become the center of the two groups. It has been agreed in principle that upon privatization of the affected banks, 51% of their total stock will be contributed to pension funds as part of a major reform of national social security provisions.⁵⁶ It is anticipated that progressive consolidation of banks may have a detrimental effect on financial services for the small business sector, as policies favouring economies of scale become more entrenched.

There is controversy about the membership of the banks' supervisory and management boards. Some argue that these positions are held overwhelmingly by *nomenklatura*, others maintain that professional competency is the only criterion for membership -- which is rewarded by attractive salaries (from PLN 4,000 to PLN 10,000 monthly). "The lack of clearly demarcated spheres of authority for the internal supervisory and management boards has resulted in power struggles. . . the public nature of their disputes is hurting the image of Poland's fledgling banking system."⁵⁷

A fundamental purpose of normal banking functions in a market economy is to intermediate between deficits and surpluses of economic actors, that is, to transform savings into investment. To provide effective payments systems and facilitate optimal allocation of financial resources is the banks' contribution to microeconomic management. By coordinating these activities, the banks minimize transaction costs and risks of economic development, and enhance aggregate growth potential. The critical question is whether the Polish banking system contributes effectively to the realization of Poland's major economic goals; specifically, this thesis examines the role of the commercial banks and complementary financing provisions vis a vis small and medium-sized private enterprises.

⁵⁶ Economic and Legal Information from Poland (December 1995 -January 1996), 1-2

⁵⁷ Andrzej Ratajczyk, Warsaw Voice, 3 December 1995.

One measure of the Programme's success in fostering a free-market in financial services is the character of bank lending to the private sector. In Part II.C, the market in bank credit market for small and mid-sized private enterprises will be examined.

C. MAJOR OBSTACLES TO THE SMOOTH FUNCTIONING OF BANKS AS FINANCIAL INTERMEDIARIES FOR THE ENTERPRISE SECTOR

1. Introduction

There was, in 1990, a breakthrough in the attitude of banks toward the private sector; the NBP President strongly urged banks to earmark 50% of their total loan portfolios for private sector firms. Thus, from January to December 1990, the nominal value of loans increased fifteen-fold, and the share of credits allocated to the private sector increased from 3.65% to 15.4%. By the end of 1991, 24% of total credits were apportioned to private firms and at end-1992, the share had grown to 29% (Wyczanski 1992, 53).⁵⁸ Banks specializing in services to SMEs began to emerge in 1990, but the rate of growth was quite slow. Only a low level of capital was amassed at the outset and it is well known that such lending was extremely risky at the beginning of marketization. As noted earlier, the SME financial market, shared between specialized banks and the large more comprehensive banks, remains dominated by PKO BP which normally does not handle foreign lines of credit.⁵⁹

Table 11 illustrates the composition of Poland's domestic credit over the years 1990 through 1993. Total commercial bank lending fell short of planned levels in 1994. The American organization, Growth and Equity through Microenterprise Investments and Institutions (GEMINI), is the major consultant to the Ministry of Industry and Trade (MIT) on the subject of SME development; GEMINI observed in 1995 that continuation of the decline in lending would progressively reduce the role played by the banking system in economic development.

⁵⁸ Total credits is defined as total credits to economic subjects.

⁵⁹ Canadian Export Development Corporation, 1995.

Obstacles to routine credit allocation to private sector companies by commercial banks are numerous. Among them, probably the most important stem from the difficulty of securing loans. The first loan guarantees were made available in 1990 by the NBP as part of a policy to promote growth of the private sector. These low-cost guarantees targetted loans of less than PNZ 2 billion to private sector subjects; a maximum of 60% of the risk not secured by other means could be protected. Another provision available in 1990 was a guarantee on loans to privatized or new trading enterprises which was drawn from the Market Development and De-Monopolization Fund. As demand for credit insurance began to emerge, new insurance companies filled a market gap as established insurers avoided the risks presented by private economic subjects. Such insurance was highly priced because of the substantial risk entailed for borrowers and their creditors, but also because creditors' ability to differentiate degrees of risk had not yet been developed.

Creation of a Loan Guarantee Fund (FPK) was approved by an April 1993 Council of Ministers Ordinance, especially to provide security to banks lending to SMEs. The Ministry of Finance reached an agreement with the *Bank Gospodarstwa Krajowego* (BGK) in 1994, and the FPK became operational in May 1995. The effectiveness and suitability of loan guarantee programmes in Poland, including those identified above, will be studied later. It will be seen that the Polish programmes are, like SME loan and guarantee programmes throughout the world, "all designed to supplement the functioning of a banking sector that is basically uninterested in SMEs" (Dec 1995, 169).

In the hyperinflationary economy of 1990, bank profits soared but systemic gains were mitigated by foreign exchange losses arising from currency revaluation. An end to the profit windfall was foreseeable:

There are fears the profits are only temporary: with the stabilization of the economy and a possible deepening of the recession, the banks will experience a considerable deterioration of the quality of their loan portfolio. Ideally, the banks' extra profits should be used to provide for their actual and latent foreign exchange losses and loan losses. The banks have not

created such provisions; without pressure they will not do so (Olex 1992, 102).

In fact, major losses were sustained by banks when new small private companies in large numbers defaulted on their obligations in 1991 and 1992. Because most loans to private firms were small, these losses could be absorbed without difficulty by large state banks but the viability of smaller banks, especially private banks, was threatened. Operating margins of all banks came under pressure as costs increased due to intensive personnel training and computerization, and interest rates fell. The tactic of diverting assets into low-risk government bills also reduced potential rates of return and earning spreads. The Financial Times reported in 1993, that

Faced with heavy losses on loans to the fledgling private sector, most banks have reduced lending to the risky but capital-starved private sector. . . . [the private sector's] capacity for future growth will be largely determined by access to affordable loans from competent banks.⁶⁰

The latter observation is confirmed by Bak who in 1992 stated "only cheap credit can stimulate investments when one's own capital is missing and the financial market is underdeveloped." However, Bak put forward a slightly different interpretation of conditions in the early post-transformation years, saying that banks exercised control over enterprises: "the working capital of enterprises was kept on purpose at a low level so that enterprises were compelled to draw credit. Enterprises obtained working-capital credit irrespective of whether they would be able to repay it or not" (Bak 1992, 56). For the purpose of the present study, we recognize that the result of high interest rates under the circumstances described had the dual effect of aggravating inflation and encouraging reciprocal credit arrangements between firms. Conditions for obtaining credit, as experienced by enterprises during the early years of the economic transformation, are summarized in Table 12.

⁶⁰

The Financial Times (London), "Poland 1993 Supplement", 8

2. Low capitalization and the shortage of domestic capital

The shortage of domestic capital is a major obstacle to financing the emergence of a new private sector in Poland. Provision by the state for the needs of its citizens throughout their lifetimes is the foundation of communism, so personal saving was normally not a function of life-cycle planning. It can be expected that a positive disposition toward saving will grow over time, but in 1994, 60% of surveyed Poles responded they saw "no point" in saving.⁶¹ If the share of savings likely to be allocated for investment was set at 15%, which is typical in the West, the total capital outlay from private individuals in 1990 would have amounted to 3.5% of the value of public-sector productive assets (Breitkopf, Gorski and Jaszczynski 1991, 29). The low supply of domestic savings has been aggravated, argued Gajdeczka, by the fact that such monetary assets as were accumulated by Poles have for successive years been severely taxed by inflation and, additionally, by negative real interest rates. In contrast, the value of fixed assets held by the state appreciated during inflationary periods. The financial means of households and the domestic private sector were insufficient to "buy back" the communal patrimony from its guardian.

In broad terms, assets holdings in a centrally-planned economy could be interpreted as a scheme whereby the state-owned banking system was an intermediary between the households as "savers" and the state as the "entrepreneur", and the banking system's liabilities vis-a-vis the household sector were backed by loans to firms that invested in physical assets managed on behalf of the state. Households were a structural creditor who held claims on the net debtor enterprise sector, while the central government's fiscal position was balanced...(except for the external debt) (Gajdeczka 1993, 176).

Another way of characterizing the skewed structure of monetary assets in the centrally planned economy is presented by Aslund. Because households held cash and operated within hard budget constraints, and enterprises held "account money" which was

⁶¹

Central European Business Weekly, 28 October-3 November 1994, 5.

relatively elastic, "When rationing is lifted and enterprises and households compete on the same market, enterprises are initially likely to expand their consumption at the expense of households" (Aslund 1994, 27). The product of the persistent inflation tax was that in 1990, the nominal value of households' monetary assets in domestic currency was 8% of GDP, a quarter of the 1981 level (Gajdeczka 1993, 181).

Gajdeczka presented two additional factors, both arising from price liberalization of 1989 and 1990, which limited the value of household assets: (i) liberalization of food prices which sharply reduced the value of broad money, and (ii) rapid appreciation of the real value of the zloty which devalued households' foreign exchange holdings which were represented by GUS - for the year end 1990 - to constitute 41.4% of total personal savings (Breitkopf, Gorski and Jaszczynski 1991, 28)]. He concluded that the only possibility of active participation by the general population in the privatization of Poland's productive assets depended on massive redistribution of fungible value from the enterprise sector to the household sector.

With few exceptions, in the early stages of the transition before foreign or institutional investors had been effectively mobilized, the scope of privatization was largely limited to small enterprises in services, trade and retailing. Although Article 25 of the 1990 Act on Privatization of SOEs commits the state to distributing part of its assets equally among Polish citizens, this redistributive aspect of privatization policy has been significantly delayed. This component of the Mass Privatization Programme was launched in November 1995, after successive delays, with the sale of certificates in the National Investment Funds.⁶² Preferential share sale provisions to employees of SOEs have, however, been influential to the extent that employee ownership was estimated in 1991 to dominate ownership structure in approximately 85% of private enterprises, largely

⁶² Purchase price, called a registration fee, was the equivalent of USD 8, and sales are slated to continue for one year.

as a result of privatization by liquidation under Article 37 of the Law on Privatization of SOEs (Olko-Bagienska, Pankow and Ruszkowski 1992).

3. Catch 22: The role of international capital

Poland has faced a unique set of factors constraining its development strategy. We have seen that the shortage of domestic savings makes foreign investment a necessity. The steep financing requirements of Poland's foreign debt have led public sector borrowing which has, it is argued, crowded out new investment and stimulated inflation. These factors create tension between policies to contain inflation and policies to stimulate investment. Finally, Poland's decision to suspend debt service in 1989 had serious reputational consequences and provoked a sustained near-embargo on outsider investment. One observes, simultaneously, reluctance to consume foreign capital and reliance upon it.

Entrepreneurs' choices among financing sources are always constrained, and the resulting financial structure of firms prejudices their chances of survival and growth. Glen and Pinto observed that sovereign credit ratings often constrain the funding choices of companies in developing nations: "developing countries have faced much more constrained choices than their developed country counterparts. Thus, the observed "pecking order" in the funding decisions of firms in developing countries is likely to reflect the extent of financial liberalization chosen by the government" (Glen and Pinto 1994, 41). While Poland pursued swift liberalization and westward integration of its financial sector, a measure of austerity and restraint is evident in domestic policy. This can be understood in the context of the radical tight credit policies imposed by the 1990 Balcerowicz plan to defeat inflation. The Plan succeeded in achieving sharply reduced rates of inflation and had well-documented deleterious microeconomic effects owing largely to tight credit policies. "It is impossible to work out the precise real rate of interest implied by this nominal rate [6% monthly for investors in the state bank with inflation of 2-3% monthly],

given the *ex-post* inflation rate and the foreign exchange policy. Nevertheless it is a phenomenally high rate by any standards" (Gowland 1992, 12). Although households struggled, the new rigidity of credit policies lacked credibility with companies which survived by collaborating in the deferral of payables and receivables while anticipating their debts would ultimately be subsidized by the state. That inflation has continued to be high is explained in part by the eventual capitalization of IEC. Control of inflation has remained a constant policy priority, not least to satisfy IMF demands that the deficit be contained below 5%. IMF Managing Director Michel Camdessus acknowledged in 1995 the "difficult balancing act" Poland must maintain to control inflation while attracting capital inflows, but stated "I believe Poland is strongly committed to the policies embodied in its stand-by agreement".⁶³

In all observed economies, the so-called "developed" and "developing" economies and, now, the transition economies, small companies have difficulty acquiring sufficient equity to maintain a desirable ratio of debt to equity financing. This difficulty is aggravated for new companies in the emerging private sectors in CEECs, where access to international capital markets is limited by immature capital markets and by below-investment-grade sovereign credit ratings. The leaders of Poland's successive post-communist governments have struggled consistently to build a positive international reputation. In present circumstances there is no substitute for investor confidence.

Owing to extensive borrowing during the 1970s, notably by the Gierek administration, Poland's external debt had reached USD 25 billion by the early eighties. Subsequent to suspension of debt service payments, the debt mounted to USD 45 billion by January 1991. Following protracted negotiations, first with the Paris Club and then with the London Club, Polish debt was rescheduled. On 19 April 1991, an agreement was

reached with the Paris Club representing foreign governments to reduce Poland's debt to 50% of its net value at the time, about USD 34 billion. In April 1996, pursuant to the Paris Club agreement, Poland must resume payments against the principal owed to foreign governments, which will intensify pressure on the resources of the banking system. Poland's debt of USD 14 billion to foreign commercial creditors was discounted by 42.5% subsequent to conclusion of an agreement with the London Club on 14 September 1994, finally rendering manageable the country's international debts. In May 1995, Moody's granted Poland its first investment grade credit rating (BAA3)⁶⁴; it is expected that international capital flows will respond favourably to the steady improvement in Poland's ranking.

Poland has not attracted a proportionate share of foreign direct investment (FDI) in eastern Europe. In October 1994, only 7% of FDI in the region was invested there.⁶⁵ According to the Office of the Trade Commissioner in Montréal, Poland is the first country to have been granted such a rating subsequent to major debt rescheduling. Their confidence that "the community feels that Poland has returned to the international financial scene as a credible partner"⁶⁶ is confirmed by a sharp increase in FDI in 1995. Preliminary figures from the Polish Agency for Foreign Investment (PAIZ) show USD 2.1 billion in 1995, as compared with USD 1.28 billion in 1994, of which foreign banks account for a large share. According to the PAIZ data, the United States was the largest investor and German investment was present in the largest number of firms.

In 1995, having announced a new package of anti-inflationary measures, Minister of Finance Grzegorz Kolodko blamed accelerating inflation on the National Bank of Poland's

⁶⁴ Standard & Poors and IBCA assigned sub-investment grade ratings.

⁶⁵ "EBRD Transition Report", October 1994.

⁶⁶ Poland Now, Vol.5 No.2, April-June 1995, 1.

failure to control money supply.⁶⁷ The central bank counters that extensive government borrowing to finance its deficit is the major instigator of inflationary trends, making a restrictive monetary policy impossible to implement. The role of the central bank in implementing monetary policy is further impeded by the fact that NBP recommendations are subject to approval by the Sejm. Resumption of external commercial debt payments in April 1996 will increase public sector demands on foreign reserves. An NBP study concluded that "The state has crowded out commercial borrowers from the market and even though firms have learned to finance investment from profits, the demand for credit is going to grow once the simple reserves for growth are exhausted."⁶⁸ However, the budget deficit has been maintained at less than 3% in recent years and the record shows it contributed to only 2.6% of total monetary expansion in 1995; Nuti therefore disclaimed the NBP position and argued that "inflation cannot possibly be imputed to the fiscal stance."⁶⁹

At December 1992, of USD 8.5 billion committed by multilateral organizations and bilateral creditors, approximately 19% had been disbursed (Lamacz 1995, 159). In 1993, Ministry of Finance data showed Poland had used less than 10% of total available foreign credits, and the Deputy Director of the Foreign Department explained: "At all costs we must avoid a repeat of the 1970s when we borrowed money with abandon until we found ourselves in the debt trap."⁷⁰ At *Bank Roswoju Eksportu* (BRE), Poland's export development bank, privatized since 1992, available medium- and long-term credit lines are underutilized because of regulatory and market uncertainty and the low level of

⁶⁷ Rynki Zagraniczne, No.6, 1995, 1.

⁶⁸ Rynki Zagraniczne, No. 4-5, 1995, 2.

⁶⁹ D. Mario Nuti (London School of Economics) cited in "Strategy for Poland", published as a special supplement to the Warsaw Voice, 4 February 1996, S3.

⁷⁰ Andrzej Chmiel, cited in Warsaw Voice, 20 June 1993, B3.

creditworthiness of private sector enterprises.⁷¹ From a macroeconomic perspective, foreign equity investment is to be preferred to foreign debt, although FDI also has its detractors.

Foreign investment in Polish businesses has been permitted since 1976.⁷² Results of early privatization initiatives to break up the monopoly of the domestic trade organizations over retail and service outlets were dominated by sale or lease of small and medium-sized businesses to their employees or managers; this limited opportunities for outside capital. The record shows, however, that foreign investment in small businesses represents a substantial share of total FDI in Poland. In 1993, a survey of 3,651 companies with foreign capital participation (almost half their total number) showed almost three quarters were SMEs: 46% had fewer than five employees, and 25.9% had between ten and fifty employees (Wielgus 1995, 49).

Since 1988, foreign companies and individuals have been free to undertake economic activities in Poland but initial preferential conditions for foreign investors, including an automatic three-year tax holiday⁷³, expired on 31 March 1994. Current provisions to attract investment are focussed around sectoral objectives and apply equally to foreign and domestic capital. In July 1993 the Council of Ministers issued a decree relating exclusively to investment in areas of structural unemployment, which provides for tax exemption of investment expenditure including purchase or construction of buildings, purchase and installation of machinery. With the addition of depreciation allowances, the tax relief amounts to approximately 125% the cost of the asset. Then, on 1 January 1994,

⁷¹ Reasons attributed by Canada's Economic Development Corporation.

⁷² 14 May 1976, Decree of the Council of Ministers on the Granting of Permission to Foreign Legal and Moral Persons in Respect of Certain Kinds of Economic Activity. With some restrictions, the Decree also established the right of foreigners to be sole owners of SMEs provided company directors were Polish.

⁷³ This provision was replaced on 14 June 1991, when the Law on Companies with Foreign Capital Participation was amended, with individualized assessment emphasizing accelerated depreciation and targetted regional promotion. Already granted tax holidays term's expired in March 1994.

an additional tax incentive was introduced for exporters, new investors and profitable companies. In December 1994, a Council of Ministers' Regulation was published establishing preferential conditions for government procurement from domestic firms and foreign companies incorporated in Poland.⁷⁴ A Special Economic Zone (SEZ) with a lifespan of twenty years was erected in Mielec (near Rzeszow) in September 1995, where, contingent on granting of a permit to undertake activities within the SEZ, clustered incentives are extended to investors. By year-end, over fifty foreign companies had expressed interest in locating there. Creation of additional SEZs is anticipated. An incentive which is especially useful to foreign investors exempts, from customs duties, assets transferred cross-border as in-kind contributions to a company.

The marked increase in foreign investment was caused by several factors : conciliation with international creditors; launching of the National Investment Funds; critical advances in telecommunications; and progressive bank privatization. However, the chairman of the Foreign Investors' Chamber of Industry and Commerce points to important disincentives which include difficulty of real estate and leasing transactions, legal restraints on holding companies, and an inadequate incentive structure. Bureaucratic clearance procedures for foreign investment deter investors; the Institute of Business Cycles and Foreign Trade Prices reported that "a foreign investor must meet several hundred state and ministerial standards as well as obtain several dozen clearances and permits when starting a project".⁷⁵ (See Table 13 for major sources of FDI.)

An MIT report issued in late 1995 identified promising sectors in Polish industry, including both outstanding performers and sectors believed to have significant competitive potential but which remain underdeveloped and inefficient producers. The study aimed to

⁷⁴ Economic and Legal Information from Poland (August-September 1995), 9. Provisions for public procurement (specified in item 776, *Dziennik Ustaw*) were modelled after those applied in the U.S. and E.C.

⁷⁵ Privatization Update, June 1994, 2.

identify relatively low-risk opportunities for investors, but the MIT specified that foreign investors should limit their undertakings in "promising" sectors to joint-ventures with Polish enterprises.⁷⁶ Tax and duties relief have been promised for investment in these industries. Fortunately, encouragement to foreign investors also comes from other sources, particularly local governments which actively seek, and sometimes compete to attract, suitable investment. With the exception of those located in regions whose development programmes are funded by multilateral organizations, SMEs rely heavily on local and *Voivod* initiatives to attract capital. According to some observers, "Small private firms may turn out to offer a much better return on western reform efforts than the bloated and geriatric state-owned firms currently languishing in intensive care" (Boisot 1994, 4).

4. Reputation: The banking relationship

The mutual antipathy of Polish creditors and borrowers can be appreciated with some knowledge of their experience in recent years. In the first years of the 1990s, Poland's loose regulatory framework was fertile ground for organized chaos and corruption, exploitation, and simple error -- which combined to create a standoff between the commercial objectives of banks and the ambitions of entrepreneurs. The central players are profoundly skeptical of one another. Attitudes are supremely important to real transformation of the national economy, which enfolds innumerable discrete business relationships into a complex and elastic whole. A higher level of confidence in the law, banks, entrepreneurs and government will take time to develop. In the following paragraphs, business leaders and government authorities are quoted. Their remarks are included here to convey the inter-relatedness of their fortunes and the urgency of the

⁷⁶ Warsaw Voice, 31 December 1995. Top performers were ranked as follows: electric and power generation equipment; lighting equipment; car parts and accessories; pharmaceuticals, cosmetics and toiletries; plastic products; and handblown glassware. Sectors deemed to have good global prospects included household appliances; mechanical vehicles; paints and lacquers; furniture; and textiles.

situation which prevailed in 1990 to 1993.

At first bankers lent liberally, without evaluating the creditworthiness of clients and the feasibility of proposed investments, with dire consequences for creditors and debtors. In 1989 through 1991, dubbed "the period of romantic capitalism" when "enthusiasm and imagination were the most important features needed to make money", entrepreneurs regularly traced a delicate line between legal and illegal activity. Regulations governing banking and private business changed frequently and so were difficult to implement, especially in a business environment disadvantaged by the inexperience of bank and public sector personnel. During that period, "Businessmen built their financial empires on the basis of bank loans made in the early 1990s, which were at the time, easier to obtain than a well-made suit."⁷⁷ In 1992, the Chairman of the Polish Business Council complained that dishonest competition among entrepreneurs had assumed "epidemic proportions".⁷⁸ Later the same year, the Chairman of the Warsaw Craftsmen's Chamber assailed the irresponsible policies of the Polish government which had opened borders without consideration for domestic craftsmen, who were gravely threatened by unfair import competition and smugglers. Import duties applied to essential capital goods had caused the collapse of Poland's leading industrial enterprises, so that the small firms which relied on them were helpless. "In Poland we desperately need institutions to finance small firms because it is very difficult to get a loan. A system of credit and credit guarantees still needs to be created. Another thing: we keep appealing to the government for the laws to be stable; frequent legal changes force many into bankruptcy - sometimes overnight."⁷⁹

Among the new bankers were opportunists who burst upon the marketplace, and

⁷⁷ Dariusz Styczek, Warsaw Voice, 18 September 1994, B4.

⁷⁸ Jan Wejchert, Warsaw Voice, 30 August 1992, B4.

⁷⁹ Boguslaw Wojcik, Warsaw Voice, 11 October 1992, B1. Wojcik was head of the organizational committee for the 1992 International Small Business Congress in Poland.

hung shingles over doors flung open to accept savings deposits -- without maintaining responsible reserve levels. In 1993, the Ministry of Finance official responsible for banks' supervision observed, "Private banks very often serve to pump money from the market into the bank owners' private firms."⁸⁰ Such banks rapidly destroyed already tenuous confidence in financial institutions. Among new entrepreneurs were many who exploited the badly fragmented legal structures, for example, by establishing companies for a single, possibly fabricated, transaction and then declaring bankruptcy so that start-up expenses would constitute a tax write-off. Short-term labour contracts were used to avoid social security payments, and profits were regularly underreported. A former GUS Chairman observed that the "growing pains of capitalism" included excessive self-reliance and an inability to access and use specialists' services and economic data; misapprehension of risk and misuse of funds; and exploitation of established ties and former status in public enterprises.⁸¹

On 12 October 1994, the Business Security Act (or Act on Business Protection) was introduced. Whereas formerly only SOEs' practices were subject to disciplinary measures by means of the Criminal Code, the present Act applies equally to SOEs and POEs. The Act can invoke prison sentences for business crimes including debt avoidance, deliberate bankruptcy and concealment of assets of firms to be privatized or liquidated, and introduces penalties for money laundering.

5. Difficulty of securing loans

A major obstacle to commercial lending is the adverse enabling environment for securing adequate and transferable collateral.

⁸⁰ Jaroslaw Biernacki, Warsaw Voice, 31 March 1993, B7.

⁸¹ Bohdan Wyznikiewicz, Institute of Market Economy Research, cited in Warsaw Voice, 18 September 1994, B4.

In a market economy, commercial banks act as financial intermediaries and are regarded as specialized institutions that can best manage the risk related to the security and terms of the deposits accepted and loans granted and are able to absorb that risk. Meanwhile, the main problem for Polish banks was the lack of the ability and the willingness to accept that risk. There was a widespread tendency to pass that risk onto other subjects: the risk of the quality of credits onto the owners of the bank (ie. the shareholders, also, in the case of banks owned by the Treasury, the interest rate risk on the borrowers and depositors, through variable interest rate on all kinds of credits and deposits (Wyczanski 1992, 42).

When state enterprises constituted the primary clientele of the banking sector, the notion of loan collateral was unfamiliar to most CEEC bankers. In Poland, security on loans is usually demanded pursuant to Article 1025 of the Civil Code and Articles 30 and 31 of the Banking Law, but these provisions merely entitle banks to claim incoming funds from borrowers' current accounts. The right to place liens on possessions is conferred under Article 307 of the Civil Code. Even mortgaging of state-held real estate is poorly developed because SOEs' property title cannot be transferred to a creditor; it was most often used by cooperatives to secure loans to farmers and small private craft interests. The Ministry of Justice initiated a project in late 1995, expected to take three years to complete, to create a comprehensive computer database (CORS) containing the commercial register of economic operators, the register of liens, and real estate registrations showing legal ownership.⁸²

The difficulty of enforcing bank title to property pledged as collateral against defaulted loans is a major deterrent to lending to small-scale projects, for which personal property normally constitutes security. An advisor of the Regional Development Agency of Walbrzych related that a major obstacle to enforcement of bank claims persists in the bias favouring *de facto* over legal ownership. This predisposition is abetted by the fact that the restitution scheme (alternatively called 'reprivatization' or 'compensation' for nationalized fixed assets) is still underway. Also, as there is no registry of pledged collateral, nothing

⁸² Cited in Economic and Legal Information from Poland (Feb-Mar 1996), 8. Registration of real estate is expected to take five years to completion.

prevents a borrower from using the same asset to back up multiple loans. In consequence of these factors, banks are extremely conservative in accepting collateral to secure loans to owner-managed businesses.

The Banking Law permits banks to guarantee loans taken by their clients with other financial institutions, accept guarantees from other legal persons, and insure themselves against risk. Such guarantees are most often used in international transactions but most foreign companies have been unwilling to honour guarantees from any but the most reputed Polish bank in foreign trade, *Bank Handlowy*. The share of guarantees in banks' total credit portfolios is much larger for banks involved in international settlements than for those handling strictly domestic transactions. Even greater is the activity of foreign banks operating in Poland which earn a significant part of their income from loan guarantees. Banks accept guarantees or blank bills endorsed by a third party, however, this type of collateral is accepted when there is an established relationship between themselves and a client in a stable financial situation, or a partner having valuable personal belongings offers a personal guarantee. The normal level of security demanded is the equivalent of 110% to 120% of the amount of credit and interest taken together, although we have seen that small businesses are typically required to pledge security at a much higher rate. Banks have sometimes preferred guarantees from other banks as collateral, but offering such guarantees is not a lucrative practice. A 1995 working paper of Canada's Export Development Corporation reports that Polish banks "undertake stronger due-diligence methods with respect to the Polish private sector and require very high limits of collateral, sometimes reaching 200% of the value of the loan" (EDC 1995, 7). Polish sources suggest collateral of 300% is not uncommon. A new collateral law has been approved by the Ministry of Justice and will come into force upon endorsement by other Ministries and adoption by the Sejm.⁸³

⁸³ There has been significant World Bank participation in the Poland-Judicial Reform project (ID#PLPA40141) toward institution of new legislation concerning liens and collateral security.

The inequity of banks' demands on small business clients versus major clients is an important factor conditioning the evolving composition of the economy; when the debts of large clients are guaranteed by government, the large enterprise sector enjoys advantages with which SMEs cannot compete.

A number of Polish banks do not emphasize portfolio diversification or institute guidelines for judicious lending practices, concentrating instead on how to retain risk-free assets and to focus, where possible, on the largest and most creditworthy of clients. . . many despite many indicators their [larger enterprises'] number will not grow. . . While difficulty in obtaining information on potential customers complicates the credit analyst's job, a number of banks are using collateral more as a substitute for credit and cash flow analysis rather than a last resort means of collection (Toland, Saffer and Heatly 1995, 81).

The Director of the Polish Business Advisory Service (PBAS), a joint initiative of the EBRD and the IFC, explained that superior investment opportunities exist for the banks; purchase of low-risk Treasury Bills or NBP bonds, stock exchange activity, foreign trade finance and dealing in the foreign currency market are all easier, more secure, and more profitable for banks than providing small loans to private businesses. Before concluding there is a shortage of finance capital, one must appreciate that the growing markets in government paper and foreign exchange offer attractive alternatives for investment capital. The availability of such alternatives is attested by the 1995 GEMINI report which showed a real increase of 35% in bank purchases of government bonds in the past two years, including a 20% real increase by the nine commercialized banks and an 80% real increase in such purchases by the private banks (Toland, Saffer and Heatly 1995, 16). Investment in securities has been instrumental in improving banking profits in 1995.

A complementary inhibition often keeps Poles from applying for bank credit. The paternalism of the communist state insulated citizens from personal risk. Households rarely had working relationships with banks which, anyway, exercised no discretion. In 1995, commercial interest rates are about 30% annually and entrepreneurs are reluctant to

assume the financial obligation and risk entailed in borrowing.⁸⁴ Instead of acceding to lenders' terms, many entrepreneurs try to raise capital through personal contacts.

Efforts to circumvent this bottleneck have been introduced largely by major multilateral funding organizations, including the World Bank (and the IFC), the IMF, and the EBRD, a range of equity funds and tied credit lines. A prominent investor since 1990 is the Polish American Enterprise Fund, which was created by the U.S. administration of George Bush to develop the private sector in Poland. The organization which invests most actively in Poland's regional development initiatives is the European Community, through its PHARE organ. A range of instruments is employed which includes project finance, grants, subsidized lines of credit, loan guarantees, and equity finance through investment funds. Risk-based assessment of loan applications replaces the normal collateral-based assessment which commercial banks generally employ. Complementary capital market institutions are needed to stabilize the situation of banks and increase the range of financing options for the business sector (see, for example, Wyczanski 1993 and Calvo and Kumar 1993). Venture capital firms are absorbing a fraction demand for high-risk credit to small businesses, and guarantee funds can protect banks and lubricate the flow of capital.

Among less-used forms of credit is the foreign currency credit extended by domestic banks intermediating delivery of grants made available by international organizations or by foreign banks (Wyczanski 1992, 44). Although these credits are an essential source of development funds within the context of government policy, the total of all foreign credits account for a very small proportion of total credit extended by the banking system. Commercial bankers in Poland have generally not been enthusiastic on-lenders of such funds, citing long and difficult application procedures, protracted approval processes and

⁸⁴ Annual real interest rates for 1995 were roughly 31% minus 24% (September 1995 on September 1994 inflation), giving 7%. However, for small businesses, lending rates are subject to spreads of up to 15%. Further, the CPI index does not translate accurately as a measure of purchasing power, because individual consumption bundles are broadly variable.

the complications arising from cross-currency lending (Toland, Saffer and Heatly 1995, 20). Sometimes conditions for funding through foreign credits are prohibitive; this is especially true of bilateral export-promotion credit lines. Foreign banks generally concentrate on large clients in urban centres, usually to assist in the delivery and protection of foreign capital; this strategy makes regional branches unnecessary and leaves service of small business to domestic banks. An NBP spokesperson observed that foreign banks in Poland are profitable because they have neither Polish clients nor their old debts; in 1993, their share in total income of commercial banks in Poland was 2%.⁸⁵

6. Legal and regulatory inhibitors

It is impossible to be precise when identifying where banking sector problems originate. Because a multiplicity of factors is involved, it is convenient and advantageous to treat the law as a primary condition. Law assists us in understanding problems of practice, because the law codifies the societal norms inherited by the new rank of policy-makers. Equally, evaluation of legal and regulatory inhibitors is useful because laws can be changed with relative ease.

We have already seen how the ability of banks to establish and enforce collateral arrangements is limited by the absence, in the Civil Code and the Banking Law, of clear registration of liens or claims on borrowers' property. Despite unpredictable results, collection procedures are time-consuming and costly to execute. The Civil Procedures Code (Article 1025) which assigns creditor rankings, places "execution costs, alimony, remuneration, work-related compensation for health and disability and taxes" ahead of secured creditors (Toland, Saffer and Heatly 1995, 22),⁸⁶ which also discourages bank

⁸⁵ Warsaw Voice, Financial Voice, September 1992, F2.

⁸⁶ Banks do have priority among secured creditors.

lending. In addition, taxation authorities are entitled to lodge claims for tax liabilities against business assets; for example, mortgages pledged to the Taxation Office do not have to be registered in the mortgage register. At present, there is no comprehensive mortgage or collateral registry.

Additional problems are faced by financial institutions in Poland arising from informational barriers. Article 48 of the Banking Law prohibits sharing of information with private agencies, which prevents the emergence of effective commercial practices in credit rating and forces lenders to rely on their own sources. While GEMINI has recommended Article 48 be amended to facilitate sharing of information, it also recognizes that Poles' recalcitrance toward disclosure and exchange of privileged information, irrespective of legal requirements, will limit the efficiency and accuracy of credit rating in the medium term. Neither is accurate information about active small businesses readily available. The Central Statistical Office (GUS) relies upon an annual mail survey of a random sample of SMEs, yielding the uneven results typical of voluntary questionnaires. GEMINI estimates that upwards of 60% of private companies registered under the Commercial Code do not submit balance sheets to the court registry as required. Single proprietorships and partnerships are obliged to register with local government authorities, the *gminas*, whose data does not cover fixed or liquid assets, sales or liabilities.

Emergence of non-bank financial services is impeded by the Banking Code which obliges lenders to obtain licenses from the NBP. Also, the practice of guaranteeing loans occupies an ambiguous position in Polish law, according to GEMINI. Use of the term "*poreczenie*" to mean "guarantee" in both the Banking Act and the Civil Code is identified as an inhibition to the emergence of non-bank guarantors because both terms, "*poreczenie*" and "*gwarancje*", appear in the Banking Act. "It is not clear, therefore, which law ultimately regulates loan guarantee activity, and the degree to which current activity may be considered illegal if undertaken by institutions not having a banking license or for whom

Article 11 in the Banking Law does not make an exception (such as a Foundation)" (Toland, Saffer and Heatly 1995, 30). The Ministry of Finance has proposed amendments to the Banking Act to remove the term "*poreczenie*", which would remove provision of loan guarantees from the exclusive domain of banking activity. The ambiguity concerning the legal right to offer loan guarantees is aggravated by the fact that Polish law makes no distinction between for-profit and not-for-profit activities. Contingent on adoption of the proposed amendment, introduction of a designation for non-profit organizations would permit a wider range of legal entities to offer such guarantees.⁸⁷

Tax deductibility of loan-loss reserves remains limited. Required loan loss reserves are assessed according to loans' classification in one of three categories: "below standard", "doubtful" and "lost". Mandatory reserves are set at 20%, 50% and 100% of loans in each respective category. Only reserves for loans established as "lost" are eligible for tax deduction, so banks are taxed on the remaining portion at the current tax rate of 40%. GEMINI has observed that banks' decisions to downgrade loans from "doubtful" to "lost" are narrowly constrained. This constraint has been eased by May 1994 amendments to the Corporate Income Tax Act which broadened the category of documents admissible in establishing loans as unrecoverable, increasing the banks' success in deducting losses from nonperforming loans. Banks are permitted to set aside, in a tax-deductible general risk fund, a maximum 1% of the average quarterly amount of unpaid credits and loans -- a proportion considered low. The definition of "doubtful" loans is esteemed by the Union of Polish Banks to discourage long-term lending. This classification embraces loans to businesses whose financial situation has deteriorated significantly but, the Union argues, does not recognize that occasional planned short-term losses may be part of businesses' strategy.

The success of the Warsaw Stock Exchange (WSE) in attracting foreign capital is also impeded by WSE regulations whose cost structure discriminates against brokerage-placed orders (pre-funding of 30% of order value is demanded for brokered orders, while custody banks will pre-fund clients' orders via credit lines), thus custody banks handling stock transactions dictate the selection of brokerages. This reverses the normal practice in western markets where clients study the market for brokers' services to choose a broker, who assumes responsibility for delivering stocks to a custody bank. In addition, the WSE paperless system renders securities which cannot be traded outside Poland. As well, holding companies and nominee-ownership are not recognized in Polish law which creates both tax and investment disincentives.

7. Experience economies: Evolution of institutions and acquisition of market-economy knowledge and skills

Commercial lending practices are extremely conservative in Poland, but banks are struggling to assume the new obligations dictated by eastern Europe's institutional sea-change. The number of bank personnel has increased sharply since 1990. In these early years, training new bankers has generally been the responsibility of senior bank personnel whose own experience was gained in a centrally planned system. Banks' inability to insure themselves completely against exposure to bad debt, galvanized by the recent history of significant losses to enterprises, causes them to institute large rate differentials resulting in interest rates charged to SMEs in excess of would-be market rates, and to demand collateral of inordinately high value. In this way, most owner/managers are effectively culled from the market for bank credit.

Another critical factor is the deficiency of regulations controlling the audit of official company documents and financial statements. Company accounts are inadequately policed and do not satisfy the due diligence specifications required to accompany applications for funding. Educating Polish accounting professionals in the various

accounting systems and standards prevailing in Europe and North America is a gradual and time-consuming process. However, interpretation of financial information is becoming progressively more consistent with relevant European norms.⁸⁸ Banking and business practice are facing parallel challenges, and competition for market share in both goods and services is increasing. According to a *Bank Handlowy* official⁸⁹, Polish companies which have surmounted the first hurdles are becoming increasingly demanding clients for sophisticated and convenient banking services -- which foreign banks will readily supply.

There is another set of basic conditions inhibiting bank lending, which is created by the steep learning curve imposed on financial sector workers and entrepreneurs alike. The General Banking Supervision Inspectorate and the National Bank of Poland (NBP) have made strides in imposing strict financial discipline on the financial system. However, bank personnel still lack appropriate and adequate training, and staff-to-client ratios are low. Under these circumstances, the substantial investment of time required to develop small business clients places a particularly onerous demand on Polish banks. Banks' staff further lack useful experience in counselling entrepreneurs and evaluating plans for small business ventures. GEMINI characterizes small business lending expertise as reliant on intuition and judgement rather than prescriptive, a practice whose "unique skills, have to this point, been difficult concepts for the Polish banking community to embrace" (Toland, Saffer and Heatly 1995, 7). It can probably be assumed that loan officers labour under considerable pressure not to waste the scarce resources of their employers, that is, by lending to ventures which may fail. It must also be understood that a majority of applicants cannot calculate production costs, assess market demand or prepare a coherent business plan. Neither can they produce clear or clean financial statements to attest to sound past-performance.

⁸⁸ Officer, Canada Poland Entrepreneur's Fund.

⁸⁹ Artur Nieradko, *Warsaw Voice*, 17-24 December 1995.

Results of a study published in the *Gazeta Bankowa* of 17 December 1994 indicated that, using criteria of liquidity, profitability and efficiency, only one percent of Polish SMEs presented acceptable credit risks to banks. The PBAS Director concurs that most applicants should not be granted loans, which fact (or perception) constitutes another significant barrier to the flow of bank credit into the SME sector.⁹⁰ GEMINI states unambiguously that "The reality is that in Poland, most SME loan applications are not bankable; most SMEs are not candidates for asset-based lending . . ." (Toland, Saffer and Heatly 1995, 18).

The approval process for granting loans is onerous and time-consuming, usually involving multiple tiers of authority. This is true especially of foreign credit lines, with the result that Polish branch banks lose interest in promoting and facilitating access to them. Approval of an SME loan from the European Investment Bank, according to a GEMINI representative, entails a minimum of four levels of approval: at a local bank, the bank's head office, the EBRD branch office in Warsaw and the EBRD head office in London.

8. Summary: Institutional transition

We have seen that several impediments to effective bank lending have substantial explanatory power: the absence of long-standing banking relationships and the inexperience of both lenders and borrowers; countervailing demands of would-be borrowers, banking authorities and the Ministry of Finance; undercapitalization and the hard lessons impressed by the losses sustained by banks and businesses. It is difficult to imagine that any of these factors can be overcome in a short time; the actors are, so far, divided by incomplete knowledge of one another and inadequate knowledge of the techniques of financial intermediation, and operate in a profoundly unstable legal environment and an

⁹⁰ PBAS, February 1996. It should be noted that inadequacy of business plans is given in Canada and the U.S. as the main reason for refusal of SME loans. (OECD, 1995)

elastic economic environment characterized by fundamental industrial restructuring. There prevails an almost perfect absence of certitude and a very limited ability to reduce looming uncertainty to human proportions of calculated risk. "Thus, while people may understand the long-term advantages of cooperation, the short-term costs of getting the information necessary to begin trusting one another are too high. As a result, potential wealth is squandered" (Levitas and Gesicka 1995, 19).

Many of the obstacles facing the buyers and sellers of financial services, and indeed of capital, are entrenched and extremely resistant to change. There are systemic hazards which cannot be avoided, and for which far-seeing policy-makers must compensate. Basing sectoral advances on near-perfect hindsight, and applying constant and sustained learning, new relationships may be created which will constitute the institutional features of Poland's economic future. Borrowing from a March 1995 GEMINI report, "The key question is whether banks will want to expand their lending to riskier SMEs at a time when they must deal with existing borrowers, many of whom, despite reaching conciliation agreements, will ultimately fail, not to mention recent statistics that the overall level of bad loans within the sector is again rising" (Toland, Saffer and Heatly 1995, 31). This thesis will conclude that a "third-way"⁹¹ adjustment strategy retaining elements of public control or public ownership contains certain advantages for the simultaneous cultivation of a healthy banking system and a durable SME sector.

⁹¹ See Gowland (1992, 114) who states the "concept of a third way, understood as a way to move to a market economy from a command economy is still well-founded."

2

PM-1 3½"x4" PHOTOGRAPHIC MICROCOPY TARGET
NBS 1010a ANSI/ISO #2 EQUIVALENT

PRECISIONSM RESOLUTION TARGETS

PART III

A. POLICY FOR SMALL AND MEDIUM-SIZED ENTERPRISES

1. Introduction: Poland's SME Policy⁹²

The obligations undertaken in the Treaty of Poland's Association with the E.C. and the specific requirements attached to release of E.C. financial assistance were important factors in the decision to undertake articulation of an SME policy. Commissioned by the Ministry of Industry and Trade (MIT), GEMINI assisted in drafting a proposed policy on SMEs which was submitted to the Minister in January 1995. On 6 June 1995, Poland's Council of Ministers adopted the Policy Toward SMEs which takes account of the industrial policy adopted by the Council of Ministers on 14 September 1993, industrial policy for 1995 to 1997 as outlined in the "Strategy for Poland", and the programme for "International Competitiveness of Polish Industry" which the Economic Committee of the Council of Ministers (KERM) adopted on 19 December 1994. Upon adoption of this policy, there ensued the establishment of the Polish Foundation for Development of SMEs and, in late 1995, the Department of SMEs within the MIT.⁹³

Poland's private sector growth since 1990 has largely been the product of the dynamism of the small enterprise sector, so it is logical that an effort would be made both to fuel and to harness that potential. The policy itself states that, for five years, "The lack of a consistent policy towards SMEs has caused the dissipation of activities, repetition of programs and consequently, ineffective utilization of accessible assets."⁹⁴ The SME policy

⁹² See Table 14 for a summary of SME definitions by number of employees.

⁹³ Before summer 1996 the plan for complete reorganization of the economic portfolios of the Polish government is expected to have been announced. To date, plans are for consolidation of a Ministry of the Economy. The change may affect responsibilities for finance and SME development.

⁹⁴ Ministry of Industry and Trade 1995, Small and Medium-Sized Enterprises in the National Economy: Policy toward SMEs, 13.

objectives are reduction of unemployment, increased participation of the private sector in the economy, local and regional economic development, cultivation of an economic environment possessing a variety of services and subcontracting potentials, and increased exports. MIT authorities committed themselves to the following:

The Government will ensure conducive conditions to the establishment and stable development of enterprises belonging to this sector through facilitating their access to financial resources and modern technologies; at the same time, the Government will ensure that the principles of equal treatment of all economic entities will not be violated.

In particular, the Department of SMEs aims to:

design activities aimed at the liquidation of existing barriers, creating conducive conditions to the development of SMEs (legal, tax and financial) and extending the institutionalized assistance in the field of organization, information, training and technology, focused on the promotion of SMEs.⁹⁵

The problem of intervention in favour of SMEs in Poland will be approached in the following way. I first establish a rationale for promotion of the SME sector in Poland. Then, I identify problems typical of SMEs in developed countries and outline the usual range of policy responses. The distinctive problems of entrepreneurs in transition economies are discussed. This is followed by examination of the four major instruments enlisted in the delivery of financial assistance to SMEs in Poland: grants and subsidies; equity provisions; credit schemes; and guarantee funds. For each of these, active programmes are summarized and evaluated. Theoretical and critical discussion introducing examples from other countries provides a corollary for each of the four categories. The thesis concludes in Part V with tentative recommendations for policy measures which the writer judges could be constructively adapted from other countries.

For this thesis, the question of appropriate models turns on the optimal role of banks in restructuring of the productive sector. Should the banking system be an impartial conduit of finance capital, distribute resources according to strict technical criteria and

allow the market for goods and services to dictate enterprise prospects? Or should the banks be active and influential in the enterprise sector? Numerous models exist for both approaches, the former being typical of North America, and the latter of Germany and Japan. In market economies, banks are profit-seeking organizations whose policies exert extraordinary influence over private sector enterprises' and households' financial behaviour. In mature market economies, a competitive financial sector characterized by diverse financial services delivered by both public and private sector institutions ensures that the price of capital does not exceed the level "the market will bear". Further, statutory restrictions govern the accountability and credibility of all agents formally endowed with authority to hold and transfer financial assets belonging to clients.

It has been shown that Polish financial sector reforms have purposefully embraced the concept of banks' significant, active participation in economic restructuring. There appears to be a proximate compatibility between the type of institutional framework exemplified by the German system and that which is being articulated in Poland *vis a vis* the normative relationship between the enterprise sector and the financial sector. In particular, the nature of the German local savings banks may correspond effectively to the needs of Poland's small business sector. Although the present thesis offers only tentative and limited conclusions, it is hoped that these insights will have relevance for other post-CPEs seeking to reorganize their economies along market lines. Some analysts argue the banks should assume a central role in controlling enterprises and managing corporate adjustment in the CEECs during their transition periods; further, it is sometimes maintained the function should be continued over the longer term. However, detractors point to the nascent regulatory and anti-trust provisions of these countries, and the limitations youth exerts on the banks' performance and the supervisory and monitoring capabilities of their financial sectors.

Brief attention to the definition of SMEs is called for. In Poland, as in most

countries, multiple incompatible definitions for SMEs are devised by governmental departments seeking technical criteria to set thresholds, for taxation purposes, for example, or to establish eligibility for specific benefits. Although the E.C. funding criteria (outlined in Appendix 5) specify that beneficiary countries must adopt the "legal" definition of SMEs, most countries, including Poland, do not apply a single uniform definition for all purposes. The definition applied in this paper is used by the Polish Agency for Regional Development (PARR): SMEs are private businesses having no more than one hundred employees. However, the subject being investigated here is little concerned with precise size, but rather with private entrepreneurial initiative which is small in scale within Poland's economic context -- one historically dominated by extremely large industrial enterprises whose employees commonly number several thousand. SMEs are a newly emerging constituency of the Polish economic environment, with sufficient productive potential to impel policy makers to move quickly to originate policies capable of ensuring its survival and growth.

2. Rationale for intervention in favour of SME development

Why should small-scale entrepreneurship command high priority in government policy? There are several reasons, of which the most evident is their prominence: at the end of 1994, ninety-five percent of active economic units in Poland were in private hands and, of these, ninety percent were small owner-operated businesses. Additional reasons are listed below.

(a) SME promotion is consistent with an active privatization policy.

(b) Approximately 2,000,000 SMEs were created in Poland between 1990 and 1994, and their activity provided the major part of private sector employment, 61% of total employment at the end of 1994.

- (c) A vast majority of new companies are active in trade and service sectors. In the absence of long-term investment capital, small entrepreneurs may be restricted to endeavours requiring no front-end investment, and manufacturing could remain largely the domain of the public sector producers.
- (d) New regional economic initiative is needed (i) to restructure the inherited productive structure of the economy and (ii) to provide economic opportunities in communities whose particular inheritance is characterized by now-obsolete industrial activities. The necessity of adjusting to the new economic reality has splintered the Polish population sharply into have and have-not communities based on their respective inherited economic and resource bases. According to the Polish Agency for Regional Development (PARR), "Any excessive polarization in the situation of individual regions therefore supposes a threat to the transformation processes and requires an active regional policy."⁹⁶
- (e) The paucity of domestic investment capital has limited the ability of most Poles to purchase state-held assets or to go into business for themselves. The Central Planning Office stated "Substantial obstacles to privatization were a shortage of domestic capital and sizeable restraint among serious foreign investors. This established a certain model of privatization in Poland. In these conditions, especially in the first period of transformation, mainly small private firms were established."⁹⁷
- (f) Adverse selection among SMEs owing to the extreme instability of regulatory, financial and economic conditions can be mitigated. Compensatory policies can be used to ensure that viable or promising firms survive the early transition period.
- (g) In an unstable economic environment, adaptability should command a high premium. It is widely agreed this attribute is more typical of small businesses than large. The MIT policy on SMEs states: "SMEs have more flexibility in production, relatively low costs, and employ a rational policy of earnings related to the profitability and efficiency of a firm."⁹⁸ A GUS survey of 2,300 manufacturers and 1,600 construction companies showed SMEs outperformed larger enterprises during the winter of 1994-95 and were more optimistic about the future.⁹⁹
- (h) The greatest number of successfully privatized state-owned enterprises were privatized by liquidation, producing a large contingent of SMEs created by combinations of management-buy-out (MBO) and employee-buy-out (EBO) arrangements, and occasionally by sale to a community: a total of 1,125 at the end of July 1995. These were generally established by leasing arrangements and financed on preferential terms.

⁹⁶ PARR 1995, Presentation of Selected Regions: Phare/STRUDER Programme, 2.

⁹⁷ CUP 1995, Poland 1990-1994, 10.

⁹⁸ Ministry of Industry and Trade 1995, Policy Toward SMEs, 11.

⁹⁹ GUS analyst Anna Gaca cited in Rynki Zagraniczne, No.3, 1995, 1.

- (i) Markets for consumer goods are stimulated by the self-employed: "Definitely the highest level of ownership is observed in households of self-employed workers (mainly cars, colour tv sets, computers)" ¹⁰⁰
- (j) SMEs are relied upon to test and innovate new processes and products, and to improve quality in niche markets.
- (k) Successful SMEs reward initiative and may induce independently-minded Poles to imitation. SMEs' owner/managers are the vanguard of economic transformation. When their efforts are profitable, they willingly become its leaders.

The Government of Poland recognized in 1995 that "there are many factors in the Polish economy which act as significant constraints to the development of SMEs. These constraints result from State economic policy, as well as from inadequate professional qualifications and insufficient financial resources within the enterprises themselves." ¹⁰¹ This thesis takes the position that the absence of a smoothly operating capital market, in a dominantly competitive market environment, constitutes a barrier to entry which should be compensated as are other market failures. A distinction should be drawn between policies devised to complement active capital markets and those which offer substitutes for the capital market. Whenever possible, a coherent strategy of marketization would favour the former in order to promote the evolution of a diversified market for financial services and products and, if possible, to facilitate it. Griffith-Jones highlights the problem of free entry and exit in the emerging market economies:

... in market economies there is a continuous flow of bankruptcies, but there is also a continuous flow of entry of new enterprises, allowing not only the absorption of the human and material resources left idle, but also a better use of those resources. In the absence of capital markets, well-functioning banking systems and a developed private sector in the countries of CEE, bankruptcies hurt more and pressures to bail out insolvent enterprises become much stronger. This would seem to point both to the need to accelerate support (including that by the financial system) of the

¹⁰⁰ CUP 1995, Poland 1990-1994, 20.

¹⁰¹ Ministry of Industry and Trade 1995, Policy toward SMEs, 7.

new private sector and design restructuring mechanisms that reduce unnecessary costs of losses of output and employment (1995, 5).¹⁰²

Taking account of the facts set out above, this thesis asserts that the current situation in Poland warrants policy-based support of the SME sector. At minimum, assistance is needed to overcome environmental barriers to entry and build institutional supports. Economic diversification, regional restructuring and development, and expanded employment opportunities are all objectives which can be addressed within the cachet of SME policy, in addition to the primary goal of buttressing the growth of the private sector. Positive externalities of such a policy can contribute to social stability and cohesion, especially at local and regional levels.

Many countries including the United States, Japan and Germany, established legislation relating to small business after the conclusion of World War 2. Then by the 1960s "the role of SMEs, though they everywhere persisted in large numbers, had shrunk and many economists regarded them as an anachronism in the modern economy" (Bannon and Albach 1991, 57). Following groundbreaking research in the U.K. and the U.S. during the late 1970s, on the role of SMEs in combatting unemployment, national policies of the 1980s showed growing evidence of SME policy as an instrument of job creation. The results of an extensive study of employment generation conducted by Birch exposed the fact that, in 1979, most new jobs in the U.S. economy were being created by small firms.¹⁰³ These findings marked the beginning of an important shift in policy-making toward a focus, prevalent today, on exploiting SMEs' significant potential to contribute to aggregate economic growth and employment growth. Since then it has been observed that "much of the proffered evidence for the greater job-generation potential of small firms is founded on

¹⁰² This point is attributed to Gérard Roland.

¹⁰³ The research is recorded in David Birch, *The Job Generation Process*. Cambridge, Mass.: Center for the Study of Neighbourhood and Regional Change, MIT, 1979. Fothergill and Gudgin produced similar results in Britain in the same year.

uncertain data and challengeable assumptions" and further that "those governments which of late have expanded public assistance to new and small firms on the back of the numerical evidence ... have made, wilfully or not, a more than generous interpretation of the findings" (Hull and Hjern 1987, 1-2).¹⁰⁴ Although to the writer's knowledge no one has contested SMEs' positive contribution to employment, the scale of that achievement has been questioned. The question has highlighted the difficulty of accurate interpretation of data on the performance of the SME sector.

Most advanced capitalist countries make special provision for SMEs because "Given the existence of market imperfections, notably in capital markets and in information and the depressive role of taxation and regulation, the presumption must be that the role of SMEs in advanced economies is likely to be suboptimal. It is the task of SME policy to exert a countervailing pressure" (Bannock and Albach 1991, 59). Among others, the United States, the United Kingdom, Germany and Canada, endeavour by direct or indirect means to ease the financial constraints affecting small businesses.¹⁰⁵ Direct assistance may include grants, subsidies, loan guarantees, preferential interest rates, dedicated credit lines, and specialized investment funds. Indirect methods are usually applied by creating favourable conditions through the taxation system or in regulatory schemes. In every case, budget disbursements or foregone revenue are invested to sustain a vital small business sector, although normally programmes include a life-cycle dimension which ensures they are at least partially self-financing. There is particular sensitivity about government intervention in post-communist economies, based on fear that the inefficiencies of administrative allocation will be maintained or that they will return. This concern

¹⁰⁴ The authors refer specifically to the U.K. and refer readers to Storey and Johnson 1984.

¹⁰⁵ See Appendix 3 for summary of SME assistance provisions in OECD countries.

amplifies the "moral hazard"¹⁰⁶ argument, which is of concern in the distribution of budget revenues toward projects whose social or economic value is neither affirmed by the capital market nor tested by the goods market. A critical difference between the western economies and the transition economies of central and eastern Europe is rooted in the fact that private sector assets constitute a solid counterpart to the public treasury in the West. Savings traditions, private wealth, and inheritance together with effective capital markets ensure that individuals and state budgets can, subject to systemic constraints, gain access to financial resources to realize their investment decisions. This condition was virtually absent in the CEECs when they declared their intentions to embrace the market system.

Let me summarize the main points of Poland's macroeconomic situation which were presented earlier. In 1989, Poland was acutely disadvantaged by hyperinflation and the magnitude of its foreign debt. Subsequent to Poland's decision to suspend service payments on its debts, capital inflow was curtailed. In 1990 measures were urgently needed to arrest inflation and finance economic transformation and recovery. Radical macroeconomic policies were imposed to contract the supply of money and credit. There is a major role to be played by foreign financial assistance and investment. These facts lay the groundwork for discussion of the role of the SME sector in progress toward Poland's economic transformation.

Assessment of government programmes, especially those which transfer resources from one sector of the economy to another, turns on their success at producing a net overall benefit. From a strictly economic efficiency perspective, special consideration given to SMEs should only compensate for or alleviate the effects of market failures and imperfections. Policies should be designed to leave as many decisions as possible to

¹⁰⁶ As this concept recurs throughout the paper, a definition is provided here. The New Palgrave Dictionary of Economics defines "moral hazard" as "Actions of economic agents in maximising their own utility to the detriment of others, in situation where they do not bear the full consequences or, equivalently, do not enjoy the full benefits of their actions due to uncertainty or incomplete or restricted contracts which prevent the assignment of full damages/benefits to the agent responsible."

market determination, but application of this principle is complicated by the fact that governmental policies are rarely devoted to exclusively economic ends; programmes organized under the rubric of small business policy usually have social welfare aims as well. A major OECD study concluded that "It is -- with a few exceptions -- very difficult on the basis of the economic efficiency criterion to determine when government action towards small businesses is warranted. . ." (OECD 1994, Taxation 17).

The following criteria are commonly accepted as a foundation for selection of best-choice instruments for policy implementation: fairness, efficiency, administrative simplicity, transparency, and minimization of cost and foregone revenues. It is often argued that programmes which level the playing field between large and small players are the first-choice policy instrument. Taxation schemes are often used, for example, building incentives for investment in the SME sector into the capital gains tax structure, or creating income tax breaks for small business entrepreneurs. On the other hand, a shortcoming of these measures is that they generally cannot target a limited constituency.

An intuitive view, formulated in a residential neighbourhood in a North American city, might hold that government should not support or promote SMEs. The decentralized and heterogeneous character of SME populations suggests they occur spontaneously. The "rugged" entrepreneur, the "traditional" family business, the "reliable" cornerstore -- these are conventional icons of our small business sector. In this view, government involvement seems inappropriate and unnecessary. Another familiar objection to government action in favour of SMEs is based on the premise that government intervention in the economy must be neutral in effect. But special provision for small-scale business may predispose the unemployed to choose self-employment over wage-employment, for example. It often tends to favour domestic over foreign capital, and long-term dispersed benefits over short-term economic gain. Attractive incentive programmes may increase movement into small business without applying any criteria to differentiate able entrepreneurs or viable business

plans from the less adept and the unrealistic. This factor is especially important in the consideration of measures which facilitate access to business finance and highlights the importance of developing the capability, within the population, to plan and articulate clear business projects, and among creditors, to evaluate loan applications.

It is argued that public assistance to businesses is anti-competitive. Not only can the government compete directly with private sector providers, but government assistance creates an uneven playing field between players who are beneficiaries of government subsidies (for example) and those who are not. Because this condition is based on the introduction of non-market factors in companies' cost structures, it distorts the market and institutes comparative advantages for beneficiaries. This is a sensitive subject which will not be resolved here. However, governments world-wide intervene to stimulate and promote growth of various segments of national economies and hence, purely competitive markets are rare if they exist at all.

Industrial or development policy cannot be neutral, but to meet market criteria for optimal allocation of resources, policy instruments are generally designed to maximize the role of markets in selection among competitors for government, as for consumer, funds. The Polish SME policy declares a commitment to honouring the "principles of equal treatment of all economic entities".¹⁰⁷ The Act on Economic Activity, adopted in 1989, aimed to raise the level of economic opportunity available to private entrepreneurs so the equivalent of that enjoyed by SOEs.

A 1991 study of small business in Europe noted that

Whilst a thriving small business sector is recognized as being the bedrock of the 'enterprise economy', government intervention to achieve this seems to be a contradiction in terms. . . The solution to this intellectual dilemma is that you cannot rely solely on market forces to achieve the optimum balance between large and small firms in a highly regulated, highly taxed modern economy, though there is room for one than one approach to achieve this

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It is not clear precisely what is meant by "equal treatment" in the SME policy.

end (Bannock and Albach 1991, 32).

The difficulties faced by SMEs worldwide are well-documented, as are the problems of effectively implementing policies which favour expansion and consolidation of SME sectors. The following list summarizes problems typical of SMEs in advanced market economies:

- (a) Shortage of own funds necessitates an early search for external financial resources. The search absorbs valuable time and usually results in introducing new costs of debt service;
- (b) Banks are disinterested in providing finance to SMEs;
- (c) SMEs have deficient financial structures with an over-large component of debt financing;
- (d) Credit is more costly in absolute terms than for large companies (short-term finance at a rate of one or two percent higher) which enjoy more negotiating power and are better known to lenders;
- (e) For the same reasons, small businesses face difficulty financing "intangible" investments such as research and training, which often are vital to their growth;
- (f) Direct costs of compliance with all manner of government regulation (environmental, health and safety, accounting and disclosure, employment and social security, taxation) are higher for small firms. Usually either high fees are disbursed to engage professional services, or the owner/manager is obliged to invest his own time;¹⁰⁸
- (g) Entrepreneurs lack the managerial expertise to manage growth;
- (h) Revenue-neutral or profit-neutral flat fees, payroll taxes or wage inflation, all have disproportionately negative cost effects on SMEs;
- (i) Average production costs are higher for SMEs, which therefore face a competitive disadvantage against LEs;
- (j) SMEs extend more credit to customers than they receive as suppliers, as they have less bargaining power than their partners in business transactions. Late payment on receivables can be critical for SMEs, especially those carrying a heavy debt load;
- (k) SMEs are penalized by diseconomies of scale and scope, and therefore excluded from competition for valuable government contracts;

¹⁰⁸ For discussion of direct compliance costs, see Taxation and SMEs (OECD, 1994) and Bannock and Albach, 1991.

- (1) Entrepreneurs are isolated from one another and lack lobbying power and political influence.

An OECD study sought to determine whether the lack of available resources and higher borrowing costs faced by smaller firms are caused by market imperfections. Most analysts conclude that the shortage of funds available to SMEs arises in large part because of assymetric information between borrowers and lenders -- larger firms producing annual reports or having stock exchange listings are more attractive to lenders. Taking larger loans, they are also likely to be more profitable investments. The OECD study concludes that the market's failure to disseminate adequate information "could be mitigated by government providing finance where the private sector would be reluctant to take the risk" (OECD 1994, Taxation, 16). However, the OECD report also states that the higher cost of credits for SMEs than for large enterprises reflects real economic cost differentials based on higher transaction costs, less diversification and higher risk (provided that the differences are reflected proportionally). The authors observe that the incidence and extent of cost disadvantage to SMEs is exacerbated by the conservatism of financial markets which are sensitive only to limited private rates of return, while the social rates of return on investment in SMEs are arguably positive.

There are also problems implicit in creating a policy enclave for SMEs. If SMEs are to be shielded from certain requirements demanded of large enterprises, criteria have to be identified which differentiate the essential from the expendable obligations of firms. For example, adherence to health and safety, training, and insurance standards for labour and compliance with enviromental regulations impose a disproportionate cost burden on SMEs. However, adhering to the standards set by the Economic and Social Committee in 1975, E.C. policy acknowledges that "Labour intensity and a high proportion of wages to costs [typical of SMEs] are a major obstacle to the achievement of social aims and objectives. On the other hand there must not and cannot be any question in this sector of not giving

social protection of equal value to that in other sectors" (Bannock and Albach 1991, 66). Subsidization of SME costs of compliance with social policies would incur administrative and transaction costs for the government. Another administrative burden arises from the obligation to protect personal information; in the West, governmental departments do not share nominative information about small business entrepreneurs but instead multiply the shop-owners' workloads so that identical data can be replicated in various departments and ministries.

Finance weighs in as a net disadvantage for small firms. Commercial lenders see SMEs as least-preferred clients. SMEs are high-risk, high maintenance accounts which offer low profit margins. Commercial criteria demand timely repayment of principal and interest or provision of satisfactory collateral or guarantees to pay the lender in case of payment default. It is commonly accepted there is a poor fit between SMEs' financial needs and the services commercial financial institutions wish to provide. In Canada, a major study by the Ministry of Industry found bankers "contend that much of the criticism results from a misunderstanding of their role in financial markets. As low-risk lenders, with responsibility to depositors and shareholders, they assess the risks involved in a business to ensure the loans can be serviced and ultimately repaid. If a bank sees the situation of a business deteriorating, it will adjust its lending to what the bank feels is a serviceable level" (Manley and Martin 1994, 18). That finance is a major problem for SMEs throughout the world is attested by surveys and statistical data. For example, a 1984 survey of German and British SMEs which asked "What is the most important problem facing your business today?" showed the major concerns to be "interest rates and financing" and "government regulation and paperwork" in both countries.¹⁰⁹

¹⁰⁹

Complete results in Table 3.1 of Bannock and Albach 1991, 15.

3. Integration into the European Community (E.C.)

Prospective membership in the E.C. to a significant extent dictates development strategies in the CEECs. The European Community's Directorate for Small Businesses (DG23) holds a mandate to harmonize, progressively, the SME policies of member states. In theory, the Directorate's objectives would constitute a prescription for Poland and the other CEEC applicants for membership. The authors of a study commissioned by the Anglo-German Foundation, Bannock and Albach, found E.C. members deeply skeptical about the proposed harmonization of member states' conditions for entrepreneurs (1991, 16).¹¹⁰ It is nevertheless imperative that the methods and standards of SME assistance employed in Poland meet with the approval of E.C. authorities, and that resulting conditions of operation are consistent and compatible with those found in the Community.

In 1993, the Single European Act created a legal union of western European countries within which labour, capital, goods and services may move freely. The E.C. Commission is determined to create a conducive competitive environment for a growing SME sector, because it is believed that these companies play an important role in the consolidation of economic strength and competitive advantage in the regional union. Among DG23's recommendations are development of a banking climate more favourable to SMEs and institution of protection against late payment by SMEs' customers. Between 1988 and 1993, the number of private companies in the E.C. increased at an average rate of about 1.8% annually, with the actual rate of increase at its maximum in 1989 and decelerating thereafter.¹¹¹ As the number of large and medium-sized firms decreased over that period, the growing numbers are explained entirely by growing numbers of small and

¹¹⁰ Questionnaires were mailed to 238 SMEs in Germany and 667 SMEs in the U.K. The SMEs consulted were in non-primary sectors (a large proportion in manufacturing), had fewer than one hundred employees. Unconditional agreement to harmonization among German entrepreneurs (35%) was much higher than among their British counterparts (21.2%).

¹¹¹ The European economy was in recession from 1990-1993.

"micro" (fewer than ten employees) enterprises. Among the E.C.'s member countries is tremendous variation in size and numbers of SMEs; on average, SME intensity is greater in southern countries and firm size is larger in northern countries.

When the Act was adopted in 1993 there were 17,000,000 private enterprises in the E.C. non-primary sector of which 99.9% were SMEs, accounting for 66% of total sales. In that group, 93.3% had fewer than ten employees. Figures for 1994 show 72% of the non-primary private sector workforce was employed in SMEs: 68 million persons of whom 18 million were self-employed and 50 million, wage employees. Micro firms employed 30% of the private sector workforce. "From 1988 to the present, micro firms have provided greater employment growth than small, medium or large firms" (Mulhern 1995, 84). Certain attributes have been identified with the E.C.'s SME sector. Roughly, its strength resides in a dynamic "birth" rate (which exceeds its high "mortality" rate), a population of well-educated entrepreneurs, an increasing rate of strategic alliances, FDI and trade; and an impressive record of job creation. However, the sector's high mortality rate belies the presence of inherent disadvantages with which the reader will shortly become acquainted. While SMEs are vital actors in the E.C. economy, some economic policies geared toward boosting competitive advantages by restructuring the Union's economy are expected to weaken the small business sector. As observed by Mulhern, "The policy stance of the E.C. implies a belief in free markets with its accent on improved competitive conditions, liberalization of markets, and better information and training. However, it should be stressed that many of these developments are not necessarily favourable to SMEs" (Mulhern 1995, 86). Macroeconomic policies are expected to drive the region's economy toward higher concentration; labour shedding will likely be a continuing feature of industrial restructuring; and E.C. authorities are anticipating immigration pressures in coming years. Acute unemployment is a certainty in Europe and, primarily for this reason,

creation of conditions conducive to growth of the SME sector is seen by the E.C. as critical for future employment and wealth generation.

4. Problems particular to SMEs in transition economies

By itself, financial capital will not bring success to SMEs deficient in managerial and administrative expertise. In the CEECs, investment in development of these human resources is at least as important as financial investment. The first Polish capitalists were skilled traders recruited from the black market, entrepreneurs with a native appreciation of profit but no experience in management or business planning. Because this thesis is concerned primarily with problems relating to the ability of Polish small-scale entrepreneurs to acquire financial capital, it suffices to state that programmes to develop human capital form part of most SME development schemes mentioned herein.

We have seen that the small business sector normally faces a variety of obstacles in market economies. The unique situation of the post-CPEs adds a number of complicating factors. Commercial banks in Poland may ultimately operate according to the same principles as their western counterparts, when the groundwork has been laid. At present, a number of environmental factors intrude to frustrate both bankers and entrepreneurs. According to E.C. officials, "SMEs cannot grow and develop within a non-conducive legal, fiscal and financial environment. A clear and proactive SME policy is therefore of utmost importance in Central and Eastern Europe. This is also the only way to guarantee the effectiveness of technical and financial schemes."¹¹² In 1994 Ewa Swenrowska, speaking on behalf of the Ministry for Privatization, identified these major obstacles faced by SMEs in Poland: the difficulty of getting access to capital; the instability of legal regulations; and

¹¹²
May 1994, 4.

E.C., PHARE programme: Support to SME development in Central and Eastern Europe,

the inability to win a significant share of government contracts.¹¹³

"PHARE" is the principal vehicle for financial assistance to the central and eastern European countries (CEECs) signatory to the Europe Agreements, and the largest source of grant aid to Poland for economic and social transformation and integration into the European Union. The E.C. statement quoted above encapsulates the PHARE mission in Poland. In negotiations with the E.C., Poland's Council of Ministers argued strongly for a shift in focus away from technical assistance toward direct financial investment. Subsequently, the PHARE guidelines for assistance (1993-97) adopted in July 1993 reflected two major decisions taken at the Copenhagen meeting of the European Council: (i) that PHARE would emphasize measures to tailor economic development of the associated CEECs as potential members of the European Union; and (ii) a shift of focus would be effected from technical assistance to direct investment (normally through local financial intermediaries). PHARE projects are generally implemented through decentralized systems whereby tendering and contracting may be executed by the Implementing Agency of a beneficiary country. In many sectors, including banking, these tasks are contracted out to local associations, professional organizations and other non-profit organizations.¹¹⁴

Banks' conservatism, as identified by the OECD study, is a major obstacle to the outflow of credit to private companies in Poland. The E.C. Commission interprets the high cost of credit for SMEs as a consequence of market failure. Its PHARE/STRUDER programme has taken the lead in devising means to deliver funds to Polish entrepreneurs, where the market is rudimentary and incomplete. Following is a statement, excerpted at unusual length in order to ensure its clarity, from the E.C. Commission's May 1994 report on "Support to SME Development in Central Europe" states:

113 Ewa Swenrowska, Warsaw Voice, 5 June 1995.

114 The list of recipients of contracts awarded for PHARE projects in Poland is appended.

Nowhere in Central and Eastern Europe is there a fully functioning financial market, and the transition period leads to a situation where small financial instruments can have very large cumulative affects owing to the environment. In particular there is a need to encourage the banking sector to lend to the SME sector under commercial terms. In addition, projects which will be commercially viable when the market is fully established may not be so at this moment, and additional financing from PHARE can make a difference in the decision making process.

In many cases, purely lending money on normal commercial terms can help in the establishment of a market by improving the terms (pay back, grace period, excess collateral), since the transitional environment has allowed the banks to operate in a non-commercial manner, for example by asking for excessive collateral or very high real interest rates. Lack of ability in the banks in project appraisal can mean that viable projects go unfunded and demonstration that such projects exist and are commercially viable can be instructive. Clearly such actions need to take place in the context of wider changes since, as mentioned above, in the current environment most local banks do not lend to the sector, owing to lack of finance and lack of information on which to base decisions.

The inexperience of the banking sector in dealing with SMEs and performing effective credit appraisal means that SMEs are starved of credit, particularly medium-term credit and working capital for manufacturing, and the banks are developing only slowly to the level where they can raise finance from international donors.¹¹⁵

PHARE increased its emphasis on support for emerging financial institutions in 1993, and has since contributed funds to strengthening the newly created central banks and bank restructuring programmes in the CEECs. In Poland, under the aegis of technical assistance programmes, PHARE supports initiatives to develop appropriate legislation, portfolio audit techniques, banking associations, information systems, payments systems and provides training to bank personnel. PHARE has also participated in schemes to address the bad debt problem and banks' recapitalization.

Care should be taken not to paint the eastern European SME sector with a too-broad brush. There is in Poland, as Riding observed in Canada, a wide range of SMEs. Even relating to size alone, consider how immensely different are the problems and challenges faced by the owner of a family shop employing five labourers (typical of the

majority), from those of a manufacturer with a staff of 250, or of 500 (which satisfies the World Bank definition of SMEs.)¹¹⁶ On average, SME loans are likely to entail more risk in the CEECs than in the West, because lending is generally riskier there. Markets have been operational only a short time, which complicates the process of making economic projections about consumer demand, product pricing and production, delivery and marketing costs, notwithstanding the potential for exchange rate and inflation fluctuations. We know it is not uncommon for governments to subsidize high risk endeavours directly, when they are part of a group targetted by public policy - for example, research and development in advanced technologies. This is a separate problem, but illustrates that risk is normally weighed against potential benefits. The government's platform asserts that positive externalities elevate the social rate of return on investment in SMEs well above the private rate of return, but financing decisions are being left to the commercial lenders who are concerned exclusively with the private rate of return.

Secondly, it is not clear that all SME projects should be categorized as high risk; for many, their small size merely distinguishes them from large clients because the profit margins on servicing small loans can be narrow. We know the present record for SME survival is poor,¹¹⁷ but the main line of reasoning in this thesis focusses on the category of feasible small business projects, and assumes they exist in substantial numbers. Its fundamental question is whether the onus for allocation and delivery of SME financial assistance should rest with the commercial banks.

¹¹⁶ The size range is important. More advanced research on SME finance would have to specify which segment(s) within the range is being treated.

¹¹⁷ Reference is to a statement in the introduction of this thesis which noted that a rate of 20 to 30 thousand firms opening monthly, in 1994-1995, was coincident with closures varying from 10 to 25 thousand monthly (GUS data).

5. What is the role of SMEs in emerging market economies?

In Poland, intensive small business activity leads economic transformation by consolidating market-economy practices and challenging institutional barriers to the operation of private companies. Dispersed entrepreneurial activity is expected to create a class of owner-entrepreneurs whose enjoyment of personal financial success will lead the cultural transition away from collectivist values toward individualistic goals.

In market economies, SMEs constitute a so-far unsubstitutable complement to large enterprises. Although they are rarely direct competitors of LEs, SMEs are clients and sub-contractors, and sometimes suppliers of specialized inputs. Growing numbers of SMEs raise the level of competition by reducing the level of market share available to LEs. They are widely recognized to be the testers of industrial innovations which, when tried and found true, are adopted by large established companies. Alternatively, small, nimble operations contest the dominance of large producers by developing and marketing specialized and differentiated products. Growth of large enterprises invokes benefits for SMEs as well, by raising household income levels and increasing demand.

If a structural equilibrium between large and small firms is reached in the Polish economy, it will take several years to achieve. In 1993 it was estimated Poland had forty-eight SMEs per one thousand population, almost equal to the E.C. average of forty-nine, but the high rate of SME turnover precludes sound predictions of the level at which the SME presence will settle. At 50%, the share of employment originating in SMEs fell significantly short of the SME contribution to E.C. employment of 72%, suggesting that large SOEs continued to dominate employment in Poland (figures from Toland, Saffer and Heatly 1995, 55). However, in a clear shift toward private sector dominance, the SME share of employment had grown to 61% by the end of 1994.

In the immediate future, an understanding of how to manage the sustained coexistence of state-owned and private enterprises must be actively sought. Profitable

relationships within a range of economic actors will have to be articulated as the CEECs become irreversibly engaged in international competition and obligations. Arriving at an efficient economic structure of production which combines companies large and small, public and private, new and established, is a significant challenge particular to the CEECs where policy options are circumscribed by existing policy in the E.C. An appreciation of the historical origins of other countries' SME policies can be helpful in trying to situate the choices faced by Polish policy-makers. Relatively little research has been done to make international comparisons in the area of SME policy. The text produced by the Anglo-German Foundation in 1991 was, according to authors Bannock and Albach, the first comparative study of expenditure on SME support of which they were aware.

Bannock and Albach recount that Germany's contemporary approach to economic policy has evolved from the direction established by economist Ludwig Erhard for the Adenauer administration after World War 2. The pre-WW2 German economy was characterized by powerful large-scale industrial enterprises. After the war, Erhard's policies aimed to prevent old class differences from surfacing as a consequence of income disparities. He envisaged free competition as the best instrument for achieving prosperity for all citizens. This strategy entailed breaking up old cartels and industrial conglomerates by aggressive anti-trust policies, and resisting demands from entrenched industrialists for preferential policies. It was afterward concluded that SMEs had played a "profoundly important role in the stability of post-war German society, dependent as it has been on the free-market economy" (Bannock and Albach 1991, 32). Germany's current programme of active financial assistance to SMEs within the context of a national industrial policy is intended to protect hard-won gains. A parallel may be drawn to the CEECs' situations, as the economic structure Erhard determined to dismantle was similar to that created in the East Bloc under Stalin's direction. In contrast, Britain uses more neutral policy methods to restore vitality to a once-strong SME sector.

The SME as a socio-economic player warrants special attention in the emerging economic map of Poland. The SME as a way of organizing business or production is fundamentally different from the extra-large centrally-planned and administered industrial complex which characterized CEEC producers until very recently. SMEs are typically owner-operated and managed. Their reach is local or possibly regional. They are usually price-takers and have little control over the conditions of sale of their products and services. However, it is in the area of management that the SME differs most importantly from SOEs, as from branch plants or subsidiaries of multi-nationals; it is in the large degree of autonomy exercised by management that SMEs are innovators in eastern Europe. While in other respects, their product lines and marketing reach, for example, SMEs may be changing, "Independence is a characteristic and indispensable feature of the SME" (d'Amboise 1991, 11).

This chapter on SME policy concludes with a blunt observation from the International Labour Organization:

At its best, self-employment can provide a person with considerable autonomy, a chance to realise his or her potential and to be rewarded in proportion to the physical and mental effort expended, the risks taken and the savings invested. At worst, it represents survival activities at the margin of society.¹¹⁸

It is evident that great care should be taken by the CEECs policy-makers not to invest scarce resources to reproduce the economic failures of the western SME experience. On the other hand, sufficient cause has been given to articulate programmes and instruments to foster and instill the best attributes of SMEs in the post-communist economies.

¹¹⁸ ILO 1990, "The Promotion of Self-Employment", Labour Conference 77th Session, Geneva, page 1.

B. INDIRECT OBJECTIVES OF SME POLICY

1. Regional development and economic restructuring

On 19 December 1994, the Economic Committee of the Council of Ministers adopted a plan for 1995 to 1997 entitled "International Competitiveness of Polish Industry". Industrial restructuring comprised an important part of that plan and featured, among other aims, development of SMEs using measures based on new legal, organizational and financial schemes, and wide institutional assistance in developing skills and expertise, modern technologies, new markets and capital resources. The plan envisages that the SME sector will provide the sub-supplier and service backing for large industry, originate innovations, and become a significant supplier of export goods and services. Grant funding from the State budget to finance credit guarantee funds for SMEs, through the BGK bank, has been allocated as follows: PZN 2,000 million in 1995; PZN 3,000 million in 1996, and PZN 3,500 in 1997.¹¹⁹

The Council of Ministers' concept of "crisis" regions provides a legal foundation permitting the state to augment financial injections into areas facing extreme difficulty in the course of economic restructuring. Measures include direct subsidies and indirect means such as tax reduction schemes. The concept employs a formula for redistribution. All regions have active labour market policies, and the level of funds provided is based on the number of registered unemployed multiplied by a coefficient. A crisis region is entitled to receive, proportionally, three times as much funding as a region deemed to face obstacles of ordinary magnitude. Designation of areas as crisis regions is based on the following criteria:

¹¹⁹ Ministry of Industry and Trade 1995, International Competitiveness of Polish Industry, page 45. Adopted by the Council of Ministers on 19 December 1994.

- (a) unemployment significantly above the average for the country and rising rapidly;
- (b) a rigid economic structure;
- (c) a severe market contraction of a single large factory in a medium-sized town;
- (d) a high proportion of state-owned property in an agricultural area.

At the time of the programme's inception, special policy measures for crisis regions included:

- (a) extended unemployment benefits entitlement (to a maximum of eighteen months);
- (b) subsidies for new investment to create, or contribute to the creation of new jobs (up to 50% of the invested funds);
- (c) selected tax reductions aimed at improving conditions for the development of private businesses.

Negotiations to expand the set of advantages offered to investors by various departments are continuing. The Minister of Finance attempts to enforce a certain discipline across the system to ensure costs are contained and tax evasion is discouraged.

PHARE/STRUDER is the main programme in Poland delivering assistance to SMEs as an instrument of regional economic development. The Polish Agency for Regional Development (PARR) was established as a foundation of the Treasury in the summer of 1993, for the explicit purpose of administering E.C. funds made available through PHARE. The Treasury is represented in the Foundation by the Minister for European Integration and Foreign Assistance and the Minister Head of the Central Planning Office. The mandate vested in PARR encompassed two functions: to give direct support to the regions and to ensure that regional development programmes fulfill E.C. standards. PARR initiated two programmes to carry out its mandate: Structural Development in Selected Regions (PHARE/STRUDER) and the Polish Swiss Regional development programme¹²⁰. The goal of PHARE/STRUDER is to assist in restoring economic health to regions whose work

¹²⁰ The Polish-Swiss programme is directed at rural development and will not be discussed further in this thesis.

forces are especially disadvantaged by the economic restructuring of Poland. The approach taken by PHARE/STRUDER is direct assistance to SMEs in the selected *voivods*, which are Katowice, Lodz, Olsztyn, Rzeszow, Suwalki and Walbrzych. PHARE/STRUDER seeks collaboration with other regional governmental and non-governmental organizations, as well as with other programmes oriented at the regional level. PARR policies are executed by Regional Development Agencies (RDAs), where they exist.

Only about two years have elapsed since the PHARE/STRUDER regional assistance programmes took effect, and changes in employment levels and the rate of increase in private sector activity achieved during that interval appear to be in line with the direction and size of changes at the national level. Because these *voivods* were selected for their distinctly poor starting points, average performance should not be understood to indicate the programme is ineffective but neither can it be pronounced a success. In every case, unemployment had stopped growing in 1995. It will be shown in the next chapter that PHARE/STRUDER encountered stubborn barriers to investment.

In Poland, regional development strategies may also be shown to foster successful SME programmes. This is true for the usual reasons -- local cultivation of banking, inter-firm and mentoring relationships -- but additionally, because Poland's administrative structure is especially suitable to this development route because of the administrative autonomy of the *gminas*. PARR, in a report dated 31 October 1995, stated:

The adoption of the principle of decentralized activity where detailed plans for utilization of resources are being prepared and carried into effect by regional and local institutions, was made in close cooperation with the authorities on the level of voivodship and local government. It has brought very good results . . .¹²¹

PARR concluded PHARE/STRUDER had met its primary objectives for its first year of operation: at 31 December 1995, a total number of 638 SMEs employing fewer than one hundred persons were subsidized, over 8500 persons received training, and 127 *gmina* infrastructural projects were subsidized.

The *gmina* is the basic organizational unit to which the legislation addresses itself and its jurisdiction is provided by law: "a *gmina* constitutes a democratic self-governing community authorized by the people to perform its legislative functions. The subject of the *gmina* authorities is consequently not the *gmina* itself but the community of a particular area on whose behalf the *gmina* executes its public tasks" (Kidyba and Wrobel 1994, Public Administration, 1). There are about 2,465 *gminas* whose governing authorities are appointed directly by the inhabitants, by referenda or universal ballot, to "satisfy the collective needs of the community".¹²² The accountability of *gmina* authorities to their constituents is constrained only by the competing demands of other levels of public administration which may delegate certain responsibilities -- a check on excessively community-driven initiatives. Pursuant to the 1990 Local Self-Government Act and the 1991 Law on Local Government Revenues and Subsidy Procedures, the *gmina's* authority to raise and allocate taxes has increased. The 1991 legislation diminished the role of the *voivods* and decisively separated municipal finance from the state budget. By some accounts, the range of centralized allocation decisions has expanded as a result.

2. Employment creation

The Ministry of Labour and Social Policy (MLSP) is responsible for carrying out labour market policies. The MLSP is assisted by the Employment Board, whose central office is replicated at regional and local levels. The Employment Boards represent, in equal

¹²² Article 7.1 of the Local Government Act of 8 March 1990. Article 7.3 authorizes certain mandatory duties of the *gmina* administrators to be set out in legislation.

measure, employees, employers, state administrators and county delegates. Since 16 October 1991, Polish labour market policy has been framed by the Law on Employment and Unemployment which establishes (1) an infrastructure of labour market institutions; (2) conditions of eligibility to benefit from services and regulates those services; and (3) the Labour Fund. Supplementary legal acts are adopted from time to time by the MLSP and by the Council of Ministers, for example, the Enterprise Pact in 1993.

Under the MLSP exist two programmes which directly allocate funds to enterprises in order to create employment. They offer start-up loans to unemployed persons wishing to start private businesses¹²³; and loans to existing businesses to enable them to hire additional staff. The latter belongs to the category of "intervention works" (IWs), which are defined as projects which create employment in existing enterprises. In addition to the loans programme, IWs offer direct wage subsidies to firms which hire individuals listed in local labour office registries of the unemployed. Employers are subsidized only for targetted groups and subsidy duration is of a maximum of six months. The main vehicle of assistance in both cases is provision of preferential loan conditions. Loans are funded by the Labour Fund, which was established and defined by the Law on Employment and Unemployment, and delivered by commercial banks. Access to such loans is contingent on presentation of an acceptable business plan. Interest rates are subsidized; the unemployed beneficiary pays 60% to 80% of the market interest rate, while existing enterprises pay 80% to 100% of the current rediscount rate. Entrepreneurs accepting loans to increase the number of employees must guarantee no layoffs within the subsequent twelve months, and are allowed two years to repay the loan. Unemployed persons have up to four years to repay, but may also enjoy relief from up to 50% of the principle if their new business survives for two years. The share of the Labour Fund allocated for loans fell sharply from

¹²³ Approval to receive a start-up loan is among several conditions causing discontinuation of unemployment benefits.

26.0% when the programme was initiated, to 3.0% in 1991 and 1.0% in 1992.¹²⁴ In fact, only 6% of the unemployed were expected to be affected any of the various active labour market policies in 1993.¹²⁵ Another initiative supervised by the MLSP is the PHARE-funded Programme for Local Initiatives (PIL), which has been instrumental in formulating community development activity since 1993. The PILs operate local credit guarantee funds.

In 1982, the private sector employed 5.9% of the workforce (excluding agricultural employment) -- the largest proportion to have been recorded since 1949. In 1989, prior to the reforms, private sector employment (excluding agricultural employment) provided about 13% of all jobs, and by the end of 1995 that share had increased to 61%. A relatively small total number of persons is employed by a large number of private firms, which GUS estimates accounted for 97.5% of the total number of active companies in 1994. Private sector employment has grown steadily, concurrent with a progressive shrinking of employment in the public sector. In the years 1990, 1991 and 1992, the number of persons employed in the Polish economy was falling at an average rate of 700,000 annually (roughly composed of losses of about 900,000 from the public sector and increases of 200,000 in the private sector).

The effects of two main sources of unemployment clustered at the beginning of economic reforms: early retirements, induced to reduce the size of the labour force, and the gradual elimination of vacancies. There were sixty-two vacancies for each job-seeker in 1989, all of which had evaporated by 1990. When these effects tapered off, a large variance between gross and net labour flows suggested the emergence of a labour market. "By the second half of 1993, gross flows to employment status increased significantly (an

¹²⁴ Labour Fund revenues come from compulsory employer contributions of 3% of gross wages, state budget transfers and other resources such as interest earned on Fund assets.

¹²⁵ Gora in Unemployment in Transition Countries: Transient or Persistent?, 205.

effect apparently not captured by the vacancy data)" (Christophides 1994, 66). In 1993, the rate of unemployment stabilized at 15.7%, rose only slightly in December 1993 and peaked at 16.9% in July 1994. The level of unemployment remained fairly constant for several months until October 1995 when the rate of unemployment rate declined to 14.7%, and average employment in companies grew by 1.7% compared with October 1994.¹²⁶

A new system of gathering and compiling labour force data began in 1992, and now shows inflow and outflow information as well as net results. However, the current labour force surveys show as unemployed only persons working one hour or less per week, and thus understate by a large margin the number of persons who are not self-supporting (Christophides 1994, 66).¹²⁷ Of the approximately three million unemployed in 1994, half had exhausted their entitlement to unemployment insurance. There are advantages to maintaining "registered" status; the registered unemployed may work provided they earn less than one half the average wage, and may include members of a household whose main breadwinner is unemployed. Even when registrants have exhausted their right to collect unemployment insurance, they are still entitled to benefits such as medical care and job search assistance. Officials estimate about two million are registered as unemployed but earn their livelihood on the black market where business activity continues to grow. Estimates of its size vary considerably and integration into official labour statistics is virtually impossible. Whether most black-market activity is carried out by the unemployed or alongside wage-employment is difficult to assess, but some guidance may be provided by a survey conducted in Poland between November 1993 and March 1994 under the auspices of the Centre for Public Policy in Glasgow. Survey results showed 71% of respondents relied on multiple income sources for their livelihood and only 19% said a

¹²⁶ Economic and Legal Information from Poland. (December 1995 - January 1996) 2.

¹²⁷ This passage states that registered unemployed exceeded the labour survey "unemployed" by one half million in 1993.

regular job provided sufficient income.¹²⁸ For these reasons, the black market is of little direct consequence in the articulation of labour market policies. As the impact of the shadow economy may be most conspicuous for its drain on potential tax revenues, it is the target of certain fiscal policies.

Marked improvement in the real household incomes of the self-employed, an increase of 3.7% from 1993 to 1994, has compared favourably with employees' average household income which increased by 0.4% and with the overall increase of 0.6%.¹²⁹, and we have seen that on average, the self-employed enjoy a higher standard of living than salaried workers. A portion of this margin doubtless represents gains from moonlighting at one's own business while earning a salary elsewhere.

¹²⁸ Finding of the New Democracies Barometer (Paul Lazarsfeld Society, Vienna) survey of eight CEECs. Results for Poland are based on interviews with more than 1000 respondents in that country. Transition (July-August) 1994, 12.

¹²⁹ GUS, cited in Poland Now, Vol.5 No.2, April-June 1995, 3.

PART IV

A. INSTRUMENTS OF FINANCIAL ASSISTANCE TO SMEs

1. Introduction

The purpose of the present chapter is to identify the major instruments of financial assistance to SMEs and to evaluate their suitability to the Polish situation. Four categories will be addressed: grant schemes, equity provisions, credit schemes and guarantee funds. It will be shown that loan guarantees have been selected as the main instrument of SME financial assistance, and the weight of discussion devoted to that subject will reflect its importance in Polish public policy. While tax obligations constitute a financial constraint on SMEs, they are not examined here for two reasons. First, while preferential tax rates, such as exist in Canada¹³⁰, allow SMEs to retain more of their earnings and, where there is equity investment, to increase shareholders' return on their investment, use of taxation measures to assist SMEs in raising capital is complicated. And only companies with positive tax liabilities may benefit from them. The incidence of taxes is highly differentiated and affected by the intricate ownership structures of businesses and the diverse categories of income from labour, capital and so on. Second, a 1994 OECD report entitled Taxation and Small Businesses concluded that manipulation of tax systems cannot effectively target assistance to viable businesses which require help to raise finance.

Three questions concerning use of financial assistance facilities in Poland are important to this thesis. The first asks how effective financial assistance programmes are in helping firms contribute to consolidation of a high quality SME sector. The second asks if such programmes are cost-effective when compared with returns on investment in alternative economic development schemes. The third asks whether such programmes are

¹³⁰ The Small Business Loans Act reduced the basic federal income tax rate for small private corporations from 28% to 12%, and applicable provincial rates range from 5% to 10%.

effective in attracting and making good use of new investment, especially foreign investment. Dynamic aspects of the situation are important because many programmes are directly financed by multilateral organizations, and mutually satisfactory exit strategies should be devised. Another aspect of issues relating to international capital, pertaining to potential conflict and rivalries between national interests and foreign capital, will not be discussed in this thesis.

2. Grant schemes

Direct grants are not uncommon in western governments' programmes to assist SMEs. To the writer's knowledge, the PHARE/STRUDER scheme is the first instance of direct subsidies being granted to SMEs in east or central Europe, certainly it is the first direct subsidy from E.C. funds. Direct grants are especially useful in market economies as a way of creating equity, for example, in unincorporated companies which are prevented from selling shares. In Poland, under the PHARE/STRUDER programme, grants are given against loans from accredited banks in this way: eligible enterprises having received loans through the banking sector may receive a grant of up to 25% of project cost, to a maximum of ECU 100,000. The subsidies are made available to entrepreneurs contingent on banks' appraisal of the creditworthiness of their business proposals. To be eligible, such firms must be located in one of the five selected regions, and entrepreneurs are obliged to contribute at least 20% from their own funds. The primary lender finances the remainder, which is eligible to be protected by the PHARE/STRUDER loan guarantee programme. Although the guarantee fund was to become operational in August 1994, a February 1996 communication from PARR stated that the Statutes of the Guarantee Fund were still being established.

The financial assistance component of PHARE/STRUDER originally encompassed a grant fund, a credit scheme, a guarantee fund and regional investment funds. The Grant

Scheme, the first programme involving direct grants by PHARE to SMEs, was launched in April 1994 and began to accept applications for projects in manufacturing, tourism and food processing. Between May 1994 and 31 December 1995, grants for 638 projects were approved with an expected total cost of about 18 MECU. Despite accreditation by PARR of selected banks to intermediate the granting process, the majority of applications in the early part of the programme came through unaccredited banks. PARR authorized the Polish Development Bank to evaluate these applications, and then signed a second agreement for collaboration with the Bank for Social and Economic Initiatives (BISE). Its financial resources having been exhausted, the grant scheme was discontinued before January 1996.

Progressive improvement in the quality and quantity of applications has been observed by PARR officials. On average, 62% of investment projects use bank credit which, PARR believes has helped to consolidate relationships between SMEs and their bankers.¹³¹ Training in financial services has been provided for development agency personnel and employees of the accredited banks and their branch offices, and the PARR financial sector staff have been educated in the methods of operation of guarantee funds in western Europe. PHARE/STRUDER envisages increasing the participation of domestic finance in the programme, so that the structure of finance portfolios will shift progressively toward dominance by Polish capital.

3. Equity provisions

Surveys identify the lack of equity as a major constraint to enterprise development throughout the world. In Western Europe and North America, over-reliance on debt-financing is a significant cause of SME failures. An important constituency of the Polish

¹³¹ PARR, Tasks and Results, 31 October 1995, 5.

SME population comprises those created by liquidation of SOEs, via lease of company assets to managers or employees. These companies have extreme difficulties in obtaining bank loans due to their undercapitalization.¹³²

At the microeconomic level, a firm whose financial structure comprises an exceedingly large proportion of debt compared to equity (having a debt/equity ratio larger than one) is said to be "highly geared". This often occurs when entrepreneurs borrow start-up or early development financing to boost their firms' potential for quick growth. Normally, they plan to reduce the gearing ratio over the shortest possible interval of time, anticipating that increasing revenues will rapidly enable them to retire the debt. But high gearing can threaten the solvency of the firm in the medium-term if market conditions are unfavourable or monetary policies change unexpectedly. Additional borrowing becomes progressively more difficult as potential lenders watch the entrepreneur's ability to repay diminish inversely with the size of his current debt. Best practice recommends that acquisition of debt be postponed until a company's viability and reputation are well established, thereby enhancing its attractiveness for future creditors and improving the terms on which future finance is offered. "The disfavour with which high gearing is viewed, especially for cases in which profits may fluctuate widely [as for many SMEs], is now apparent" (Reid and Jacobsen 1988, 37). Based on research into the highly-leveraged Canadian SME sector, Riding affirmed that "Indeed, risk investments are traditionally best financed by equity" (Riding 1996, 5). Results of a recent study of the Canadian SME sector, reported in Strategies for Success: A Profile of Growing Small and Medium-sized Enterprises in Canada, found fast-growing small companies use relatively more long-term capital than short-term capital, and more equity than debt. "The more successful and more profitable of these businesses make less use of internally generated funds to finance their

operations, though it is not clear whether this is an underlying cause or a result of their success" (Manley and Martin 1994, 43).

A problem often identified in the literature on SMEs is the sometimes extreme reluctance of small business owners to accept equity participation. The aversion is based partially on logical calculation of increased operational transaction costs arising from more complicated monitoring, organizational and communications structures. However, accounts show entrepreneurs are disinclined to give up their independence and autonomy, and to share authority or profits (see, for example, d'Amboise 1991 and Reid and Jacobsen 1988). The OECD Best Practice review examined the use of informal equity by SMEs, denoting shareholdings by individual investors acquired without recourse to stock exchanges. The importance of this source of financing varies significantly from one country to another: for example, in the U.S., informal equity dominates the equity market while the inverse is true in the U.K. For very small companies, informal equity is prevalent largely because of the high cost of selling securities; stock markets levy high registration fees and additional costs are entailed in complying with disclosure requirements.

Over-the-counter brokerage is another potential source of equity capital being developed in Poland. In the U.K., the Unlisted Securities Market (USM) has become the major source of equity finance for small businesses by offering lower-cost access to securities markets and easing regulatory restrictions. But the USM is used primarily by well-established SMEs because costs and volume are still prohibitively high for new businesses. For similar reasons, it is expected that informal sources of equity capital will dominate brokered equity, in Poland, for the foreseeable future.

For Polish entrepreneurs, informal investment by so-called "investment angels" would likely appear in the guise of foreign investors seeking to enter into joint ventures (JVs). Significant mutual opportunity for SMEs of east and west arises from the coincidence of the growth potential westerners perceive for themselves in "going east", and

the eastern entrepreneurs' need for financial resources. In-kind benefits from west to east investment, such as managerial and technical know-how, product and process design, and so on, also confer important competitive advantages to host firms.

Culpan and Kumar identify three theoretical streams used to explain western firms' interest in joint-ventures (JVs): reduction of transaction costs for operations in distant or extraterritorial locales; expansion of the fund of available resources; and increased competitive advantage. They propose that small western companies seek JV opportunities in the CEECs because of their belief that they possess competitive advantages in the relatively underdeveloped markets of eastern Europe. Cooperative ventures with domestic CEEC companies mitigate the significant risks of doing business in unstable economic environments with unsettled property rights. Culpan and Kumar observe that the smallest western companies prefer alliances and collaborative ventures, or other contractual non-equity arrangements to joint ventures. The authors assert: "We believe that small and medium-sized western firms are active players in the emerging eastern European markets" (Culpan and Kumar 1994, 275). The potential for east-west exchange and strategic alliances among small European companies is being promoted by "Europartenariat". The record shows that German entrepreneurs, sharing a contiguous border with Poland, have been most active initiators to date of small business opportunities. In 1992 a minimum threshold of USD 50,000 for foreign investment was introduced, and progressively higher rates of initial capital have since been observed. It should, however, be noted that a survey conducted in July 1993 showed Polish JVs established with foreign capital participation had relatively low initial capital. About 75% of JVs relied on their own financial resources and did not use bank credits. Of the almost 20% which borrowed funds, more than half received loans from the foreign partners' parent company (Bluszkowski, Garlicki and Sadowska-Cieslak 1993).

Equity funds offer an alternative source of capital; three examples are presented in the following paragraphs. The main differences for providers between equity-fund financing and debt financing are: (i) the funds are mandated to develop their capital base; (ii) they are subject to an exit-clause; and (iii) they are directed towards a fairly narrow field of high-calibre projects.

Polish American Equity Fund (PAEF): The PAEF was established as a non-profit corporation pursuant to the U.S. Government's "Support for Eastern European Democracy Act" of 1989 (the SEED Act), dedicated to promoting growth and consolidation of the Polish private sector. PAEF established several financial institutions which include the First Polish-American Bank, Bank Rolno-Przemyslowy, the Polish American Mortgage Bank, and the Housing Development Corporation. Of special interest here are two arms of the PAEF, the Enterprise Credit Corporation (ECC) and Fundusz Mikro (FM), which provide investment finance to SMEs.¹³³ Established in 1990, the ECC administered loans to SMEs in cooperation with the Ministry of Finance and eleven state-owned banks. From its inception, PAEF programming eschewed use of standard collateral-based loan assessment criteria and focused instead on the quality of enterprise management and the viability of proposed business plans (some collateral was nevertheless secured). The PAEF Annual Report of 1995 reports that, having funded approximately 5,000 private SMEs since its operations began, the ECC had registered total loan losses of only 1.4% of the active loan portfolio -- presenting an attractive model to be emulated by other development funds. Presently ECC funds are administered by the First-Polish American Bank and are repayable in U.S. currency. A majority of PAEF investment takes the form of equity investment in common stock in manufacturing companies, with financial services

¹³³ companies.

The PAEF may be represented on the management and supervisory boards of investee

absorbing the second largest share.¹³⁴

In 1994, Fundusz Mikro was established to extend short-term zloty loans for operating capital and equipment purchases to very small companies unable to access commercial loans. Set up as a tentative exercise to determine if small affordable sums could be profitably loaned, Fundusz Mikro has achieved a 98% repayment rate on credits averaging PLZ 5000 (two hundred loans were granted through MF's six outlets). Notwithstanding excellent results, PAEF states "it is still not clear whether this type of microlending will prove economically viable given the required overhead of the programme and its small loan size."¹³⁵

The Polish Private Equity Funds (PPEF) I and II, closed-end venture capital funds, were created in 1992 with USD 150 million in funds targetted at SMEs with significant growth potential. The Funds are financed mainly by the Polish-American Enterprise Fund (PAEF), the EBRD and the Austrian Creditanstalt-Bankverein, but include major American private investors. This has satisfied one of PAEF's major objectives, which was to attract other investors to Poland. PAEF direct investment in PPEF projects has diminished to 20%. By end-1995, PAEF was beginning to exit markets and find buyers for its holdings, and was expecting to recover most, if not all, of the original USD 240 million U.S. Government grant (which was provided by the U.S. Agency for International Development).

The Canada Poland Entrepreneur's Fund (CPEF): The CPEF was launched in January 1996, under the auspices of the Canadian International Development Agency, and plans to extend medium-term equity capital based on risk-based evaluation of business

¹³⁴ In conversations, PAEF activity has been praised for effective delivery of equity to SMEs (by an employee of GEMINI) and criticized for "self-promotion" of American investment (by the Director of PBAS). This is roughly typical of the opposite poles of opinion regarding the activity of foreign financiers in Poland.

¹³⁵ PAEF 1995 Annual Report, 13.

proposals. Fund capital will be drawn from the unused portion of Canada's contribution (CDN 32 million) to the stabilization fund, and is expected to be operational for a period of seven years.

Regional Investment Funds (PHARE): Following the failure of an equity scheme established by PHARE as a complement to European Investment Bank (EIB) loan programme, PHARE concluded that Polish banks are disinterested in equity lending. Based on prior experience in Slovakia and the Czech Republic, PHARE elected instead to establish small regional investment funds to facilitate access of small businesses to equity finance. Eligible investments would include start-up and existing SMEs, MBOs and JVs, and would normally be divested within five to seven years. The Regional Investment Funds (RIFs) should provide funds by a two-step procedure through the recipient state to national financial institutions. Calculated on the basis of the numbers of pre-existing SMEs in the regions, PARR concluded that RIFs were most needed in Lodz, Katowice and Walbrzych. To maximize efficiency, only two RIFs have been opened (the Katowice RIF also serves Walbrzych); as of December 1995 neither was yet in operation.¹³⁶

We have seen that available equity capital is limited, also that it typically is shunned by entrepreneurs. For example, a survey of Scottish SMEs showed only 15% used equity financing and 53% started operations with a gearing ratio greater than one (Reid and Jacobsen 1988, 30-36); and Canadian sources affirm most small businesses are highly leveraged in their first years of operation and acquire equity only by reinvesting retained earnings (Manley and Martin 1994). Earlier chapters developed the problems faced by Polish SMEs in efforts to borrow from the commercial banking system, thus it remains for

¹³⁶ Personal communication from the official responsible for relations with Poland, for the E.C. Directorate General 1A.

us to examine how banks may be influenced to collaborate in expanding credit opportunities for entrepreneurs.

4. Credit schemes (PHARE)

Of the line of credit originally offered to Poland through the PHARE/STRUDER programme, the European Commission noted:

The initial 19 MECU credit line in Poland experienced considerable operational difficulties, owing to problems in finding suitable disbursement channels for small operations in the difficult regions selected, the generally SME averse nature of the Polish banking system and the relatively low margin to the banks. Forty-three loans have been approved, totalling 2.3 MECU, all manufacturing projects. The scheme has been discontinued and the balance reallocated to the STRUDER programme.¹³⁷

Recent information confirms that there is no line of credit available through PHARE/STRUDER. Based on what is known about impediments to the flow of capital through the banking sector, it may be reasonable to conclude that effective delivery of foreign and multilateral credit lines (or so-called "overdrafts") depends on smooth operation of normal banking services to the corporate sector.

A survey reported by Griffith-Jones showed use of bank credit varied significantly among the CEECs. In CSFR, 80% of surveyed firms had short-term bank loans; in Poland, the proportion was 65%; and in Hungary, about 30%. However, in Poland 28% of respondents did not apply for credit because interest rates were too high, and in Hungary many problems with obtaining credit were reported (Griffith-Jones 1995, 11). The United Nations Economic Survey of Europe in 1994-95 found that lending priority in the CEECs was still given to large SOEs, and only in the Czech Republic and Hungary did companies make extensive use made of bank credits. There, a clear preference for foreign credit explained at least part of the variance in borrowing practices; JVs used their western

partners to gain access to credit from foreign commercial banks whose lending rates were more affordable. The variation among lending rates within the CEECs is also enlightening: in 1994, positive real *ex-post* rates of interest ranged from 6-8% in Hungary to 10-15% in Poland, and the spread between deposit and lending rates, at 10.7 percentage points, was also greatest in Poland (U.N. 1995). See Table 15 to compare lending practices among the three countries.

5. Loan Guarantees

5.1 Loan guarantees in Poland: The background and the policy

The use of loan guarantees to mitigate the risks of lending to SMEs was contemplated in Poland as early as 1990. Subsequent evolution of the concept has been divided into three stages by Herbst: (i) proposals of 1990 and 1991 which were limited to the notion of insuring risk by capitalizing a fund with fees collected from participants; (ii) in 1992, initiatives to launch loan guarantees were popularized as components of broader state policies - thus incorporating national resources to support smaller funds; (iii) in 1993, local and regional communities themselves began to invest in guarantee funds to defend and fortify their economic resources.

The original LGs failed because the capital base was absorbed by claims against the guarantee:

If losses were minimal, the untouched part of the fees were to be refunded to reliable borrowers, similar to a bonus for good loan performance. In practice however, the losses incurred by bad debts quickly exceeded the size of the fund created by the fees and there was no possibility of paying refunds . . . As a result, the fee for the fund simply raised the cost of credit. (Herbst 1995, 55-68).

A central fund was proposed to enlist state financing to reguarantee small, undercapitalized funds. The Ministry of Business Development in 1992 commissioned GEMINI to develop the notion of a two-tiered programme in which a national fund

increases the productivity of local funds; subsequent dismantling of the Ministry temporarily foreclosed work on the GEMINI project.

In 1993, PHARE-funded Local Initiatives Programme (PIL) launched the process of animating communities to articulate local development strategies and devise measures and institutions for their realization. Fifteen communities were selected to participate, each facing serious problems adjusting to the new economic situation. The idea of establishing guarantee funds arose "as much from people's awareness of the need to support SMEs as from their desire for clear, impartial rules for the governance of public funds" (Levitas and Gesicka 1995, 75). The PILs are widely regarded as a vanguard of Polish local activism. However, realization of the concepts so conscientiously formulated brought disappointment; participants were apprised of the fact that the funds were not adequately capitalized to grant loans, which had still to be approved and administered by banks. Thus, the effectiveness of the PIL projects in delivering PHARE funding is dictated by the attitudes of the lending banks. Since 1993, a number of guarantee proposals has emerged. These are the product of local initiatives stimulated by the new Regional Development Agencies (RDAs), and engage the capital and infrastructural resources of a variety of assistance programmes. Herbst summarized the distinctions of the current generation of loan guarantee provisions as follows: the task of credit analysis is done both by the lender and the guarantor; the lender assumes a share of the risk; fees are collected to defray or reduce costs; local knowledge is integral to funds' activities.

A major loan guarantee fund (LGF) was established in 1994 by conclusion of an agreement between the Minister of Finance and the BGK bank. The programme, which has as its objective "to facilitate access of SMEs to bank credits", became operational in May 1995 and has to date provided only a small number of guarantees. Eligible SMEs must have fewer than 250 employees and annual income not exceeding ECU 20 million. The Fund will be administered by twelve cooperating commercial banks through more than two

hundred branches throughout Poland. The maximum level of guarantee offered is 60%, although, in conformity with BGK's agreement, it is anticipated the level may be raised to 70%. The remaining portion of the loan must be secured by the borrower's collateral.

The 1995 Policy towards SMEs sets out in its implementation methodology for 1995 to 1997 the following three "financial instruments":

- (a) further development of the system of credit guarantees for SMEs on the basis of the credit guarantee fund established in *Bank Gospodarstwa Krajowego* (BGK) (a responsibility of the Ministry of Finance (MF));
- (b) development of the concept of a credit reguarantee system aimed at local institutions granting guarantees on the basis of the resources at the disposal of the Government (a responsibility of the MF);
- (c) development of the system of criteria to grant SMEs various kinds of state aid (a responsibility of the Ministry of Industry and Trade (MIT)).

The Policy's "organizational instruments" include, among others:

- (a) support of the creation of local networks of credit guarantee funds for SMEs including the creation of a local credit guarantee fund based on donor resources (a joint responsibility of the MF, the MIT, and the *voivods*);
- (b) promotion and support of the creation of a system of regional mutual insurance companies and other non-banking financial institutions (investment funds, for example) (a joint responsibility of the MF and the MIT).

The MF-sponsored local credit-guarantee institutions are intended to stand guarantee for "higher-risk credits", thus "the guarantee institutions can expect the amount of bad credits they will have to cover to be higher than average. Therefore", the document continues, "it is necessary to create a re-guarantee fund which will share the risk undertaken by local credit guarantee funds. The way in which BGK will cooperate with local guarantee funds in sharing the risk in extending credits will be determined."¹³⁸ The Policy does not state (i) how the MF classifies "higher-risk" loans, (ii) why the local funds were selected as a conduit to guarantee such loans, or (iii) why the government has chosen to allocate budget revenue first to guarantee and then to reguarantee "higher-risk" loans.

The strategy suggested is not one of an investment policy, but an insurance policy. It identifies the "higher-risk" credit as its target and is mobilized by enterprise failure -- the inverse of rational investment policy. Except in special instances where the commitment to LGs is complemented by targeted, positive investment measures, one can conclude the government policy with regard to SMEs is to consign investment decisions to the market.

Nature of guarantee funds

The nature of guarantee funds will be outlined briefly to provide a context for further discussion. Loan guarantees (LGs) are a feature of SME policy throughout the world and are offered by organizations as diverse as government, private companies, trade associations and NGOs. Normally, a borrower purchases the LG, usually through an agent who lends on behalf of the guarantor, to indemnify against potential liabilities. LGs are normally intended to increase the number of loans granted in a particular lending market. By guaranteeing a portion of outstanding debt in the case of default by the borrower, the risk assumed directly by the creditor is reduced. The features of LGs are designed to facilitate access to capital for borrowers lacking sufficient or suitable collateral to be granted credit on commercial terms. In payment to the guarantor, borrowers may pay an elevated interest rate, specified fees or both. There is considerable variation both in the guaranteed portion of a loan and in the interest rate premium charged to borrowers. Poland's BGK fund will assess a graduated annual fee (starting at 1.2% and increasing by increments of 0.2% in each of the five years of the guarantee term) however, deviating from normal practice, some administering banks have indicated they will offer discounted interest rates. See Table 16 to appreciate the range of LG features.

The most common source of credit guarantees is a loan guarantee fund (LGF), which metes out guarantee payments from a capitalized fund. LGFs can be divided into two basic categories: those financed by government or private donors; and those which are self-

financed, whose operating funds are raised from the proceeds of stock-ownership in joint-stock companies or from membership contributions in cooperatives (in business environments which are capital-poor, like present-day Poland, it can be difficult to raise sufficient financial means from members).

Fund risks comprise consequences of non-payment, which could occur for a variety of reasons ranging from failure of a business plan to natural catastrophe. "Like other insurance businesses, guarantee funds are based on the assumption that the sum total of their liabilities will not fall due on a single day" (Oehring 1995, 177), and guarantors' revenues are generated by multiplying guarantees. One estimate gives a minimum multiplier of three for cost effectiveness (Oehring 1995, 177). Differentiated levels of risk exposure provide a rationale for reguarantee facilities, which enable banks to be somewhat less conservative in lending while ensuring their readiness for worst-case scenarios -- in which, for example, an entire community may be forced to call on loan guarantees because of drought or flooding. Typically, reguarantee facilities are publicly funded. By encouraging banks to tolerate higher multipliers, reguarantees can significantly increase the profitability of first-floor guarantee funds. At the same time, reguarantee institutions can exert a disciplinary force on LGFs, obliging them to raise the standard of guaranteed loans.

Attributes which have been identified with successful LG programmes include the following: responsiveness to changing needs and circumstances of borrowers, lenders and the economy; innovation; strong local presence; close cooperation between the LG programme and lenders; informed and active promotion; transparent and efficient administration; standardized procedures and regulations; clear guidelines regarding the ratio of the value of guarantees extended to fund capital (the multiplier); conscientious monitoring and support of borrowers. Additional criteria which presume superiority of market mechanisms include delivery by private sector lenders having specialized expertise in financial services, and application of market rates which ensure that borrowers are not

subsidized and creditors are not penalized.¹³⁹ The latter criteria affirm that the price of LGs, comprising fees and interest rate premiums, should be established in competitive markets, implying that LG activity can be profitable.

Rationale for the use of loan guarantees

When LGs are used as an instrument of public policy, it becomes necessary to specify a rationale, situate it in a global context embracing other pertinent policy aims, and determine what the programme "is worth" to taxpayers. The Minister of Industry and Trade, being the government Ministry charged with responsibility for the SME sector, has selected loan guarantees as the main instrument whereby SMEs' access to credit can be improved. We have seen that access to bank financing by small Polish companies is strictly rationed, as banks direct investment capital to safer and more lucrative ends. A major obstacle preventing entrepreneurs from borrowing is the banks' disinterest in lending on affordable terms (as we have seen, there are other obstacles). It is, therefore, important that the objectives, both of the Ministry of Finance and of the National Bank, are taken into account when choosing measures to close the credit gap. Consider that the majority of Polish banks continues to be weak. Of total loans in the banking sector, the share of non-performing loans diminished moderately from over 30% in 1993 to 28.7% in 1994, and the share of loans in net assets of the banking sector continued its decline to 27.4%. In 1995, the share of securities held by banks increased by 58%, to 27.8% of net assets.¹⁴⁰ The Ministry of Finance is committed to strengthening the banking sector. Therefore one must ask if the objectives of financial assistance programmes for SMEs can be promoted in a way which, simultaneously, recognizes the banks' profit motive and the population's need to create gainful work opportunities? Policies which foster employment creation and

¹³⁹ This summary compiled from comments of presented by the Canadian Delegation to the OECD's Industry Committee's Working Party on SMEs in 1994; the report of the 1994 conference on loan guarantee funds in Poland; and own research.

¹⁴⁰ *Rynki Zagraniczne*, 4-5, 1995, 2.

regional development are often compatible with those promoting SMEs.

The question, "what is this programme worth?" could be paraphrased to ask if support of loan guarantees implies subsidization. If the answer is positive, one should ask who is subsidized. When LGFs are capitalized with government funds, as are the BGK fund (Polish taxpayers) and the PIL funds (E.C. taxpayers), cost recovery, while it is an objective, is rarely a reality. Costs in excess of receipts constitute a subsidy, which in the case of loan guarantees, is paid to the banks. A rough outline of the transaction goes like this: Guarantee fees are paid by borrowers to the guarantor, at the level set by the guarantor; and interest rate premiums are paid by borrowers, to the lender, at the level established by the lender. Guarantors' costs are mitigated by fee receipts and increased by defaults. Lenders are compensated by fee premiums. Borrowers who default enjoy a subsidy, unless collection procedures succeed in extracting full payment from them.

Is there a net gain? The best-case answer would be that the increase in the number of loans extended (over loans which would have been made in the absence of the guarantee) has generated the desired effects -- jobs are created by establishment of new companies and expansion of existing businesses; increased wealth provokes increased demand; banks enjoy repeat business, and so on. A variety of factors influences the likelihood of that outcome. Alternative scenarios result in guarantee funding being locked up while banks disregard guarantee options or being expended on poor quality loans -- both resulting in no net social or economic gain and disappointing expectations. Another possibility is that banks promote the guarantee provisions to existing clients, whose loan volume increases. The latter would be a rational strategy by risk-averse bankers and, it could be argued, a benefit to the economy.

Supposing clear programme objectives are agreed upon, let us look at the problem of establishing a level of acceptable cost. (In practice, cost cannot be divorced from risk, as will be illustrated later.) A 1994 OECD working team on SME policy affirmed that

determining loss-tolerances is difficult in most countries where LGs form part of national SME policies. In Poland, where SME programme objectives all point toward economic renewal, business finance should be accountable to criteria tied to quality: viability, soundness, and preparedness of the business plan. Otherwise, public funds should be redirected to secure a better rate of return.

Riding, of Carleton University, Ottawa, drew a distinction between offering guarantees because lending entails exceptional risk, and offering guarantees which suffice to compensate banks for assuming a moderate level of risk. He argued that LGFs should facilitate capital formation for good business projects,

not to subsidize risky firms. At any level of firm size, there exists a distribution of risk of borrower. It is the task of the credit markets to discriminate according to quality of borrower. . . . If size of firm is the issue, there ought to be no subsidy and the only firms that ought to receive loan guarantees are the less risky ones within the small firm universe (Riding 1996, 6 and 9). Emphasis added

The business environment of the CEECs differs substantively from that characterized by competitive and more-or-less comprehensive capital markets. The vulnerable parties to loan agreements in Poland are not only bankers and investors, but borrowers themselves -- bearing in mind that, even in the presence of guarantees, defaulters lose their collateral. Financial assistance should not only shield financial institutions from risk but, for the reasons outlined in the previous chapter, minimize borrowers' exposure. Riding's advice to hold close to the low-end of the risk spectrum can be exported to the CEECs only with the caveat that, for the present, all business undertakings are implicitly riskier in eastern Europe than they are in the West.

Debate always crackles around issues of public expenditure, and the subject of disbursement for LGFs is no exception. East and West, popular wisdom maintains that bureaucrats who finance projects with public capital are dismally poor managers who

exploit conditions of weak accountability, and welcome political bargaining and leveraging.

In 1994, a Polish MP remarked:

Last year the State Treasury guaranteed 9 trillion zlotys worth of bank loans to particular industries. Two-thirds of these loans have gone bad already and the situation will probably get worse. These guarantees obviously have little to do with helping firms develop. Rather, they are political concessions to industries that are de facto being subsidized by the national budget.¹⁴¹

It is generally accepted that compensation for adverse effects of market imperfections are bankrolled with Budget funds. In the Polish case, imperfect credit markets constitute a barrier to entry for Poland's SMEs, which the state is endeavouring to correct by instituting a regime of loan guarantee provisions.

Empirical research on the American Small Business Assistance programme (SBA) by Rhyne (1988) classified objectives of the SBA in three groups: (i) correction of the effects of imperfect capital markets on SMEs; (ii) encouragement of a certain type of economic or social activity or result; and (iii) assistance to a targetted beneficiary group. She proposed that differentiated acceptable levels of risk and of cost were attendant upon programme's identified with specific categories, with the strictest rigour required to establish acceptable investment levels in the first class of objectives, and devolution to weaker standards in the third. In Rhyne's analysis, a public policy perspective implies tolerance of an economic subsidy under LGFs. "When the credit decision includes only returns to lenders, even if credit markets judge costs and returns accurately, firms that are financially risky but offer high equity or social benefits will receive too little credit with respect to the total social and economic benefits they produce" (Oehring 1995, 97). However, when externality objectives are identified, criteria for success must be based on satisfaction of the condition that "the value of such benefits attributable to the programme (incremental benefits) must equal or exceed the subsidy" (Rhyne 1988, 104).

Within the range of Poland's programmes to assistance SMEs are many instances in which LGFs have an explicit target group and ambitious social objectives; one example, by now familiar to the reader, is the E.C.-funded PHARE/STRUDER programme instituted in especially designated regions which structural unemployment of critical magnitude. A perspective different from Rhyne's is evident in the following statement by a representative of FUNDES, a private LGF company with origins in Latin America, which argues that non-economic criteria endanger LGF effectiveness:

When [regional development or employment creation become primary goals], the motivation for issuing loans becomes unclear and financially dubious. In short we feel that small business promotion must be understood as an entrepreneurial undertaking and not a political one. If it is an entrepreneurial undertaking, then one is obliged to cover one's own costs. If this isn't understood, as it often isn't when the public sector comes into the arena, then the market will be distorted by organizations that fail to charge for the services they provide. On the one hand, this tends to negatively affect the expectations and behaviour of entrepreneurs. On the other hand, it discourages private actors from becoming involved in the sector because they are facing unfair competition (Oehring 1995, 158).

Oehring recounted that, of twelve LGFs established in eleven countries in Latin America, nine had ceased operations, two are in deficit positions, and one is successfully insuring loans to the micro-enterprise sector. All but the last were publicly funded and most were administered by the countries' central banks, and in most cases the guarantee option simply was not used. However, resistance to SME lending appears to be deeper in Latin America than in Poland, because the European standards for creditworthiness are more generous. Oehring calculated that of loan applications rejected as unworthy in Latin America, 50% would be deemed worthy of credit in Europe (or 75% with a guarantee), (Oehring 1995, 30-31).

Techniques and delivery of loan guarantees

Careful selection of the technical features of loan guarantees is extremely important if loan guarantees are to be used effectively as policy instruments. These features include (i) eligibility criteria; (ii) share of debt guaranteed; (iii) structure of risk-sharing among the

borrower, lender and guarantor; (iv) the presence of a re-guarantee option; (v) fee structure and level of interest rate premium; (vi) duration of guarantee; (vii) level of collateral demanded; and (viii) level of multiplier. All of these factors directly affect the rate of demand for and supply of loan guarantees, and indirectly influence incidence of default.

In tandem with fine-tuning LGF features, the way the set of tasks involved in their execution is divided between the lender and guarantor is equally important. For example, who evaluates loan applications and arrives at the lending decision, or who collects from defaulters. Similarly, whether such duties are performed locally or by a remote head office is significant. A related group of services, which provides non-financial business support to borrowers, has been identified as essential both to the success of particular LGFs and to the achievement of policy objectives. Such services must include advising loan applicants, monitoring company performance of borrowers, continuous counselling and miscellaneous consulting services, and may extend to training (direct provision or referrals). How the full portfolio of services can best be delivered is a controversial question everywhere LGFs exist; the range of approaches cleaves fairly smoothly along the lines of market or non-market delivery, and private or public providers. The relationship between guarantor and lender is generally characterized as a principal-agent arrangement, in which the potential for moral hazard exists because the agency makes decisions about disbursement of resources belonging to the principal. "The authority is delegated because the agent possesses comparative advantages in making the required decisions. Agency relationships work well when the principal pays the agent according to a fee schedule that varies with the success of the choices" (Rhyne 1988, 82).

Most LGFs have structural inefficiencies which impede their ability to execute programme mandates. Some attention to common problems implicit in the operation of LGFs will illustrate that selection of techniques is as much a function of policy objectives, as a determinant of their successful achievement.

(a) *Moral hazard created by high guarantee levels*

Most loan guarantee programmes, pursuant to a policy of "neutral" administration or simply to minimize the direct administrative burden, leave the "sell" decision to the market. This means that the lender evaluates loan applications and makes the decision to grant or refuse, leaving the quality of the loan portfolio entirely in the control of lenders -- usually banks. Riding has researched the mathematical relationship between guarantee levels and default rates, and concluded that the level of guarantee offered is the single most important variable in determining the rate of default.¹⁴² He explained this as a function of lenders' profit-seeking behaviour, which inclines them to maximise the number of loans extended and minimize rigour applied in the evaluation of loan applications. According to Riding's hypothesis, the lower the share of LG costs borne by the lender, the higher will be the rate of poor quality applications approved. It follows that overall default rates will increase, lenders claim a higher rate of guarantees resulting in mounting LG programme costs.

The higher is the share of the loan which is guaranteed, the lower is the incidence of risk on the lender. High guarantee levels insulate bankers from costs associated with defaults and encourage exploitation of public funds. This results in a skewed reward structure for the agent to whom the lending task is delegated. Agents are rewarded with a transfer of public funds when they have failed to achieve the objective of contributing to the establishment or growth of durable business enterprises. A similar finding from the U.S. revealed, bluntly, that "the public-private partnership . . . is so lax that it allows banks to select businesses that are too likely to default" (Rhyne 1988, 5). In that case, guarantors would likely increase the fees charged to current borrowers or target a lower-risk client group to maximize recovery of invested capital.

(b) *Negative self-selection caused by high fees*

While the "sell" decision rests with the agent, the job of fixing programme parameters resides with the guarantor. Like guarantee levels, fee levels and structures vary. However, programme fees should be coordinated with guarantee levels to attract the number and composition of clientele which will ensure the programme is self-financing, or has the potential to become self-financing. In combination with multiplier levels, these factors must be calculated to project future revenues and to discourage high risk investments which generate excessive costs.

When the price of guarantees increases beyond a certain threshold, adverse self-selection among applicants can result in a lower standard of projects being approved. Entrepreneurs having alternative sources of funding would decline to pay the high fees; the actual target clientele will be discouraged from applying for loans; and the weakest projects would become the main beneficiaries of the guarantee programme.

(c) *Failure to enforce criteria*

When criteria for guaranteed loans are unclear or not enforced, guarantee usage may be more broadly used than is intended. By funnelling new commercially viable loans into the guarantee programme or encouraging exiting clients to increase their obligations, lenders minimize their own risk without exceeding the total number of active loans that would exist in the banking system in the absence of the programme. The Canadian Small Business Loans Act (SBLA) programme provides an illustration: a 1988 study concluded that two-thirds of guaranteed loan recipients would also have received loans on strictly commercial terms (Manley and Martin 1994, 25).

A way of ensuring criteria are honoured would be to include the guarantor in evaluation and decision-making processes. This would increase costs, but also enable the guarantor to ensure non-commercial factors are taken into account where the LGF envisages positive social or political externalities. Effective screening of loan applicants should result

in a low level of defaults in initial years of the lending period. The longer borrowing firms survive (before defaulting, should they default), the greater are accumulated revenues from repayments to offset programme costs.

It can be concluded that when LGFs are not well-designed and effectively monitored, they produce unintended results. These often allow both "high-end" borrowers who are eligible for loans on commercial terms, and "low-end" borrowers whose projects entail inordinately high risks, to benefit from guarantees which are intended for a middle-range of viable firms -- which may be overlooked when inappropriate techniques or standards are employed. Even in the absence of the intended gains for private enterprises, two unintended consequences may result: (i) as a consequence of profit-seeking or carelessness, unsound businesses are financed; and (ii) programme costs increase. In such circumstances, the SME sector is not strengthened but may suffer from negative stereotypes volunteered to explain the failure of LGF programmes. In many instances, however, the lending banks are fortified -- an outcome which may not be unattractive to Poland's policymakers.

It seems clear that, by requiring lenders to share the risk and liability for loan defaults, the incentive to maximise the number over the quality of guaranteed loans can be countered. A different incentive would be substituted therefor, making lenders stewards of the projects in which they invest, in order to secure future profits. One example (there are many) of such a solution is the German system of public lending and savings banks which will be explored in the next chapter.

A brief survey of the Poland's major loan guarantee funds (LGFs) shows the BCK fund has a moderate loan guarantee level (60%) and fee structure (1.2% in the first year, with the addition of increments of 0.2% in each of the subsequent four years). Its maximum allowable term of five years is short by international standards. An unusual and favourable (in the view of the writer) innovation may be that some lenders have proposed

to offer preferential interest rates - the inverse of the rate premiums normally demanded. Eligibility for protection under the PHARE/STRUDER LGF is restricted to recipients of grants under its former grant programme, which ensures beneficiaries have been carefully screened and restricts latitude for misuse. The programme has set 70% as its guarantee level. Other LGFs active or setting up in Poland offer guarantee levels of 60% to 70% (in Lublin and Bialystok, funded by the British Know-How Fund); and 55% (FUNDSTAR, in Starachowice, funded by PHARE). Thus, the proposed LG protection levels undercut the high rate (up to 90%) offered in Canada.

5.2 The Polish experience to date

We have seen that the SME policy adopted by the Council of Ministers in June 1995 established loan guarantees as the major instrument of financial assistance to SMEs. A little over one year before that, a conference brought together representatives of major players in the development, administration and delivery of guarantee funds: advisors from the Regional Development Agencies and the Polish Agency for Regional Development; representatives of the E.C.-, American- and British-sponsored assistance programmes active in Poland; executives from private funds; consultants from guarantee funds in Latin America, Italy, France and Germany; bankers; lawyers; government officials from various levels of administration; and at least one member of parliament.¹⁴³ At the time, there were estimated to be between fifteen and twenty-five organizations in Poland issuing, or planning to issue, loan guarantees. Two scenarios were described. A "pessimistic" scenario in which each of these agencies attempts, by trial and error, to achieve an effective level of performance, has their efforts defeated by overwhelming odds. The alternative "optimistic" scenario is based upon the notion that by communication, coordination and learning, the

¹⁴³ The conference took place in Madralin, a town near Warsaw. A text edited by Anthony Levitas and Grazyna Gesicka was published pursuant to the conference, under the title, Local Guarantee Funds. There are several contributors who will be cited in the bibliography. However, the book includes a discussion which is reproduced in a "court proceedings" style; speakers who are not contributing authors are cited in footnotes which identify them by name and affiliation, and will not be found in the bibliography. My source is given as Levitas and Gesicka.

odds of successful operation are significantly improved. The potential for delivery of fund services to viable SMEs envisaged in the second option, provided the rationale for the 1994 conference.

At the conference, important observations were made about the need to foster mutual trust among the main actors in financial markets. It was clear that the banks mistrusted the ability of small fund managers to perform credit analyses, and the funds were skeptical of the banks' newly-acquired expertise. However, if trust is a necessary condition for development of effective economic relations, it is not a sufficient one. The shortage of own-capital and the competitive toughness of the emerging economic environment combine to make technique, expertise and institutional transparency essential elements. From the Bank for Social and Economic Initiatives, "No matter how much actors trust each other there are always economic and social risks that are beyond their control . . . the principal criteria must remain the economic risks associated with particular undertakings in a given environment."¹⁴⁴

Another factor must be emphasized: the role of foreign capital participation in provision of capital for SME start-ups and growth. In some instances, a principal/agent relationship exists between a donor organization and the beneficiary; for example, the PHARE/STRUDER programme uses PARR, an administrative body constituted in Poland, to allocate E.C. grant capital. More often, foreign agencies themselves actively promote the use of their funds for development purposes. PAEF is among the most influential agencies in Poland (the PAEF investment funds were discussed in the previous section). A spokesman for the PAEF guarantee fund told conference participants:

misunderstanding has been apparent in our discussions with every Polish government since the Mazowiecki government. . . . it is not our role to carry out regional restructuring policies or to guarantee loans on anything less than

¹⁴⁴ Włodzimierz Grudziński, Bank for Social and Economic Initiatives, in Levitas and Gesicka 1995, 149.

a commercial basis and that if the government wants to pursue such policies it should do so on its own. . . .

It is our feeling that the worst thing that we could do for Polish business is to relieve entrepreneurs of the risks associated with their undertakings. . .

Our first principle is therefore that entrepreneurs must risk their own capital if we are to risk the capital of American taxpayers. The second thing is that we charge for our services. Third, we think that from the issuer's point of view there should be little difference between a guarantee and a loan. Both create the same sort of liabilities and should be treated with equal seriousness.¹⁴⁵

The emphasis, above, has been added to amplify the importance of achieving clarity regarding the agents of public policy. The fundamental tasks of governing authorities are (i) to receive the decisions of parliament establishing the priority of certain public policy objectives and (ii) to mobilize resources toward the accomplishment of those objectives. This is not easily done. Poland's reliance on external capital schemes limits to a degree the ability to direct or coordinate active programmes. Private providers of financial services are, as stated above, unambiguously "in business" to generate profits. Their contribution, from the perspective of Polish economic needs, is to stimulate and capitalize productive economic activity in Poland and to introduce demonstrated market practices. The government of Poland has initiated programmes to support economic restructuring goals and must now determine, in more precise terms, how they will be financed and whom they should benefit. Comparison with the post-war reconstruction efforts of the axis nations, Germany and Japan, is not inappropriate.

5.3 Obstacles to the execution of loan guarantees

The following section on the execution of loan guarantees in Poland examines legal and structural obstacles to achievement of LGF objectives. In the earlier chapter on impediments to smooth functioning of the banking sector, several aspects of prevailing laws were discussed. We shall see that two issues mentioned there present major

¹⁴⁵ page 159.

Marek Kulczycki, Enterprise Credit Corporation (PAEF), in Levitas and Gesicka 1995,

roadblocks to the operation of guarantee funds: the requirement that lenders be licensed by the NBP; and the absence of a legal category for non-profit activity. A third factor impeding LGFs is the centralized structure of the banking system, which LGF representatives argued prevented the knowledge possessed by local banks from being introduced into loan and guarantee decisions which are taken exclusively in Warsaw by the central bank. The following paragraphs outline the elements of what was described by a representative of the Foundation for Social and Economic Initiatives (FISE) as a "hostile legal environment" (Herbst 1995, 173).¹⁴⁶

An organization of almost any legal structure can offer guarantee services; usually, in Poland, guarantee funds (LGFs) are joint-stock companies (JSCs) or foundations. There are certain advantages to each form. A foundation is far less expensive to register than a JSC, but can be registered only in Warsaw. The registration fee for JSCs is about one hundred times higher, but JSCs may be registered by the provincial courts. It could be argued that a high registration fee, in the guise of standard-bearer, deters the capital-poor from launching LGFs. JSCs are also subject to the uniform 40% corporate income tax and are obliged to pay an excess wage tax (Ebrill et al. 1994, 21)¹⁴⁷. Operation of a LGF through a JSC structure is the more costly option. The wage tax raises the price of engaging specialized professionals such as financial analysts, actuaries and accountants whose services are critical to the LGFs' success. Some conference participants argued that the corporate structure of the JSC is more conducive to disciplined execution of the mandate to reproduce and expand the fund's capital base, while foundations face regulatory difficulties when carrying out commercial functions. In the case of a JSC and of a foundation, the managing board is legally responsible for decisions taken in the foundation

¹⁴⁶ FISE is a small business advisor, the partner to the BISE.

¹⁴⁷ The excess wage tax (*popiwek*) lapsed in April 1994 and was reintroduced in a negotiated form in August 1994.

or JSCs name, so tension between the managing board and other members of the selection committee is not uncommon.

We know that the legal right of non-banking organizations to offer loan guarantees is unclear, and lobbying is underway to create a legal non-profit status which many people believe is more suitable to loan guarantee activity. Another proposal would see income reinvested by LGFs into economic development projects designated tax-exempt.

The Commercial Code, written sixty years ago, allows private entities to guarantee each others activities and to issue loans. The more recent Banking Code states that these activities must be licensed by the NBP. It is therefore unclear at what point the issuing of guarantees by a non-banking institution comes into conflict with the Banking Code. We have tried to resolve the issue by getting the NBP to officially sanction our loan and guarantee activities. Unfortunately the NBP does not have the authority to license us as a bank. As a result we are acting on the edges of the law.¹⁴⁸

The present situation for non-bank LGFs is tenuous, while a variety of arguments is enlisted to circumvent Banking Code restrictions:

- (a) If LGFs do not charge for lending or guarantee services, these are non-commercial activities; alternatively, fees could be concealed as charges for auxiliary goods or services;
- (b) A foundation could operate with a two-tiered structure, creating JSCs to carry out its commercial activities;
- (c) Organizational statutes are registered with the courts. As the organization's mandate to provide loan guarantees is identified therein, the practice is legally defensible;¹⁴⁹
- (d) Banks are subject to licensing by the NBP as custodians of citizen's deposits. Because LGFs are not capitalized with deposits but by investors who "know what they are doing and are fully conscious of the risks they are taking"¹⁵⁰, jurisdiction over guarantees should default to the Commercial Code.

On the other hand, the central bank has an obligation to ensure that the level of liabilities in the system is contained, and to control money supply. The NBP, according to

¹⁴⁸ Jan Drozd, Mielec Regional Development Agency, in Levitas and Gesicka 1995, 145.

¹⁴⁹ In Poland, modification of organizational statutes is difficult.

¹⁵⁰ Janusz Szlanta, National Association of Regional Development Agencies and Foundations, in Levitas and Gesicka 1995, 146.

participants at the Madralin conference, takes a skeptical view of non-bank LG activity and has warned it will intervene if the LGFs abuse the ambiguity in prevailing laws. Apparently, it has not specified what constitutes punishable abuse.

There appear to be good reasons for the NBP's lack of confidence. Many LGFs are small and have very little own-capital; for some, a single default could foreclose operations. Banks doubt the LGFs' ability to meet their obligations as guarantors and, so, tightly restrict guarantee multipliers. Said a representative of the Bank for Social and Economic Initiatives, "At BISE, we don't like these kinds of arrangements because in effect they force us to analyse the financial status of two firms instead of one."¹⁵¹

On the other hand, the guarantee funds' small size is due in part (if they operate as foundations) to the fact that they are prohibited by the Banking Code from charging fees; if they could expand their capital bases and generate surpluses, small LGFs would become stronger cooperants for the banking system.

If programmes feel that charging fees and moving towards greater volumes will attract the attention of the NBP, then they will avoid doing precisely what is necessary to become financially self-sufficient. If they attempt to recover costs by charging fees while keeping volumes low to avoid NBP intervention, the price of guarantee services to their clients could quickly become prohibitively high (Levitas 1995, 190).

Banks perceive another danger in the presence of many small independent LGFs: intensified pressure on local banks to increase the number of loans to SMEs, even when loan applications are unsound, which would increase liabilities both of the banking system and the LGFs. This concern is exacerbated by the uncertain legal status of many LGFs, which stiffens the resolve of the NBP not to condone their activities: "This could push the whole problem of bad credit analysis and bad loans out of the banking system per se and into an area where everybody is operating in the edges of the law."¹⁵² Another significant

¹⁵¹ Włodzimierz Grudziński, BISE, in Levitas and Gesicka 1995, 149.

¹⁵² Włodzimierz Grudziński, BISE, in Levitas and Gesicka 1995, 146.

weakness of the independent LGFs is that Polish law vests only banks with statutory rights to collect defaulted receivables, leaving ultimate responsibility for resolution of bad debts with the bankers. The bankers present at the Madrigal conference perceived loan guarantees are not "taken seriously enough" by LGFs' agents. A representative of the Polish American Enterprise Fund (PAEF) pointed out that, from a lender's point of view, guarantees differ little from loans:

According to the Banking Code, guarantees require the creation of the same reserve funds that loans require, but they don't generate profits. Worse, income taxes have to be paid on these reserves. Banks can, of course, earn a one-time fee on a guarantee, but the profit margin is very small. Guarantees also require the same kind of credit analysis as normal loans. As a result, and for most banks, credit guarantees are not worth the effort and are issued only as a service to good and well-known clients.¹⁵³

One can appreciate that these conditions, with which the designers of the new SME policy must now contend, could lead to suppression or even deadlock of SME credit guarantee provisions.

¹⁵³ page150.

Marek Kulczycki, Enterprise Credit Corporation, PAEF, in Levitas and Gesicka 1995,

PART V

A. SYNTHESIS & CONCLUSIONS: The broad lines of an alternate approach

1. Introduction

The purpose of this final part is to synthesize what has been learned about the general business environment in which SMEs operate, and to propose a policy direction which the writer considers could help to relieve certain bottlenecks and expedite the financing of small businesses in Poland. "The economic transformation of eastern European countries will be complete when . . . within limits imposed by legitimate regulation, individuals are free to start and carry out any activity they wish" (Tanzi 1992, 7). It has been argued that, to enable the individual economic freedoms Tanzi wrote about to take root, certain conditions must be fostered and others created by the state. There are two main factors in the present stand-off. First, a majority of SME business proposals are seen not to be commercially viable, and second, there prevail systemic obstacles preventing worthy projects from being realized, which are unrelated to the viability or level of risk associated with them. Chief among these is the reluctance of commercial banks to facilitate access to credit.

The approach taken here envisages combining an active role for the public sector, in collaboration with local business, industry and community initiatives. This direction could be perceived to be regressive in light of Poland's clear determination to minimize government intervention in economic matters. But, in the view of the writer, timely appropriate action to correct for systemic deficiencies would constitute good government.

Since 1993, when the Government of Poland absorbed almost 60% of the increase in total credit, banks' profits have been rising due to their increasing rate of investment in government bills. A simultaneous reduction in the share of lending in total assets of the banking system and a decline in the rate of lending to the private sector have occurred

(Toland, Saffer and Heatly 1995, 12),¹⁵⁴ while available credit lines are underused. Research has not shown evidence of improvement in the relationship between banks and small business borrowers. We have seen that the Ministry of Industry and Trade and the Ministry of Finance are prepared to invest quite aggressively in implementing loan guarantees, and have elaborated medium-term objectives for establishment of local loan guarantee programmes and a re-guarantee facility. Although the fine points of these plans have not been developed yet, it is hoped that guarantee measures will decisively reduce the cost, to banks, of SME lending.

Actual operating conditions in Poland appear not entirely to support the use of loan guarantees as the main pillar of SME financial assistance programmes. Loan guarantees are not normally used to incite banks to lend. The relationship is rather one of their reliance on the cooperation of the banking sector to be effective in fostering the delivery of financial capital to SMEs. Even in developed market economies, banks are induced to make small loans (i) by competition for overall market share and (ii) by direct or indirect government pressure. In Poland, only a small number of banking licenses has been granted in recent years, pursuant to a policy suspended in 1996, and the financial services sector is insufficiently competitive. Were markets more complete, competitive pressures would likely force banks to cultivate small business clients but, in the short-run, the SME sector has limited potential to raise bank profits. At present, neither domestic nor foreign competitors appear interested in the sector, notwithstanding the advice from GEMINI consultants that "developing customer relationships that will generate interest and commission income over time (and investing in the skills necessary to bring those relationships about) will have a much greater impact on profitability than the interest earned on government paper" (Toland, Saffer and Heatly 1995, 86). Using the Canadian

example, we see that most of the chartered banks have substantially increased their SME loan portfolios in recent years and about 30% of total commercial lending now goes to small businesses (Manley and Martin 1994, 9).

It is, of course, far too soon to conclude that LGs will not significantly enhance lending to the SME sector. In combination with progressive hardening of SOEs' budget constraints and increased competition in the provision of financial services, LGs may have the effect of releasing an important margin of funding for private businesses. However, this thesis explores the potential for complementary measures which can help mobilize available resources even in the absence of effective state-guarantees on bank loans. A formula must be found which can make allies of the banks and small businesses or, indeed, which does not foreclose the possibility that such a relationship will take hold in the near future. Measures to provide assurances and support to banks would definitely favour emergence of a more cooperative relationship between SMEs and the banks. Although large banks enjoyed rising profitability in 1995, the majority of smaller banks remain weak. Pre-tax banking sector profits increased by 66% in 1995, but the increase is explained by the fact that the decline in costs (20.3%) dominated the decline in revenues (12.2%).¹⁵⁵

This thesis explores avenues of reducing direct reliance on the commercial banks to make financial capital accessible to small businesses. The problem was expressed in this way by a FISE representative:

The difficulty here is that access to credit in Poland is not a marginal problem and it is hard to imagine how funds employing banking methodologies will find large numbers of new credit-worthy projects. It thus seems to me that if LGFs are to be successful not only in the sense that they do not decapitalize, but successful in the sense that they do more than improve access to credit at the margins, then they will have to develop methodologies and practices different from those currently being used by Polish banks (Herbst 1995, 60).

Let us return to the three questions we originally posed in Part IV.A. It must be admitted that it is too early to answer these questions, because few programmes targetting SMEs were launched before late 1994 and the main policy instruments are not yet fully operative.¹⁵⁶ Nevertheless, the three questions constitute a useful framework for a preliminary analysis of the situation.

First we asked "How effective are existing financial assistance programmes in helping firms' start-ups and investment; that is, do they contribute to consolidation of a high quality SME sector?" With the exception of direct grants, the effectiveness of such programmes has been severely hampered by banks' recalcitrance. A "high quality" implies sustainability, which so far cannot be ascertained both because statistics are poor and too little time has elapsed. Therefore, this discussion must be based on a reading of the intentions and capabilities of existing programmes to select viable projects for funding, and to deliver funding in an affordable manner.

Two aspects of the situation should be noted. First, Poland's business environment is teeming with activity. Warsaw is a mecca for Western expertise and foreign capital, alive with promise and with risk. Multilateral organizations and multiple levels of Polish government have introduced a vast range of programmes geared to support business ventures. An immediate objective of the Polish government is to coordinate these diverse initiatives, rationalize delivery of services, and harness available resources more effectively than has been done to date. Second, a strong local orientation is taking shape. Historically, locally-based programmes have been most successful in mobilizing small business activity. On 16 May 1995, the Council of Ministers adopted a resolution to establish local institutions to extend active assistance to SMEs. Important examples of local programmes are the numerous "cooperation funds" of the Programme for Local

¹⁵⁶ Experts say a "cost equilibrium" can be reached in five to seven years after start-up of lending or guarantee programmes (depending on duration of loans and guarantees), before which a dynamic disequilibrium prevents useful evaluation of costs.

Initiatives, the Regional Development Agencies (non-governmental joint-stock companies) and the Municipal Development Agency.

There follows a brief comment on the effectiveness of the four types of financial programmes that were discussed in the previous chapter: grants; lines of credit; equity; and loan guarantees. Officials of PHARE/STRUDER, between May 1994 and December 1995, committed 18 MECU in direct grants to SMEs and then, having exhausted the supply of funds, closed the booth to new applicants. At present, it is not expected that the grant fund will be recapitalized. It is hard to say whether direct grants are effective, but one can say that limited resources suggest they cannot constitute durable or broad public policy.

Available lines of credit are underused. PHARE/STRUDER provided the example of having delivered only about 12% of a line of credit, before the programme was discontinued due to the impossibility of finding "suitable disbursement channels".¹⁵⁷ The reader is familiar with impediments to bank lending to SMEs, but should bear in mind also the hazards of high gearing at both microeconomic and macroeconomic levels. The supply of equity capital in Poland has increased steadily since 1990 and contributes favourably to the economic strength of growing companies, but the majority of SMEs are too small to attract the interest of venture capital funds. It is too soon to assess the performance of the loan guarantee funds, but the proposal to build an SME support structure primarily on guarantee measures will be evaluated.

We asked, secondly, "Are these programmes cost-effective?" Because loan guarantees have been identified as the central pillar of financial assistance to SMEs, the answer must focus on the anticipated costs and benefits of the loan guarantee strategy. The tentative conclusions of this thesis are based in part on the writer's impression that the large size and broad incidence of costs generated by implementation of the proposed

guarantee plans may be disproportionate to their ability to achieve the government's stated policy objectives. The projected direct cost to the government of loan guarantees for industrial enterprises "covered by sectoral restructuring programmes", as established annually in the Budget Act, was PLN 2,000 million in 1995; PLN 3,000 million for 1996, and PLN 3,500 million for 1997. A total of PLN 45 million was paid specifically to finance the BGK loan guarantee fund in 1995.¹⁵⁸ A sense of the importance of guarantees among measures to support business ventures can be deduced from these figures: of a total PLN 14,802.4 million committed in the category "state expenditure to improve Polish companies' competitiveness", PLN 10,284.5 million comprised allocations for a range of guarantee programmes (including those dedicated to export promotion), of which PLN 4,000 million is allocated specifically as "state guarantees for investment loans".¹⁵⁹

Consider that the Canadian loan guarantee programme is the product of several years in which bank operations pursuant to the Small Business Loans Act (SBLA) guarantee programme have been refined. It has nevertheless been concluded that the programme, which boasts of an unusually low default rate, is too costly to the Canadian government. Therefore, subsequent to major amendments in 1993, the SBLA is again being reformed.¹⁶⁰ Bisignano explained that "the role of government as a contingent creditor or implicit shareholder creates a moral hazard problem in that the presence of some form of public backing, ultimately the taxpayer, may significantly alter the risk preferences and incentives of bank managers and shareholders, who may attempt to leverage the contingent

¹⁵⁸ Ministry of Industry and Trade, Department of Economic Strategy and Policy, "Implementation Stage of the Programme for the Policy Toward SMEs", 31 October 1995.

¹⁵⁹ Ministry of Industry and Trade: The International Competitiveness of Polish Industry.

¹⁶⁰ Despite the low rate of defaults, the high guarantee rate offered under the Canadian SBLA programme may account for the programme's high cost. The LGP administered in Japan is profitable under normal conditions. See Riding (1996) for discussion.

support role of the government" (Bisignano 1992, 178).¹⁶¹ The level of risk affecting the fiduciary obligations of governments in their capacity as executors of state budgets increases directly with the degree to which the banking system is leveraged. In Poland, the present policy slate commits expenditure of considerable magnitude to fulfill the role of "contingent creditor" -- committed funding which will be mobilized in conjunction with business failures.

Another factor should concern policy makers. A majority of the locally- and regionally-based LGFs are funded by multilateral organizations. If such bodies decide to exit these programmes before guarantee funds are self-financing, it is likely the market will become dominated by private funds such as FUNDES and PAEF, and users' costs will increase. Funding decisions of such organizations as PHARE, the Know-How Fund and the World Bank, are normally determined in the context of global medium-term plans of three to five years which should allow some crude forecasting of anticipated levels of donor and preferential finance. The World Bank recently pledged to provide USD 400 million to USD 500 million annually to Poland for the duration of the Country Assistance Strategy (CAS), which expires in the year 2000.¹⁶² But a shift toward business-oriented principles for CAS provisions is under consideration at the World Bank, and the effective planning horizon may be reduced to only two years.

"Are these programmes effective in attracting and mobilizing new investment, especially foreign investment?" The writer does not anticipate that guarantees constitute a sufficient incentive to investors. If LGs succeed in promoting new lending relationships between banks and borrowers, positive experiences would likely have the indirect effect of

¹⁶¹ Bisignano gives the example of U.S. Federal Deposit Insurance Corporation action in response to the massive failure of savings and loans institutions as the "classic" case.

¹⁶² World Bank Vice-President Johannes Linn cited by the Polish Press Agency on 20 March 1996.

promoting confidence in the Polish banks' expertise. Normally loan guarantees are characterized as compensation for the perceived deficiencies of SME clients, not as incentives to lend. We have also seen that barriers to investment are not limited to financial markets. However, private sector investment has grown rapidly since conclusion of the London Club agreement, and the recorded increase of 68% from 1994 to 1995 was concentrated in firms having foreign capital participation.¹⁶³ In fact, "Acceleration of investment was made possible by significant 'improvement of companies' finances, as -- due to still expensive credit -- they are mostly financed from their own resources."¹⁶⁴ In March 1996, the *Sejm* amended the Law on Companies with Foreign Capital participation to conform with E.C. and OECD standards requiring that member states provide an even playing field for foreign and domestic firms.¹⁶⁵

2. Loan guarantees as public policy: Why not

Some reservations about the Polish government's emphasis on loan guarantees are summarized here. First, we have seen that banks operating in Poland are not eager to participate in granting guaranteed loans. They argue it is costly to them: reserves held against guarantees are taxable, and the level of research and evaluation required for processing is commensurate with that for loans. Second, non-banking institutions have tenuous legal status for granting or guaranteeing loans in Poland. A third factor is the writer's reservation about the appropriateness of the loan guarantee structure as the central measure of support for SMEs in the incomplete market conditions prevailing in Poland.

There is a fourth consideration, based on the concern that over-emphasis on LGs

¹⁶³ *Statystyka Polski*, 13 February 1996. This figure does not include firms with fewer than fifty employees.

¹⁶⁴ Economic and Legal Information from Poland (June-July 1995), 3.

¹⁶⁵ Polish Press Agency, 15 March 1996.

may have the ultimate effect of discriminating significantly against SMEs. Price discrimination is apparent in the assessment of fees and interest rate premiums from borrowers; this levy comprises the purchase price of a guarantee. However, of possibly more consequence is that LGs justify and galvanize bankers' preferences not to lend on commercial terms to SMEs. If banks are enabled to select clients based on their willingness or ability to pay for a guarantee, they may ghettoize SMEs based on their size. These concerns can be addressed by (i) recognition of the heterogeneous character of the SME population, and (ii) a shift in the relative attractiveness for banks of investment in government bonds, Treasury Bills and securities, compared with investment in the private sector. Already, the rate of bank lending to SOEs has declined more sharply than has lending to the private sector. With sustained attention to clear market-driven incentive structures for banks, one expects that, within a few years, the market-ready entrepreneur or mid-sized company will find a lender willing to sell them capital and services at a market rate.

It is difficult to differentiate the Polish government's intentions toward the banking sector from its broader economic objectives, including SME assistance. A dominant policy orientation toward satisfaction of the first objective would be rational in light of Poland's rapid, progressive integration into international markets, implying both imminently increasing demand for and supply of financial services. One should ask whether the Budget-funded guarantees are intended more to subsidize the commercial banks operating costs than to promote SME growth.

3. Appropriate policy: The broad lines of an alternate approach

Let us review how the credit problem for SMEs in Poland differs from that of counterparts in the West.

- (a) The major distinction is that the credit problem in Poland is not restricted to

the margins of economic life, and neither are the firms being denied access to credit unusual, in the circumstances. On the contrary, credit rationing has the effect of marginalizing vast numbers of small companies and foreclosing opportunities for mainstream entrepreneurial growth. Credit guarantees are normally used to insure against default in a particular market sector comprising a small fraction of total loans. For example, in 1991 in Germany, guarantees covered 0.25% of total commercial loans.¹⁶⁶

(b) While shortage of collateral is typical of SME owners worldwide, it is endemic in countries whose communist governments collectivized private assets. Even property which belongs to an individual or family is of limited value as collateral because of the unpracticable nature of ownership claims at the present time.

(c) Personal savings and transferable wealth are very limited. The promised redistribution of domestic assets has been greatly delayed. Share certificates in the National Investment Funds which manage the assets of the Mass Privatization Programme became available for purchase in November 1995; at the end of January 1996, 20% of adult Poles had acquired them. A market in trade of these certificates is beginning to emerge.¹⁶⁷

(d) There is an absence of recorded business history and pre-existing private banking relationships.

(e) Incomplete records and poor communications infrastructure prevent efficient and timely response by banks.

(f) Banking functions are traditionally segmented and even deposit-holding institutions are undercapitalized for historical and systemic reasons.

(g) Market relations and their corollary institutional and regulatory structures are still incomplete.

(h) Continued growth of the private sector will depend on the strength and durability of the SME sector.

Recall that several observers of the CEECs' transition have suggested new private banks should handle specialized portfolios of high calibre accounts, in order to foster stability, strength, and, ultimately, credibility of the new financial institutions.¹⁶⁸ That proposal is not inconsistent with the writer's view that the emerging private banking sector

¹⁶⁶ This percentage is given in a 1981 publication of the Anglo-American Foundation entitled "The British and German Banking Systems", by E.V. Morgan.

¹⁶⁷ Poland Now, March 1996, 4.

¹⁶⁸ See Calvo and Frenkel (1991); Thorne in Lampe (1992).

could be relieved of responsibility for delivery of what could be interpreted, by virtue of the positive externalities it generates, as "public good" credit. To require that SME loans profit lenders seems, to the writer, to misallocate scarce financial resources which could be profitably invested by prospective business owners. Alternatively, lending facilities for a select group of borrowers could be based on a self-financing formula, without necessarily generating surpluses, or the function of capitalizing loan guarantee funds could fall to borrowers (though not exclusively).

We recall that the first loan guarantee funds, which were funded by participants' fees, dried up because the capital base was not replenished. With hindsight, such funds might be more effectively managed. First, expertise in loan assessment and risk evaluation was acquired later, precisely to shore up the losses sustained by the banking sector in the early 1990s. Secondly, pooling of public and private resources to increase the size of a fund's capital base would keep fees down and fortify the fund against claims. The public component of required funding could possibly be contributed from funds raised by municipal bonds. Although early municipal bond issues in Poland were not very successful, a proposal setting out technical parameters for subsequent issues was prepared by USAID and submitted to the Finance Ministry in October 1995. Another proposal which applies the "mutual fund" concept comes from Charemza, who recommended "allocation of preferential credit through self-controlled risk-sharing investment pools" (Charemza 1993, 163). The aim of increasing the size of a fund's capital base is often accomplished by multiple tiers of guarantees, as is proposed in the MIT policy. An interesting model for public-private collaboration presents itself in Germany's system for financial assistance to SMEs, which will be presented further on.

4. Environmental constraints: The European Community

We looked previously at the parameters of public policy, regarding SMEs, that are

enforced by impending membership of Poland in the E.C. It must also be asked how the Association Agreement of 16 December 1991 affects the ability of Polish authorities to establish banking provisions particular to its needs, and especially how local lending and borrowing provisions may be constrained. Complete trade liberalization is projected for the end of 1998¹⁶⁹, and progressive harmonization of financial services will be critical in optimizing trade relations between Poland and the E.C. The issues implicated by introduction of a common market in financial services have significance and depth which exceed the scope of this paper. For our purpose, the E.C. suprastructure is a referant for Poland's options in the articulation of a domestic financial system; specifically, the concern here is with the complementary roles which may be assumed by government and banks in delivering credit to small private sector businesses.

Member states of the E.C. have undertaken to intensify competition in financial services by assuring complete freedom to establish bank branches and subsidiaries in all member states, and to provide a wide range of services. The basic banking model adopted by the E.C. is the universal banking system which has historically been exemplified in Germany, and the NBP President has acknowledged that adaptation of such a system would seem to be prescribed for Poland. With a broad commitment to free and open competition, integration of banking markets among member states is based on three principles: "minimal harmonization of regulations, mutual recognition of rules and regulations and home country rule". The first tenet implies the number and range of regulations instituted specifically by Community legislation will be minimized. "The second and *essential* principle of mutual recognition provides that each member state basically accepts as applicable within its own boundaries the regulations (importantly with respect to permissible activities) established in other member states" - *emphasis added* - (Bisignano

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The exception is automobiles which will be freely traded as of 2002.

1992, 156)¹⁷⁰, allowing that the scope of activities permissible to foreign banks may exceed those vested in domestic banks. The third ensures banking operations are subject to supervision by the financial authorities not of the host but of the home state.

These principles are effectively summarized in the commitment set out in the E.C. 1988 Second Banking Directive for construction of a pan-European banking practice, to "safeguard certain fundamental public goods" by minimal common legislation, beyond which "regulatory pluralism" will prevail. The 1988 Directive includes, among fourteen banking activities subject to mutual recognition, lending, credit reference services, and guarantees and commitments. Adherence to the capitalization standards introduced by the Basle Committee on Banking Supervision 1987¹⁷¹ is required of internationally active banks; these standards set 8% as the minimum ratio of capital to weighted risk assets. However, more specific requirements apply pursuant to the Maastricht Treaty, whose fiscal criteria have already been achieved by the Ministry of Finance. Admission to the E.C. would require so-called "monetary conversion" criteria to be met by the NBP. These conditions include limiting interest rate differentials and domestic currency stability (domestic currency may not have been devalued with respect to the ECU within the prior two-year period). The E.C., where "the nature of banking is almost as diverse and idiosyncratic as the languages and customs of its members" (Bisignano 1992, 177), is committed to honouring economic pluralism. Restrictions bearing directly on the articulation of banking structures and services in the associated states are therefore relatively few.

Despite these commitments, prospective E.C. membership does imply narrowing the range of strictly domestic options regarding SME policies. Research has shown that the

¹⁷⁰ This condition prevails with the caveat that the public good in the host country is not adversely affected.

¹⁷¹ International Convergence of Capital Measurement and Capital Standards

U.K. and Germany view harmonization of policies vis a vis SME policy with skepticism; there is concern, especially strong in Germany, that national provisions will be diluted (Bannock and Albach 1991, 17). The far-reaching nature of SME policy suggests other social and economic policies would not be insulated from such consequences.

The conflicts that arise in implementing effective SME policies will become more apparent as (and if) governments continue to move SME problems up in the political agenda, and as (and if) increasing harmonization of social, fiscal and other economic policies within the European Community reduces the room for purely national compromises in these areas (Bannock and Albach 1991, 67).

The E.C. banking sector contains an almost equal number of public and private banks. In 1987, the number of private and public banks in The Banker's Top 500 was roughly equal, as was the breakdown among the one hundred largest banks in the E.C. (44 privately-owned to 42 publicly-owned banks). Although the private sector employed almost twice as many individuals and its capital/assets ratio was higher (Bisignano 1992, 179 and 180), by other indices the public and private banks' aggregate performance was comparable: value of assets, and pre-tax profits as a percentage of capital, and of assets.

Some general attributes of the German system can be outlined in this context. Concentration of banking activity varies considerably among member states. Germany, with the largest banking sector, has the lowest level of concentration, with the five largest banks controlling 31.2% of total sectoral assets; a comparable figure for the U.K. shows control of 32.6% (Bisignano 1992, 181).¹⁷² Although the U.K. banks hold almost the same level of assets as Germany's, only 661 banks operated there compared to 4,465 in Germany, where a large variety of specialized banks offers customized lending services, for example, for mortgages, small businesses, or building societies. It should also be noted that entry by domestic or foreign concerns into the financial services sector is relatively unrestricted, with minimum capital and staffing standards imposed by the Bank Act

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Data for 1986.

(Pozdena and Alexander 1992, 580). The *Deutsche Bundesbank* may extend strictly limited last-resort funds to banks without penalty, but recourse to Lombard credits is penalized by a rate premium and quotas are strictly imposed. "German banking policy reflects the desire to rely on market forces. . . . This relatively consistent policy of providing little *ex post* public support likely enhances the role of market and depositor discipline in restraining risk-taking at German banks" (Pozdena and Alexander 1992, 581). Although the German banks' substantial shareholdings in the corporate sector are often viewed as conferring excessive influence and authority over non-financial economic activities, statistics indicate intervention by German banks in corporate management is not unusually high: "executive dismissals, changes in controlling ownership, and other indicators of corporate discipline processes are weaker in Germany than in the U.K. or France" (Pozdena and Alexander 1992, 584).

The proximity of Germany's banking sector with industry is widely regarded as anti-competitive¹⁷³, and the underdevelopment of venture capital markets is viewed as an anachronism which weakens the country's international competitiveness. However, German banks in the post-war period have been quite stable despite high leveraging, which may attest to successfully combined market discipline and banking supervision (Pozdena and Alexander 1992, 577).

¹⁷³ Jackson (1992) notes that although shareholdings, even by banks, are restricted, banks voting rights are significantly enhanced by the exercise of proxy votes. In the 1970s, German banks held a tenth of total seats on the supervisory boards of the country's largest one hundred companies.

B. THE BROAD LINES OF AN ALTERNATE APPROACH

1. Public-private collaboration to finance SME support: Does Germany offer a model which can be advantageous for Poland?

There are opposing views about whether the "Anglo-American" system of competing securities and financial markets, or the Germanic financial system with its heavy reliance on universal banks, is a more appropriate model for eastern European financial institutions. M.R. Jackson described the "continental" banking paradigm, within which he placed Germany at one extreme and Britain at the other (Jackson 1992, 70). He characterized the German model as comparable to Japan's, in which monitoring and active supervision of businesses by banks largely supplant bankruptcy provisions and improve firms' chances of survival. Jackson proposed that the German institutional arrangement has advantages over capital markets of the American variety for the eastern European transitional economies. Jackson argued that such a model could compensate for (i) weakness in company governance due to inexperience and an adopted incentive structure, (ii) undercapitalization and poor loan portfolios of banks, and (iii) inadequate information collection, flow and coordination. He calculated that "it might take longer to organize a broad, competitive system of specialized financial intermediaries than it would to strengthen the major banks" (Jackson 1992, 73).¹⁷⁴ Any general recommendations which might flow from these observations are beyond the scope of this thesis.

Another important feature distinguishes the German and south-east Asian models from their Anglo-American counterparts: a bias in favour of long-term corporate planning horizons.¹⁷⁵ Managers of companies driven by quarterly performance reports to institutional and individual shareholders, as North American firms are, must be sensitive

¹⁷⁴ The proposal is outlined in greater depth, and involves banks in administering stock funds connected with privatization voucher or coupon schemes.

¹⁷⁵ See Table 18 for comparative lending levels.

and responsive to market fluctuations. They know that divergence from this regime would likely cause them to be ousted from their positions. Government support of the type provided by the *chaebol* in South Korea and the *keretsu* in Japan encourages corporate managers to commit themselves to long-term planning; similarly, the German banking sector is relied upon as a major source of long-term finance.

The German financial system lends explicit support to the SME sector. It is proposed that certain elements of the model may be fruitfully imitated in Poland. To highlight the role played by banks in realization of German public policy toward SMEs, Germany's financial support system for small business will be outlined briefly.

We learned in Part III.A, that German economic policies have a strong social welfare foundation, which helps to explain the large expenditure on promotion of SMEs. German small business legislation exists at the federal and most regional levels. Although not all *Länder* have established such laws, each has a small business policy unit. In 1988/89, the share of GDP expended in direct support for the SME sector was 0.25%, compared with Britain's at 0.1%; the part of this expenditure comprising loans, grants and guarantees was 59.3% in Germany; in Britain it was 0.7% (Bannock and Albach 1991, 29).¹⁷⁶

The scope and depth of SME programming in Germany is substantial, ranging from guidelines requiring public procurement contracts to be offered in lots small enough to enable SMEs to make competitive bids, to a range of numerous "soft" loan facilities. In the German Federation, actual disbursements by the *Länder* for economic development exceed those by federal authorities¹⁷⁷ and SME policy implementation involves actors such as trade associations and the Chambers of Trade Craft and Industry which are established by public law. The present German SME financial assistance programme had its origins in the

¹⁷⁶ These figures do not include financial assistance for start-ups.

¹⁷⁷ In the range of one-third of *Länder* revenue is transferred from the federal government in the form of equalization payments.

allocation to SMEs of interest earnings from on-lending of Marshall Plan funds under the post-WW2 European Recovery Programme (ERP). The ERP name has been retained but funds are now raised from Federal grants and bond issues. The programme aims to compensate for competitive disadvantages faced by small firms and is defined by the credo: "help for self-help". Normally government funding does not exceed 50% of total investment costs and the remainder is raised through own-funds; in the case of R&D investment the government will lend up to 75%. The vast majority of loans are administered through the four public banks, but the loans are assessed and delivered through the commercial banks which assume full responsibility for risk, except where LGs are applied. The largest programme, accounting for about 40% of government lending to SMEs, is administered by the public bank which manages the ERP fund, *Kreditanstalt für Wiederaufbau* (KfW). KfW is engaged in major rehabilitation of the financial sector in the Eastern *Länder*, and, in Poland, provides financing for German-Polish joint ventures and SME investments to promote environmental recovery near their common border; there is also a credit line for small Polish firms.

Loan guarantee banks (LGBs) have been active in Germany since the 1950s; their objective is to promote the extension of credit to SMEs and, consistent with their post-war mandate, counteract tendencies toward economic concentration. They are limited liability companies founded and financed by financial institutions, trade associations, local authorities, and federal and *Länder* governments, whose expertise is combined to inform guarantee decisions. LGBs operate under German banking law but their guarantee activities are tax-free owing to the socio-economic mandate they carry; nevertheless they are private commercial institutions which are expected to contribute equity to the Fund. Membership of LGB supervisory boards must include at least two qualified bank managers, and minimum capital and reserve requirements are established by regulation. Recall that only a small fraction of the total number of commercial loans are protected by

loan guarantees; in 1991, the portion was 0.25%. Applicants' creditworthiness is assessed by the lending bank, the Chambers and the trade associations. Application of Germany's "help for self-help" principle is explained in this way: "State help to LGBs is seen as a way to delegate the politically and socio-economically desirable task of SME support to private institutions; to reduce their risks; and to achieve high rates of capital productivity with low levels of public expenditure" (Genter 1995, 54).

Because of the low profile of capital markets in Germany, most households deposit their savings with banks. In consequence, the banking system has a relatively inexpensive supply of investment capital. "The most striking feature of the German effort is the large amount of additional support provided by the public banks in the form of loans at below-market rates of interest" (Bannock and Albach 1991, 27). The local savings banks, the *Sparkassen*, are known as "public law" institutions, meaning they are publicly-owned and incorporated. Along with the central *Giro* agencies, they form one of the major groups of public law financial institutions in Germany. The *Sparkassen* are legally independent banks, federated at the national and regional levels, whose chief shareholders are normally the local authorities governing the district in which they reside. The *Sparkassen* inherited the public welfare mandate of their 19th century origins, when they were created to serve the disadvantaged among community members. The statutes of the *Sparkassen* specify that the scope of their banking activities shall be limited to the geographical region in which they are located, and that such activities must be characterized by a "public welfare orientation".¹⁷⁸ In 1993, the share of lending in total assets of the *Sparkassen* (60.17%) exceeded the level of lending both in commercial banks (57.91%) and in the banking system as a whole (54.83%) (OECD 1995, Bank Profitability).

¹⁷⁸ Paragraph 40(1)3, *Schutz der Bezeichnung "Sparkasse"*, Dritter Abschnitt, Gesetz über das Kreditwesen (enacted 10 July 1961 and amended 30 June 1993).

The conclusions of Hull and Hjern, authors of a 1980-81 study of German manufacturing, provide an interesting perspective on the present situation of SMEs in post-CPE Poland.¹⁷⁹ They investigated the hypothesis that SMEs often fail to overcome typical impediments to their survival or growth, in large part because they do not utilize available support. The authors therefore examined the effectiveness of mobilization and delivery of external resources dedicated toward SME assistance, and classified obstacles to deployment of such resources for SMEs as arising from entrepreneurs' lack of knowledge, or prices exceeding their reasonable ability to pay. Following from an examination of linkage patterns among providers, customers and assistance resources, Hull and Hjern concluded that local and regional organization of public support measures confers important advantages to such programmes (as regarded effectiveness in job creation), as compared with those administered from a greater geographical or hierarchical remove. This finding is confirmed by certain observers of the economic environment for SMEs in Poland, and increasingly promulgated by governmental and multilateral initiatives there.

Hull and Hjern carried out a comparative study of small business assistance programmes in four regions of Germany, and identified the *Sparkassen* as capable, under certain concomitant conditions, of providing exceptionally effective support to SMEs. Necessary conditions included leadership in the banks and the local economic development agencies, dedicated to the success of local businesses and committed to integrated implementation of assistance programmes. Important elements contributing to the success of the *Sparkasse* lending programme include: (i) local identity, which generates customer loyalty as well as experience economies based on knowledge of the population, history and resources; (ii) active participation of local public authorities, hence practical integration of

¹⁷⁹ Hull and Hjern termed the method they used as "implementation research" which "spans political science, public administration and organization theory to explore the structural and behavioural factors affecting policy success" (1987, 16). The method originated in research undertaken by the International Institute of Management of the Science Center Berlin in the 1970s.

financial investment with local and regional development objectives and resources; (iii) rapid processing of loan applications, because credit decisions involving relatively large disbursements can be made locally; (iv) in conformity with its economic development mandate, the *Sparkassen* favour long-term loans (which, they claim, also limits the level of service fees charged to borrowers); and (v) the banks guarantee and often pre-finance the public loans they mobilize.

We have seen that when banks share in risk-taking, they are induced to evaluate projects carefully. Therefore one expects that moral hazards are mitigated and indiscriminate use of public funds is discouraged by the *Sparkasse* model. It should be noted that the *Sparkassen* loan officers protest that their share of responsibility is excessively high, but acknowledge that "economic development and economic structural improvement [are] prime tasks of the Bank", and deride short-term lending as "just bureaucracy" (Hull and Hjern 1987, 168). Featured in the Hull and Hjern study, the Borken *Sparkassen* serve the region surrounding the town of Borken which, at the time of their research, was undercapitalized compared with neighbouring counties. As net importers of capital, the Borken bankers developed particular expertise in exploiting existing public loan programmes on behalf of their SME clients. One cannot ascertain if the *Sparkassen* managers are motivated by a commitment to public welfare, but they do anticipate netting profits in subsequent business with borrowers. Hull and Hjern found that 78% of entrepreneurs included in their survey regularly used the *Sparkassen*.

The *Sparkassen* are operated by management committees, which in turn are supervised by administrative boards comprising local business leaders and government officials. This administrative structure has been criticized because the members of the supervisory boards, while they may be aware of community needs and objectives, often are not qualified to evaluate or make recommendations concerning banking practice. Critics contend the structure survives owing to political suasion.

The relevant aspects of the German example, for this study, are (i) dovetailing of the activities of publicly-owned institutions within the banking system (and governed by bank law) to achieve the objectives of German public policy regarding SMEs; and (ii) integration of financial services with local resources including private enterprise, municipal and *Länder* administrations, and trade and commerce associations, to fully mobilize community potential.

Two other models of locally-based SME support systems will be outlined briefly, to broaden the range of models from which elements potentially beneficial to Poland may be drawn. Both are committed to animating a range of public and private actors and have demonstrated success in dovetailing enterprise and community goals with able financial intermediaries. In one, which originates in rural China, public ownership and direction dominates, while in the other, whose origins are in a Scottish industrial community, members of the business community take the lead. J. Oi, the author who studied the former model, observed (the writer thinks, correctly) that poor performance of central planning in the Soviet Union and the CEECs has prompted "a rush to get government out of the economy, but a minimalist state is not necessarily the answer. The goal should be more effective government" (Oi 1995, 114C).

Enterprise finance in rural China was examined by Oi in the context of that country's current economic transition. Oi identified a particular form of state-led development which she described as 'local state corporatism', in which officials of local governments perform not only the supervisory functions, akin to those of boards of directors, *vis a vis* the local economy, but sometimes even those of the chief executive officers *vis a vis* local companies. This structure emerged from the Maoist economic system which vested local governments with considerable responsibility for administration of economic plans, unlike Soviet communism in which enterprises were themselves mandated to achieve centrally-planned economic objectives. Chinese township and village enterprises, Oi

explained, are owned by the government in the capacity of entrepreneur: "Post-Mao institutional changes blended the entrepreneurial and governmental roles of local governments" . . . "with the reforms [which hardened their budget constraints], local governments had to bear the risks as well as enjoy the benefits that come with entrepreneurship" (Oi 1995, 1137 and 1139). According to Oi, the strategy has brought remarkable success to rural initiatives and fattened local government revenues.

Opposition to government deployment of economic resources is based broadly on hazards arising from the principal-agent relationship. Oi pointed out, as was seen in the case of loan guarantee, that agency theory posits a clear reward structure as the most important mechanism to evoke efficient deployment of duties by agents; in consequence of fiscal reforms which established the entitlement of local government to a share of profits, China's local governments have implemented strict controls over credit based on performance standards. However, Oi noted also that bargaining for preferential treatment is now undertaken with great effectiveness by well-connected government officials advocating on behalf of local enterprises.

There are obvious and marked differences from the Polish case. Present-day rural China lacks even rudimentary financial markets and market institutions. Privatization has not been a priority of Chinese economic reforms, and neither has political democratization been promoted. In contrast, Poland's reforms are strongly market-oriented and her pre-Soviet political traditions are unambiguously democratic.

The third model we will consider originated in 1982 in Ardross, Scotland, where the Enterprise Trust was introduced by Scottish Business in the Community (Scot BIC) in 1982, in response to unacceptably high unemployment.¹⁸⁰ Scot BIC is an independent organization of business people committed to fostering cooperative relationships among

¹⁸⁰ These also exist in Wales and England, as Enterprise Agencies. In 1988, 38 Trusts existed in Scotland and none had ever been closed

community, business and government collaborators; it operates by inducing well-established businesses to contribute expertise and financial resources to new local initiatives on the basis of enlightened self-interest. Scot BIC cultivates business sponsors for the Enterprise Trusts, whose sole purpose is to encourage the growth of local private businesses "which in terms of scale are undeniably only of microeconomic consequence" (Reid and Jacobsen 1988, 67). Their mandate entails giving advice, disseminating information and providing practical assistance on production, staffing, marketing and finance, and may also include direct grants or loans. As the Trusts' administration must be self-financing, a small variable rate premium is charged on loaned funds. About one-half of the Trusts' funding is raised in the private sector, one quarter from the Scottish Development Agency, and the remainder from various sources including district and regional councils. The Trusts' Boards of Directors contain representatives of all sponsors, among which the Scottish Development Agency is always present. The ET is required to submit, annually, a detailed business plan to the SDA.

A 1985 study by Reid and Jacobsen of eighty-six small-firm start-ups in Scotland examined SME finance. The authors concluded that the integration of services facilitated by the Trusts was responsible for the unusually positive relationship between surveyed SMEs and the commercial banks, which were cited by respondents as the major source of start-up finance. Few complaints of rigid or harsh lending policies were heard; according to the authors, "Banks emerged as being very significant in fostering the birth and growth of SMEs in Scotland" (Reid and Jacobsen 1988, 6). Although debt financing was used by 84% of respondent firms, high gearing was evident in fewer than 25%. Equity injections (other than own-capital) were eschewed by 93% of the firms; stock markets and venture capital were too costly and individual investors generally unwelcome. Most entrepreneurs in the study financed growth and development from retained earnings. Subsequent studies

revealed that the survival rate of Trust-assisted Scottish SMEs was double that of the general SME population (Reid and Jacobsen 1988, 75).

By promoting the inception and development of small entrepreneurial firms, Enterprise Trusts have played a crucial role in encouraging the economic progress of local communities. . . The ET provides access to an information network without which the SEF [SME] would be uninformed, isolated and ineffective. The ET acts as a 'high communicator' within the information network as it has the capability to use informational links with with personal contacts in other institutions that can help enhance the viability of the SEF (Reid and Jacobsen 1988, 75).

The differences between present-day Poland and the latter U.K. model are also marked by the absence, in Poland, of well-established business leaders who could fulfill the mentoring role embodied in the Scot BIC. The strong free-market orientation restricts the Enterprise Trusts to performing an active mediation function, in mediating the flow of information, physical resources and capital.

In the three cases discussed above -- Germany, China and Scotland -- the dominant characteristic of the approach taken to SME promotion (at least for the purpose of the present discussion) is the purposeful integration of the full range of local economic participants in at least one major organ in the chain of significant institutions. Physical proximity, accessibility and informed responsiveness are in every case the key to successful deployment of available resources. The enlightened self-interest of all participants is enlisted to discipline financial allocation to ensure community resources are exploited to full advantage. Because of Poland's location, right of centre by a socialist measure and left of centre (if only by virtue of its adolescence) by a capitalist measure, the German model which marries public and private initiative seems most appropriate to the Polish case.

There is broad support¹⁸¹ for the view that where market imperfections eliminate whole groups of borrowers from credit markets "because of imperfect risk assessment", government action is justified to create specialized financial institutions (for example,

¹⁸¹ For example, see Dunning 1994, 373-388

savings and loan cooperatives) which will enable affected constituencies to overcome systemic barriers to finance. Vos pointed out this did not imply the government should "take control nor subsidize credits" (Vos 1995, 212). Using the examples of South Korea and Taiwan, he observed that "Government-directed and preferential credit schemes have made an important contribution to successful industrialization in a number of East Asian countries" (Vos 1995, 188). However, when similar efforts applied in Latin American economies had much weaker results, Vos concluded that protection from international competitive markets explained their failure. In East Asia, preferential credit was made strictly contingent on performance in export markets, and systemic financial liberalization has been incremental. In all cases, highly segmented capital markets, concentrated banking operations and extensive informal credit arrangements prevented financial markets from effectively allocating available capital resources. Taking the notion of government intervention a step further, to include public ownership, is more controversial. However, direct public shareholding in local banks has the important potential to penetrate critical bottlenecks by overcoming informational inefficiencies in the financial system.

Were local savings banks in Poland to retain a strong element of public ownership, it would be necessary to structure supervision of lending with care because the disposition of budgetary assets ought to be monitored, in some capacity, by elected, informed and accountable representatives of the tax-paying population. The appointed representatives of the *gmina* would satisfy that criterion. Along the lines set out by the *Sparkassen*, substantial regional public ownership of banks is accompanied by risk-bearing stewardship of local business projects. This differs from banking practice which withdraws support as soon as a business faces difficulty. The variance is based on the banks' own definition of their mandate and statutory accountability. Canadian bankers complain their role *vis a vis* small business is misunderstood. They argue the commercial banks' obligation to maintain highly liquid assets to protect their shareholders overrides other considerations. In this

regard, the *Sparkassen's* accountability to its owners has a unique character because the shareholders have a public policy mission.

In Poland, PHARE/STRUDER authorities observed that "Cofinancing and risk-sharing of financial instruments by the participating financial intermediaries is even more important than the technical assistance, since this is the only way to ensure that the financial intermediaries are not just funds channels and that they will do their utmost to develop SME services."¹⁸²

2. Goodness of fit: The Sparkasse model in Poland?

Certain likenesses suggest there may be a reasonably good fit between the *Sparkasse* structure and Poland's small business credit needs. It should be recalled that the *Sparkassen* originated in the 19th century specifically to compensate for conditions which were prejudicial to a certain segment of the population. In Poland today, a bridge must be constructed to close a credit gap that restricts access to firms by virtue of their small size. It is as the provider of public goods that the government would take up the initiative to organize financial resources in a way that ensures financial assistance reaches its target. Under the aegis of SME policy, the target beneficiary is not the banking system but the entrepreneur. Secondly, the *Sparkassen's* activism in fostering, monitoring and developing local endeavours should not be altogether foreign to Polish policy-makers. Pursuant to the 1993 Law on Enterprise Restructuring, the government conferred, and Polish banks accepted, an unusually broad mandate to initiate and direct enterprise restructuring activity, thus there is an important precedent for banking activism. Third, the Polish administrative structure comprises autonomous *gmina*, and implementation of economic transformation measures since 1989 has consistently devolved to decentralized, regional or

local bodies. Collaboration at local and regional levels would come easily for at least two institutions which are interesting for their potential adaptability to the *Sparkasse* model. Fourth, the composition of the Polish banking system is expected to develop along the lines of Germany's: dominance of universal banks with strong representation of specialized banks.

Were such a model to be adopted, probably the premier choice would be the PKO BP, which is a state-owned savings bank and traditionally the lender of choice for Polish small businesses. PKO BP was Poland's most profitable bank in 1995, with assets second only to Bank Handlowy W Warszawie.¹⁸³ Several attributes of PKO BP favour this suggestion: It has an extensive branch network (offering the unique convenience of banking through postal outlets), and throughout Poland is regarded as a trustworthy local bank. It is a bank favoured for household deposits and generally does not intermediate for foreign credit lines. Thus the bank is capitalized with zloty deposits (which, increasingly, are preferred to hard currency by Poles), so borrowers are not intimidated by the prospect of repayment in appreciated currencies. Maintaining this segmentation might be to the mutual advantage of PKO BP and the commercial banks; foreign credit lines could be facilitated by new banks whose reputations are improved because they do not participate in "low-end" loans. Commercial banks could become willing competitors for lucrative foreign credit.

An alternative would be to develop the cooperative bank system (presently under the management of its central bank, BGZ), which GEMINI recognized had the potential to become a significant source of funding for SMEs. This option is not without problems; the cooperatives have traditionally served rural enterprises, and have in recent years experienced severe financial difficulties. There are 1600 cooperative banks, of which 700 have been identified as potential bankrupts. However, the sector's major problems have

¹⁸³ PKO BP earned a net profit of PLN 428.39 million, and held assets valuing PLN 1052.6 million. The second ranked, Bank Handlowy, earned a net profit of PLN 329.0 million on assets valued at PLN 1,489.3 million. Figures from *Gazeta Bankowa*, cited in the *Warsaw Voice*, 31 December 1995.

been linked to poor management by BGZ, and local activism has already given rise to the emergence of two new independent regional banking networks involving several hundred banks. In its 1995 report, GEMINI affirmed "there are many specific examples of independent cooperatives lending to SMEs who view this activity as an integral component of economic development in the local community" (Toland, Saffer and Heatly 1995, 19).

A third option which might warrant investigation is to utilize the network employed by the Labour Offices to process subsidized loans under the Ministry of Labour and Social Policy. Start-up loans under MLSP provisions reported a 90% repayment rate in 1995 (Mika 1995, 124).

Through any of these institutions, direct public financing or shared financing with a clear public policy mandate could, potentially: (i) free-up banks to undertake lucrative commercial transactions; (ii) cut down lag time between application and decision by vesting decision-making authority in *gminas* or municipalities; (iii) provide longer-term loans to SMEs; or (4) advance local and regional development goals.

3. Drawbacks of public intervention or public ownership

Drawbacks to this approach warrant careful evaluation and further research. The most obvious drawback is the high cost to the government of providing credit, which has been a concern even in a wealthy economy such as Germany's. Bisignano aptly formulated a problem which is central to the examination of the role of banks in the achievement of public policy objectives. He asked how banking authorities could "structure regulations and banking supervision so that the government does not implicitly become the ultimate risk-bearer for the banking system" (Bisignano 1992, 161). Given the prominence of loan guarantees in its platform for SME assistance, one might consider it plausible the Polish government is mobilizing its limited resources to protect the emerging private banking sector from risk. It is proposed, therefore, that informal segmentation of the credit market,

roughly between public and private providers, could achieve that objective at lower cost and at the same time facilitate effective delivery of loan capital to the SME sector. For example, this could be achieved via local investment funds, built on pooled private and municipal or regional resources.

One must acknowledge, also, that public providers face opposition when public policy changes. However, this alone is insufficient ground to reject the principle. Subsidies and grant provisions made available subject to a clear time limit or to clearly defined parameters are not uncommon in the West and should not be precluded from consideration in the post-socialist countries. A strategy providing for progressive attenuation of government involvement or ultimate exit could accompany any movement toward direct provision, unless such a programme was envisaged as a permanent element of Poland's financial system.

We should also be wary of the spectre of inefficiency which is associated with public provision of goods and services, typified, perhaps, by the averred ineptitude of bureaucrats and politicians as members of the *Sparkassen*' supervisory boards. Evaluation of loan applications would have to be rigorous and systematic to counteract a tendency to award loans for politically-motivated cause, and conditions of granting structured in such a way as to exert a persuasive disciplinary force on borrowers. The experience of south-east Asia suggests effective exposure to market competition can be achieved despite non-market financial support.

C. CONCLUSIONS AND RECOMMENDATIONS

This thesis has naturally not answered all the questions it has raised. To reiterate the assertions of the introductory statement, its proposals are based primarily on the writer's conclusions: that the present antipathy of commercial banks toward SMEs is rational in the circumstances and will not be overcome in the short run; that the commercial banks should not be expected to subsidize small businesses; and that allocation of public funds for SME lending is justified and necessary to give direct support to entrepreneurial initiatives. Advanced capitalist countries only approximate what Poland is presently searching for: an effective market-driven formula of mutual benefit to small businesses and to banks. Despite the determination of Polish authorities to privatize financial services, the writer proposes that certain impediments can be overcome by direct participation of the public sector in investment activities. Some ways of approaching the task have been suggested, and we have seen that there have been notable successes using these methods. Policy measures which attempt to maximize the net benefits of public investment must take careful account of the particularities of Poland's economic, social and political culture. Therefore, more specialized research would be required before one could advocate implementation of a specific form of public-private collaboration in investment decisions.

For example, attention must be given to the problems of private enterprises created by employee- or management-buyout (EBO or MBO). In Poland, privatization by liquidation conferred ownership rights to firms by means of leasing arrangements financed by preferential loans. Because of the large incidence of EBOs and MBOs in the private sector, it is important to research the problems created by high leveraging of such firms' financial structures. The writer would propose, additionally, that longitudinal forecasting be undertaken to anticipate the implications of the budget plans of multilateral funding agencies for the aggregate level of financial assistance available to SMEs in Poland. Finally, attention to the policies of the Czech Republic toward SME finance could be fruitful. We

have seen that bank lending is more prominent there than in Poland or Hungary. Two factors -- the low level of international debt inherited by the post-Communist government, and early distribution of privatization vouchers -- should be investigated for their significance to emerging financial intermediation practices.

An important lesson of this research has been that, in unstable circumstances, public policy must be especially well-informed and responsive. The role of efficient collection, exchange and documentation of information assumes grand proportions, and must be given priority to increase the effectiveness of markets and of government.

In summary, a small number of practical recommendations for policy makers follows: Address regulatory dissonance and harmonize provisions for loan and collateral registration; mortgage registries; information sharing; creation of a non-profit category; tax deductibility of loan loss reserves; agency rights with regard to lending and guarantee of loans; and expansion of non-bank financial intermediaries. Promote competition in the banking sector; issue more licenses to domestic and foreign banks. Foster, by public-private collaboration, the ability and willingness of banking and non-banking financial intermediaries to produce an intelligent, timely and measured supply response to demand for capital by small and medium-sized businesses. The writer believes these actions would reduce both the need and demand for loan guarantees.

Warning against the tendency of governments to centralize control over, instead of cooperating with, economic and financial institutions, Hausner and Owsiak prescribed adopting a "combination of two tendencies" to foster the institutional changes necessary for creation of a market economy:

making the various agents of economic activity (banks, enterprises, insurance companies, local self-government. etc.) independent and, simultaneously, creating, on the basis of their market orientation, a network of mutual ties, thus facilitating effective response to negative phenomena resulting from the operation of market mechanisms (Hausner and Owsiak 1992, 52).

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TABLE 1

Basic economic indicators 1994-1995		
	Nov. 94	Nov. 95
*Sales of industrial goods & services	114.0	109.7
*Consumer price index	133.5	122.0
*Producers' price index	129.7	120.1
Unemployment (%)	16.1	14.7
Corporate performance (million PLN)		
Total revenues	266,120.2	**334,907.8
Total sales	171,462.8	**213,471.2
Cost to sales ratio (%)	95.2	**95.4
Zloty Lending Rates (principal commercial banks)		
Discount Rate	29-45	24-40
Past Due	53 +	42-59
Zloty Deposit Rates (principal commercial banks)		
Demand	5-16	6-16
Past Due	27.7-33	22-25
* corresponding month of previous year = 100		
** October 95		
SOURCE: National Bank of Poland Information Bulletin 11/1995		

TABLE 2

Basic indicators of size of the private sector 1990 to 1994					
	1990	1991	1992	1993	1994
% employment	48.9	54.3	56	58.9	60.9
% GDP (constant prices)	31.4	45.3	47	53.5	52.1
% sales revenue (current prices)					
industry	18.3	27	30.8	35	38
construction	41.8	63	78.7	84.3	86.2
transport	14.2	25.2	39.3	38.7	42.8
trade	63.7	82.8	86.4	89.1	89
% exports					
	4.9	21.9	38.3	44	51.3
% imports					
	14.4	49.9	54.5	59.3	65.8
SOURCE: Central Planning Office					

TABLE 4

Share of economic results by company size in 1994 (% of total)				
	Total	Large	Medium	Small
Income	100	87.3	9.8	2.9
Costs	100	87.1	9.9	3
Gross financial result	100	94.6	6.1	-0.7
Net financial result	100	98.3	6	-4.3
Gross profits	100	89.3	8	2.7
Gross losses	100	80.4	11.1	8.5
Fixed assets	100	91.4	5.9	2.7
Liquid assests	100	88.5	8.1	3.4
-Cash	100	85.3	9.6	5.1
-Payables	100	88.4	7.8	3.8
Own funds	100	92.7	5.1	2.2
Credits	100	85.3	9.9	4.8
Credit (long term)	100	83.1	11.5	5.4
Profitability of gross turnover	3.7	4	2.3	-0.9
Profitability of net turnover	1.5	1.7	0.9	-2.2
<p>"Small" denotes firms having no more than five employees "Medium" denotes firms having 6-20 employees (in mining more than 50) "Large" denotes firms having more than 20 employees (in mining, more than 50)</p> <p>SOURCE: <i>Bilansowe Wyniki Finansowe Podmiotow Gospodarczych za 1994 R.</i> (Warsaw 1995) GUS, adapted from Tables 13 and 14.</p>				

TABLE 5

Growth of private and public sectors 1980 to 1989 (1979=100, in terms of constant prices as of 1984)								
	1980	1982	1984	1986	1988	1989		
Gross NMP	94	79.4	88.8	96.1	102.8	102.9		
Private sector	86.7	93.2	105.1	113.4	116.4	130.4		
Private sector (non-farming)	95.2	94.4	113.2	125.7	150.9	189.2		
Public sector	95.4	76.8	85.7	92.8	100.2	97.6		
Employment in material production								
Private sector	97.9	105.3	106.2	106.5	107.6	114		
Private sector (non-farming)	106.6	130.3	166	193.6	241.4	306.4		
Public sector	100.2	96.9	96.4	96.3	95.8	93		

SOURCE: Adapted from Breilkopf et al, 1991.

TABLE 6

Level of monetization 1993: Comparative			
	CR	Hungary	Poland
Average M3/GDP	7 2	5 8	3 0
Average M2/GDP	6 6	5 0	2 2
M2 = broad money = currency + zloty deposits M3 = broad money = currency + zloty deposits + foreign exchange deposits			
SOURCE: Chopra in Ebrill et al, 1994.			

TABLE 7

Number of enterprises judged by the major banks not to be creditworthy					
		<u>1989</u>	<u>1990</u> (end of period)	<u>1991</u>	<u>1992</u>
Total		88	584	2,880	4,448
Of which:	industrial	21	247	1,077	1,671
	trading	7	138	529	908
	agricultural	40	90	965	1,236
Source: Polish Banking System, 1990-1992, Pawel Wyczanski Based on data from the National Bank of Poland research department					

TABLE 9

Banks recapitalized under the Financial Restructuring Act		
	Twinned	Commercial or Specialized
Bank Depozytowo-Kredytowy SA	Bank of Ireland	C
Bank Gdanski SA	NMB Postbank	C
Bank Gospodarki Zywnosciowej	no	S
Bank Przemyslowo-Handlowy	ABN-Amro Bank	C
Bank Zachodni SA	Midland Bank	C
Pomorski Bank Kredytowy SA	Unibank	C
Powszechna Kasa Oszczednoscdnosc Bank Panstwowy	no	S
Powszechny Bank Kredytowy SA	San Paolo Bank	C
Wielkopolski Bank Kredytowy	Allied Irish Bank	C

TABLE 10

Actions taken pursuant to the Financial Restructuring Act by the seven commercial banks		
LOANS	INTEREST	# Debtors
Separated loan portfolios (bad loans above 1 bln zlotys)		
13,442,791	2,785,942	794
Bank and court-led conciliation proceedings completed		
6,581,659	1,381,772	198
Loans sold		
1,088,812	502,333	13
Liquidation and bankruptcy proceedings completed		
1,734,441	560,093	202
Others		
4,037,879	341,744	381
Source: Polish Development Bank, Annual Report 1993-1994		

TABLE 11

Domestic Credit: Real percentage change over previous year					
	1990	1991 (a)	1991 (b)	1992	1993
Net domestic credit	0.3	66	88.8	19.5	6.4
General government	-	-	-	30.6	9.7
Non-government	31.3	19.5	16.4	1.4	-(1.5)
Non-financial SOEs	-	6.2	-	-(13.7)	-(10.6)
Private enterprises	-	137.7	-	19.6	3.4
Households	84.2	21.5	-(9.9)	27.2	38.8
Source: GEMINI (1995) based on World Bank calculations Note: 1991 (a) represents former NBP methodology and 1991 (b) represents current methodology					

TABLE 12

SUMMARY OF CASE-STUDY FINDINGS: Documented results of empirical studies on Polish companies after 1989

Author (s)	Duration	Number and ownership	Methodology	Conditions of study on control group	Use of credit	Author's conclusions
E. Jorgenson, A. Gelb, I. Singh	Jan to June 1990	9, 7 SOEs, 1 coop, 1 POE	personal interviews with management groups	n/a	None had large debt, so were unaffected by high interest rates. To the extent necessary, firms dealt with high cost of credit by postponing payables (ranking gave suppliers lowest priority)	Potential foreign partners required guarantees on investments
L. Bieganski, B. Wawrzyniak	1989 - 1991 (and company histories)	8, 3 SOEs, 3 POEs, 2 banks	detailed company monographs based on financial data and interviews	industry leaders	POEs were "threatened" by high cost of domestic credit and, by the second half of 1991, had no access to lower cost credit.	In 1990, banks increased credit operations without regard for risk. By the second half of 1991, there was a "significant" reduction in credit.
L.M. Webster	Jan 1990 - June 1991	93 POEs	Warsaw registry & in-depth interviews with owners or senior management	manufacturers: equal representation of rural and urban companies	Asked to identify their main problem, of the total number 29% said finance was their main problem (disaggregated as follows: 15%, highest cost of interest; 8%, late payment by SOEs; 6%, lack of working capital) Short-term credit was readily available; 81% had loans, and only 2 companies had been refused. Loans for working capital were needed to compensate for slow receivables.	In 1990, there was no evidence the banks applied any criteria to lending decisions. By mid-1991, "the common attitude was one of defeat, anger and disappointment." (p.35)
M. Grabowski, P. Kulawczak	Jan 1990 - Jan 1992	Two groups: (a) 30 POEs and (b) 300 POEs	random selection from (a) in-depth, repeated interviews with managers (b) questionnaires and one-time interviews with managers	SMEs	Informal relations with state officials, SOE departments or enterprises dominated efforts to manage financial constraints. Of (a) and (b) together, 70% had never applied for a loan and 66% expected to increase working capital and fixed assets. Cash transactions preferred to prevent problems collecting receivables.	n/a

TABLE 12 CONTINUED

W. Pankow, Research Centre of Solidarity's Mazowie Chapter	1990 - 1991	four groups of "collectivized" producers: 60, 99, 99, 100	questionnaires and discussions with management, Workers' Councils and trade unions	n/a	Scarcity of funds blocked economic adjustment of firms in which there was social support for "major internal transformation".	Continuing perception by managers that credit was too expensive prevented use of investment credits.
Olko-Bagleska, W. Pankow, P. Rutkowski	Nov 1991	187 companies privatized by liquidation (171) or commercialization (16)	questionnaires	n/a	Liquidated firms, dominated by employee buy-outs, gave top ranking to financial difficulties; these were not only credit-related but encompassed "excessively high" lease fees and assets appraisals. Employees held shares in 94% of liquidated firms and were sole owners of almost 60%. In 85%, share purchases were made with personal savings, and in 15% they were paid out of distributed enterprise profits. In 29% of EBOs, funds were borrowed from a foundation, a housing fund or a stockholders' association.	53% of firms employing over 500 people secured loans, compared to 14% of small companies.
B. Plato, M. Belska, S. Krajewski	1989 to June 1992	75 SOEs (by the end of the period, 34 had been commercialized and 3 were privatized)	selected firms; interviews	strong companies	Firms having after-tax profits had access to credit and reduced interfirm lending.	The role of banks was crucial to the allocation process.
P. Lamezal, M. Motien	1990 to early 1992	8 POEs	selected firms; thorough, continuous case studies	large size	Accounting for inflation, lending rates were 55-60% which combined with a shortage of acceptable collateral to make access to credit difficult.	Extremely important to find foreign strategic partners having financial resources; access to international capital markets or hard-currency loans. "The time is not ripe for financial capitalism in Poland." (p. 129)
B. Wyzankiewicz, B. Plano, M. Grabowski	late 1992 early 1993	75 POEs	random selection; interviews with entrepreneurs	have invested own capital; manufacturers; having over 20 employees i.e. (20 to 400)	Entrepreneurs used savings or borrowed from personal friends.	Banks would not risk capital, although surveyed firms had average net profits of USD 100,000.

Authors of studies are cited in the Bibliography. W. Pankow draws extensively on studies conducted by other research teams, notably, from the Institute of Market Economy and Ownership Rights Research, J. M. Dabowski, M. Federowicz and A. Levitas, 1991.

TABLE 13

Major sources of FDI (end of third quarter 1995)				
Country	Equity & Loans	%	Commitments	Number of firms
	(USD million)		(USD million)	
U.S.	1,815	30.6	1,618	58
International	912	15.4	194	13
Germany	614	10.4	417	71
Italy	390	6.6	1,748	10
Netherlands	362	6.1	218	12
U.K.	310	5.8	165	19
France	335	5.6	191	25
Austria	248	4.3	16	23
Switzerland	196	3.3	69	15
Sweden	178	3.1	100	15
Denmark	124	2.1	5	18
Canada	72	1.2	5	18
SOURCE: PAIZ (Polish Agency for Foreign Investment)				

TABLE 14

Definition of SMEs by number of employees 1995				
	micro	small	medium	SME
Canada*				< 100
PARR (Poland)				< 100
E.U.	< 10	10 - 99	100 - 499	< 500
U.N. (Poland)	na	< 50	51 - 250	< 250
GUS** (Poland)	na	< 6	6 - 20	< 21
Minister of Finance (Poland)	na	< 50	50 - 499	< 500
European Investment Bank	<10	11 - 50	250 - 499	< 500
Germany***	na	< 10	10 - 499	< 500
World Bank				< 500
* < 50 in services, < 100 in manufacturing ** <50 in mining *** Institut für Mittelstandsforschung SOURCE: Authors' compilation				

TABLE 15

Financing start-ups and planned investments: Comparative			
% share of total financing			
START-UPS			
	C R	Hungary	Poland
savings	28	57	60
bank loans	42	9	12
profits	14	7	10
investors	4	16	4
other	12	11	14
Total (%)	100	100	100
PLANNED INVESTMENTS			
	C R	Hungary	Poland
savings	1	14	11
banks loans	42	28	26
profits	37	27	48
investors	9	11	3
other	11	20	12
Total (%)	100	100	100
SOURCE: Toland, Saffer and Heatly (GEMINI), 1995.			
Data from Central and East European Dynamic Entrepreneurs' Database and European Venture Capital Association			

TABLE 16

LOAN GUARANTEE FUNDS						
COUNTRY	level (%)	(%) initial fees	(%) annual fees	rate premium (%)	default (%)	collateral (%)
Canada	85	2	- .	1.75	4	(max) 25
France	50 to 65	0.3 to 0.6	- .	0.6	- .	- .
FUNDES (private)	(max) 50	3.1	1.3	- .	5.9	190
Japan (CIC)	70 to 80	1	- .	0.33 to 0.57	- .	- .
Germany (LGBs)	80	1	- .	- .	- .	- .
Poland (Struder)	70	- .	- .	- .	- .	20
Poland (BGK)*	60	1.2	1.2 + 0.2 (yrs)	0	- .	40
U.K.	70 to 85	- .	- .	1.5	40	- .
U.S.	70 to 90	- .	- .	2.25 to 2.75	25	- .

* BGK may increase level of guarantee to 70%.

Sources: OECD, 1995; Kaufman, 1992; Japan CIC, 1993; BGK, 1996; Phare, 1995; Levitas and Gesicka, 1995; Rhyne, 1985.

TABLE 17

Claims of the banking sector (millions of zlotys)									
	1988	1989	1990	1991	1992	1993	1994	Q2 1995	
<i>Central bank (NBP)</i>									
on general government	137	595	601	4,365	12,170	15,729	19,530	15,177	
on non-financial SOEs	n/a	n/a	n/a	15	8	6	3	3	
on private sector	n/a	n/a	n/a	5	15	2121	20	20	
<i>Commercial banks</i>									
on general government	108	403	1,321	7,445	12,037	19,278	27,402	33,386	
on non-financial SOEs	1,002	3,061	10,105	10,379	11,770	14,252	16,751	18,011	
on private sector	110	199	1,719	8,979	13,111	19,022	25,165	30,413	
<i>Total domestic credits</i>									
net general government	80	587	-(919)	8,832	19,001	30,029	40,471	40,780	
on non-financial SOEs	1,002	3,061	10,105	10,394	11,778	14,258	16,754	18,014	
on private sector	110	199	1,719	8,984	13,126	19,043	25,185	30,433	

Source: IMF International Financial Statistics (December 1995)
Note: Net general government equals claims minus deposits

Source: IMF International Financial Statistics (December 1995)

Note: Net general government equals claims minus deposits

TABLE 18

Debt of non-financial companies - 1988				
	U.S.	Japan	Germany	U.K.
Loans from banks	27	67	88	88
Of which long -term:	(1)	n/a	(58)	(0)
Other loans	17	20	6	8
Securities (not shares)	56	13	6	4
	100	100	100	100
SOURCE: Bisignano in Kaufman, 164. Based on BIS estimates.				

APPENDIX 2

Summary of laws pertaining to privatization

1.0 Commercialization

1.1 Capital privatization

Capital privatization of individual companies is carried out using traditional sales techniques - initial public offerings, trade sales or a combination of the two, for larger enterprises, especially for those of strategic economic importance. The capital privatization method is reserved for Poland's strongest companies, the top five hundred according to the Minister of Privatization.

Potential buyers of stocks and shares receive a prospectus outlining the value of the firm's assets, the balance sheet for preceding years and projected projects based on an evaluation done by specialists, at the request of the firm. The prospectus shall meet the requirements of the Securities Commission regarding the disclosure of economic and financial information about publicly-traded companies.

The Law on Privatization of SOEs establishes employees' entitlement to purchase 20% of the shares of a commercialized or privatized firm's total shares at 50% of the public share price; purchase of additional shares at the regular price is unrestricted..

The process for private sales is as follows:

1. The Minister of Privatization appoints an advisor, who may already have been active in sectoral analyses commissioned by the Ministry;
2. The advisor prepares the enterprise for privatization, generates an information package, and through the mass media and personal contact, invites investment.
3. Interested investors are provided with the information package and invited to present a proposal including the price offered, and a business plan which specifies future investments and projects employment levels.
4. The advisor assesses applications and prepares a short-list of potential investors who are invited to negotiate with a "restructuring team" including representatives of the Ministry, the Supervisory Board or Workers' Council, and community social organizations.

Privatization of medium-sized firms may entail setting up a company under the Commercial Law prior to offering shares for sale. This procedure may be initiated by the enterprise, a significant potential buyer, or the Founding Body with the Minister of Privatization or one of its Regional Offices. Purchase of shares by individuals is facilitated by special programmes, for example, permitting conversion of State Treasury Bonds (discounted) into shares of private companies, special credit facilities, and payment by instalment. The bonds of exceptionally-sound, privatized companies may also be accepted in

payment of shares.

1.2 Sectoral Studies

A programme of sectoral studies was initiated in mid-1991, which comprises thorough market and industry analyses, as well as assessment of prospects for industry development. The Minister of Privatization explained the programme (in September 1991) as a response to the "need for a consistent conceptual framework which would allow the integration of various privatization and restructuring options in the overall effort to reshape and revitalize the Polish economy". The programme seeks to develop a context favourable to foreign investment, and to target, search for and then assist foreign investors in their selection of profitable enterprises and Polish partners.

By vesting, in one agency, responsibility for restructuring and negotiating the privatization of an entire industrial sector, the scheme is intended to reduce per unit costs of privatization by capitalizing on the acquired knowledge of consultants, and coordinating the search for, and matching of, investors. The Minister of Privatization also anticipated that sectoral privatization would enable the Ministry to bundle weak and strong firms together, to be sold as a package.

1.3 Mass Privatization

The Mass Privatization Programme (MPP) envisages the more-or-less simultaneous privatization of several hundred of Poland's largest SOEs. (At end-1995, these numbered 514 having a book value of PLN 6.2 billion, about USD 2.5 billion). The MPP process has three stages: commercialization of the firms; establishment of about twenty National Investment Funds (NIFs); and distribution of shares to Polish citizens. Enterprises privatized in this way must have above-average financial standing and economic performance: a minimum annual turnover of 10 million USD and at least zero gross profits.

The MPP distributes the assets of participating firms, all of which have been commercialized and are joint-stock companies wholly-owned by the State Treasury, to be managed by the NIFs. Each NIF, itself a joint-stock company, holds controlling shares in several firms. Pursuant to an international tender, NIF managers were selected by The Commission for Selecting Fund Managers. The Funds' share prices will be posted on the Warsaw Stock Exchange, ensuring that the NIFs will compete against one another. Managers' remuneration is tied to performance. The economic motive for concentrating assets in competing NIFs is to raise the market value of shares and thus, of Poland's capital assets.

The shares of each enterprise privatized in this manner will be allocated according to this regime: 33% to the controlling NIF, 27% among the remaining NIFs, 30% to the State Treasury and 10% will be distributed free to its employees (modified from 20% at half-price). Of the allocation received by the Treasury, a portion will be distributed free of charge (conceded in the last round of amendments) to compensate (i) state-sector employees for wages lost during a sustained wage-freeze, and (ii) pensioners for a sustained period during which pension indexation fell short of inflation.

1.4 Privatization through restructuring

Privatization through Restructuring (PTR), created by the Minister of Privatization in fall 1992, aims to attract capable management and industry expertise while demanding a relatively small capital commitment at very low risk. The object of PTR is to exploit western know-how in preparing viable small and medium sized companies for privatization. ITCA Europe Ltd., a branch of the American-based International Team for Company Assistance, was contracted by the Minister of Privatization to develop, promote and manage the programme.

Under the PTR, a selected management group assumes responsibility for establishing a firm's legal ownership rights; preparing economic and financial analyses and determining the value of the firm; preparing a professional prospectus and conducting its sale. Joint-stock companies wholly-owned by the State Treasury (under the Minister of Privatization) and SOEs belonging to their founding bodies may participate in this programme. In the first instance, application must be made by the Supervisory Board and management, in the latter, applications flow through the Workers' Council and management, but require approval by the founding body. Before a management contract to restructure is signed, the enterprise must have been commercialised. The restructuring plan shall cover evaluation and reorganization of human resources, financing, production goals and technology, and marketing and distribution strategies.

To attract qualified managers, PTR offers financial incentives to managers who realize a substantial increase in the value of an enterprise. Thirty percent of capital gains will be awarded to the employees and the Supervisory Board of the given company. In both cases, the capital gain will be payable in shares in the company.

2.0 Liquidation

On the initiative of its Workers' Council, and after consultation with the Minister of Privatization, an SOE may be privatized by liquidation by its founding body.

2.1 Article 37 of the Law on Privatization sets out the conditions for privatization by liquidation:

- (i) sale as a whole or in part;
- (ii) transfer of assets to a newly created company; or
- (iii) lease of assets.

Employees may lease-to-buy, provided at least half of the firm's workforce is organized into a company under the terms of the Commercial Code. In exceptional cases, the firm may be sold to other legal persons, with the permission of the Minister of Privatization.

Partners or shareholders must put up initial capital or stock valuing at least 20% of the combined value of the founding capital and the fund of the liquidated

enterprise (Article 38 of the Law on the Privatization of SOEs). The minimum acceptable offer price for the enterprise is equal to the value established by an independent specialist.

2.2 Law on Privatization of SOEs, Article 37.1, Section 1:
Law on SOEs, Article 18 (a), Section 2 and 3.
"Fast-track" Privatization

The "fast-track" may be used when an enterprise is sold as a whole and legal ownership of the land and capital assets is clearly established (in which case, the Director General of the enterprise becomes the "liquidator"). By using such indicators as book value and annual profit, the process of setting the purchase price is simplified. The "fast-track" method collapses the time required to privatize to only six weeks and cuts privatization costs.

2.3 Liquidation under Article 19, Law on SOEs

An insolvent firm may be liquidated under Article 19, on the initiative of the Founding Body or upon application by the Workers' Council; the Minister of Finance and the Minister of Privatization have up to two weeks to raise objections. This is the only capacity in which the Minister of Privatization intervenes in liquidation under Article 19; a firm's management, Workers' Council and founding body are the decisive actors in this form of privatization. Enterprises whose debts exceed the value of its assets are automatically transferred to the receiver general.

APPENDIX 3

Government Grants and Subsidies to Small Businesses (at 1 July 1992)
From Taxation and Small Businesses (OECD, 1994)

Country	Grants and subsidies
Australia	Government assistance to small business is aimed at improving management skills and encouraging the development of export strategies. Income support and business advice is provided for unemployed people who wish to set up new ventures.
Austria	One programme ("Bürges - Kleingewerbe - Kreditaktion") is available only for small businesses and is aimed at reducing the interest costs for those businesses. Sch 200 million were granted under this programme in 1990.
Belgium	Direct aid is given by the regions. For example, in Brussels, small businesses with a turnover of under BF 400 million and staff of under 40 (commercial undertaking) or 50 (other sectors) can get an interest rate loan subsidy of 3-5% or an equivalent allowance on capital if investment is equity financed. In addition those companies receiving such aid are exempt from tax on buildings and receive increased depreciation allowances.
Canada	Debt financing programmes encourage private sector lending to small businesses whereby approved lenders are compensated for 85% of any losses on defaults. Loans, loan guarantees, venture capital, management counselling and information and training and planning services are provided to small and medium-sized businesses by the Federal Business Development Bank including export financing guarantees covering 60-90% of value of export receivables. The bank may also provide venture capital, half of which is given to companies in early or start-up stages of development. Programmes including a range of services which reduce risk of export activities, such as export credit insurance and foreign investment insurance.
Denmark	<p>Provincial government offer financing programmes to small businesses, similar to those provided by the federal government described above.</p> <p>Private employers in small businesses (wage bill less than DKr 4 million) and self-employed can receive an insurance for sickness benefits, the premium covering 50% of total costs (40 per cent for self-employed). Total budgetary cost is approx. DKr 345 million. A few additional but minor programmes are in force.</p> <p>The enterprise establishment scheme aims to help unemployed to start their own firm. This benefit can be received for up to 3 1/2 years. The cost is DKr 700 million. Small businesses also typically benefit more from other subsidies than do larger firms - for example, technological advice from technical centers and assistance from agricultural experts.</p>
France	Small personally owned businesses receive compensation for the administrative work related to taxation of up to DKr 6 000 annually. The compensation is scaled-down in proportion to the number of employees and amounts to DKr 4 000 for businesses with one person in full-time employment and DKr 2 000 with two persons in full time employment. The compensation is taxable, and is deducted from the state income tax. The annual cost of these grants is DKr 350 million after tax.
Germany	<p>Information not available</p> <p>A substantial number of schemes are currently in force. These may be summarized as follows:</p> <p>a) Loan programmes: subject to certain conditions, loans are given to promote small and medium sized business, principally where the new business are owned by young people, or where investment is required for urban planning or environmental purposes. Cost: DM 2.7 billion. In addition are self-financing programmes: the KfW loaned DM 4.9 billion in 1990, and the DAB DM 217 million. There are now also modernisation grants for the Eastern Lander.</p> <p>b) Capital Assistance: up to DM 300 000 can be made available from Federal funds, depending on the amount of funds put up by the person concerned. This should generally be at least 15% of total investment. Access to this scheme also can lead to loan subsidies, namely fixed interest rates of 0, 2, 3, and 5%, with a 20 year term and no repayments due in the first 10 years. The cost in 1990 was DM 432 million.</p> <p>c) Savings-linked promotion: individuals can commit themselves to saving for between 3 and 10 years to set up new businesses; the government will commit 20% of the amount saved or DM 10 000. The cost in 1990 was DM 8.5 million.</p>

APPENDIX 3 (continued)

Country	Grants and subsidies
Germany (cont.)	<p>d) Equity stakes: equity investment companies taking stakes in small businesses can borrow at concessionary rates to refinance up to 75% of their equity stake. The cost in 1990 was DM 403 million. Self-help organisations which provide cover for up to 70% of the assume default risk for equity investment companies are themselves covered by federal funds to cover losses.</p> <p>e) Venture capital: access to the share and general conditions for taking equity stakes in small businesses revised to make them more favourable.</p> <p>f) Advisory activity: assistance on start-up. Cost: DM 5.3 million.</p> <p>g) Export promotion: many measures taken to help small businesses, including coverage of political and commercial risks, provision of information, individual export advisory services, assistance for participation in international trade fairs, Euro-fitness programme (cost DM 19 million in 1990) to prepare for the EC Single Market. Total spending was approximately DM 220 million in 1990.</p> <p>h) Promotion of Research and Development: including the Development of technology in the pre-competitive field (DM 200 million in 1990 for project promotion for small businesses); grants of 30-40% of the cost of R&D contracts given to third parties, up to a maximum of DM 120 000, as long as turnover is below DM 200 million; equity stakes in emerging technology companies; research cooperation between industry and science, designed to bridge the gap between science and industry, especially small businesses, by giving grants for secondments from industry to research institutions and promoting transfer of technology and joint industrial research. Total spending in 1990: around DM 275 million.</p>
Greece	None
Iceland	None
Ireland	<p>A number of government agencies make grants and subsidies available for small businesses (i.e. business with assets < Ir£ 800 000, turnover < Ir£ 2 million and number of employees < 50) on the basis of varying criteria, but in general the business must (1) produce goods for sale primarily on world markets, or (2) produce goods which are technically advanced, or (3) be a service company. Also, in some cases the small business must be sited within a particular geographical area. In 1991, 960 companies received Ir£ 37 million in grant aid.</p>
Italy	<p>Soft loan for the financing of small and medium sized industrial enterprises operating in the Mezzogiorno for the building of new installations or the modernising or expansion of old ones. This finance is also available to cover the costs of accumulating stocks. The rate of interest is equal to 30% of the prevailing rate. The loan can last for up to 15 years. (Cost: L 59.4 billion in 1986, L 36.2 billion in 1987 and L 43.8 billion in 1988).</p> <p>Small and medium enterprises can buy certain categories of machinery with payment by letters of exchange guaranteed by the Bank of Italy or the Mediocredito Centrale. This is structured in such a way as to reduce the interest rate otherwise payable -- a 55% reduction in the difference between the rate offered commercially and the base rate, or a 65% reduction in the Mezzogiorno. (Cost: L 202.6 billion in 1986, L 426.8 billion in 1987, L 500.2 billion in 1988 and L 576.7 billion in 1989).</p> <p>Aid is given for the purchase of high technology machinery by small and medium sized businesses, varying from 10-25% according to the number of employees, up to a total of L 600 million. (Cost: L 175.7 billion in 1986, L 137.1 billion in 1987, L 103.8 billion in 1988 and L 106.9 billion in 1989).</p> <p>Long term soft loans are granted for new investments, enlargements and modernisations for small and medium sized enterprises in the Centre North. The degree of aid varies by the degree of development of the region in which the enterprise is located. (Cost: L 110.4 billion in 1986, L 88 billion in 1987, L 167.3 billion in 1988 and L 125.3 billion in 1989)</p>
Japan	Information not available.

APPENDIX 3 (continued)

Country	Grants and subsidies																				
Luxembourg	None																				
Netherlands	Loan guarantees for small and medium-sized businesses (≤ 100 employees) with good prospects. Management support scheme grant (abolished as of 1.1.1992) which provides for subsidies of 30% or 70% of consultancy fees.																				
New Zealand	There are grants and subsidies available to small businesses which are paid by government departments and local authorities.																				
Norway	Government assistance to small businesses generally takes the form of grants. At present, there are special programmes aimed at establishing small businesses and at introducing new technology in small businesses. In addition, favourable loans, practical assistance and investment assistance are provided to small companies.																				
Portugal	A wide range of grants and subsidies, under condition that the small and medium-sized businesses are primarily extractive or manufacturing, that they employ less than 500 employees, that turnover is less than Esc 2 200 million, and that they do not own or are not owned more than 50% by another enterprise. In addition, there is a special system of financial incentives for small investment projects aiming at the creation, development and modernisation of small enterprises in these sectors. To qualify, small companies must employ no more than 30 employees and have a turnover of less than Esc 100 million.																				
Spain	Special grants and subsidies to small businesses are provided by a special independent agency under the Industry and Energy Department. Budget in 1990: Ptas 3 192 million. The agency also provides a number of different services (e.g. research, consulting, information). The total amount in the central government budget aimed at small businesses in 1990 was Ptas 50 billion. The Chambers of Commerce and the Institute for Medium and Small Industrial Enterprises organise training, counselling and some technical assistance to small businesses.																				
Sweden	None																				
Switzerland	None (apart from special schemes for agriculture).																				
Turkey	None																				
United Kingdom	<p>A substantial number of different schemes are at present in force. These schemes may be summarised as follows:</p> <table> <tr> <th>Scheme and its objective:</th><th>Costs £ (year)</th></tr> <tr> <td>a) Small firms and purchasing, which aims at encouraging access by small firms to markets</td><td>350 000 (1989-90)</td></tr> <tr> <td>b) Enterprise allowance scheme, aims to help unemployed to create businesses</td><td>172 million (1989-90)</td></tr> <tr> <td>c) Loan guarantee scheme, helps small businesses (turnover limits) with viable prospects to obtain finance where conventional loans are not available;</td><td>5.6 million (1989)</td></tr> <tr> <td>d) Employer training programmes</td><td>55 million (1990-91)</td></tr> <tr> <td>e) Financial assistance to unemployed people to set-up businesses in Northern Ireland</td><td>2.6 million (1989)</td></tr> <tr> <td>f) Local enterprise programme, which aims at encouraging formation and growth of small enterprises in Northern Ireland although the provision of workspace accommodation</td><td>1.8 million (1989)</td></tr> <tr> <td>g) Selective assistance for small firms in Northern Ireland, a variety of grants, loans and services</td><td>25 000 (1989)</td></tr> <tr> <td>h) Regional enterprise grant scheme, provides investment and innovation grants</td><td>12.4 million (1989)</td></tr> <tr> <td>i) Consultancy initiative, aims at encouraging smaller firms to use outside expert advice to improve management performance by offering subsidised consultancy assistance</td><td>44.6 million (1989-90)</td></tr> </table>	Scheme and its objective:	Costs £ (year)	a) Small firms and purchasing, which aims at encouraging access by small firms to markets	350 000 (1989-90)	b) Enterprise allowance scheme, aims to help unemployed to create businesses	172 million (1989-90)	c) Loan guarantee scheme, helps small businesses (turnover limits) with viable prospects to obtain finance where conventional loans are not available;	5.6 million (1989)	d) Employer training programmes	55 million (1990-91)	e) Financial assistance to unemployed people to set-up businesses in Northern Ireland	2.6 million (1989)	f) Local enterprise programme, which aims at encouraging formation and growth of small enterprises in Northern Ireland although the provision of workspace accommodation	1.8 million (1989)	g) Selective assistance for small firms in Northern Ireland, a variety of grants, loans and services	25 000 (1989)	h) Regional enterprise grant scheme, provides investment and innovation grants	12.4 million (1989)	i) Consultancy initiative, aims at encouraging smaller firms to use outside expert advice to improve management performance by offering subsidised consultancy assistance	44.6 million (1989-90)
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g) Selective assistance for small firms in Northern Ireland, a variety of grants, loans and services	25 000 (1989)																				
h) Regional enterprise grant scheme, provides investment and innovation grants	12.4 million (1989)																				
i) Consultancy initiative, aims at encouraging smaller firms to use outside expert advice to improve management performance by offering subsidised consultancy assistance	44.6 million (1989-90)																				
United States	Loans and loan guarantees, with fees paid by the borrowers to support the programmes																				

SOURCE: Taxation and Small Businesses, OECD, 1994.

APPENDIX 4

Pertinent Legislation

1919	Law on Trading in Securities and Trusteeship Funds
1934	Commercial Code (allows for limited liability co's; JV co's; 3 types of partnership) The Bankruptcy Act The Law on Mutual Agreement
1952	Constitution (based on Stalin's 1936 Soviet)
1964	Civil Code (based on Napoleonic Code)
1974	Labour Code
1976	Law permitting establishment of unincorporated firms by non-residents (Polonian firms) Amendment of the Constitution to reinforce the leading role of the communist party and fraternity with the USSR
1981	Act on State Enterprises Act on State Enterprise Workers Self-Management Act on State Enterprise Finances
1982	Law on Cooperatives (allowed non-state cooperatives)
1986	Law on Foreign Investment permits establishment of incorporated firms with foreign capital participation
1989	Law on Economic Activity (equality of econ agents) Law on Financial Management of SOEs (introduces budget constraint and dividend on capital assets) Law on Group Dismissals (establishes obligation to give severance pay of one to three months salary for mass lay-offs) Law on Joint Ventures (unrestricted transfer of profits and capital; no consent required from Agency for foreign investment for firms valued at <USD 1 million)

APPENDIX 4 (continued)

Pertinent Legislation

- 1990**
- Anti-Monopoly Law (March)
 - Law on Privatization of SOEs
 - Law on Land Ownership and Expropriation increases authority of municipalities
 - Amendment of Law on Financial Management of SOEs (1989) founding body could override decision of WC to force liquidation; reinforcement of bankruptcy provision
 - Amendment of the Civil Code (1964) (private companies equal with state-owned)
 - Amendment of the Act on Land Resource Management and Compulsory Purchase (foreigners allowed to purchase property where there is a majority Polish holding. Where majority holding is foreign, permission of Minister of Internal Affairs is required.)
 - Social Assistance Act (replacing "state-sponsored charities")
- 1991**
- Amendment of Act on SOEs (1981)
 - Act on Public Trading of Securities and Trust Funds
 - Act on Establishment of the WSE
 - Revival of the Bankruptcy Act and the Law on Mutual Agreement (1934)
 - Law on Companies with Foreign Capital Participation (amends 1988 law) to permit 100% foreign ownership)
 - Amendment of the Commercial Code resurrects limited partnership company
 - Law on Employment and Unemployment
 - Law on Trade Unions
 - Law on Organizations of Employers
 - Law on Settlement of Group Disputes
- 1992**
- "Little Constitution" (increases powers of president and executive) (Aug)
 - Council of Ministers Decree #93 designating high-risk regions re: unemployment
- 1993**
- Enterprise Pact to upgrade Labour Code to conform with ILO standards, included:
 - (a) Law on remuneration of government employees - (1994 wages to be adjusted for projected inflation ie.23% retail sector) and victims of bankruptcy (10 Dec)
 - (b) Law on Social Benefits Funds in SOEs.
 - Law on Financial Restructuring of Enterprises and Banks
 - Amendment of 1989 Law on Economic Activity (imposed an obligation to carry out all business operations through bank accounts)

APPENDIX 4 (continued)**Pertinent Legislation**

- 1994** Law on Copyright pertains to audio, video, computer software
 Law on Insurance of Export Contracts
 Law on Economic Crimes
 Amendment of the Law on Cooperative Enterprises
 Law on Business Security extends protection against, and penalties for,
 unfair business practices to include private enterprises
- 1995** Law on Public Orders establishes obligation for public bodies to go to
 tender
 Amendment to Public Procurement Act provides for simplified procedures

APPENDIX 5

EC conditions for "Admissible state aid" (Defined in Articles 92 to 94 of the Treaty of Rome)

Financial assistance to SMEs is allowable in the category of "assistance for horizontal (problem-oriented) purposes".

The basic regulations provide that:

1. All assistance programmes shall use the legal definition of SMEs.
2. The following volume of assistance is allowed:
 - (i) up to 15% of investment costs for SMEs operating outside the regions covered by regional assistance programmes.
 - (ii) surpassing the admissible threshold of regional assistance by 10 to 15% (depending on the level of development of an individual region) for SMEs operating within the regions covered by this kind of assistance,
 - (iii) surpassing the admissible threshold of the assistance for R&D.
3. The State is allowed to participate (up to 50% gross) in the costs borne by SMEs for programmes of staff retraining and upgrading, various types of training, consulting services, etc.
4. Implementation of the extraordinary, accelerated procedure of approving SME assistance programmes (except for SMEs privileged to operate in "high-sensitivity" sectors).

APPENDIX 6

Contracts awarded by PHARE

Contracts awarded by PHARE (E.C.) for SME development in Poland:

- Restructuring of the textile industry and SME development in Lodz: contract awarded to "Novacité et Chambre de Commerce de Lyon";
- Assistance to regional agencies in Poland: contract awarded to the Centre de Rencontres et d'Initiatives pour le développement local (CRIDEL-DATAR, France) avec le Centre de recherche sur les reconversions et les mutations (CERRM, Longwy);
- creation of a guarantee fund for SMEs for Poland: contract awarded to CEPME, France, Crédit d'Equipment des PME;
- assistance to SME associations in the CEECs: contract awarded to UAPME (Union of SME Associations);
- creation of financial assistance schemes: contract awarded to IAPME, Instituto de Apoio as Pequenas e medies Empresas e as Investimento, Portugal;
- SME support (Public administration and training): contract awarded to European Senior Service (European Association of Retired Managers, established specifically for TACIS and PHARE);
- development and training of rural cooperative bank staff in Poland (re: food aid): contract awarded to EC Association of Cooperative Banks.

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