



How entrepreneurship could be promoted after the collapse of a socialist economic system

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ARTICLE INFO

Article history:

Received 6 May 2011

Received in revised form 7 September 2011

Accepted 24 September 2011

Available online 20 October 2011

JEL classification:

D01

D40

H32

P20

P26

Keywords:

Small enterprises

Postcommunist transition

Economic systems

Tax system

Regulation

ABSTRACT

The purpose of this paper is to provide empirical observations from postcommunist countries to suggest which policy sets applied make most sense for the promotion of micro-enterprises. Three overall conclusions can be drawn. First, an early, comprehensive and radical reform is the superior approach for the promotion of entrepreneurship, because the prevalence of rent seeking interests is so easily established and it is so difficult to break. The second conclusion, however, is that a certain space for small enterprises can be created even in a very corrupt economy dominated by severe rent seeking. A third conclusion is that the Russian deregulation of 2002 represents the worst of all worlds, because all its elements were incremental.

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Institutions such as strong property rights and the rule of law are important for both long run economic performance and short run volatility.¹ Developing good institutions is generally viewed as a desirable goal but there is no agreed road map for such changes. Recent experience in Eastern Europe, East Asia, and South America supports the idea that institutions – i.e., an effective judiciary, the protection of property rights, and more specific laws – are key to both long-term economic development and recovery from crises. How can a poor country improve its institutions substantially? Does it have to take a long time, or can it be done all of a sudden?

Small and medium-sized enterprises (SMEs) are important both as an indication of the presence of good institutions and their promotion. They face two grave dangers. One is expropriation by a predatory state, and the other is business elites that enjoy disproportionate power and leverage. In order to withstand both kinds of predation, small enterprises can only persist as legal entities if property rights are sufficiently strong. This concerns all kinds of government policy, not least taxation.

Therefore, it is vital that countries that do not have small enterprises obtain them. In the last two decades, the world has seen an extraordinary experiment. At least 30 countries have undergone the transition from a centralized socialist economic system with predominant state ownership of the means of production to a market economy with mainly private ownership

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¹ This paper was presented at the ADB Workshop on: "Transitional Economies: Progress and Pitfalls," East-West Center, Honolulu, Hawaii, February 18, 2011. I am grateful for the many useful comments I received during that workshop, in particular from Christopher Edmonds, Marcus Noland, Richard Pomfret and from one anonymous reviewer. Natalia Aivazova has ably provided me with research assistance.

in the last two decades. These transitions have been quite different, and not least the development of small enterprises has varied greatly.

Statistics on small and medium-sized enterprises (SMEs) are notoriously poor for three reasons. First, definitions vary. The OECD (2005, 17) standard definition is that medium-sized enterprises have 50–249 employees, small enterprises 10–49 employees, and micro firms less than 10 employees. Most postcommunist countries, however, define these categories of enterprises as much smaller, which reduces the official size of SMEs. The second problem is that statistics on SMEs are patchy, and the third problem is that much of the activities of SMEs are not measured.

These differences in definitions tend to reflect differences in policy as well. The qualitatively most important category might be enterprises with 11–249 employees, because their ample existence suggests that no glass ceilings exist. These are usually the most scarce in countries with poor governance. Many such countries do accept micro-enterprises with a maximum of ten employees. Countries with truly bad governance do not allow many micro-enterprises either, while a slightly more liberal category tolerate them but neither register them nor offer them any social rights.

The purpose of this paper is to provide empirical observations from postcommunist countries to suggest which policy sets make most sense for the promotion of micro-enterprises. I shall distinguish between four different patterns of policy development towards micro-enterprises.

The first group of countries was those that carried out early, radical and comprehensive market reforms. As a consequence, large sectors of small as well as medium-sized enterprises mushroomed from the very beginning. These were largely the countries in Central Europe, the Baltics and South-East Europe. A second group of countries saw a substantial early development of small enterprises, but soon these predominantly micro-enterprises were suffocated by red tape and corruption. Among these, however, a significant number offered special conditions for micro-enterprises so that they could develop in spite of the general situation in the economy. Some steps were taken in many countries, but Kyrgyzstan and Ukraine stand out for their extensive developments, but the glass ceiling remains. In 2002, Russia undertook an attempt at partial deregulation of the enterprise environment on a big scale. This was interesting because five years later these reforms were reversed. Finally, a group of post-Soviet countries sought a broader liberalization of enterprise conditions in recent years, especially Georgia, but also Azerbaijan, Kyrgyzstan and Belarus.

An underlying assumption of this paper is that most state regulation is predatory rather than socially beneficial. Naturally, this is not universally true, but considering the very high level of corruption in most postcommunist countries, this appears an empirically correct observation in this region (Transparency International, 2010). In the future, if more legality is established, state regulation could be discussed from other perspectives, but today predation is all dominant.

1. The importance of small enterprises

Small and medium-sized enterprises are of critical importance to the functioning of an economy and thus economic development. In developed OECD economies, about 60 percent of GDP is generated by small enterprises, i.e., enterprises with a maximum of 50 employees (OECD, 2002). It is easy to understand why this is the case. A modern market economy consists of thousands of markets, which require millions of enterprises to be reasonable, competitive and efficient. A large number of small enterprises guarantees a high degree of competition, and the variety of economic activities is so great that as many enterprises as possible are needed in a modern economy. The extent of small enterprises varies greatly among countries. Semi-developed countries, such as those in Latin America or the post-communist region, have far fewer small enterprises. This is one of their major structural weaknesses (De Soto, 2000; World Bank, 2002).

The density of small enterprises varies even across regions within countries. Italy is a classic case with abundant small enterprises in the often communist-ruled Emilia in the North and a lack of entrepreneurship in the conservative South. Here, a standard argument is historical differences in social capital (Putnam, 1993).

Much of the world's economic production is of very small scale: one or two people operating "under the radar" as individuals rather than as an organized business. A major problem for economic growth is how to persuade these people to invest, employ others and, preferably, pay taxes. It is primarily the risk of expropriation by government and powerful individuals that constrains entrepreneurial investment and causes business people to stay very small scale and completely unofficial in many countries. This expropriation risk depends on taxation, regulation and the strength of property rights. At least in some countries, national, and local bureaucrats intentionally make tax and regulation systems complicated, in order to make sure that almost no one can fully comply, rendering entrepreneurs vulnerable to extortion and expropriation.

From a social point of view, it is desirable that small enterprises are not only plentiful but also legal and officially registered. An unregistered entrepreneur is deprived of most official and social rights with regard to courts as well as pensions (De Soto, 2000), and he or she does not pay taxes. Without secure property rights semi-official entrepreneurs are disinclined to invest, expand or hire employees. Nor does the government know what is going on in the entrepreneurial underground and cannot plan for anything from infrastructure to social facilities. Thus, both entrepreneurs and government should have an interest in the legal existence of small and medium-sized enterprises, but all too often government policy offers entrepreneurs the simple choice of closing up or disappearing in the underground.

These observations suggest three points. First, relatively small institutional differences can produce large differences in the size of the small enterprise sector. Second, if institutions do not change, the share of small enterprises can persist in being very different across otherwise similar economic areas for long periods of time. Third, limited changes in economic policy can quickly change the size of the small enterprise sector.

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