

RESTRUCTURING THE YUGOSLAV ECONOMY THROUGH DEVELOPMENT OF ENTREPRENEURSHIP, AND THE ROLE OF THE FINANCIAL SYSTEM

Aleš Vahčič and Tea Petrin

1. Introduction

In this paper* it is argued that the recent attempts made in many socialist countries to reform their economies through greater reliance on the market cannot be successful without the development of a mechanism for the entry of new firms; and that this, in turn, cannot be developed without massive investment in domestic entrepreneurship. To support this process, a full-scale reform of the financial system is necessary.

2. The need for transition from bureaucratic to market coordination

Over the past decade a number of leading socialist countries have started to introduce economic and political reforms which seem to be more serious and far-reaching than any undertaken in the past. The common denominator of these reforms is an open recognition, at the highest political levels, that without a much greater reliance on the market coordination of economic activities, as opposed to the existing bureaucratic coordination, future economic development will not be possible. Although many prominent socialist economists have, since the early beginnings of socialist states, advocated market coordination as a necessary condition of efficient socialism, it is only recently that this view has been widely accepted by the top policy-makers in socialist countries.¹

This change in ideological position is mainly a consequence of the profound change in global economic conditions, where technological advances and shifts in demand patterns have led to a rapid shift from mass-produced standardized consumer products to high-quality diversified products for specialized market niches. This shift made it almost impossible for the socialist countries to follow technological progress and to compete on the world markets within the existing framework of bureaucratic economic coordination. If socialist countries wanted to maintain or even enhance their position in the world economy, they had to reconsider their economic organization.

It is obvious that the introduction of market coordination in socialist countries can have a positive effect only insofar as the markets will be reasonably efficient, which means that they will have to be reasonably competitive. To achieve competitiveness it is necessary to develop a mechanism for the entry and exit of firms, and to ensure that the number of firms competing in the market can become as large as possible.

Empirically we can observe that, in market-oriented economies, the market structure is characterized by what can be called a normal-sized distribution of firms, which means that the size distribution consists of a healthy mixture of small, medium and large firms. Small and medium-sized firms are extremely important for the maintenance of a competitive structure, and can be regarded as a vital part of efficient market economies.

If we look at the market structure and size distribution of firms in socialist countries, we find that small firms—particularly in the range of from 10 to 100 employees—are nearly non-existent.² This is a direct consequence of bureaucratic coordination, including the control over the allocation of investment funds. For years there has been practically no entry and exit of firms, and growth has been achieved mainly through the expansion

of existing firms. New firms, if created, are invariably of medium or large size. There is practically no reduction in size of existing firms, in spite of the existence of hidden unemployment in most large firms. Whereas in the past there were many instances of the growth of firms through vertical and horizontal integration, the disintegration of large firms was very rare. It follows that an industrial structure of this kind is incompatible with the operation of efficient markets, and therefore one of the most important aspects of the future development of market coordination in socialist countries will have to be radical changes in industrial structure, which will eventually lead to a size distribution of firms which will bear a much closer resemblance to the existing size distribution in market economies. The crucial question is how to bring about this change in the market structure.

3. The development of entrepreneurship and entrepreneurial management

The transition from a highly-concentrated and inefficient market structure to a competitive market structure in socialist countries may be achieved (a) by the entry of new firms, and (b) by the division of existing firms into smaller units that can compete on the market.

For the entry of new firms, one needs entrepreneurs, and for the trimming down of existing firms one needs entrepreneurial management.³ A massive entry of firms requires the generation of a large number of project ideas and a correspondingly large number of entrepreneurs or entrepreneurial groups to carry out the projects. For this purpose the socialist countries will have to stimulate entrepreneurial behavior which may bring about entrepreneurial growth.⁴

In socialist countries the entrepreneurial role has been limited to the state bureaucracy. The system of economic regulation in these countries has required and stimulated managers who were good at performing tasks set by the bureaucratic leadership. Traditionally such managers have tended to exhibit limited initiative, conforming and accommodating themselves to regulations, and attempting to utilize the system to the advantage of the enterprise. They have been preoccupied with building effective links upwards, with the official organs of economic guidance. All of this has restrained them from making entrepreneurial decisions and from adopting an entrepreneurial mode of behavior. The development process was therefore limited to those processes and aspects which were consistent with bureaucratic entrepreneurship, most of which were related to the establishment of large enterprises producing low-quality mass-produced products for the protected domestic markets. In this development process—with the exception of some farming concerns, some handicrafts, and some personal services—there was no room for small- and medium-size enterprises which would require a large number of autonomous entrepreneurs.⁵

In this paper we argue that the following chain of relationships is crucial for effective economic reform in socialist countries: *increased efficiency - efficient markets - competition - competitive market structure - entry of new enterprises - entrepreneurship*.

It is necessary to distinguish between two types of entrepreneur, each of which may require a different kind of person, with different background and training. The first type of entrepreneur comprises people who can effectively develop new, and especially small-scale, enterprises, and bring them to market success. The second type of entrepreneur comprises those who can effectively break up, trim down and restructure existing large-scale enterprises and make them into viable economic units. The first type comprises entrepreneurs in the classic sense, those who realize their ideas through new ventures; the second type comprises managers who can handle large organizations, but who are also capable of developing entrepreneurial management within existing organizations.

In socialist countries there is an enormous need for both types of entrepreneur, since the

development of a competitive market structure actually implies the filling-up of the so-called *socialist black holes* — totally empty economic spaces found in all sectors of socialist economies which, in entrepreneurially efficient countries, are occupied by firms employing between 10 and 100 employees.⁶ In socialist countries firms of this size can be brought into existence either by establishing new firms, or by breaking up existing ones. Although the central parts of a divided enterprise may remain quite large, many subsidiaries, plants and establishments formerly belonging to the bigger firms would become independent enterprises, falling within the range of small- or medium-size firms. In order to increase the supply of entrepreneurs and to stimulate entrepreneurial management, socialist countries will have both to introduce macroeconomic measures which will induce managers to take and accept risks and responsibility, and to develop full institutional support for the development of entrepreneurship.⁷ It should be realized that in many market-oriented countries, both developed and developing ones, full-scale policies for the development of entrepreneurship are now in operation, and this approach should be adopted by socialist countries as well.

The most important part of the institutional structure which has to be developed in support of what we may call “entrepreneurship-led reform” in socialist countries comprises the financial institutions which would be specifically developed for the efficient performance of this task. In the remaining part of this paper, we discuss some ideas about the development in Yugoslavia of financial institutions of this kind.

4. The “Socialist Black Hole” in Yugoslavia, and how it may be filled

To illustrate the order of magnitude of the market structure disequilibrium in Yugoslavia we present a graph (FIGURE I) of the “Socialist black hole” for the Yugoslav manufacturing sector.

The “black hole” in this example is constructed by comparing the size distribution of manufacturing firms in a mature economy close to equilibrium, in this case the Swedish economy, with the size distribution of Yugoslavia. The total area under each curve represents 100% of the total manufacturing labor force. The size class limits are calculated in such a way that the Swedish manufacturing labor force is uniformly distributed in the size classes containing 10% of the manufacturing labor force each. The Yugoslav size distribution of firms is then plotted against the same scale. This presentation clearly shows an almost complete absence of small-scale enterprises in Yugoslavia. The only small enterprises are at the very low end of the distribution in the private sector.

The long-term strategy of industrial development would then require as one of its key elements the “filling in” of this “socialist black hole,” achieved by the division of large firms and the entry of small ones. This “filling in” will not only require the development of entrepreneurship, which in turn will require strong institutional support and an economic environment which will stimulate managers to take risks and assume responsibilities, but will also require the development of financial institutions that will support restructuring.

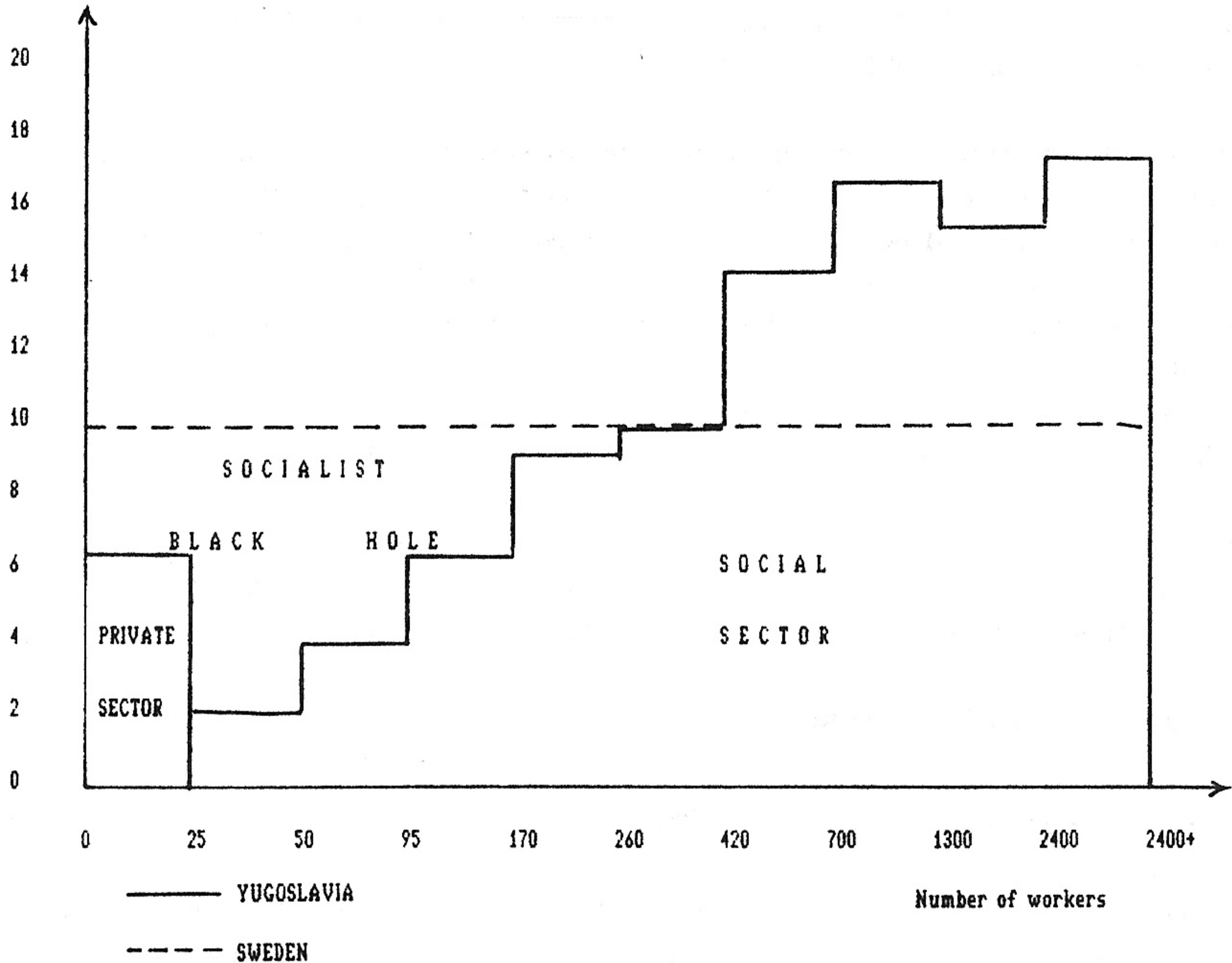
Two aspects of the financial market should be addressed: the primary and the secondary market. The former deals with the financing of new enterprises from new savings; the latter deals with the restructuring of existing enterprises. The question is: What sort of financial system should be developed to deal with both of these tasks?

5. Financial institutions for restructuring existing enterprises

In Yugoslavia it has become clear that a piecemeal and gradual approach to system

GRAPH I: SIZE DISTRIBUTION OF PUBLIC AND PRIVATE MANUFACTURING ENTERPRISES, BY EMPLOYMENT SIZE CLASS, FOR YUGOSLAVIA AND SWEDEN

Percentage of total manufacturing labor force employed in firms of given size



reform yields no tangible results. There is therefore now a growing awareness that radical changes in the economic system and the economic structure must be carried out. This effectively means that one has to take a global view and ask the following question: What should be done with existing production organizations, both in physical as well as in organizational terms, if maximum economic value is to be extracted from them? To visualize the extent of the problem we should consider that in the Yugoslav production sector there are at present over 20,000 production units, employing over 5,500,000 people, and having assets whose replacement value is about \$80 billion. From the financial point of view we can visualize these 20,000 units as 20,000 balance sheets, with corresponding assets and liabilities. The fundamental fact of the current distorted financial system is that for most of the enterprises the balance sheet data, on both liability and asset sides, have practically no economic meaning. Identical fixed assets have widely-differing book values, depending on the particular arrangement and date of the assets' acquisition; and the same is true of liabilities. Related to this is the fact that identical real assets will imply widely-differing flow obligations for different enterprises. In any serious reform of the financial system, therefore, the existing balance sheets could in fact be scrapped.

The next step would be to evaluate the current book value of all assets of all firms and enter the equivalent amounts as equity on the liability side of the balance sheets. All equity should be transferred to caretaking institutions which would then be charged with the responsibility of managing the social capital and would be directly responsible to the

representative political bodies. This would in effect be equivalent to the resocialization of social productive assets, which at present are more or less *de facto* in the collective ownership of workers' collectives, subject to haphazard outside intervention from political authorities at various levels. We can say that at present the property rights on productive assets in Yugoslavia are not clearly defined, and that it is unclear which groups of people, agencies or institutions are actually responsible for their efficient use. The new balance sheet would represent the basis on which the negotiation between the enterprises (workers' associations) and the caretaking institutions would be carried out. The main issue in negotiations would be to determine the economic value of the assets which would be a labor-managed equivalent of the market value of a joint-stock company. The determination of this value is of course a non-trivial matter, and the key problem is how to motivate all economic agents who have information on the potential use of the assets to reveal their knowledge, and so contribute to the objective evaluation of the economic value of the assets in terms of their future income-earning power. Once the economic value has been assessed and the equity adjusted accordingly, the assets would be leased to the collective at the lease price, calculated by applying the prevailing interest rate. The past performance of the enterprise could be used as a bench mark for the evaluation of the lease price. Initially a simplified solution could be used, by simply charging to each enterprise as the lease price the amount obtained as the difference between the past period's revenue minus the sum of material cost, taxes and contributions, and imputed labor cost.

After the leasing arrangement is made the firm would be allowed to operate freely on the market without any direct intervention, formal or informal, and would be allowed to distribute all the surpluses that accrue. The firms would finance working capital requirements through normal commercial bank arrangements, while long-term investment would be financed through bank credit, fixed or variable bond issue, or equity investments by the caretaking agency. It would be in the interests of workers and managers to maximize the residual income which would then reveal the economic potential of assets and provide a new bench mark for the new leasing agreement. Although the scheme is not fully efficient—since there would be a tendency, at least initially, to determine lease prices that would be too low—it would have the advantage that it would be relatively simple to implement, and would have the dynamic tendency to improve the economic use of assets while at the same time equalizing workers' incomes. It should also be pointed out that not everything should be prescribed in advance, and that more detailed arrangements, which would more precisely define the roles of various decision makers (i.e., workers, management, and outside agencies), should be left to the participants to decide. The fundamental idea, however, should be preserved, namely, that the basic economic relationship is between the enterprise as a whole—including its management—and society represented by the caretaking agency, rather than between society and management alone.

6. Financial institutions for the entry of new enterprises

Due to the magnitude of the problems associated with the need in Yugoslavia for the massive creation of new enterprises, it can be argued that the general reforms of the financial system to ensure the independence and commercial behavior of the banks would not be sufficient to perform the task. A highly developed network of financial institutions dealing specifically with the entry of new firms would have to be created. These institutions can be conceived as blends of development banks and venture capital firms, adapted to the conditions of a self-managed economy. Institutions of this kind can be structured, to a great extent, following the model of the Caja Laboral Popular of Mondragon, particularly its entrepreneurial division.⁸

It would be important for institutions of this kind to have diversified sources of funds, in order to spread the risk of failure over a large number of depositors; and also that the network of investors would include relatively large, financially strong organizations.

The main source of investment funds would come from the lease payments by existing enterprises to the caretaking institutions, and from banking sources, whose ultimate source would be savings made by the general population.

The basic difference between financial institutions of this kind and the traditional financial intermediaries is that the former, to a much greater extent than the latter, would be involved in the preparation of the investment projects, including the training of the entrepreneurs, and later the supervision of the efficiency of investment.

Some of the principles underlying the formation of these financial institutions would be the following:

- It is necessary to finance a large number of projects simultaneously; high returns can only be ensured for a large group of enterprises, rather than for individual ones.
- The average expected rate of return of the newly-created firms (calculated at opportunity cost of labor) should be much higher than the return on financial investment on world financial markets.
- The financing of each project must be carried out in phases. After each phase it is necessary to make a decision about the continuation of the project.
- For each project full costs, including all preparatory work, should be accounted for.
- The cumulative costs of unsuccessful enterprises at the moment of project discontinuation should be transferred back to the financial institution.
- Each enterprise which eventually succeeds must, during its lifetime, cover all investment costs, including all the interest from all projects.
- The entrepreneur-innovator of a successful enterprise must receive part of the extra income generated.
- When the enterprise begins regular production, it is constituted as a regular self-management enterprise with business autonomy. In many cases the entrepreneur is supported by a professional management team.
- For the minimization of risk, it is important that the financial institution should be able to intervene in the enterprise, should it determine that the return will be lower than expected. For this purpose it is necessary to establish an intervention department which monitors the activities of new enterprises when the expected results are not achieved. An intervention department would not interfere with the self-management rights of the enterprise, but would only be authorized to safeguard its investment. These organizations would be run according to market principles, and their costs would be included in the costs of financing which the newly-established firms would have to cover from their income.

Ekonomiska fakulteta Borisa Kidriča
Ljubljana

NOTES

* This paper was written for *Slovene Studies* 11/1-2 (1989), *In Honor of the Memory of Toussaint S. Hočevar (1927-1987)* and was submitted to the editors but thereafter was unaccountably mislaid. The editors hereby express their regrets to the authors.

1. J. Kornai, "The Hungarian reform process," *Journal of Economic Literature* Dec. 1986: 1687-737.
2. A possible exception being China.

3. On entrepreneurial management see P. Drucker, *Innovation and Entrepreneurship*, New York: Harper & Row, 1985.
4. History shows that countries that have fostered and protected entrepreneurship have become the motive force of international economic expansion. On the other hand, countries where entrepreneurship has been historically hampered (as in most of the developing countries, as well as in the socialist countries) have traditionally lagged behind those where entrepreneurship has been supported through the institutionalization of incentives, ownership rights, and accessibility of new knowledge. See L. Suarez-Villa, "Entrepreneurship and the international diffusion of innovations in manufacturing: A general approach," *Revista Internazionale di Scienze Economiche e Commerciale* 1987: 369-91.
5. J. Noar & P. Bod, "Socialist entrepreneurship in Hungary: Reconciling the irreconcilables," *Columbia Journal of World Business* Summer 1986, 55-68.
6. See T. Petrin & A. Vahčič, *Razvoj drobnega gospodarstva, ključni element strategije razvoja slovenskega gospodarstva v naslednjih desetih letih*. Ljubljana: Ekonomska fakulteta Borisa Kidriča, 1985.
7. T. Petrin, J. Prasnikar & B. Pečenko, *Strokovna podlaga za zakon o ustanavljanju majhnih delovnih organizacij v družbenom sektorju gospodarstva*. Ljubljana: Ekonomska fakulteta Borisa Kidriča, 1985.
8. T. Petrin, "Mondragon - dokaz, da je podjetništvo mogoče in zaželeno tudi v samoupravnem sistemu," *Naši razgledi* 35, 20 Jun. 1986, 12.

POVZETEK

PREGRAJANJE JUGOSLOVANSKEGA GOSPODARSTVA S SREDSTVOM RAZVOJA PODJETNIŠTVA IN VLOGA FINANČNEGA SISTEMA

Članek obravnava pomen razvoja podjetništva in finančnih inštitucij za prehod iz dosedanjega birokratskega uravnavanja v tržno uravnavanje gospodarstva, kot nujen pogoj povečanja učinkovitosti jugoslovanskega gospodarstva. V prvem delu avtorja navajata posledice dosedanjega birokratskega upravljanja gospodarske aktivnosti na gospodarski razvoj Jugoslavije ter razloge za institucionalno podporo razvoju podjetništva in podjetniškega vodenja, še posebej v družbenem sektorju gospodarstva. Na koncu avtorja obravnavata razvoj finančnih institucij, potrebnih za uspešno prestrukturiranje jugoslovanskega gospodarstva z vstopom novih in prekstrukturiranjem obstoječih neučinkovitih pojetij. Avtorja razlikujeta primarni in sekundarni finančni trg ter temu ustrezno navajata možne finančno-institucionalne rešitve.