

Report No. 8991-POL

Poland

Review of the Private Small and Medium Scale Enterprises Sector

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CURRENCY EQUIVALENTS

Currency Unit - Zloty (Zl)

AVERAGE EXCHANGE RATES

(Zlotys per US\$)

	<u>1986</u>	<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>
US\$1.00 = Zl	175	265	430	4000	9500	(June) 11,100

WEIGHTS AND MEASURES

Metric System

ABBREVIATIONS

BRE	-	Export Development Bank
BGZ	-	Bank for Food Economy
BISE	-	Bank of Social and Economic initiatives SA
BTT	-	Banking Telecommunication Society
CMEA	-	Council of Mutual Economic Assistance
DDSR	-	Debt and Debt Service reduction
EBRD	-	European Bank for Reconstruction and Development
EC	-	European Community
EIB	-	European Investment Bank
ETP	-	Economic Transformation Program
FIDL	-	Financial Institutions Development Loan
GDP	-	Gross Domestic Product
IDA	-	Industrial Development Agency
IEDL	-	Industrial Export Development Loan
IMF	-	International Monetary Fund
LIB	-	Limited International Bidding
LIBOR	-	London Interbank Offered Rates
NICA	-	non interest current account
MOF	-	Ministry of Finance
NBP	-	National Bank of Poland
PDB	-	Polish Development Bank
PKO BP	-	PKO State Saving Bank
PRP	-	Privatization and Restructuring Project
SAL	-	Structural Adjustment Loan
SBA	-	Standby Arrangement

POLAND - FISCAL YEAR

January 1 - December 31

POLAND

REVIEW OF THE PRIVATE SMALL AND MEDIUM SCALE ENTERPRISE SECTOR

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POLAND
REVIEW OF THE PRIVATE SMALL AND MEDIUM
SCALE ENTERPRISES SECTOR
EXECUTIVE SUMMARY

I. The Government of Poland has adopted and initiated a radical program of restructuring of the economy which aims at replacing the inefficient centrally controlled economic system by a competitive and decentralized market economic system. A key element in this transformation is the replacement of the present structure of production and service enterprises, which are relatively large in size and few in number, with a network of small and medium scale enterprises. This would permit a dynamic response of the enterprise sector to market signals and promote a more competitive environment. It is in this context that the Government is seeking to develop a program to aid the growth of the private sector, focussing on small and medium size enterprises (SMEs).

II. As part of the World Bank program to support the Polish Government in the transition of the country's economic system, a World Bank team conducted a study of the private, small and medium scale enterprise (SME) sector. The purpose of this study is twofold: first, to identify current and potential constraints limiting the expansion and efficiency of the private SME sector, and second, to provide Polish authorities with recommendations on policy instruments and institutional development actions, toward a strategy for the development of the private SME sector. The findings and recommendations of the study are expected to provide elements for identifying a government program, which could encourage the development of the sector and could be supported by a World Bank loan.

III. The concepts of SME and private sector are used interchangeably throughout the report. Currently the two concepts are essentially identical in Poland, because of, on the one hand, the overall size of private enterprises has been restricted until very recently, and on the other, the state-owned enterprises are, in general, large. However, considering the recent developments in Poland, private sector activities might expand into large scale enterprises. The recommendations and strategy included in this report are addressing mainly the needs of the private SME sector, and relate to enterprises involved in manufacturing and services activities.

IV. To carry out the study, World Bank staff visited Poland in May/June 1990, and met with Government officials of ministries and agencies¹, banking

¹ Including representatives of the Office of Government Plenipotentiary for Ownership Changes, Ministry of Finance, Ministry of Industry, Ministry of Domestic Market, Ministry of Foreign Economic Cooperation, Agency for Foreign Investment, Ministry of Labor, and Central Statistical Office.

institutions and the main institutions representing private sector, such as the Chambers of Commerce and Industry, Economic Societies, and the Association of Enterprises with Foreign Participation. To supplement the information gathered from the official sources of data, a firm-level survey of thirty-five enterprises was conducted. This survey also provided qualitative information on the characteristics of the private SMEs, on the impact of the economic reform program in their production, and on constraints to their further growth.

V. The report is structured in five chapters. Chapter I introduces the study. Chapter II, presents a profile of the sector, based on official statistics and data gathered through a small firm-level survey of enterprises. According to the current classification used in Poland, the sector comprises three categories of enterprises: (i) the unincorporated business -or natural persons-; (ii) incorporated business -limited liability and joint stock companies-; and (iii) joint ventures, i.e., firms involving foreign investment under the Law for Foreign Investment. Currently, private enterprises are still defined only based on legal considerations and regardless of their size. The impact of the implementation of most recent legislation, (e.g. the Law on Privatization) on enterprise structure, would require to change this situation. The chapter concludes that, although small today, the sector is growing rapidly. Moreover, it is highly responsive to policy changes; time lags between the introduction of such changes and the establishment of new companies are remarkably short. At present, growth is particularly rapid in the types of private enterprises which are larger (incorporated companies and joint ventures) and more ambitious than the traditional sole proprietorships. Further, the contribution of these enterprises to employment and exports is usually higher than average, suggesting that the sector would have a useful role in absorbing labor shed from large enterprises as they restructure, and in earning convertible currency.

VI. Chapter III reviews the Government's Economic Transformation Program (ETP) and changes in the regulatory framework including the privatization program and assesses their impact on SMEs. The ETP, inter alia, aims at rapid liberalization of markets. It also aims at establishing a level playing field with regard to policy and incentives for all agents in the economy. This is a strong move away from the tradition of the last forty years, where direct and discriminatory intervention was the rule. This chapter combines firm level surveys and an analysis of the adjustment program from the perspective of the SMEs to provide a coherent picture of their situation today. In particular, this chapter reviews how the macroeconomic adjustment program affected SMEs; how SMEs adjusted to these reforms; and why many firms have problems operating in the new environment. It concludes that firm level responses to the macroeconomic adjustment programs and regulatory reforms indicate resilience and dynamism. However, to ensure this resilience over the long run, as the implementation of the reform program continues, supporting programs for SME development need to be adopted.

VII. These supporting programs would address the main firm-level constraints which are limiting the SMEs' capacity to adjust to market conditions. The

following are among the most critical ones: (i) business practices are not compatible with the new market oriented economy. The broad set of cultural and behavioral norms, the internal practices of management and labor, and the ways of servicing customers require change; (ii) management skills in the past were developed to serve a shortage economy. In the former shortage economy, quality control, financial management, pricing, and marketing were not major concerns. Now, the needs are different, and management skills and information systems have to be adapted accordingly; (iii) technology used by most SMEs is outmoded, resulting in obsolete design and low product quality, which are obstacles in external, but increasingly also in the domestic markets; (iv) productivity in SMEs appears to be low, a situation related to historically low labor costs, work practices, and limited access to modern technology. Major productivity increases will depend upon the introduction of "best practices" in management and improved technologies.

VIII. The chapter concludes that: (i) The private sector in Poland faces a new and challenging environment with a number of transitory problems. On the one hand, firms that had the advantage of monopoly positions in a shortage economy now face competition. Much of the existing private sector has been tightly linked to the state sector for inputs and sales of final products. These linkages will weaken as the state sector is forced to reduce operations. Currently, almost all firms face greatly increased costs and reduced demand for their products. On the other hand, opportunities abound for those firms capable of adjusting to the costs of doing business in an economy in transition. Raw materials are available; firms are free to develop export markets; and Polish consumers are looking for new and varied products. However, these opportunities can only be fully exploited with complementary actions on the part of the authorities, local administrations, and the private sector itself. (ii) The opportunity to help this sector meet the challenges of international competition should not be lost. In this context, the report argues that the Government needs to continue to improve the regulatory environment and thus assist the private sector in channeling its apparent energy into productive activities. (iii) Poland has not yet adopted a consistent, overarching policy for SMEs, and even though a number of policies supporting SMEs have been adopted, they have not been taken in the coordinated fashion needed to enhance their impact and effectiveness.

IX. Chapter IV examines the most critical weaknesses in the business environment in which SMEs are expected to operate in the immediate future. Efforts made to date, such as those analyzed in the previous chapter, are modest given the scope of the constraints which are: the lack of banking and financial sector capabilities; the lack of institutional support; inadequate physical infrastructure; and the lack of an effective distribution system. The chapter emphasizes the limited banking facilities, and the lack of appropriate supporting infrastructure (such as technology development, export promotion, business and entrepreneurship development programs). This chapter examines the existing banking institutions, suggests the basic banking services needed for private SME development, and reveals the main constraints

to the development of better banking services. It also provides a review of the major initiatives to increase supportive services to the private sector to date.

X. The chapter argues that private firms in Poland have had access to few of the supporting services available within market economies, particularly the more advanced industrial economies. The major part of the existing public sector support infrastructure, such as trading companies, training institutes, banks, and research facilities, have operated to meet mainly the needs of large, state owned enterprises. Institutions, such as chambers, associations and societies, which have focused on the needs of the private sector, have tended historically to have non-commercial orientations and to emphasize policy advocacy. This situation has begun to change recently. However, while all the above institutions display enthusiasm and determination to develop their service capabilities, they are weak in market economy experience and in financial resources. Thus, much needs to be done in this area.

XI. Chapters II through IV draw attention to the rapid recent emergence of the SME sector in Poland, and at the same time, point out the constraints to their growth during the period of Poland's transition towards a market economy. Chapter V puts forth specific recommendations to relieve these constraints, and proposes a strategy for assisting the development of private SMEs. Even assuming that policies and legislation currently being implemented manage to place the private SME sector on an equal footing with state-owned enterprises, there still remains a need for a proactive program to promote an economic and business environment conducive to the development of the sector.

XII. The recommendations included in chapter V are presented as an agenda of measures and/or initiatives to introduce government supporting mechanisms -as found in most market economies- for the operation and expansion of the private SME sector. As such, their implementation would be gradual and the completion of the overall program might take several years. The chapter includes also a preliminary proposal for their time phasing.

XIII. These recommendations are structured in five action areas.

- Action Area I refers to policy formulation and the regulatory framework, which include proposals aimed at formulating appropriate SME policies, simplification of regulatory arrangements, and establishing centers of information. To ensure consistency in policy formulation, and in designing government contributions and delivery arrangements for the various programs and actions proposed, the report recommends the establishment of a Central Organizational Unit, which would also play an instrumental role in formalizing mechanisms to support local governments, locally based organizations, and private groups in designing and implementing programs (as described in Action Areas III, IV and V below) for the strengthening of the local or regional SME sector.

- Action Area II focuses on actions and programs to develop the aspects of the financial sector to address SMEs' needs, and recommends complementary actions which would allow SMEs to transact with formal financial sector institutions. Perceptions of high risks and costs keep many banks from lending to SMEs. Banks require high levels of collateral, and SMEs encounter major problems in obtaining long-term financing and more innovative financing such as equity participation or leasing arrangements. The recommendations included on an apex institution, export financing, equity financing, leasing, SME credit lines, microenterprise financing, SME loan guarantee schemes, etc. attempt to address these issues. The report proposes the establishment of an apex institution, which would play a catalytic role in guiding and assisting the banking institutions in the provision of term financing and other financial services for private SMEs. The recently established Polish Development Bank could serve as such an apex institution.
- Action Area III focuses on the support programs for technology, export and entrepreneurship development. Technology support programs include, for example, the establishment of technological seed grant programs for partial funding of product development costs of SMEs to enter new export markets; and the development of science parks to provide the facilities for stimulating the growth of SMEs with strong technological capabilities. Export development programs include initiatives to assist SMEs in entering the export markets; such as the availability of improved export market information, introduction of trade dispute resolution mechanisms, etc.. Entrepreneurship development programs include mechanisms for channeling services to SMEs, and support for providing start-up assistance.
- Action Area IV addresses additional measures at the institutional and legislative level aimed at establishing a positive business climate for SMEs. These measures are important, particularly in the case of Poland where, mainly for historical reasons there appears to be an unfavorable sentiment to profit making by individuals. The proposals include: information campaigns for promoting a positive environment for profit-making activities; and mechanisms to support the development of local private sector groups, develop public procurement policies with full access for private SMEs, and to increase the participation of SMEs in regulated (by quotas or protocols) foreign trade markets.
- Action Area V addresses selective public sector physical and institutional infrastructure investments. This area includes recommendations to increase short term supply and improve market operations of business space, and to identify short and medium-term arrangements to increase the supply of telecommunications.

XIV. The tasks of addressing all the areas identified is rather daunting, particularly when the necessary support mechanisms are almost non-existent. To develop the required institutional infrastructure and programmatic assistance a program of gradual implementation would need to be adopted. In the short-term, the strategy would relay in two main elements: (i) identification of basic support institutions (at the level of central government, local governments and private organizations) to be created or reinforced; and (ii) concentration of promotion efforts on competitive (or at least promising) firms to stimulate their growth. This initial modest and narrowly focussed program would, in a reasonable period of time, evolve to be a comprehensive assistance vehicle for the development of the private SME sector.

XV. The implementation of the proposed strategy and programs would require the establishment of the proposed Central Organizational Unit (COU), to instigate and coordinate specific support programs for the development of the sector. Initially, this unit would be rather modest, equipped with a highly qualified and motivated, but small in number, staff. However, as the program expands, this unit is to become a full fledged SME Development Agency. Examples of such a unit can be found in both developed and developing countries, e.g., the Small Business Agency in Japan, the Small Business Program in Ireland, and the Development Commissioner for Small Scale Industries in India. The recently approved Office of Government Plenipotentiary for Support of Enterprises and Economic Initiatives could assume such a role, provided it is launched with a clear definition of the scope of its mandate and staffed with selected, skilled and motivated professionals. The second main institution required to deliver assistance to SMEs is an apex lending institution, with a specialized refinance window for SMEs. The role of this institution may well be served by the recently established Polish Development Bank.

XVI. While these two institutions would be the pillars for addressing and ensuring that the main programs are put in place in the short-term, most of these programs are expected to be implemented with a large participation of private sector institutions and local governments. Most programs, while identified and financed fully or partially with government resources, would be implemented by private sector agents, through sub-contracting or other arrangements.

POLAND

REVIEW OF THE PRIVATE SMALL AND MEDIUM SCALE ENTERPRISES SECTOR

CHAPTER I - INTRODUCTION

A. Background

1.1 The Government of Poland has adopted and initiated a radical program of restructuring of the economy which aims at replacing the inefficient centrally controlled economic system by a competitive and decentralized market economic system. A key element in this transformation is the replacement of the present structure of production and service enterprises, which are relatively large in size and few in number, with a network of small and medium scale enterprises. This would permit a dynamic response of the enterprise sector to market signals and promote a more competitive environment. It is in this context that the Government is seeking to develop a program to aid the growth of the private sector, focussing in small and medium size enterprises (SMEs).

1.2 In the short-term, the development of this sector is expected to help the absorption of labor shed by the restructuring of state-owned enterprises and assist the stabilization program through a relatively quick supply response, particularly of consumer goods and services. In the longer-term, the development of a strong and competitive private SME sector in production is a necessary condition for the development of linkages (subcontracting, sourcing) between the SME sector and the larger enterprises in Poland, the absence of which has resulted in inefficient vertical integration of Polish industrial enterprises. In the service sector, the participation of private SMEs in domestic commerce and other services will improve the quality and efficiency of these services.

1.3 Overall support for these efforts is being provided by the Government's Economic Transformation Program (ETP), with emphasis on macroeconomic stabilization and structural adjustment including a liberalization of the foreign exchange and trade regime, freeing of most prices, and enforcement of financial discipline at the enterprise level. The ETP also comprises a program for the privatization of existing state-owned enterprises, and more forceful action to promote competition and to counteract monopoly practices. These policies (backed by required legislation) represent significant progress in eliminating fundamental constraints to the development of private SMEs. Following the enactment of the Law on Economic Activity in January 1989 and subsequent related legislation, many specific barriers to the establishment and growth of private sector enterprises have been removed. Equal rights have been granted to the state, private, and cooperative sectors.

1.4 Legal and policy changes alone, however, cannot remedy structural problems which have evolved for decades. An enormous gap exists today between the artisanal sector on the one hand and state monopolies, on the other, with little economic activity occurring at a medium-scale. This gap in the productive structure is reflected in the composition of output; industries are tooled to manufacture equipment for large-scale monopolies and state farms, but equipment needed by smaller enterprises, such as tractors appropriate for small farmers, refrigeration units for shopkeepers, or equipment for local dairy and food processors, is not produced. Given the goal of the Polish authorities of a rapid transition to a market economy, and given the embryonic development of the private SME sector, active programs of entrepreneurial development, including training, information and technical assistance are required to complement the changes in policies and legislation currently being implemented.

B. Purpose of the study

1.5 The purpose of the proposed study is twofold. First, to identify current and potential constraints limiting the expansion and efficiency of the private SME sector, and second, to provide Polish authorities with recommendations, in terms of policy instruments and institutional development actions, for establishing a sectoral development strategy. For these purposes, the study includes an analysis of both the policy and regulatory framework and the existing supportive infrastructure.

1.6 The concepts of SME and private sector are used interchangeably throughout the report. Currently the two concepts are essentially identical in Poland, because of, on the one hand, the overall size of private enterprises has been restricted until very recently, and in the other, the state-owned enterprises are, in general, large on scale. However, considering the recent developments in Poland, private sector activities might expand into large scale enterprises. The recommendations and strategy included in this report are addressing mainly the needs of the SME sector, and relate to enterprises involved in manufacturing and services activities.

C. Organization of the Report

1.7 The report begins with a description of the profile of private SMEs in Chapter II, based on official statistics as well as data gathered through a firm-level survey of a sample of enterprises. Chapter III presents an assessment of recent policy reforms and changes in the regulatory framework, including the privatization program, and their impact on SMEs. It also examines the initial response of these enterprises to the changes and their expected long-term adjustments. Chapter IV reviews the principal remaining constraints to the appropriate creation, adjustment and growth of private SMEs. The limited capabilities of the banking and financial sectors are emphasized as the most significant constraints. Weaknesses in other supporting institutions, related to technology development, export promotion, business and entrepreneurship development programs, are also examined, as well as limitations in the physical infrastructure such as shortages in office or

factory space, or telecommunications. A strategy to address these is proposed in Chapter V, with specific recommendations to address each of the main constraints identified in previous chapters.

CHAPTER II - PROFILE OF THE PRIVATE SME SECTOR

A. An Overview

2.1 The private SME sector in Poland comprises three categories of enterprises: (i) Unincorporated businesses, i.e., sole proprietorships and partnerships, also known as 'natural persons'. This category includes the Polonia firms which are SMEs owned by non-residents, which for legal purposes are considered to be 'private individuals'. (ii) Incorporated businesses, which are limited liability and joint stock companies. (iii) Joint ventures, i.e., firms involving foreign investment under the Law for Foreign Investment^{1/}. Until recently, private sector enterprises were defined only from a legal point of view, and it is assumed that, as a result of restrictive legislation for private sector activities enforced until early 1989, all of them are under the category of SMEs. A new classification for enterprises, based upon the number of employees was adopted in January 1991. According to this classification small enterprises are enterprises with less than 50 employees, medium size enterprises are enterprises with more than 50 employees but less than 300 employees. Currently, all statistics reflect the legal classification. Their activities include manufacturing, construction, and services.

Table 2.1 An Overview of the Private SME Sector
Participation of Private SMEs in the Economy - 1989

	Total Exports %	Exports to CC* Areas%	Ind. Output %	Ind. Empt. %
Unincorporated firms (of which Polonia firms/a)	1.2 (1.2)	2.2 (2.2)	7.7 (0.5)	10.9 (1.9)
Incorporated firms	1.0	n.a.	0.7	1.9
Joint Ventures b/	1.9	3.7	1.6	1.9
Total Private SMEs	4.1	5.9	10.0	14.7

* Convertible currency areas

a/ Mainly industrial SMEs owned by non-residents.

b/ This includes all joint ventures, regardless of size. The Law permitting Joint Ventures with foreign capital for private individuals was enforced in 1986.

Sources: - Foreign Trade Research Institute, Warsaw (1990); Central Statistical Office, Warsaw;
World Bank Data (Report No. 7998-POL, January 1990).

^{1/} Since January 1, 1990, when the latest amendments to the Law on Foreign Investment were enforced (Act on Economic Activity with the Participation of Foreign Parties), all firms with foreign participation, (i.e., Polonia firms and joint ventures) are treated equally. Polonia firms operating under the previous law (Law on Economic Activity of Foreign Small-Business Firms; 1982) may continue to do so until their current permits expire or alternatively may asked to be recognized as companies operating under the new Act.

2.2 Two striking characteristics of Poland's private enterprise sector, are first, its small size and limited contribution to the economy, and second, its rapid recent development, in response to changes in policy. This rapid evolution suggests that despite its limited role today, the sector could be a major source of dynamism and growth in the near term.

2.3 As of December 1989, there were some 800,000 private SMEs of all categories in Poland, as compared to around 9,000 state enterprises. Yet these SMEs accounted for only 10 percent of industrial output, and around 15 percent of industrial employment (Table 2.1). The contribution of this sector to aggregate exports was even lower, at 4 percent, although the proportion of their exports in convertible currency was somewhat more significant (6 percent). The limited role of the private SME sector in Poland is even more evident if compared with other countries (Table 2.2). In most industrialized countries, around 40 to 55 percent of total employment in industry is accounted for by firms employing less than 200 persons and in some countries (e.g. the Netherlands) the share of such enterprises can be as high as 75 percent.

Table 2.2 An Overview of the Private SME Sector
A Cross-Country Comparison

Countries	% share in Employment ^{a/}	% share in Industrial Output
USA	58.2	52.6
UK	44.3	41.1
Italy	53.7	50.5
France	40.3	30.9
Netherlands	75.0	n.a.
West Germany	43.4	31.9
Japan	54.4	41.2
Thailand	49.8	n.a.
Korea	35.6	n.a.
Poland	<u>14.7</u>	<u>10.0</u>

^{a/} Small and Medium Enterprises are defined to be those which employ 200 workers or less, for all countries except Thailand and Korea (100 workers or less). For Poland, see Table 2.1.

Sources: Small and Medium Size Enterprises in Developing Countries (1986), World Bank; Table 2.1 data.

2.4 Despite its small size, this sector has shown remarkable dynamism since the early 1980s. Its rapid growth (Table 2.3 below) has largely been the consequence of the removal of a number of constraints through policy reforms. Between 1981 and 1989, the total number of private SMEs grew from around 350,000 to over 800,000. Of these, around 155,000 small unincorporated firms were added between 1988 and 1989. During the first half of 1990, the number of enterprises continued to grow at a rate of 9 percent over the semester to

reach a number above 900,000, increasing their contribution to the industrial production to about 13 percent. Probably more significant in terms of investment, the number of incorporated businesses grew from less than 2,000 in 1988 to over 10,000 in 1989, and to over 12,000 in the first half of 1990. The total number of private sector joint ventures registered grew from 32 in 1988 to 265 in 1989 and to 1,290 in the first half of 1990. These are clear signs of the remarkable transformation which this sector is undergoing today.

Table 2.3 An Overview of the Private SME Sector
Number of Firms and Employment

	<u>Number of firms</u>					<u>Employment (000s)</u>				
	1981	1985	1988	1989	1990c/	1981	1985	1988	1989	1990c/
Unincorporated firms (of which Polonia firms)a/	357,000 (78)	481,400 (683)	659,556 (689)	814,462 (727)	886,977 --	653 n.a	954 (54)	1,19 (82)	1,500 (100)	1,556 --
Incorporated firms	n.a	n.a	1,275	9,852	11,890	n.a	n.a	n.a	141	142
Joint Ventures b/	n.a	n.a	32	265	1,290	n.a	n.a	n.a	29	142

a/ Mainly industrial SMEs owned by non-residents.

b/ This includes all joint ventures, regardless of size. The Law permitting Joint Ventures with foreign capital for private individuals was enforced in 1986.

c/ As of June 30, 1990

Sources: - Foreign Trade Research Institute, Warsaw (1990); Central Statistical Office, Warsaw; World Bank Data (Report No. 7999-POL, January 1990).

B. An Analysis by Category

2.5 Until 1986, when the law on Foreign Investment was enforced, for all practical purposes the only legal form of ownership generally available to Polish entrepreneurs was the unincorporated firm or proprietorship. Such units included craftsmen, persons engaged in trade and services and some small manufacturing enterprises. Since 1988, as a result of changes in tax and labor legislation, private entrepreneurs began to establish partnerships as well as joint-stock and limited liability companies (spolka)^{2/}. These are classified as incorporated firms. Another significant change in 1988 was an amendment to the Law on Foreign Investment to allow private individuals and enterprises to enter into operations with foreign partners or Joint Ventures.

2/ This alternative was allowed by the 1934 Code of Commerce (revised in 1964) but until the changes in tax and labor legislation of 1988 were introduced, there was little incentive for adopting this form of organization.

In 1989, there was a further elimination of a series of severe restrictions on private initiative with the enforcement of the Law on Economic Activity leading to the significant increase in the number of SMEs and change in their composition, as noted above.

1. Unincorporated Firms

1a. Domestic Ownership

2.6 Until 1989, the growth of private businesses was restrained by ceilings on the number of employees allowed, which was limited to 50, and by the sectors and activities they were allowed to enter. With the abolition of all regulations on numbers of workers and most limitations on sector of activity in January 1989, the number of self-employed people increased from 1.1 million to over 1.5 million over a year and half (Table 2.3). Around 55 percent of the firms in this category are in manufacturing; the rest are in trade and services.

2.7 This small-scale sector is highly volatile with many new entrants and a large number of rapid exits. On average, around 40,000 new enterprises began each month in early 1990 while about 16,500 per month were closed. Most are located in the major cities (Warsaw: 91,750, Katowice: 71,400, Lodz: 55,600, Poznan: 48,400 and Gdansk: 37,500). The average size of enterprise remained small, at 1.3 persons per firm.

1b. Polonia Firms

2.8 Between 1982 and 1986, when the Law on Joint Ventures was passed, foreign investments were limited to those permitted under the 1982 Law on the Principles of Running Small Scale Industry Businesses by Foreign Persons. The government had expected, when first permitting this category of enterprises, that they would both increase the range of goods for domestic markets and raise hard currency exports. By the end of 1989, over 700 Polonia firms, with an average employment of around 140 workers per firm, were established (Table 2.3). Most of these (88 percent) are industrial enterprises engaged mainly in food processing, chemicals and plastics, wood products, electronic equipment and footwear. Sales data indicate that the bulk of production by these firms has been for domestic markets with a maximum of 10 percent devoted to exports in 1988^{3/}. In absolute terms, however, their exports almost doubled in a single year, from 1988 to 1989 (from US\$ 118m to US\$222m) and the proportion of these destined for hard currency areas rose simultaneously, from 55 to 70 per cent. Since 1990, Polonia firms are regulated by the Act on Economic Activities with the Participation of Foreign Parties, and are included under Joint Ventures or firms with foreign participation.

^{3/} Exports are estimated to have increased to 17.2 percent of production in 1989. However this is attributable mainly to the devaluation of the zloty.

2. Incorporated Business

2.9 The fivefold increase in the number of incorporated enterprises between 1988 and 1989 (Table 2.3), represents an impressive response to the new Law on Economic Activity. Industrial activities accounts for about 25 percent of the 10,000 new incorporated enterprises. The remaining firms are roughly equally divided between construction and other sectors of activity, such as trade and services.

Table 2.4 Incorporated SMEs of the Private Sector
(December 1989)

	No. of Units	Employment	Gross value of Fixed Assets ----- (million zloty)	Sales	Exports
TOTAL	9,852	141,202	209,528	2,652,925	186,762
Industry	2,452	42,117	52,481	716,514	65,581
Fuel and Energy	12	70	18	886	61
Metallurgy	8	105	1,073	1,882	329
Electro-Mechanical	996	14,219	11,960	233,800	25,389
Chemicals	191	2,906	5,480	53,619	3,918
Minerals	270	4,202	3,721	62,419	322
Wood and Paper	211	3,011	8,788	35,149	1,77
Light Industry	489	11,529	9,366	112,103	1,337
Food Processing	89	3,990	9,833	184,394	30,583
Construction	2,509	44,691	51,750	701,328	8,586
Other Material Production	1,996	29,250	57,594	545,587	32,536
Non-Material Services	979	7,343	5,214	143,861	17,271
Trade	1,235	10,660	23,614	448,960	53,530
Transport	78	730	12,665	15,338	4,505
Agriculture	37	399	404	5,250	2,278
Other	566	6,012	5,806	76,087	1,475

Source: Central Statistical Office, Warsaw.

2.10 While the size of such companies varies widely, from very small workshops with three to five workers to factories with several hundred workers, the average company is small, with 14 workers, US\$3,200 in fixed assets, US\$41,400 in sales, and US\$2,900 in exports.^{4/} Within this group, the average industrial enterprise is somewhat larger (17 workers and average annual sales of US\$ 45,000) and more export-oriented, with average annual exports of US\$ 4,200. Note that while the average ratio of exports to total sales is only around 7 percent for all enterprises and 9.3 percent for industrial enterprises, the ratios for certain branches of industry (electro-mechanical and food processing) are considerably higher, at 11 percent and 17 percent, respectively.

^{4/} The exchange rate used is 6,500 zloty/US\$1.00 (December 1989). Note however that given tendencies to underreport for tax purposes, a downward bias is likely in the figures on the value of fixed assets, sales and exports.

3. Firms with Foreign Participation - Joint Ventures

2.11 Growth of joint ventures has been even more recent, and more rapid, than the former two categories. Of the 1,290 joint ventures licensed as of the end of June 1990, 1238 had been created since January 1989. About half of them are already operational. The total initial capital of these enterprises was US\$350 million at the time of licencing, of which 52 percent (US\$186.8 million) was foreign capital. The size of these firms, with an average total capital of US\$315,000 per enterprise is thus several times larger than even the private incorporated firms, whose average fixed assets were around US\$3,300 per enterprise^{5/}. The share of foreign capital in total capital is US\$50,000 or less in 39 percent of firms, between US\$50,000 and US\$200,000 in 59 percent of companies, and over US\$ 1 million in 2 percent of firms.^{6/}

2.12 Foreign investment thus far accounts for a small share of the Polish economy. Sales by joint ventures account for 1.9 percent of total sales of goods and services, 3.7 percent of hard currency exports, 1.6 percent of employment and 1.8 percent of enterprise profits. Explanations for the small size of foreign investment in Poland relate to the time-horizon required to put together large ventures, the uncertainties of the political and economic climate in Poland and the fact that a large number of the new investors are natural 'persons', mostly Polish émigrés.

2.13 Investors from Western Europe and the United States predominate among the foreign partners. West German investors hold shares in 404 firms (41 percent of all joint ventures registered and 21 percent of total foreign investment). Sweden follows with shares in 101 companies (9 percent of firms and 10 percent of foreign investment). Other investors, by size of investment, come from Austria, the United States, Great Britain, France, Holland, Italy, Switzerland, Belgium, Canada and Denmark. Nineteen companies with Soviet share capital and five with multinational shares were registered in the past year.

2.14 Most of joint ventures are small companies established by local entrepreneurs with a foreign partner, who is of Polish descent. Large joint ventures include the Kvaerner Gdynici Shipyard in Gdansk with Norwegian investment of US\$35 million; Intercell with US\$20 million from Sweden,; and SIPMA with US\$20 million from Italy. The industrial composition of these firms is similar to incorporated firms, with many firms engaged in fruit and

5/ Note however that these figures do not imply that joint ventures are ten times as large as domestic incorporated enterprises. The total capital cited for the joint ventures is likely to include both debt and equity, taken from the new corporation's liabilities, while the fixed assets cited for the latter are only one major element of the company's assets.

6/ Regulations on joint ventures, introduced in December 1988, require that new foreign investors put in not less than 20 percent of the total and a minimum of US\$50,000.

vegetable processing^{7/}, followed by clothing, furniture and other industries. Some significant joint ventures are also engaged in service activities.

C. Firm-level Survey

2.15 In addition to the information gathered from the official sources of data referred to above, some data were also collected through a firm-level survey of thirty-five enterprises, undertaken in May 1990^{8/}. This was intended to supplement the aggregate statistical data presented above with qualitative information on the characteristics of SMEs, the impact of the economic reform program on their production, and on the constraints to their further growth. Details of the sample are given in Annex 1.

2.16 It was found that like traditional small businesses elsewhere, the majority (85 percent) began with personal savings: few have applied for loans from financial institutions (38 percent) and few still have received them (8 percent short-term and 15 percent long-term). The current business is the first one owned by 65 percent of people. The owner takes care of virtually all aspects of business management except for the few larger firms that employ an accountant to handle accounting, tax preparation, and payroll. Entrepreneurs in this sample came from state firms directly or through spin-offs (41 percent), from families that were already in private business (25 percent), and through foreign contacts and/or sponsorship (9 percent).

2.17 The unusual characteristics of small firms in Poland which were observed include, first, their relatively close links to state firms. Seventy eight percent of these enterprises buy most raw materials from state companies and 46 percent sell their finished products to state firms.^{9/} Second, private entrepreneurs in Poland are remarkably well-educated. Two thirds of the persons interviewed were college or university graduates, typically with engineering or technical qualifications, while 17 percent had post-graduate degrees.

2.18 At the same time it was also noted that most firms are even more isolated and technically out of date than expected. Equipment in many cases is very old; even if recently purchased, it is often second-hand. Many

7/ Agricultural processing enterprises receive a six-year tax holiday and require minimal amounts of start-up capital.

8/ Firms surveyed were pre-selected by the Office for Ownership Changes and therefore may reflect a bias toward larger and more successful enterprises. The geographical distribution of the sample was: 11 firms in Warsaw, 6 in Krakow, 5 in Gdansk, 7 in Wroclaw and 6 in Poznan. Details of the sample characteristics are given in the Appendix I.

9/ Given that more than 90 percent of Polish industry is in state hands, this finding is not surprising. It is of interest because it is different from many developing countries where linkages with large and/or state firms are weak.

entrepreneurs have seen up to date equipment in catalogs but have little basis for choosing new equipment and no prospects for financing it.

D. Conclusions

2.19 The survey of the SME sector suggests that, although small today, the sector is growing rapidly. Moreover, it is highly responsive to policy changes; time lags between the introduction of such changes and the establishment of new companies are remarkably short. At present, growth is particularly rapid in the types of private enterprises (incorporated companies and joint ventures) which are larger and more ambitious than the traditional sole proprietorships. Further, the shares of these enterprises in employment and exports are usually higher than average, suggesting that the sector would have a useful role in absorbing labor shed from large enterprises as they restructure, and in earning convertible currency.

2.20 The outdated technology and poor condition of the equipment of these firms can be remedied. Relatively limited access to, and use of, institutional finance for such purposes is a major issue. It must also be noted that, despite the large net growth in such enterprises, a large proportion fail, reflecting the fact that difficulties still remain in the new environment. On the positive side, many small enterprises have already begun to establish the links with large state owned companies that could eventually help the transformation from the vertically integrated production structure of industry. There is a need to examine these links more closely and see whether they are linked to subcontracting arrangements, which industries they predominate in and how they may be fostered. Detailed measures to address these issues are discussed later in the following chapters.

CHAPTER III - RECENT POLICY DEVELOPMENTS AND ADJUSTMENTS OF PRIVATE SMEs

A. Introduction

3.1 Poland's Economic Transformation Program (ETP), inter alia, aims at rapid liberalization of markets. It also aims at establishing a level playing field with regard to policy and incentives for all agents in the economy. This is a strong move away from the tradition of the last forty years, where direct and discriminatory intervention was the rule. This chapter combines firm level surveys and an analysis of the adjustment program from the perspective of the SMEs to provide a coherent picture of their situation today. In particular, the first section reviews how the macroeconomic adjustment program affected SMEs; the second section looks at how SMEs adjusted to these reforms; the third section reviews why many firms have problems operating in the new environment; and the final section concludes that Poland has not yet adopted a consistent, overarching policy for SMEs, and even though a number of policies supporting SMEs have been taken, they have not been taken in the coordinated fashion needed to enhance their impact and effectiveness.

B. The Impact of the ETP on Private SMEs

3.2 Poland's ETP aims to stabilize the economy quickly, and to deepen structural changes as a means to improve resource allocation and elicit strong supply responses. The main elements of the stabilization component are price liberalization, unification of foreign exchange rates along with adoption of a new foreign exchange regime, restricting temporarily wage increases to a fraction of price increases, fiscal balance, tighter credit policy, and positive real interest rates. The main elements of the structural reform are, enterprise reform and restructuring with an increasing private ownership, the overhaul of the banking system, trade liberalization, and the establishment of a social safety net outside the enterprises.

3.3 In January of 1989, Poland introduced a major legislative initiative for the promotion of the private sector, namely the Law on Economic Activity. This law gave business a freer hand. This law removed restrictive licensing and registration requirements for private firms, eliminated limits on the number of employees private firms can hire, and opened up to the private sector activities formerly restricted to the socialized sector. Subsequent legislation has reinforced the foundations for the creation of a competitive economy.

3.4 The new laws include the Law on Foreign Economic Activity (as amended in December 1989), the Law on Counteracting Monopolistic Practices (effective in April 13, 1990), the Bill on Cooperatives (passed in early March, 1990), amendments to the Law on Premises (passed in May, 1990) facilitating access to premises ("local uzytkowy") for private businesses, the Law on Privatization passed in early July, 1990, and amendments to the Law on Land Economy and Real Estate (forthcoming), which will facilitate the practice of perpetual leasing (up to 99 years) of land for private enterprises.

3.5 Government agencies have been created to execute and monitor the implementation of the new legislative and regulatory framework. The Agency for Foreign Investment is responsible for both the administration and approval of foreign investment as well as for the promotion of foreign investment. The Anti-monopoly Office is responsible for initiating demonopolization efforts, counteract monopoly practices and promote competition. As a result of the approval of the Law on privatization, a new Ministry was established which is to be responsible for privatization of state property, and for promoting the development of the private sector.

3.6 The Government's overall strategy has been to introduce a comprehensive and consistent package of legislation in order to avoid a repetition of the bad experience from the piece-meal approach reforms of the 1980's. This package of legislation is expected to contribute to a competitive environment by reducing barriers to entry, establishing a level playing field for economic actors of different scale and ownership, opening the economy to foreign trade, demonopolizing and breaking up large state enterprises and cooperatives, and privatizing large sectors of the economy. As described in Chapter II, soon after the enactment of the Law on Economic Activity in early 1989, registration of enterprises in all types of initiatives boomed.

3.7 Price deregulation eliminated the administrative allocation of inputs and facilitated the access to raw materials and inputs for private SMEs. However, as a result of stabilization, domestic demand fell sharply during the second quarter of 1990. Reductions in demand from large state-owned enterprises, reductions in consumer purchasing power of consumers and growing import competition have had an adverse impact on demand for SME goods.

3.8 Higher nominal interest rates and adjustable interest rates, while contributing to the fall in demand, have not affected SMEs directly since SMEs traditionally draw funds from personal savings and profits. The tax on excessive wage increases has not affected most SMEs directly, since most SMEs are unincorporated, and as natural persons for tax purposes, these firms are exempted from the tax.

3.9 Reforms in foreign exchange and trade policies have had a substantially positive effect on SMEs. Certainly one of the boldest and most important steps taken in January, 1990 was the introduction of "internal convertibility" of the zloty, which replaced the multiple rates of exchange with a uniform rate at which foreign exchange could be freely traded. At present, firms and individuals can acquire foreign exchange within three to five days - a drastic improvement over the past. In addition, specifying transactions which are restricted (negative list) instead of those which are permitted has introduced transparency and simplicity to the trade practices.

3.10 To date, it seems that the Government has largely succeeded in opening its economy to foreign trade and in dealing in an internally convertible currency. In virtually all enterprises studied foreign exchange availability, import and export permits and trade duties no longer posed any barrier to the flow of goods and services. As part of the liberal trade regime, the government has eliminated virtually all quantitative restrictions on imports from convertible currency countries, and at the same time, import duties have

been reduced and rationalized. Similarly, Polish exporters face a much liberalized regime in which most of the quantitative constraints have been eliminated and export taxes substantially reduced. Furthermore, all firms are permitted to import and export directly, a freedom which has increased the competition faced by local producers. While the state trading companies still channel 80% of Polish exports (in value), their dominant position is under pressure. Exporters in need of imported inputs may take advantage of a duty-drawback scheme; no exports subsidy schemes exists.

3.11 Important tax reforms are: the unification of income tax treatment vis a vis state-owned companies by reducing the maximum rate on income tax for legal persons from an upper limit of 85% to a uniform tax rate of 40% (for natural persons the tax rate was reduced from 75% to 50%); some simplification of procedures for the smallest firms that pay on a lump-sum basis; the unification of sales taxes for socialized and private firms; the elimination of the turnover tax on inputs of private firms as of May 1, 1990; one to two year income tax holidays for new small private ventures in selected fields; and, the exemption of the "excessive" wage tax for unincorporated firms (natural persons). Annex 2 presents the main changes in the tax system introduced in 1990 and the taxation system as it is currently being enforced.

3.12 As a result, taxation procedures for most unincorporated private firms in Poland have been greatly simplified with respect to the past; and assuming a degree of unreported income, marginal rates for private businesses have been moderate. In fact, taxation does not appear to have been a disincentive for unincorporated firms to work, save, and invest.

3.13 However, still greater simplification is needed if Poland is to advance towards a true market economy. For example, larger incorporated SMEs and firms wishing to expand, face drawbacks stemming from the complexity and fluidity of the tax system. Since 1981, and up through the first half of 1990, Poland has introduced complex and frequent changes in tax laws and regulations for incorporated SMEs. The result is a tax system that, while relatively simple to comply with for most of the unincorporated enterprises, still represents operational difficulties for incorporated firms.

3.14 The forthcoming value added and personal income tax will have a dramatic impact on SMEs. This study did not review the substance of these reforms or the means by which they will be implemented; however, the changes in the tax system are an area of concern. Marginal rates that are too high, and intricate compliance procedures and documentation requirements could have significantly adverse effects on entrepreneurs.

3.15 In conclusion, the regulatory reforms affecting SMEs have occurred chiefly in the areas of price deregulation, reduction of entry barriers, trade reform, tax reform, and a number of laws aimed at promoting competition have been passed. At the macroeconomic level, key reforms have been foreign exchange rate unification, internal convertibility, adoption of adjustable interest rates, and higher nominal interest rates.

C. Response of Private SMEs to the Reform Program

3.16 Firm level interviews indicate that the economic reform begun in January of 1990 has squeezed profit margins on most firms in the private sector. Costs have gone up and demand has dropped considerably, and competition has increased from other firms and from imported goods. Twenty-one percent of enterprises interviewed said that production had increased, while 72 percent reported a decrease in production, in response to falls in demand. In spite of the high percentage of enterprises that have been adversely affected by economic reform, 96 percent still report profits, although a number have been reduced to minimum profit levels; others have shifted into exports or found new niches.

3.17 The unevenness of the impact is evident in the responses to questions concerning production costs and prices. As compared to January 1990, in relation to their costs of production, 57% of firms report that the cost of inputs has risen by more than 25%; 54% of firms said that labor costs have risen by 25% or more. Prices of final products have not risen on a commensurate basis: 32% of firms report that they have dropped their prices due to competition and flagging demand; 26% have maintained prices at the same level; 10% have raised their prices by up to 50%; and 32% are charging more than double their prices in January 1990.

3.18 The explanation for why a third of firms dropped their prices while a third doubled theirs goes to the heart of why some firms are maintaining a strong profitability while others are losing their competitive edge. Those who are overcoming the costs associated with the adjustment program have found niche markets where they essentially can exercise monopoly power; or these firms have shifted, partially at least, into exports. Examples include a service firm that overhauls large machines used by state firms and a jewelry exporter that has established strong markets in Europe. Firms that were forced to drop their prices are those that face stiff competition, from imports or from new entrants that find it easy to overcome the low entry barriers. Depressed demand from consumers and state firms has further stiffened competition. Examples include a small ceramic block maker, a firm that produces circuit boards for state enterprises, and a garment maker.

3.19 Clearly the adjustment program has introduced effective competition into the private sector, causing a higher level of efficiency. Many firms have responded with the dynamism and flexibility that one expects from the private sector, particularly for small and medium scale enterprises. With the legalization of private enterprise and the opening up of the economy, opportunities for the entrepreneur have expanded dramatically. Thirty-nine percent of firms are now exporting to both the CC market and the CMEA - 26 points are accounted for by direct exportation, and 13 points of the 39 are accounted for by indirect exports. Many firms indicated that they had switched into export production in response to the fall in domestic demand. Sixty four percent of firms indicated changes on their product mix since start-up and the most common practice reported was the introduction of new products. Eighty percent of respondents said that they had purchased some equipment (both new and used) since start-up.

3.20 In addition to the flexibility inherent in their small size and relatively independent decision-making, the ability of the private firms to respond quickly has been due to a number of reasons, namely:

- (i) private unincorporated firms were able to release workers until March, 1990, without notice or severance payments. Workers received immediate support from state unemployment benefits. Since March, this has been changed so that employers -both from the state sector as well as private sector- who release more than 10% of their workforce in a single month are required to pay severance costs.
- (ii) many firms accelerated their investments in new plant and machinery during 1989, to take advantage of the 50% investment tax credit. This credit was eliminated as of January, 1990.
- (iii) firms operate on a cash basis, even for investments, and this reduces their exposure to the increase in nominal interest rates.

3.21 In conclusion, firm level responses to the macroeconomic adjustment programs and regulatory reforms indicate resilience and dynamism. However, it is not clear whether this resilience will persist over the long run, as the implementation of the reform program continues. Furthermore, in spite of many positive reforms, strong constraints remain. The opportunity to continue to improve the regulatory environment and to channel the apparent energy of the private sector into productive activities and to help this sector meet the challenges of international competition should not be lost. Transition periods are a crucial time, for they lay the foundations for the future behavior of all economic agents, and the rules established now will ultimately determine the reform's success or failure.

D. Firm-level Constraints and Self-perceived Needs.

3.22 What are the major constraints to further SME development, as perceived by the small and medium size firms themselves? A review of an SME's capabilities, constraints, and self-perceived needs are the starting point for assessing its ability to adjust to a new environment. When entrepreneurs were asked about their three largest problems, the two largest, accounting for 25% of all responses, were lack of finance (lack of credit, inadequate banks, and excessive interest rates) and lack of skills and information (relating to improved technologies, accounting systems, management approaches, and knowledge of foreign markets). Other problems include: lack of domestic demand (15% of responses); taxes, both amount paid and the instability of tax regulations (8%); macroeconomic instability (7%); and poor state of telecommunications (5%).

3.23 Lack of finance is the most common complaint of small businesses - across countries. The extent to which it operates as a barrier can only be assessed at the firm level. Cash flow becomes a serious problem when demand drops precipitously. Many entrepreneurs look to external financing as a source of funds to bridge the gap. If low demand is a temporary phenomenon, as a

result of short-term hyperinflation and is expected to level out, lack of "bridge" financing is a serious constraint. Financing for restructuring and adjusting firm operations in the face of a changed economic environment can also be critical.

3.24 As in most surveys covering issues about constraints, it was expected that Polish SME owners would also emphasize credit as a major constraint for the expansion of their production and investment. That was the case. However, the survey also revealed considerable firm-level constraints to the capacity to adjust to market conditions from a great number of firms. The following are among the most essential ones:

- established business practices and expectations are not compatible with the new market oriented economy. The broad set of cultural and behavioral norms, the internal practices of management and labor, and the ways of servicing customers require change.
- existing management and entrepreneurial skills are those that were developed to serve a shortage economy. For instance, formerly, a premium was placed on the ability of owners or operators to maintain access to input supplies from socialized sector firms. In a shortage economy, quality control, financial management, pricing, and marketing are not major concerns. Now, the needs are different, and the management skills and information systems required are correspondingly different.
- technology used by most SMEs is outmoded. SMEs are ill-equipped for quality and design of products for external markets, and for the domestic market, as Poles begin to demand quality from their homegrown products. Cash flow alone will not be a viable source of finance for the investments required in technology.
- productivity in SMEs appears to be low, a situation related to historically low labor costs, work practices stemming from labor hoarding and the limited access to modern technology. Some SMEs report that productivity has increased recently as a result of lower absenteeism. Major increases, however, will depend upon the introduction of "best practices" in management and improved technologies.

3.25 The private sector in Poland is in transition. New opportunities have opened up as the old environment crumbles. On the one hand, firms that had the advantages of monopoly positions in a shortage economy now face competition (36 percent of firms report that their primary competition comes from other private firms). Much of the private sector has been tightly linked to the state sector for inputs and sales of final products. These linkages will weaken as the state sector is forced to reduce operations. Almost all firms have faced greatly increased costs and decreased demand for their products. On the other hand, opportunities abound for those firms capable of adjusting to the costs of doing business in a transitional economy. Raw materials are available (a vast majority of firms report that obtaining domestic and imported raw materials is no longer a problem); firms are free to develop

export markets; and Polish consumers, to the extent that they can afford consumer goods, are looking for new and varied products. However, these opportunities can only be fully exploited with complementary actions on the part of the authorities, local administrations, and the private sector itself.

E. Absence of a strategy for the development of Private SMEs

1. Current Status

3.26 The Government has made the development of the private sector in general, and of the SME in particular, a high priority. It is from the SME sector that the Government expects to increase competitiveness and efficiency in the system and to accelerate the country's growth. However, to date the bulk of legislative changes and reforms in the organizational framework are aimed at restructuring and transforming state enterprises and selling state assets. Actions to support existing and new SMEs are as yet few.

3.27 The many individual actions taken by various Government institutions are a step in the right direction, though, even if they require greater coordination. The most notable changes in the administration aimed at supporting the private sector are described in this section.

3.28 In early 1990, the Ministry of Finance established a unit within the former Office of Government Plenipotentiary for Ownership Changes (OGPOC). This office engaged in advocacy for small and medium size businesses. This unit collaborated with Economic Societies (see para. 4.27) and private businesses in identifying legal and institutional constraints to private development. As a result of this unit's work, specific tax incentives for SME enterprises were introduced (para 3.38).

3.29 The Ministry of Labor is developing programs - including the introduction of mechanisms for financial assistance (para 4.24) - aimed at supporting micro-enterprises set up by individuals laid-off by state-owned enterprises. The Ministry of the Domestic Market is in the process of developing a data base on SMEs involved in trade and services, and in establishing basic procedures (with the OGPOC) for the privatization of retail and wholesale state-owned enterprises. The Office of the Council of Ministers has also established a group to identify initiatives to support the development of SMEs in collaboration with an EC-supported program.

3.30 The recently restructured Ministry of Industry has established two departments to address the development needs of SMEs. One department is responsible for the promotion of SMEs and the other for research on SMEs. The main tasks are to: (i) initiate legal, economic and financial actions to support development of small business; (ii) assist the development of the private sector in production and services; (iii) assist in reprivatization of formerly private enterprises nationalized illegally; (iv) collaborate with chambers of commerce and enterprise associations; (v) assist in counteracting monopolies. However, because these departments are new, they have not yet formulated a strategy on how to carry out these important tasks.

3.31 In addition, among the different initiatives is one to support private businessmen through loans and equity participation from various government funds (drawing from the Ministry of the Domestic Market, Ministry of Industry, Ministry of Finance). Some government agencies are taking an initiative to establish specialized banks for this purpose. Similar efforts have been made by some regional Governments as well.

3.32 Recent institutional developments, however, are expected to have an important impact on -and clarify the role of the different institutions in implementing- the Government program to support the SME sector. As a result of the establishment of the Ministry of Ownership Changes in September 1990, the responsibility for Government programs to support the development of the SME sector have being transferred to the Ministry of Industry. To implement the Government programs, in late 1990 a new Office of Government Plenipotentiary for Support of Enterprise and Economic Initiatives was established.

3.33 The role of the proposed Plenipotentiary is to be vital as it would fill in the currently missing coordination of the various existing schemes; and in elaborating and implementing a long term strategy for the development of private SME sector. The Government agencies themselves have no programs for the development of SMEs, per se, yet there are numerous plans for restructuring funds for large state enterprises. Actions of local authorities are hardly coordinated: a wide variety of initiatives are springing up in isolation of basic guidelines which could provide the objectives, and the mechanisms for the achievement of these objectives. In addition, the limited exposure to, and lack of familiarization with, alternative programs and their relative merits for supporting the development of private SMEs will damage the trust in these programs if they are not properly implemented.

3.34 For these reasons, the commitment of the Government to support the development of the private sector may need to be reinforced through additional measures on the institutional front. The private sector, and particularly the SMEs, are forced to operate in the environment of the stabilization program, yet this environment still maintains most of the shortcomings of the previous institutional system. The structural reforms required for an efficient performance of the private sector are not yet underway. In particular, this is the case of those reforms related to banking and distribution systems and supporting institutional and physical infrastructure. Specific proposals for reforms and programs in these areas are elaborated in Chapter V.

2. Privatization Program

3.35 Privatization of socialized enterprises has begun for "small privatizations", or the de facto transfer of small and medium size enterprises in the domestic commercial sector to private owners. Privatization of large state-owned enterprises required the passage of the Act on the Privatization of State-Owned Enterprises, approved in July and enforced since August 1, 1990, after several months of preparation and discussions. Delays in approving this Act created some degree of uncertainty, particularly at the level of local governments. This generated spontaneous privatization based on local initiatives, through, for example, the sales of state-owned assets to

individuals or workers of the company on ad-hoc basis, due to the lack of a clear and uniform legal framework. Actions such as auctions of shop-space have taken place occasionally, generally with preferential treatment given to current managers or workers. There are instances of the transfer of the right of ownership through the granting of a perpetual lease, or of a lease with a first option to purchase space at a rent well below a market-clearing level. These approaches are subject to criticism with respect to the fairness of the transactions and with respect to the efficiency of asset management.

3.36 Initiatives to break up large state enterprises are in preparation, but have not yet had an impact on SMEs. The area which affects SME development the most is the privatization of trading establishments. Examples are the regional trade enterprises founded by local authorities or voivodes - known as WPHW -, the cooperatives operating in cities in trade of food products - Spolem -, and trade cooperatives operating in rural areas - Samopomoc Chlopska. These privatizations were undertaken by the Ministry of Domestic Market in collaboration with the OGPOC at the former Office of Government Plenipotentiary for Ownership Changes. Since August 1990, this responsibility has been transferred to the new Ministry of Ownership Changes. The disposal of state owned retail and wholesale shops and the cancellation of leases of municipally and privately owned shops will greatly increase the number of small privately operated trading establishments. The procedure for distributing the state and municipally owned shop space, and the retail equipment and inventories, is problematic, however. Voivodship and municipal authorities are given significant discretion in disposing of these assets. The procedures may not be completely transparent; a fair, competitive process for the distribution of shop space and warehouse space is not evident.

3. Gaps in recent policies and regulations

3.37 As described above, the main policies and the structural reforms undertaken by the Polish authorities have contributed significantly to the development of the private SME sector. However, recent developments and existing regulations have introduced some elements which need to be evaluated in terms of their consistency in establishing a level playing field for all agents in the economy. The cases in the following paragraphs are not exhaustive, but do serve the purpose of illustrating gaps in the policy and operating framework for private SMEs.

3.38 A principle that should be adopted in introducing tax incentives is that they be neutral, simple, and transparent, particularly regarding their administration and costs. These attributes can be found in the investment tax credit implemented in 1989. The response of many SMEs (75,000 firms were eligible for the 1989 investment tax credit, according to tax officials) to investment tax incentives and the use by 90% of SMEs (estimate of tax officials) of the simplified approaches to taxation indicates that the system has provided useful incentives and that compliance costs have been reasonable.

3.39 However, new tax incentives, effective as of May 18, 1990, provide temporary sales and income tax exemptions for quite detailed selected distribution, trade and services activities, thus differentiating among activities. This practice is highly undesirable and constitutes an dangerous

precedent for potential backsliding on the principles of transparency and simplicity of the new economic system. While the objective of the new tax incentive is presumably to facilitate the privatization of shops, aspects have been introduced which are worrying. The incentives attempt to stimulate entries into markets perceived as uncrowded in which more activity is desired (e.g., small trade) and to discourage entry into "crowded" markets. The incentives are so detailed that entry into "flower selling", for example, is discouraged while entry into other market gardening products is encouraged. It is certainly not clear that such specifically targeted incentive schemes will achieve their purpose.

3.40 The opportunity for a foreign presence in private ventures in Poland has been identified by the government as an important factor for SME development. Thus, current changes in legislation were made with an active foreign presence in mind. There is broad agreement that the Foreign Investment Law (FIL) as recently amended, is liberal, clear, and addresses the needs of the Polish economy and foreign investors. Despite the generally positive construction of the FIL, certain aspects of the law may in fact act to constrain foreign investment in Poland. Chief among these potential constraints is the restriction of dividends repatriation to 15% of profits, except in cases where the company has generated a net foreign exchange balance sufficient to cover the additional dividend repatriation.

3.41 Tax holidays provided exclusively to enterprises with foreign participation may require further consideration since they create a bias against domestic SMEs. For example, the preferential tax treatment of investments granted to enterprises with foreign participation may not be fully justifiable. Foreign investors may charge capital expenditures against taxable profits and receive relief on excise duties on imported capital goods. The possibility of accelerated depreciation is presently under consideration. In contrast, the 1989 provision which allowed SMEs to deduct 50% of their investment costs from taxable profits, was removed for 1990. Finally, there are no schemes for SMEs to carry losses forward.

3.42 Regarding the current business environment established for exporting SMEs, certain practices seems to be creating a biased environment: First, many export SMEs reported that large state enterprises are favored in the allocation of the export quotas (existing as a result, for example, of the endorsement of the "multifibre agreement") in products such as textiles and garments. SMEs, with fewer resources, and little knowledge of the system, have been less successful in gaining an allocation of certain quotas. Similarly, uncertainty with respect to trade developments in the CMEA trade protocol have introduced another element of concern among SMEs as the government-to-government trade protocols which govern trade among CMEA countries seems to be biased towards state-enterprises. Second, many exporters, and smaller firms in particular, lack the information on changes in tax and trade legislation as well as an adequate understanding of the trade and marketing links in their target export markets. While commercial firms and self-help organizations, such as trade associations, have started to appear to meet these needs, they lack the resources needed to help the SMEs master important policy changes and tap new markets. Third, only five banks are licensed to undertake foreign exchange operations. The banking oligopoly

that prevails in foreign exchange transactions raises the SMEs cost of access to foreign exchange, letters of credit, payment transfer services, and so forth. Limitations in this area encourage SMEs to pay cash for imports. Finally, there does not seem to be a formal mechanism for assisting enterprises in settling trade disputes. Firms with on-going trade disputes reported that they were unable to secure resources and did not know how to seek formal redress.

3.43 This chapter has reviewed the major macroeconomic and regulatory reforms in Poland from the perspective of the SMEs, and has indicated the responses of the private sector to these reforms, based on firm-level surveys and interviews. Although the private sector response revealed a surprising degree of dynamism and resilience, it also revealed a number of significant constraints to private sector activity which must be addressed and resolved. Government policy in particular requires greater coordination and consistency if Poland's obvious desire to support the growth of the private sector is to be translated into concrete results. The next chapter explores the most critical weaknesses in the operating environment of the private SME sector.

CHAPTER IV - WEAKNESSES OF THE BUSINESS ENVIRONMENT TO ADJUSTMENT OF SMEs

A. Introduction

4.1 This chapter examines the most critical weaknesses in the business environment in which SMEs are expected to operate in the immediate future. Efforts made to date, such as those analyzed in the previous chapter, are modest given the scope of the constraints which are: the lack of banking and financial sector capabilities, the lack of institutional support; and an inadequate physical infrastructure and the lack of an effective distribution system. The main emphasis of this chapter is first, on the limited banking facilities, and second on the lack of appropriate supporting infrastructure. In particular, this chapter examines the existing institutions, explores the reasons for weak credit demand, suggests the basic banking services needed for private SME development, and reveals the main constraints to the development of better banking services. It also provides a review of the major initiatives to increase supportive services to the private sector to date.

B. Banking and Financial Sector Capabilities

1. Key Institutions Serving the Private SMEs

4.2 Banking services for the private SME sector are not well developed. Until now they are provided mainly by cooperative banks, most importantly the eleven Craftsmen Banks. The Craftsmen Banks, possess a cooperative organizational form, but appear similar to joint stock companies with groups and individuals holding shares. The other estimated 1,670 cooperative banks operate as credit union-type organizations and serve mainly small farmers and small agricultural service and processing businesses in rural areas. The Craftsmen Banks and the rural banks were until May, 1990, part of the network of the Bank for Food Economy.

4.3 In terms of types of private business clientele, the Craftsmen Banks have traditionally served "craftsmen", the unincorporated private firms engaged in industry and related services. In practice, the banks serve private firms of all sizes. Since 1989 there has been a strong increase in their services to private limited liability companies. In foreign exchange related operations the Craftsmen Banks must use the services of one of the five banks which has a foreign exchange license. The PKO S.A., serves the estimated 730 Polonia firms, which are private unincorporated ventures involving the capital of foreigners of Polish origin.

4.4 The banking sector in Poland is dominated in terms of asset size by the large state-owned banks. These banks provide deposit services to individuals (mainly PKO-Savings) and basic domestic and external financial services to the socialized sector. More recently, PKO S.A. branches, PKO-Savings, and the new state-owned commercial banks are making efforts to develop services for private businesses.

4.5 Banking services for private businesses are limited. Banking services formally available to private businesses have been mainly payment orders, current account (checking) and savings deposit services, working capital and investment credits and inter-bank credit guarantees. With the exception of the deposit accounts, however, most of these services are rarely used by the private sector. Barriers to the use of these services have been high fees, slow processing, long queues, sparse networks of branches and offices and, for credits, high collateral requirements. To this can be added the recent phenomenon of high interest rates. Private businesses use the banks primarily for security and for savings facilities. Payments through the banking system, when utilized, are effected by (i) payment orders, (ii) bank confirmed checks or (iii) bank guaranteed checks, all of which are demand time consuming to arrangements and are slow to clear. Inter-bank payments, according to business people, require three to four weeks.

4.6 The expressed demand for and actual supply from the banking system of credit remains low. In spite of a great need for credit, institutional credit to the private business sector in proportion to the size of the sector is minimal. It is a situation in which the causality appears, in part, to be circular: limited credit services from the banks contribute to the development of alternative financing methods by private businesses which contribute to low demand for institutional credit. Of the total amount of credit outstanding at the end of 1989, 6.1% was to the private sector, including business and personal credits. Most of this credit to the private sector was for personal loans.

4.7 Loans to private businesses, other than to Polonia firms, are extended mainly by the Craftsmen Banks. An initial appreciation of the service level and credit demand of SMEs is given by the following data: of the 32,000 business accounts kept in Craftsmen Banks in Warsaw and Poznan, 15% had loans outstanding at the end of 1989, and 3% had loans outstanding at the end of April, 1990. PKO-Savings (Poznan), PKO S.A., (Warsaw, Wroclaw and Gdansk) and Bank Gdanski reported a combined total of approximately 250 credits outstanding to private firms at the end of April, 1990, not including Polonia firms. A new private bank in Poznan reported 19 loans outstanding to private businesses as of the end of April, 1990. Extrapolating roughly from these findings, an estimate was made of the proportion of private firms in the Poznan and Warsaw areas which have recently used institutional credit. It appears that less than 5% of registered private firms had credits outstanding at the end of 1989, and less than 1% at the end of April, 1990.

4.8 Credits to the private business sector have been small, with few loans above the equivalent of \$50,000. Banks report no significant problems with repayments by private firms, although forbearance was required in a few cases during the first quarter of 1990 due to the contraction of domestic demand. A more complete understanding of the use of credit by private businesses would require additional information on the credits through the whole banking system, but particularly on credit provided by the Craftsmen Banks.

4.9 Information provided by enterprises and banking sector representatives indicates that the growth of investment and output of the private sector during 1989 was accomplished without significant institutional credit. Credits

which were taken during 1989, including medium term credits for equipment and machinery purchases, were largely prepaid in full by the end of January, 1990, in response to the steep increase in interest rates.

4.10 Credit resistance under current conditions appears to be strong in Poland. Reduction of indebtedness was one response of private businesses to the economic situation of early 1990 and reflected a traditional resistance to using debt to finance long-term firm growth. Reasons reported for a lack of interest in credit included: the high cost of debt including both fees (including a 3% notary fee for putting on and taking off mortgage liens) and interest charges, high collateral requirements, the availability of high cash flows, concerns over weak market demand, concerns over payment for those exporting to Eastern countries, and uncertainty about the future economic situation.

4.11 SMEs also exhibit a tendency for cash-based, self-financing practices. In addition to limited access to sources of credit through the banking system and, in 1990, high nominal interest rates, the weak credit demand of private businesses in Poland is a characteristic of the business strategy of many Polish entrepreneurs. Private firms in Poland operate extensively on a cash basis for both purchases and sales. A common practice of Polish small entrepreneurs seem to be to travel abroad with large sums of cash to purchase equipment and machinery. Cash-based operations have helped to shield private businesses sector from uncertain political-administrative and economic risks and taxation. Many private firms during the 1980's grew to more significant size and entered into a wider array of business activities than strictly provided for under the administrative and legal system. Cash-based operations, less visible than operations through the banking system, provided the means for unrecorded business activities and capital accumulation. Over many years, the officially unsupportive policy environment in Poland for private business and the difficult business environment contributed to the establishment of the risk adverse, cash-based method of operating. Also, during 1989, cash payments as compared with payments through the banking system had become increasingly attractive to sellers of goods and services because of the rapidly accelerating inflation.

4.12 Small private businesses in Poland finance start-up capital requirements from personal resources, including funds saved from short periods of work abroad or remitted by family members resident abroad. Working capital, capacity expansion and modernization investments have been financed from cash flow and reinvested profits. Equipment leasing, which is a potential alternative avenue for financing start-up costs, is not, with few exceptions, available to private businesses in Poland. Self-financing is a frequent feature of small business financing in most countries. The use of self-financing in Poland, however, is practiced to an exaggerated degree and constitutes a serious constraints for the development of the sector. Apart from issues of limited banking sector services and high nominal interest rates, self-financing likely reflects owner/operator assumptions about firm growth and confidence in the policy and business environments. Willingness of SME owners to accept risks is conditioned by prudence in exposing assets which are often the personal and family resources of last resort. In a context

perceived as being high risk, self-financing is consistent with a business strategy of maintaining low fixed cash flow requirements.

2. Basic Banking Services for Private SME Development

4.13 This review considered the current role of the banks from the perspective of the requirements for the development of the private SME sector. A broader assessment of the banking system is currently under preparation under the context of a proposed Financial Institutions Development Project.

4.14 A review of the basic services provided by commercial banks to small and medium scale private businesses in market economies indicates the importance of these services to business development. The following services are not currently available in Poland or are available only in a rudimentary fashion:

- (i) Current account management, including on-line balance information and timely periodic reporting with transaction details, to permit firms to maintain funds in a secure location, to manage cash flow and to provide supporting documentation for internal accounting control.
- (ii) Night deposit facilities to permit businesses to place cash and checks received after banking hours in a safe location with entry into the current account on the following working day.
- (iii) Safe boxes to permit businesses to store important documents in a secure location.
- (iv) Automatic payments (standing orders) to effect selected payments without additional instructions from the account holder.
- (v) A range of savings instruments, such as higher interest earning fixed deposits, to permit small business to invest short term excess cash. In certain situations these might include foreign exchange deposits.
- (vi) Overdraft facilities to permit business to manage normal working capital requirements within reasonable limits.
- (vii) Working capital credits based on preapproved limits to cover, for example, pre-export and seasonal financial requirements.
- (viii) Branch networks and inter-bank connections to permit rapid transfers between accounts and wide access to services.
- (ix) International correspondent banking relationships to permit international transfers.
- (x) Letter of credit services to permit the normal operation of importing and exporting activities.

4.15 A second group of commercial banking services, provided directly by banks or in cooperation with non-bank financial institutions, which would be normally available to small and medium size businesses in many countries would include:

- (xi) Investment credits to permit expansion and modernization of firms.
- (xii) Acquisition financing to permit the sale or purchase of a business.
- (xiii) Equipment lease financing to permit business to take advantage of tax provisions and to lower the equity requirements for financing business investments.
- (xiv) Insurance services to secure loans and to protect the business.
- (xv) Guarantee schemes to permit banks to lend to otherwise sound investments which do not meet a bank's minimum collateral requirements.

4.16 Business advisory and networking services are normally provided through the discussions that banks have with clients as part of standard operating practice. 'Know your client' is the common maxim of commercial bank service sellers. It is a guideline which serves the mutual interests of the small businesses and the banks. Through knowledge of the client, the client's business, similar firms in the subsector and area, and the business environment, experienced commercial bank staff are well-informed and can assist the small business person to analyze problems and opportunities, to provide useful information, and to suggest options. From the perspective of the bank, this approach assists the bank to market a group of interest-earning and fee-based services to each client (which improves income flow for the banks while reducing risk through increased knowledge) and, when successful, helps the client's business to grow. This also improves the bank's income flow.

4.17 Finally, there is a wide range of additional financial services which are available to small and medium scale private firms in a more elaborated financial system. Perhaps most importantly, these include facilities for attracting equity and quasi-equity venture capital and insurance services which are not available as yet in Poland.

3. Constraints to the Development of Better Banking Services

4.18 There is a widespread recognition that a largely unindebted private sector now exists in Poland alongside a largely state-owned banking system which, with exceptions, is not geared to provide services to private businesses. Efforts to stimulate private sector development are thus widely viewed as being closely dependent for their impact upon efforts to reorient the services of the banking system, including through the entry of new banks private and joint venture banks.

4.19 A change in the direction of services provided by the existing banking sector in Poland would be required in order to provide services such as those listed above to the private business sector. The revamping of the sector to achieve a customer-driven service orientation with new, competitively priced service products would face considerable constraints. Key constraints to the development of banking services for private businesses include:

- (i) Banking services which are, ultimately, a result of the incentive structure for bank operation. The current incentive systems are more akin to those of large scale, public sector bureaucracies than those of commercial banks. Issues of ownership and competition within the financial sector will need to be resolved in order to establish incentive structures appropriate to the development of private business services.
- (ii) The skills of commercial and retail banking for private SMEs have not been introduced in Poland. Training and other forms of skills development is carried out internally by the individual banks with SME lending not being included within any training program. In a very limited number of cases attachments with Western banks, for example Barclays, have been used to provide short-term training, e.g., in letter of credit operations. The shortage of experienced and trained staff will constrain the rate of growth of financial services to the private sector.
- (iii) The banking information technology now in operation in the banks in Poland is outmoded. Major improvements in data processing based on new methods and procedures would be required to be able to provide effective services to private business clients.
- (iv) Critical shortages in institutional infrastructure, most notably a modern payments clearing system, and physical infrastructure, most notably in telecommunications, affect the ability of individual banks to improve services to businesses.
- (v) The weakness of accounting and auditing standards and the limited availability of suitably trained professionals in these fields makes valuations and determinations of the creditworthiness of firms extremely problematic for banks. New standards are scheduled to be introduced in January, 1991.
- (vi) The small current private business client base of the banks and the cash-based operating practices of most private businesses creates difficulties in establishing the credit histories (if any) of potential credit applicants.

4. Major Initiatives to Increase Banking Services to Private SME Sector

4.20 A number of initiatives for Polish, bilateral, and international organizations have been developed in an attempt to address the various

constraints imposed by the lack of adequate banking services to the private SME sector; the following are among the most important ones:

4.21 Establishment of New banks. One approach to the development of increased banking services for private businesses is to develop new banks. Reportedly, twenty new banks have been granted licenses as of May 30, 1990, five are operational and an additional 20 applications are being considered. Also, there are several new banks which are in the early stages of formation. None of the new banks have been given a foreign exchange license. Most of the new banks are focusing on the private sector. In addition to confronting the constraints listed above, with the possible exception of the incentive system issue, most of the new banks face difficulties imposed by low capitalization.

4.22 Creation of Apex financing operations. Two major apex financing institutions for SMEs are included within the proposed uses of the significant sums of assistance available from the EC and the U.S. government. A proposed development bank to be established with EC support could include among its activities a specific focus on small private firms: (i) a window for refinancing SME credits made by a selective, small group of banks; (ii) an SME loan guarantee scheme; and (iii) a capacity to train bank staff and to develop the capacities of intermediary agencies in SME credit and related activities.

4.23 The American Enterprise Fund, with US\$240 million over three years at prevailing market terms, would have a strong focus on SMEs, including: (i) a possible development-type bank which would refinance SME loans; (ii) a possible venture fund operation for investments; (iii) a technical assistance component for supporting, among other things, SME related institutional development efforts.

4.24 Creation of Quasi-banks. A number of efforts to use external assistance to provide soft financing to SMEs are either underway or under discussion. First, most prominently, the French have implemented a program of support for small and medium scale joint French-Polish ventures using credits extended through the Central Bank and on-lent through Bank Handlowy, PKO S.A. and the Export Development Bank. Nine-hundred million French Francs are available over three years to be on-lent to the ultimate borrower at 4.5% per year (comparable market rate is about 9.5%) in French Francs, up to 10 years with 3 years grace.

4.25 Second, EC support for the proposed development bank to extend soft credits to SMEs is being considered. Third, a number of ministries are operating funds (sometimes named "banks") to provide credit on soft terms to, for example, unemployed individuals (Ministry of Labor) or to assist in the privatization of small shops (Ministry of Domestic Trade). In the latter case a special fund of Zl 170 billion, with an expected addition of Zl 150 billion, would have been established to provide loans at 3.5% per month, compared to market rates which are about 6%.

4.26 Promotion of Training facilities. There are a number of initiatives aimed at providing training. Most prominent among them is the training institution for the banking sector (the Bankers' Training Institute), due to open in Katowice in October, 1990. The school, which is a venture of 18 Polish

banks with French support, is intended to be able to train 5,000 staff per year in courses ranging from one week to four months in length. Other initiatives which would result in the training of bank sector staff include: the Technical Support Unit within the proposed development bank which would train credit staff within participating banks; and a private initiative to establish a bank training school in Poznan being developed to seek proposed U.S. Enterprise Fund support. While all of these initiatives appear to have merit, it is clear that with the exception of the French supported effort there will be a considerable delay before they could become operational. Also, the usefulness of the training will be conditioned by the progress achieved in reorienting the services and incentive structures of the banks.

C. Institutional Support

4.27 Private firms in Poland have had access to few of the supporting services available within Western economies. The major part of the existing public sector support infrastructure, such as trading companies, training institutes, banks and research facilities, have operated to meet the needs of large, socialist sector firms. Institutions, such as chambers, associations and societies, which have focused on the needs of the private sector, have tended historically to have non-commercial orientations and to emphasize policy advocacy. This situation has begun to change recently as new and existing institutions, as well as commercial firms, have initiated steps to provide supporting services to SMEs. However, much needs to be done.

1. Main Institutional Support Requirements

4.28 Given the firm level constraints and the specific business environment (para 3.33 and 4.02), the institutional support for business development in Poland is seriously inadequate in the following areas:

- (i) Absence of Advocacy for SMEs. The relatively recent legitimacy of the private sector is reflected in the weakness of the private business communities at policy levels. Nonetheless, there are a number of dynamic Economic Societies and the Chambers of Commerce and Industry being created through out the main cities of the country.
- (ii) Inadequate business information services. Data services for small businesses are very limited in Poland. From the perspective of the needs of private businesses the accumulation of massive amounts of statistics by the government are of limited usefulness since publications lag collection times. Commercial services are not developed. On a more positive note, business networking, which creates opportunities for entrepreneurs to make contacts, gain information and explore possible transactions, is developing within the frameworks of various fairs and the activities of the private chambers and associations.

- (iii) Minimal legal and accounting services. The fluid legal and tax systems and changes in the role of financial planning for firms adjusting to a market economy, place a premium on professional legal and accounting services.
- (iv) Need for entrepreneurship development, management training and assistance services. Marketing, financial management, quality control and business organization training and assistance are inadequate. However, there are several initiatives to address constraints in this area including on-going and proposed MBA programs, the opening of private consulting firms, proposed private and public-private business advisory centers and small business incubators. Also, there is an impressive number of initiatives proposed by private businesses, local governments, proper business organizations and international agencies. Their materialization, however, needs a great deal of support.
- (v) Minimal product, production and technology assistance. Technical services to SMEs, other than those occasionally made available by equipment suppliers, are not developed. Industrial consulting service (as opposed to management consulting) do not appear to have captured the attention of the authorities or private sector groups.
- (vi) Little export information and assistance. Many SMEs are attempting to shift from domestic and CMEA markets to convertible currency markets. There are few, if any, credible and established suppliers to SMEs of information (e.g., on buyers, distributors, products, documentation requirements, prices, marketing opportunities) or assistance (e.g., in design, productivity improvement, marketing, resolution of payment problems). Lacking services in these areas, small entrepreneurs are forced to rely on expensive and time-consuming efforts to shift into other markets.

2. Existing Institutional Support

4.29 In most industrial countries, institutional supporting services for SME development are provided mainly through market mechanisms by other private businesses on a commercial or professional fee basis. At the same time, however, public sector organizations, non-profit private organizations, institutions of higher learning and mixed public-private organizations engage in the institutional provision of many supporting services for private businesses³. In the context of Poland's transition to a market economy, the potential contribution of institutional support for services assumes a special importance.

4.30 Until mid-1990, unlike what prevails in Western countries, there was no public sector organization involved in the provision of the services listed above. In late 1990, the Government established the Office of Government Plenipotentiary for Support of Enterprises and Economic Initiatives (para 3.32) which is expected to provide some of these services; however, its programs are still at a very embryonic stage. Also, in late 1990 new

institutions were created, such as the Project Support Unit, in collaboration with the EC, which is expected to implement a program aimed at strengthening the capacity of local SME agencies.

4.31 A number of private institutions are developing supporting services for SMEs. These include:

- (i) Foundations (including the Foundation for the Support of Local Democracy, the Stefan Batory Foundation, the Solidarity Economic Foundation and Rural Solidarity), which are generally concerned with the promotion of civic responsibilities and local democracy, provide support for private sector development.
- (ii) Economic and Industrial Societies, most of which were established before 1988 as clubs or associations where private business people, academics and other professionals could meet to discuss reforms and to exchange views on the ways to transform the economy along free market lines. The Krakow Industrial Society, started in 1984, is the oldest of such societies. Since 1989 these societies, supported in part by funds from overseas, have been developing programs to support SME development. In 1989, about 15 of these societies (excluding the Krakow Society and others) formed the Polish Council of Economic Societies, which is to serve as their umbrella organization.
- (iii) Chambers of Commerce, Trade, and Industry are active throughout Poland. The National Federation of Chambers of Commerce was formed in 1989. It now combines 30 separate local Chambers, and it is absorbing the former Chamber of Foreign Trade (CFT). The intention is to adjust the CFT network into an organization capable of providing services to private firms.
- (iv) Crafts Associations, and their associated branch organizations, were for many years the only significant organizations of private manufacturing and service firms. Membership in the Associations was obligatory until recently. The Crafts Associations represent about 500,000 small businesses through an estimated 400 branches. There were also 26 Chambers of Craftsmen. The organizations of the Crafts were responsible for organizing apprenticeship training. With membership of the Associations now voluntary, their service role will likely change over the coming years.
- (v) Universities and specialized academic institutes and professional associations provide some support to SMEs. Examples of these include a number of existing MBA programs and of assistance provided in fields such as feasibility and market studies, incubator development studies, staff training and policy reform.

4.32 While all the above institutions display enthusiasm and determination to develop their service capabilities, they are weak in market economy experience

and in financial resources. Many are also now in contact with sources of advice and offers of various forms of assistance from outside Poland. To fill in an important gap in assisting private entrepreneurs in setting-up businesses IFC has sponsored and supported the Polish Business Advisory Service, which would provide direct assistance to emerging businesses and entrepreneurs.

D. Physical Infrastructure

4.33 A shortage of suitable factory space is reported by SMEs as a problem in many areas. The difficulties are linked to major constraints in the market for land, including (i) the existence of numerous cases of disputed ownership of land and of efforts to reprivatize buildings and land previously nationalized and (ii) a general lack of physical land use planning (zoning) which would establish principles for property use. While strategies to address these broad constraints do not appear to exist, ad hoc initiatives of several municipal governments are being adopted to make space available for SMEs through the leasing or other forms of privatization of buildings and land. Also, several municipalities have shown an immediate willingness to accept offers of outside assistance to develop small business incubators or other projects aimed at increasing space availability.

4.34 Poor or unavailable telecommunications services is a constant source of difficulty in Poland. It affects the performance and potential of SMEs more so than large scale firms as smaller firms do not have the resources to invest in dedicated capital intensive communications systems.

4.35 A weak distribution system has been a characteristic of the previous economic system, as most of the distribution system was monopolized by large distribution chains, mainly in hands of a system of state cooperatives. The current demonopolization efforts and the program for the privatization of the commercialization system are steps in the right direction. However, these measures, while necessary, have created in the immediate term a vacuum in the supply of distribution services for SMEs. In the medium-term, while an efficient distribution system and network is being established, the performance of the private SME enterprises could be severely affected.

4.36 This chapter elaborated in some detail on the problems in the financial sector. Many new institutions to support the private sector have emerged, such as Chambers and Societies, and this reveals Poland's willingness to support the private sector; however, the inexperience of these institutions means they are not as yet capable of drawing up a work program and of advancing a strategy to realize their objectives. Infrastructure continues to leave much to be desired, especially in the areas of telecommunications, business space, and distribution. The next and final chapter draws from the conclusions of the previous four chapters to provide recommendations for promotion of SMEs in Poland.

CHAPTER V - DEVELOPING A STRATEGY FOR THE PRIVATE SMEs

A. Introduction.

5.1 The preceding chapters have drawn attention to the rapid recent emergence of the private small and medium enterprise sector in Poland, and at the same time, have pointed out the constraints to their growth during the period of Poland's transition towards a market economy. This chapter puts forth specific recommendations to relieve these constraints, and proposes a strategy for the development of private SMEs which is consistent with Poland's ongoing structural transformation. Private enterprises, regardless of their size, respond to signals from the overall economic, legal, and regulatory environment in which operate. If the signals are distorted, the economic activities of the private sector will reflect these distortions. Improvements in this "enabling" environment are almost always necessary to enable the private sector to function efficiently. In this context, this report includes recommendations which are not necessarily private SME sector specific, but they are mentioned as they are deemed critical for the sector development.

5.2 Even assuming that policies and legislation currently being implemented manage to place the private SME sector on an equal footing with state-owned enterprises, there still remains a need for a proactive program to promote an economic and business environment conducive to the development of the SME sector. The overarching recommendation of this report is that the Government create an environment conducive to the development of private SMEs and adopt a strategy for their promotion. While many of the recommended promotional programs are to be instigated by, and supported with government resources, the underlying principle is the overall participation of private sector institutions in the implementation of most of these programs.

5.3 There is no generalized solution to the appropriate mix of economic policy, incentives and institutional support, that will best lead to a successful transformation from a centralized towards a market economy, without unduly taxing available resources. The general principles that guide the recommendations are: that they minimize macroeconomic distortions, particularly of interest rates and foreign exchange rates; that the selection of firms be conditional on performance criteria and not on size or other predefined parameters; and that blanket subsidies be avoided, in favor of infrastructure support or through assistance programs. In the fluid and ever-changing context of transition, and in the nearly absolute absence of government supporting mechanisms -as found in most western countries- for the operation and expansion of the private SME sector, the value of the recommendations included in this chapter is in suggesting an agenda.

B. Action Area I: Policy Formulation and the Regulatory Framework

5.4 Formulating Appropriate Macroeconomic Policies: These would ensure an adequate exposure to competition which would shift labor and other resources

into their most productive uses. The Government has already made great progress in introducing both an appropriate macroeconomic policy and the proper regulatory framework. If they are maintained, they will create a climate conducive to investment and allocation of resources in productive activities. While this report does not elaborate on these macroeconomic measures, it does subscribe to the policy measures introduced by the stabilization program (paras.3.1 - 3.2). Within this context, this reports proposes that assistance programs for SMEs be linked to export performance (see Action Areas II and III, below). As the example of the fast growing Asian countries shows, performance in export markets is a reasonably reliable indicator of efficiency and competitiveness.

5.5 Formulating Appropriate SME Policies and Strategies: Establishing a coherent policy framework and designing a strategy for the development of the SMEs is the function of central government. However, this needs to be done in a consistent manner. Achieving consistency is not an easy task in Poland. For one, there is no channel through which the government can introduce SME related issues into economic policy, and for another there is as yet little analytical capability (let alone data) to inform policy making on SMEs. Ad hoc policy making which may therefore emerge for SME related issues, must be carefully avoided.

5.6 At this point there is great interest in SMEs. This is evident in a host of measures (paras. 3.28- 3.31), such as the establishment of SME units within the Ministry of Industry, the work of the Ministry of Finance and Ministry of the Domestic Market in the privatization of small shops, the activities of the Ministry of Labor in promoting assistance to unemployed people wishing to enter into business (including the proposal of creating a special "bank" for this purpose), the proposals of local governments to foment "agencies of local initiative" and finally, the proposals of many bilateral, multilateral and non-governmental organizations for mounting SME related interventions. Many initiatives involve models which are based in part on public sector funding or subsidies such as the French Credit Cooperatif and Boutiques Gestations. However, the growing interest makes the need to establish a clear policy framework all the more urgent. Consistent policy formulation requires some central coordinator. Thus, the first recommendation takes primacy all over others as it provides for the basic institution responsible for coordinating and devising Government contributions and delivery arrangements for the various programs and actions proposed.

Recommendation 1.1: Establish a Central Organization Unit. This unit would be responsible for the advocacy of policies and programs to support the development of a strong SME sector^{10/}. It would also be responsible for instigating actions to develop the sector. The proposed unit should be distinct both from branch ministries, which have sectoral

10/ The recently approved Office of Government Plenipotentiary for Support of Enterprises and Economic Initiatives could assume such a role, provided it is launched with a clear definition of the scope of its mandate and staffed with selected, skilled and motivated professionals.

concerns, and the proposed privatization unit, which will focus on the divestiture of the socialized sector. This group should not be responsible for SME program implementation by public, private or mixed groups. Rather, it should contribute, through its strong knowledge base, to program design and should be closely involved in facilitating and monitoring program implementation and impact.

5.7 The work of the proposed unit would include: (i) the role of advocacy, of appropriate policies and programs to promote entrepreneurial SMEs. This includes monitoring the activities of other government units and urging measures to reduce negative impacts on SMEs (e.g., simplification of reporting requirements; appropriate measures for SMEs in the introduction of the value added tax arrangements), but would also include a large dose of advocating against providing "gifts" to the SME sector such as subsidized credits. The unit would also: (ii) formalize mechanisms to support local government and locally based organizations, as well as private groups, in designing and implementing programs for the strengthening of the local or regional SME sector.

5.8 In addition, the unit would undertake (iii) data collection and analysis to project and monitor policy impacts on SMEs. Data gathering activities should give priority to the collection, analysis, and use of information gathered by, for instance, licensing offices, the central bank, tax authorities and individual ministries. Finally, (iv) the unit would also promote firm networking and networking among others interested in SME development to increase learning, accessibility to information and to stimulate outside analyses of SME issues, all of which hold the potential for generating feedback to improve policy formulation. These activities would include the sponsoring of conferences, contacts with international SMEs support associations, regular meetings with SMEs and SME representative groups, the provision of assistance to researchers and the commissioning of studies and investigations.

5.9 Participation of Private SMEs in policy formulation. As part of the changing political culture, the adoption of mechanisms to get the views of SMEs need to be addressed. Private groups promoting the interests of Polish SMEs are many and their numbers are increasing. The mechanisms for the insertion of private sector groups into the policy formulation process however, are weak. Private sector access to policy formulation on a nondiscriminatory, open and regular basis is crucial to the success of these policies; it legitimizes the role of the private sector in the emerging economy, and builds confidence in the long-term viability of the private sector. Some progress has already been made in involving the private sector in policy decisions. The adoption of non-obligatory membership in crafts associations and similar quasi-official representative organizations is a step in the right direction. However, much more is needed.

Recommendation 1.2: Promote private sector participation in policy formulation. Develop policy formulation processes which are open and which increase information flows between the public and private sectors. Examples of possible mechanisms would include: (1) regular meetings of officials with representative private sector groups without according

exclusivity to individuals or groups; (ii) wide consultations with private sector groups on proposed changes in policies and administration that affect SMEs^{11/}.

5.10 Economies based on private enterprise systems are based on legal property rights. A fully developed system of commercial law which protects these rights and ensures the validity of contracts is a cornerstone of this system. The property rights situation in Poland is still far from clear. The Privatisation Law has not fully clarified all the issues in this area, for example, ownership titles to land or premises, title registration systems, property valuation systems or mortgage registration systems. In the West, institutions supporting property rights are well in place but this is still to be developed in Poland.

Recommendation 1.3: Review the legal system, particularly in the areas of property rights and contract law, from the perspective of the small firm. As the Polish SMEs grow in numbers, and as the entrepreneurial firms expand aggressively, the operation of the judicial system will become an issue. The recommendation is that this be studied in anticipation of developments in that sector.

5.11 Regulatory Arrangements. Regulations concerning SMEs should be consistent and nondiscretionary. They must take into account the high costs of compliance to small firms of tax and labor codes, foreign investment, statistical reporting, and of environmental protection. Public policy up to 1989 often permitted arbitrary exemptions to favored private business people, which allowed them to grow beyond legal maximums. The present policy of stimulating efficient private enterprise requires much reorientation, towards a simplification of requirements, clearer instructions, and access to explanations and guidance as a means to demystify and rationalize government actions. This will also reduce the urgent demand for scarce specialized knowledge in fields such as accounting, auditing and financial consultancy.

5.12 Providing assistance and explanatory information to SMEs to increase their understanding of, and ease compliance with regulations is an important government role, particularly at local levels. Although preliminary steps in these areas were initiated by the former Office of Government Plenipotentiary for Ownership Changes (OGPOC), and a program has been introduced to collect

^{11/} An example is to involve the SME sector in establishing the details and the process for the introduction of the Value Added Tax and the Personal Income Tax. These type of consultation mechanisms with private SMEs could enhance confidence of SMEs in Central Government. A possible mechanism would be to set up a working committee, composed of public and private sector representatives, to develop proposals and procedures jointly. The earlier this is done the better. To ignore the SMEs' views on the introduction of new regulations and laws which affect the sector and present them with a fait accompli could be counter-productive.

and revise proposals from the private SMEs to ultimately simplify current regulations, much is still needed in the area of regulation. The specific recommendations made are therefore:

Recommendation 1.4: Revise existing regulatory processes. Establish a major effort across governmental units, with deadlines, to review existing regulatory processes. The objective of such a review should be to simplify compliance requirements for SMEs.

5.13 Examples of possible results of this effort would be (i) simplify approval process of fully private joint ventures, which reportedly include governmental review of business plans, projections and feasibilities, and which can take more than four weeks; (ii) collecting registration data on separate forms strictly for statistical reporting purposes, rather than using information already available through licensing, labor and taxation offices; (iii) review forms to be used, the explanatory material to accompany them and the data and documentation required to complete them - with a view to reducing compliance cost to SMEs

Recommendation 1.5: Adopt legal principles of due process, accountability and conflict resolution for all regulations. This would include developing independent administrative appeals procedures in areas such as taxation, zoning enforcement and reprivatization. The principles of such due process are fairness, low cost, speed, and no bias. This would also include the appointment of an Ombudsman, i.e., a mediator and conciliator to address misunderstandings and problems that arise between SMEs and the regulatory administration.

Recommendation 1.6: Establish one-stop centers (i) for start ups and (ii) for entrepreneurial firms, at which information, forms, referrals, licenses, permits and guidance on financial and programmatic assistance is provided. This one-stop center would also be partly responsible for resolving problems between SMEs and government entities. The nucleus for these centers may be the existing economic development offices at the regional (voivodship) offices at which general economic information is compiled and made available to potential investors. However, the one-stop centers should focus sharply on the requirements of SMEs. It should not be viewed as an office which courts potential foreign investors or meets the recurrent information needs of governmental officials. Also, the one-stop centers can include mobile services.

C. Action Area II: Financial Services

5.14 Financial sector restructuring, complete with institutional development, is a precondition in Poland for the development of financial services responsive to the needs of SMEs. In comparison with the industrialized countries, the number of credit and non-credit services which are absent is daunting (see list presented in para 4.14 - 4.15). However, SMEs operating in countries with even the most modern financial sectors still have difficulties transacting with large financial institutions, as they require specialized services. This section focusses on developing those aspects of the financial

sector which address SMEs, and recommends complementary actions which will allow SMEs to transact with formal financial sector institutions.

5.15 Across countries, most SMEs (particularly small enterprises) do not borrow, from any source. Depending upon the objectives of the owners, zero borrowing is a viable means to do business. Programs aiming to convince people to borrow are not recommended. In fact, programs should aim to develop the capacities of business people to identify non-credit ways to improve their businesses (e.g., improved inventory control, cost-controls and marketing) prior to considering credit as a solution. Many small business owners, apparently across countries, identify finance as their main constraint. However, this is most likely a reflection of their unwillingness or inability to specify constraints associated with their own lack of knowledge and skills and of their skepticism concerning the value of non-financial assistance, such as consultations and advice.

5.16 Furthermore, bank lending to SMEs in all countries is problematic. Perceptions of high risks and costs keep many banks out of the SME field. Those that do lend to SMEs normally depend heavily upon collateral. This is also the case in Poland, although here the problem of collateral is extreme, as is clear from the description made above in paragraphs 4.10 - 4.12. SMEs also have special problems in areas such as working capital, which is especially important for exports, and in obtaining more innovative financing, such as equity participation or leasing arrangements. The recommendations which follow, on apex institution, existing banks and new banks, training, export financing, equity financing, leasing, SME credit lines, and microenterprise financing, attempt to address these issues.

Recommendation 2.1: Establish an apex institution. Such an Apex institution could be basically the recently established Polish Development Bank (PDB), using commercial and cooperative banks as intermediaries for financing SMEs, thus complementing, rather than competing with, these banks. The PDB would play a catalytic role in guiding and assisting these banks in the provision of term financing for private SMEs. Refinancing of SME credits and lease financing contracts would be key activities of the PDB in relation to SME operations.

Recommendation 2.2: Enlarge capacities of existing banks. The development of a financial sector capable of servicing the SME sector will require considerable time. In the short term, expansion can only occur from the present base. Enlarging and upgrading the capacities of the Craftsmen Banks is therefore recommended. These are the only banks within the present financial structure with a solid capability, in terms of accounts, portfolios, and experience, to service the SME sector. This would include a streamlining of policies and procedures as well as staff training and granting of foreign exchange licenses. Additionally, programs to improve capabilities of the banking system as a whole to service SMEs need to be introduced. In the longer term, new banks and joint venture participation in banks create further opportunities to enhance SME financial services. New banks and joint ventures would provide competition for the services of SMEs and access to the soft technologies provided by joint ventures. The opening of institutionally

and financially sound new banks, with foreign participation if possible, to service SMEs should therefore be encouraged. Successful models of banks which engage in substantial SME lending and which have developed efficient technologies for this can be found, for instance, in Western Europe and among the smaller regional banks in North America.

Recommendation 2.3: Establish banker training. There is little experience in Poland with financial services for SMEs. Specific modules which address the special requirements of SME lending should be included within the programs of the proposed Bankers' Training Institute, as well as in other similar type of institutions. This should be initiated immediately.

Recommendation 2.4: Provide working capital guarantees for exporters. The first major credit requirement for SMEs within the context of a strategy which emphasizes entrepreneurial firms is for short term credit. Short term credit is needed typically to produce for confirmed export orders. A government backed program should therefore be established, of nondiscriminatory guarantees for working capital credit for export orders for direct and indirect exporters. As has been done successfully in Taiwan and Korea, the guarantees can be made against confirmed letters of credit, including parallel domestic letters of credit enabling an indirect exporter, such as a components supplier, to participate. The guarantees could be subsidized; the interest rates, however, should be set at market rates. Concentrating on export-linked working capital and providing the funds at market interest rates makes it likely that subsidies in the program will go to relatively productive activities.

Recommendation 2.5: Provide medium-term credit assistance to firms which require these to implement export related growth strategies but have difficulties with collateral or access and contacts. This assistance can be channelled through programs which make available private technology, export marketing and business planning and consulting services to SMEs. Ultimately, these programs would lead to solid credit applications to financial institutions. This assistance could be provided at a subsidized cost, while the credits themselves should be at market rates so as to minimize distortions and diversion into rent seeking and inefficient activities. The proposed IFC-managed Business Advisory Service for Poland (PBAS), illustrates the basic characteristics of the schemes herein recommended.

5.17 Programs to provide equity financing for entrepreneurial firms are being proposed by several donor groups in Poland, including CARE (a non-governmental organization) and the American Enterprise Fund, to provide equity financing for selected SMEs.

Recommendation 2.6: Encourage privately backed, and donor supported equity financing institutions for SMEs. The Government is not recommended to provide financial backing for these investments, but rather to permit them to operate as fully private operations.

D. Action Area III: Support for Technology, Export and Entrepreneurship Development

5.23 Fundamental services for SMEs, including business information services, legal and accounting services, entrepreneurial development, management training and assistance services, are non-existent or at best inadequate. Other gaps include product, production and technology assistance, and export information and other export services. This section refers to these issues and specific recommendations are formulated for their possible solutions.

5.24 Support for SMEs will deploy Government assistance, including subsidized programs. These programs should be transparent and provided in ways which minimize market distortions. Effective programs in North America and Western Europe have relied on a wide variety of sources of funding, such as central government subsidies and user fees. Programmatic assistance from the public sector should not supplant or compete with commercial capabilities. The government should take market-completing actions while encouraging the development of commercial (domestic and foreign) suppliers of product development, market research and development, industrial consulting, accounting, auditing, international trade and similar services which can reduce market transaction costs.

5.25 Organizationally, programmatic assistance for SMEs in most countries has been effective when it has depended heavily upon local initiatives. Examples from Western Europe show the effectiveness of local private, public and mixed initiatives for the promotion and management of programs for SMEs. In the export, business, and entrepreneurial program areas, the report has eschewed making specific organizational recommendations other than to urge (i) reliance upon local initiatives and not on establishing a pattern of cloned "regional centers" or "local agencies" and (ii) adoption of an inclusive rather than exclusive approach to encouraging such local initiatives. In the area of technology, however, it is suggested that an organizational unit be designated to have an overall promotional responsibility.

5.26 Organizational arrangements in Poland will vary from one local area to another. There are many vibrant private sector groups developing (Economic or Industrial Societies, Foundations, Chambers of Commerce and Industry) and there appears to be no shortage of local initiative. These organizations display a great enthusiasm and a motivation to learn quickly; however, this energy needs to be channeled into a deeper understanding of small and medium entrepreneurship. The types of services offered by these groups would differ according to the nature and capacity of the organizations. Based on an evaluation of organizational capabilities of these groups, it would seem that the Economic Societies and Foundations would be best equipped to promote new small businesses. Their structure is informal and composed of a core staff and volunteers, which suggests that they are able to provide "one-stop" practical advice centers for small business start-ups. The Chambers in turn could concentrate on established entrepreneurial SMEs offering broader and more sophisticated service programs.

5.27 Different programs are required for the "entrepreneurial" SMEs than for "other" SMEs. For the entrepreneurial firms, a wide range of sophisticated

services are often necessary, few of which are currently available through commercial sources in Poland. Programmatic assistance for entrepreneurial SMEs is most effective when it is focused on: (i) the firm rather than investment projects; (ii) profitability rather than employment generation; and (iii) the articulation of the firm with its market environment rather than on the firm's internal operations. Small firms possess an infinite number of ways by which they can organize their affairs, a number equal sometimes to the number of small business owners. Organizational efficiencies are created through competitive pressure. Management assistance becomes necessary when a firm expands to a scale at which management functions begin to unbundle and become more specialized.

5.28 Services for the entrepreneurial group of SMEs should be carefully designed and should be distinct from the services provided to other SMEs. The entrepreneurial group requires programmatic assistance in product and production technology support, export services for new markets and specialized business services.

5.29 Basic start-up information and advice is needed for the other SMEs, including follow-up counseling and training in elementary business administration skills. Many of these firms, including pre-start-ups, can benefit from easy access to one-stop centers or first contact points equipped to provide guidance on licensing, taxation, provide information and referrals on sources of counselling and training. They can also benefit from short courses on business operation and on business plan development and financing.

5.30 In terms of technology and product quality, the Polish SME sector is in general not competitive with the industrial countries and indeed with many developing countries. Major efforts are required to find, acquire and diffuse improved technologies. Individual firms rarely have the resources to search for new techniques and establish their commercial feasibility. They also lack the ability to carry ideas through to the stage of construction and evaluation of prototypes. Technological assistance for SMEs would encourage technology diffusion, increases labor productivity and help avert a form of "suspended" structural transformation, like that which occurred in many Latin American countries, where large numbers of SMEs have become stuck in low wage activities.

5.31 In most European countries, there exist special schemes for SMEs aimed at providing access to research and development financing; while the instruments of finance and the agencies implementing the programs vary among countries, they all have the common objective of product development and production innovation. There are for example the Technical Centers (Centers Techniques Professionals and the Centers de Recherche Industrielle Collective) in France, which may enter into consulting arrangements for technical matters and may also grant medium or long-term loans for innovation without guarantees, at low interest rates.

5.32 In other countries, mechanisms have been developed to encourage the transfer of technology from research institutes and large companies into SMEs. Netherlands' "Transfer Point Mechanism" is one example. Through links between research and educational institutes it supports the use of new technologies by

5.18 Lease financing of equipment and machinery is a common way in which small businesses in industrial countries reduce the upfront cost of an investment, whether for startup or expansion.

Recommendation 2.7: Establish a legal framework for lease financing for SMEs and build the institutional capacity for this. This is a field in which foreign investment should be encouraged.

5.19 Directed credit lines with subsidized interest rates for SMEs have experienced considerable difficulty in many countries. The recent review of the extensive experience of the World Bank in this field has shown that the results were often the opposite of what was intended, particularly on the total availability of credit for SMEs and on the development of the financial sector capabilities for SME financing. Nonetheless, credit lines priced at market interest rates, used as a vehicle for the transmission to the financial sector of technologies and capabilities for servicing the SMEs, may be useful at this initial stage of development of the SME sector in Poland.

Recommendation 2.8: Establish a refinance window within the Polish Development Bank. A potential issue is the tendency for directed credits, focused on small firms, to crowd out the strategically important, entrepreneurial middle size group. This might occur in the event that size criteria are set too low.

5.20 Guarantee schemes can assist the financing of viable firms and projects which however do not fully meet the collateral requirements of the financing institutions. The problems of guarantee arrangements, however, including high costs, difficulty of use, and the moral hazard aspect when government guarantees are involved are well known. A recent example of problems in this regard is the Savings and Loan Association crisis in the United States. Heavy collateral requirements are also common.

5.21 Guarantee schemes which are private offer the prospect of addressing the issue of inadequate collateral while largely avoiding the problem of moral hazard. Two examples of such privately run schemes are the Italian small industry association (CNA) and the mutualist credit guarantee arrangements of innovative microenterprise financing programs. Government backed guarantee programs can work effectively, but require careful study and administration. This is because government schemes cover only a portion of the loan, are based on stringent and clear rules, and require that the SME exhaust all other means for recovering the loan. Sometimes the reasons banks are willing to engage in government backed guarantees is because of other benefits, such as involvement in an active secondary market or meeting reserve requirements. These other reasons are an important factor in the success of the guarantee program as they stimulate the banks to use the program. The American SBA guaranteed loans is one such example.

Recommendation 2.9: Review SME loan guarantee schemes including the feasibility of implementing these schemes, building upon the experiences of West European countries. Such a review should give priority to establishing the legal mechanisms for private and mixed guarantee arrangements. As examples of guarantees from the private sector, it

might be useful to include a review of associations such as the Italian "loan guarantee cooperatives" scheme, or the Swiss "cooperative guarantee schemes." Consideration should be given to the proposal that the development bank be responsible for the operation of the guarantee scheme.

5.22 Over the past 15 years, microenterprise lending in developing countries has been effectively led by local private business sectors and non-governmental organizations. This has been achieved in cooperation with international non-governmental organizations (e.g., Women's World Banking), bilateral donors (particularly A.I.D.) and by the regional Inter-American Development Bank. In Latin America in particular, the results have been impressive. The World Bank has been keenly interested in these programs. In some cases, they are mounted by established banks, in other cases by financial institutions established for that very purpose. The target group of these programs consists of very small firms, characterized by low funding needs for investments or working capital. These firms have usually demonstrated a minimal stability in that they have been in operation for a stipulated minimum length of time. The methods of these programs are recommended as learning models for microenterprise lending in Poland.

Recommendation 2.10: Support microenterprise lending programs using "minimalist loan-making methodologies". Examples of such programs can be found in Colombia, the Dominican Republic, Indonesia, and India. The usual format of these programs consists of short-term loans, at market rates, accompanied by little if any other assistance. The loans are characterized by low cost documentation, performance is closely monitored, and operations are computerized. Small firms can expect to receive additional loans if the initial one is repaid promptly. Problems usually arise as a result of the weakness of the intermediary organizations, which are often non-profit groups. Further problems which have characterized these programs are (i) the low rate of graduation of microenterprises into full-scale borrowers from the formal financial sector, and (ii) the difficulty of scaling up these programs because their success has depended largely on the personal commitment of the leaders and staff of intermediary organizations, and not on institutional strengths. The proposed program would be closely coordinated with other initiatives included under a proposed World Bank Employment Promotion and Services Project, currently being prepared jointly with the Ministry of Labor.

Recommendation 2.11: Reinforce current investment incentives. Stimulate SME investments through simplified tax treatment of investments which would provide particularly small firms with significant financial incentives. This could be done by: (i) deducting as operating costs investments of less than a stipulated total amount per year (say, \$10,000); and, (ii) providing for automatic loss carry forward.

the SMEs. Also, in some Asian countries, such as Singapore, different government-supported schemes have been established to develop local applied research and to develop products. For example, the "Product Development Assistance Scheme" (PDSA) provides a dollar-for-dollar grant to support the development of product and production technologies and the Government and the firm share equally the direct cost of the project equally.

Recommendation 3.1: Establish a technological seed grant program for partial funding of product development costs of SMEs which are attempting to enter new export product market niches. This should include primarily prototype development costs and not market studies. The selection of seed grant recipients should be competitive. The selection should be made by a highly qualified group from the private and public sectors consisting of commercially astute and technically proficient individuals. The grant amounts should be modest, not exceeding, say, \$50,000.

5.33 A relevant example is provided by the "Skills Development Fund" (SDF), set up in the late 1970's in Singapore. The SDF is administered by the Economic Development Board, a statutory body charged with fostering rapid development and upgrading of SMEs. The SDF is financed by the enterprises themselves through a levy on wages amounting to less than a predetermined threshold. The SDF offers four schemes which covering up to 90% of the costs of (i) purchasing approved machinery and equipment to upgrade SMEs operations (Interest Grants for Mechanization Scheme,) (ii) training programs (Training Grant Scheme), (iii) engaging external consultants (Development Consulting Scheme) and (iv) of manpower training and development needed in setting up hi-technology industries (Initiatives in New Technologies Scheme)

Recommendation 3.2: Promote subsector specific studies for technological change through subsector studies, and establish mechanisms for follow-up worker training and technology acquisition. The studies should be supported by many agencies, and involve staff from the financial sector.

Recommendation 3.3: Develop SME worker training programs based on (i) active participation of local SMEs in decisions about the content and scheduling of vocational-technical training programs and (ii) partial subsidization of costs of managers training in export related areas. The notion of customized training to meet the needs of local businesses is one element of a market driven training approach. The provision of incentives which reduce the cost to a firm, particularly a small firm, of worker training is a standard way to subsidize an activity whose benefits can not be captured by the firm.

Recommendation 3.4: Develop science parks (a type of intensive incubator linked to science and technology) to provide the facilities for stimulating the growth of SMEs with strong technological capabilities. Science parks can assist aggressive firms in resolving technological problems in product development. Funding should draw from a variety of sources, both public and private; however, in all cases, management should be private.

5.34 Most European countries employ science parks. Technology Parks in West Germany and Science Parks in England were established in the early 1980's. While in the German case sources of funds ranged from the federal government to private organizations such as banks or insurance companies, in the case of England funds are linked to Universities or Polytechnics. The main purpose of these initiatives has been to foster the start-up of new-technology-based-companies, by providing infrastructure, technological advise, and associated services.

Recommendation 3.5: Establish a technology diffusion center to promote technology diffusion among SMEs. This would be a mixed private and public unit which would initiate the above recommendations and assist directly in the technology search-through-diffusion process of SMEs by: (i) assisting in negotiating and, if appropriate, subsidizing foreign technology licensing; (ii) supporting technology research centers dedicated to the requirements of SMEs in particular areas (e.g., machine tools, electronics). The institutes would import foreign technology, adapt local and imported technologies, develop prototypes; and provide training for technicians and engineers; (iii) maintaining access to technological information (through development of libraries or access to international sources); (iv) subsidizing businessmen's trips to attend equipment shows and visit foreign factories; (v) providing direct assistance to companies through the visits of subsidized foreign and local technological consultants; (vii) promoting "sister industry" programs with individual countries under which SMEs would be twinned, sometimes in a joint venture. The Swedes have successfully operated such a sister industry program.

Recommendation 3.6: Promote joint ventures by strengthening the capabilities of staff of Government commercial offices abroad (commercial attaches, consulates, etc.) to promote joint ventures with foreign companies which are export oriented, or with companies which sub-contract for local enterprises. As in Taiwan, this can be an important source of technological learning and entry Polish SMEs. Joint ventures should be given priority in the Government's efforts to stimulate foreign investment and should be those which spur linkages between domestic SME suppliers. Local technological capability will be strengthened as foreign production methods and equipment are imitated by SMEs.

5.35 Export assistance. As a consequence of inadequate knowledge, services and infrastructure, export markets are characterized by high entry costs, particularly for SMEs. A remedy to this problem is suggested in this section.

Recommendation 3.7: Provide export market information including: (i) up-to-date information on standards, customs and documentation requirements and practices in specific countries; (ii) specific assistance in locating buyers and distributors; (iii) low cost access to export information networks; and, (iv) assistance in attendance at fairs and exhibitions to sell to scope out the competition.

Recommendation 3.8: Develop trade dispute resolution mechanisms which will assist SME exporters to resolve payment problems and other disputes at low cost.

Recommendation 3.9: Increase the number of foreign exchange licenses allocated to banks working on foreign trade, to increase competition among them. Encourage joint venture banks and correspondent banking relationships. For exporting SMEs, trade related services resulting from competition among banks would address one of the major constraints in performing in export markets (see also recommendation 2.2).

5.36 Business Services. The business services required by entrepreneurial firms include: brokering services which link together investors with firms desiring capital and technology through venture or licensing arrangements; referrals to specialists on finance, business planning, taxation, and such; advice on franchise opportunities; access to specialized data bases such as the EC's Business Information Network; and, identification of financial sources and financial packaging assistance. These service should be based on partial cost recovery. There are many initiatives underway in Poland to provide business services. Most appear directed more at start-up, general information and advice for "other" SMEs, than the kind of services needed by entrepreneurial firms.

Recommendation 3.10: Establish mechanisms for channeling services (technology, export and business) to SMEs. The mechanisms would include subsidies for specialized assistance provided not by staff but by vetted specialists contracted by the firm, and assistance in loan applications. Organizationally the mechanisms should be based on the one hand, on local initiatives and on the other, on the government's capabilities in providing information and experience.

5.37 Entrepreneur development. Services to get would-be business people and other small business people through the initial stages of starting a business and to help them learn the basics of running an owner operated small firm are lacking in Poland. The never-ending cycle of short-courses for beginning and newly formed businesses which are common in North America and many Western European countries have not yet begun in Poland.

Recommendation 3.11: Arrange for start-up assistance. Support local initiatives to provide training and technical assistance to pre-start up and recently formed SMEs.

5.38 This will assist their entry, allow them to comply with regulations and will provide them with guidance for business plan preparation. They will also help entrepreneurs adopt and implement appropriate business strategies in production technology (material handling systems, plant layout, quality control systems, etc.); marketing and sales strategies (product diversification, market penetration, sales organization, product pricing, etc.), business planning and financing, marketing, and control systems (cost accounting, inventory, etc.) Pre-start-up assistance should be geared to those exploring the possibility of running their own business and should prepare them for the legal requirements and the demands upon their time. This

start-up assistance should operate as a screening process, so that individuals not suited to SME management realize their own limitations early on.

5.39 Much of this assistance can be provided by para-professionals. In many countries business administration students assist in these programs, and in Poland some initiatives - including assistance from foreign universities - have already started. This is fertile ground for non-governmental schemes, and based on the experience in other countries, this is also the most effective approach.

E. Action Area IV: Supporting Measures for Positive Business Climate

5.40 The development of the private sector may need to be reinforced through additional measures at the institutional and legislative levels. The social attitude towards SMEs remains negative. For historical and cultural reasons there appears to be some sentiment in Poland which is antagonistic towards profit making by individuals. Measures needed to address these are fluid, and this section can touch only a few, deemed the most urgent.

Recommendation 4.1: Promote a positive environment for profit-making activities through public statements, information campaigns and by ensuring transparency in public/private sector dealings. This is a recommendation which applies to government at all levels. It also applies to businesses. Business groups have an important role to play in developing a sense of business ethics and of corporate responsibility to communities.

5.41 On the other hand, private groups of business people and public - private groups at the local level can be very effective in establishing a positive business climate. Many private groups are currently emerging in Poland. At the moment it is not clear how they will interact with the government and in particular what form public and private cooperation on private sector promotion will take.

Recommendation 4.2: Support the development of local level private sector groups and of public-private sector cooperation. One principle of action is transparency. Appearance of favoritism can do much to harm the business environment. Non-preferential access to groups will help simulate a market for those wishing to represent private sector interests. The "lobbying" which is carried out by private groups is a valid way of channeling information to policy makers. The development of local public-private cooperation would parallel the increased access the private sector to policy formulation.

5.42 SME access to government and socialized sector procurement, and access to the sales of state firms in the privatization process is important in establishing the confidence of the SMEs in the new market system and in creating a demand for SME services and products. This is the subject of public procurement and sales policies. Open, transparent and competitive policies which create possibilities for SMEs to compete, such as simplified bidding and bonding procedures for low cost contracts, increase the potential market for

SME services and products and increase the confidence of SMEs in the business environment.

Recommendation 4.3: Develop supportive public procurement policies applicable to purchases and sales of goods and services by socialized sector firms which provide barrier free competition by SMEs. Ensuring that procurement and sales processes are transparent and fair is critical for developing private sector confidence.

5.43 Access to external markets, including those regulated by quotas and protocols is important to the development of SMEs. Access to information and to the limited number of buyers in such markets is often restricted to the large, socialized firms.

Recommendation 4.4: Assist with access to regulated markets. Identify mechanisms to increase the participation of SMEs in quota and protocol regulated trade. Foreign trade offices and the various private chambers and associations can act as channels for the dissemination of information.

F. Action Area V - Selective Public Sector Physical and Institutional Infrastructure Investments

5.44 Small businesses are particularly affected by weaknesses in basic infrastructure. They are less capable than large firms of making the capital investments needed to provide compensating private facilities in communications, power, technology diffusion, and training.

5.45 The conceptual approach in making public sector infrastructure investments is twofold. First, efficient private enterprise can be stimulated through a policy of selective "forward thrusts" in investments which address critical bottlenecks to SME dynamism and which complement private investments. Second, make the infrastructure requirements for private development available. Appropriate disinvestment and investments in physical and institutional infrastructure will exploit externalities. This is better than depending upon assistance to individual firms which is more likely to generate distortions. The appropriate areas for investments are those in which social returns are greater than private returns. Typically this means investments in roads and ports; appropriate investments could also include those in training and in information technology. The latter requires public investments since search and acquisition costs for private sector is high, and the benefits are uncapturable since they are diffused among many firms.

5.46 It is not recommended that the Polish government invest in new enterprise investments as a means to exploit externalities. However, opportunities for small firms arise from disinvestment (privatization) since it increases the possibilities for subcontracting. The large socialized firms are "slimming down" through a process of stabilization and structural adjustment. This will encourage them to spin off their operations and become

buyers of services and products which were formerly supplied in-house. To exploit these changes it is imperative that policies are in place which provide full access to SMEs.

5.47 Ostensibly, the public sector is now making investments to assist private sector development. Cases in point are public sector investments in several of the new banks. Such investments however, should be the exception, not the rule, because of strong potential conflict of interest. The requirements for banks should ensure strong prudential guidelines and ensure that there is not even a hint of conflicts of interest.

5.48 In Poland the lack of adequate telecommunications facilities and physical space for private business operation are major constraints. Recommendations in this section cover physical and distribution infrastructure while the following two sections cover financial and other services.

5.49 Telecommunications, which affects more than just the SMEs, are being addressed separately in Poland and so there is no need to reiterate all the issues here. Having said that, in the absence of an adequate supply of lines, it is still possible for government to make arrangements for telecommunications services to be available to businesses from common services points. For instance, in some countries private businesses are developed which "on-sell" from a common point telephone, telex and facsimile. The ownership of such businesses in Poland could range from private to public, and in the latter case, by management contracted privately.

Recommendation 5.1: Increase the supply of telecommunications by identify specific short and medium term arrangements. The means should be consistent with the local conditions; management and ownership of services should be private; and taxes and prices should be set keeping in mind the principles of public goods. Bulk sales with appropriate pricing of telecommunications to business which on-sell to SMEs should be the base of the program. Priority should be given to facilitating incoming and outgoing international communications.

5.50 Business space - Measures to Increase Short Term Supply and Improve Market Operation. Currently, space is being made available to private SMEs by municipal authorities, socialized sector entities, and by private individuals. The arrangements range from outright sales to temporary leases. However, the supply of space for small business purposes, whether industrial, commercial or service, is limited by the lack of adequate zoning and land use planning at local levels, and by the lack of property taxes encouraging efficient use. The mission's understanding is that property taxes are uniform and based on area (square meters) rather than value of property. In particular, the supply of purchasable property is limited by state ownership which is widescale and by titles which are disputed, particularly in the cases of nationalized properties.

5.51 Increasing the supply of physical space for businesses will be addressed over the longer run through the creation of a more open market for property. Space for business is in artificially short supply because of widespread public sector ownership of land and buildings. During the transition period,

there is a need to increase supply by making available existing buildings and developing new facilities. One approach being pursued at this time by local authorities is to rent and lease public property. Clearly the preferred option in most cases is the sale of property to private owners; also, it would be worrying if governmental bodies saw the leasing/renting business as an opportunity to generate income for governmental operations. This is an area in which the government should be complementing (e.g., through zoning) rather than competing with the private sector. Another approach is the opening of incubators. With high unit costs and therefore with limited efficiency, these policies will have minimal impact. They can, however, direct local energies into directions which stimulate business. If these policies are backed by external funds not available for other purposes, their opportunity cost may not be great and they will help to reinforce a positive business environment.

Recommendation 5.2: Increase the supply of business space through (i) new investments and (ii) through the privatization of socialized sector assets. Investment should be undertaken at the local level with, when appropriate, central budget support for one-time costs. Investments needed are in physical infrastructure (roads, utilities) and in areas zoned for businesses. These investments would also include the development of business parks and industrial areas complete with adequate infrastructure and services. These investments could spring from local initiatives, in collaboration with public and private sectors on the issue of ownership, or from private management, with some central financial support for one-time infrastructure costs. This pattern of public - private cooperation is frequently found at local levels in North America and Western Europe.

5.52 In addition to the basic need to sell large amounts of property to increase gross supply, one priority of privatization should be to encourage private firms to enter into the business of renting business space. This could take the form of installment sales linked to monthly payments generated by rental income.

Recommendation 5.3: Develop locational economies and market information Exploit economies resulting from better location and reduced search costs, by increasing the proximity of participants in the markets. Mechanisms to achieve this can be (i) incubators which provide access to guidance and counseling and, on market terms, space and basic services; (ii) information networks, such as those proposed for export marketing, which also reduce market fragmentation through wider information availability.

Recommendation 5.4: Improve property markets Create the conditions for a more active real property market in Poland by (i) introducing and improving the legal framework for effective zoning in order to create enforceable property rights; (ii) adopting a property taxation system which encourages efficient use; and (iii) establishing the legal framework for real estate trade in commercial and industrial property. As of early 1990, the government was considering legal amendments to the Law on Land Economy to put trade in real estate on a market basis and to simplify purchase procedures. This should continue to be pursued. If

necessary, the Civil Code should be amended to permit business space to be sold on the same basis as residential space.

Distribution

5.53 The socialized (cooperative) distribution system for consumer goods in Poland is being privatized and otherwise broken-up. Prior to this, most private SMEs did not have access to major distributions systems because the socialized network did not carry private firm's products and private shops were relatively few and not organized into a distribution system. Now private firms do not have access to major distribution systems because none exist. Also, industrial wholesaling and distribution systems, for supplies, spares, materials, are extremely weak in Poland. This is particularly detrimental to SMEs.

5.54 However, distribution is not an area in which the mission is recommending government investment. The broad recommendation is that government maintain the competitive framework within which distribution systems will develop. The removal of the socialized monopolies and the enforcement of anti-trust and unfair trading policies, including ensuring that sales to socialized and private firms by large socialized sector firms are on equal terms, are the most effective role for government. In promoting foreign investment, some priority should be given to encouraging foreign investments in distribution, including export trading.

G. Proposed Program of Implementation

5.55 The paragraphs above have included recommendations for addressing the basic constraints and needs of the private SMEs as they seek to prosper and adjust to the new economic and business environment introduced in Poland. The tasks of addressing all the areas identified above is rather daunting, particularly when the necessary support mechanisms are almost non-existent. Thus, to develop the required institutional infrastructure and programmatic assistance a program of gradual implementation, which would evolve overtime, would need to be adopted. The initial objective is to works towards achievement of short-term goals which, following assessment and evaluation, can produce the platform on which a fully fledged national/technical support program can flourish.

5.56 The overriding short-term strategy for implementing such a program line on two main elements. First, considering the state of affairs in Poland, with regard to the institutional framework to support private SME, such a program would need to identify the basic institutions -at central Government level as well as at level of local governments and private organizations- that need to be created or reinforced. Second, considering that it is the entrepreneurial firms which will provide the dynamism needed to transform Poland's economy, the programmatic assistance would focus primarily on those measures aimed at expanding the pool of competitive enterprises and at encouraging their growth. The initial set of measures/actions to implement such a short-term strategy would have the ultimate effect, in time, of producing a comprehensive national

assistance program. In addition, to ensure the effectiveness of the program, have an impact and thus gain the trust of the entrepreneurs, the institutions to carry out this initial program need to be established and launched with a clear definition of the scope of their mandates. This initial modest and narrowly focussed program would, in a reasonable period of time, evolve to be a comprehensive assistance vehicle for the development of the private SME sector.

5.57 A core of the implementation of any program would require the establishment of a Central Organizational Unit (COU), Recommendation 1.1, as it will be required to instigate and coordinate the implementation of the initial measures and programs to support the development of the sector. Initially, this unit would be rather modest unit in terms of number of staff, however, as the program to support the sector expands, this unit is to become a full fledged SME Development Agency. Examples can be found in both developed and developing countries, e.g., the Small Business Agency in Japan, the Small Business Program in Ireland, and the Development Commissioner for Small Scale Industries in India.

5.58 A second main institution required to deliver assistance to SMEs would be the establishment of an Apex lending institution, Recommendation 2.1, with specialized refinance windows for SMEs. This institution would fill in the current gap existing in the banking system by developing an initial capability to on-lend credits through the banking system.

5.59 While these two institutions would be the pillars for addressing and ensuring that the main programs are put in place in the short-term, most of these programs, however, are expected to be implemented with a large participation of the private sector institutions and local governments. The success of the different programs requires the participation of the public and private agents interested in each project, in the design, formulation and/or implementation stage of each of the actions. Most of the programs, while identified and financed fully or partially with government resources, would be implemented by private sector agents, through sub-contracting or other type of arrangements.

5.60 An initial composition of a core of actions, as well as a set of the main institutions involved, is illustrated in table 5.1. Alternative time phasing of the proposed actions could be proposed, depending on the priorities to be adopted and assessment of the capabilities of the existing institutions. The extent of the involvement of each institution would not only depend on the type of action, but also on the capabilities of the public institutions and private sector agencies to carry out the different programs. Considering the Polish situation, in many instances the implementation of specific programs would need to rely on the assistance of foreign advisers and/or representatives of institutions involved in similar SME supporting programs in other countries. The vast experience in these areas of most of the European countries would provide convenient cases of reference and expertise. Independent of the composition of the initial program, the basic principle to be kept in mind is that the short-term strategy and programs should produce the initial framework for a successful assistance program for SMEs and should establish a good foundation on which valuable experience can be gained.

5.61 The priorities for the longer-term are to build on this experience through the consolidation and improvement of the range of services on offer, the development and encouragement of further closer cooperation with other relevant agencies and institutions and the systematic analysis of ways in which further improve technical and extension services to SMEs. This will involve the adoption of a pioneering role and the exploration of methods to deal with diverse issues which may range from excessive bureaucracy to better access to financial, technical and marketing support.

5.62 Overall, it is critical to the ultimate success of the program that all the interest involved in both government, the institutions and the private sector play their part. This is a central strategic issue and will need continuous monitoring and assistance. Finally, in assessing the implications of this program on the institutional front and in adopting a sequence of its actions and measures, main attention must be given to different Government's initiatives towards, and assistance provided by different donors, such as the EC, and bilateral programs, such as the U.S. Enterprise Fund, involved in the development of the private sector, so that resources can be fully utilized and duplication can be avoided.

Table 5.1

TIME PHASING OF PROPOSED ACTIONS

Rec No.	Action	Agents	Immediate Term				Short/Medium Term				Medium/Long Term			
			COU	PSO	LG	Apex	COU	PSO	LG	Apex	COU	PSO	LG	Apex
<u>Action Area I: Policy Formulation and the regulatory framework:</u>														
1.1 (i)	Role of Advocacy		*	*	*									
1.1 (ii)	Formalize mechanisms to support local govt. and locally based organizations		*	*	*									
1.1 (iii)	Develop data collection and analysis					*	*							
1.1 (iv)	Promote firm networking					*	*							
1.2	Promote private sector participation in policy formulation		*	*	*									
1.3	Review the legal system		*	*	*									
1.4	Review existing regulatory process.		*	*	*									
1.5	Adopt legal principles of due process					*		*						
1.6	Establish One stop centers			*	*	*								
<u>Action Area II: Financial Services</u>														
2.1	Establish Apex institution		*											
2.2	Enlarge capacities of existing banks		*		*									
2.3	Establish bankers training		*		*									
2.4	Provide working capital guarantees for exporters		*		*									
2.5	Provide medium term credit assistance		*		*									
2.6	Encourage private equity financing									*			*	
2.7	Establish a legal framework for leasing									*			*	
2.8	Establish a refinance window					*			*					
2.9	Review of SME loan guarantees schemes											*	*	
2.10	Support microenterprises lending programs									*	*		*	
2.11	Reinforce investment incentives					*	*	*						
<u>Action Area III: Support for Technology, Export, and Entrepreneurial Development</u>														
3.1	Establish a technological seed grant program					*	*	*						
3.2	Promote subsector specific studies for technological change									*	*	*		
3.3	Develop SME worker training programs									*	*	*		
3.4	Develop science parks									*	*	*		

TIME PHASING OF PROPOSED ACTIONS

Rec No.	Actions	Agency	Immediate Term				Short/Medium Term				Medium/Long Term			
			COU	PSO	LG	Apex	COU	PSO	LG	Apex	COU	PSO	LG	Apex
3.6	Establish a technology diffusion center					*	*	*						
3.8	Promote Joint Ventures					*	*	*						
3.7	Provide export information		*	*	*									
3.8	Develop trade dispute resolution mechanisms									*	*	*		
3.9	Increase the number of foreign exchange licenses		*											
3.10	Establish services for SMEs					*	*	*						
3.11	Arrange for start-up assistance		*	*	*									
<u>Action Area IV: supporting measures for positive business climate</u>														
4.1	Promote a positive environment for profit-making activities		*	*	*									
4.2	Support the development of local level private group		*	*	*									
4.3	Develop supportive public procurement policies					*	*	*						
4.4	Assist access to regulated market					*	*	*						
<u>Action Area V: Selective Public sector physical and institutional infrastructure investment</u>														
5.1	Increase supply of telecommunications					*	*	*						
5.2	Increase the supply of business space									*	*	*		
5.3	Develop locational economies and market information									*	*	*		
5.4	Improve property market									*	*	*		

COU: Central Organizational Unit
 PSO: Private Sector organization
 LG: Local Government
 Apex: Apex Institution

POLAND

REVIEW OF THE SMALL AND MEDIUM SCALE ENTERPRISE SECTOR

Notes on Data Sources for Chapter II.

1. Official Statistics

A. Sources of official statistics on private small and medium scale enterprises in Poland include the National Office of Statistics, the Tax Office, the Ministry of Domestic Markets, and the Foreign Trade Research Institute. Most of the information on firms with foreign capital was obtained from the Office for Foreign Investment in Warsaw and from a paper prepared by the Foreign Trade Research Institute, entitled 'Foreign Investments in Poland, Regulation, Experience and Prospects'. Data on other countries' small enterprises was taken from a publication of the Research Center for Cooperation with Developing Countries, 'Small and Medium-size Enterprises in Developing Countries'; Belgrade, 1986.

B. Traditional reporting categories used in official statistics in Poland are not well adapted to an analysis of the sector and some revisions in these could be usefully introduced in the future. For example (i) the category 'cooperatives' does not distinguish between small private ventures organized in this form, and large socialist cooperatives; (ii) the category 'craftsmen' does not separate small private proprietors with modern plants from traditional artisans and (iii) data on 'Joint Ventures' do not distinguish between joint ventures formed between individual and corporate entities (except for state firms). In the future, such adjustments to the traditional classifications would permit a more detailed follow-up of the sector's performance.

2. Firm-Level Survey

C. Of the thirty five enterprises surveyed, 25 were unincorporated businesses (19 sole proprietorships and 6 partnerships) and 10 were incorporated firms (4 joint stock and 6 limited liability companies). All were private, locally-owned firms except for one Polonia firm and one joint venture. The oldest firm started in 1945 but most were established in the 1980s; including 15 between 1985 and 1988.

D. Sample firms ranged broadly in size from US\$250 to US\$100,000 in monthly sales, and from 2 to 400 full time workers. Factory space varied from small workshops in people's basements and back yards to relatively modern factories. The average factory was a relatively dated building of about 500 square meters. The subsectors which they belonged include wood products (1), metal products (7), chemicals (5), garments and textiles (4), electronics (4), food processing (3), construction materials (3), services (2), and other (6).

POLAND
REVIEW OF THE SMALL AND MEDIUM SCALE ENTERPRISE SECTOR

Major tax and charge burdens on legal and natural persons in the private sector (as of April 15, 1990)

1989

1990

I. Income Tax

1. For legal persons: 40% rate

- additional income tax on wages in excess of the norm set in the relevant Act.

2. For natural persons:
progressive rates between 6% and 75% (in 11 steps); taxation of no more than 50% of income; tax-free ceiling: ZL 574,200

a) tax concessions - relief on account of investments for some lines of activity, including private trades;

- exemptions for some lines of newly undertaken activity for 3, 5 and 10 years and in respect of uphill regions)

b) preferential, simplified forms of taxation (e.g., of services)

- tax charter (lump-sum taxes)

- other forms of lump-sum taxation retained.

1. For legal persons: 40% rate

- regulated by a separate Act Wage Gri with Taxation.

2 For natural persons:
progressive rates between 20% and 50% (in 4 steps) taxation of no more than 40% of income tax-free ceiling: Zl 3.6 million

a) tax concessions - reduction of investment-linked relieves; selective tax concessions linked to environmental protection, processing, construction, technological change;

- exemptions for some lines of newly undertaken activity, as in 1989.

b) preferential simplified forms of taxation (e.g. services)

- tax charter; 8-fold growth on 1989 rates

- other forms of lump-sum taxation retained; reduction of percentage rate in lump-sum arrangements, in accordance with changes in income-tax scales.

II. Sales Tax

1. For public-sector units

- diversified rates for particular products: basic rate for manufacturing activity: 15%

- basic lines of services free of tax;

- distribution free of tax;

- tax concessions for newly established units;

- export exempt of taxation

- basic rate for manufacturing activity: 15%

- basic services and distributions: 5%

- exemptions for some newly undertaken lines of activity (for specified periods);

- purchased production inputs subject to taxation.

- diversified rates for particular products: basic rate for manufacturing activity: 20%

- basic lines of services free of tax;

- starting from May 1, 1990, 1% rate for distribution;

- absence of concessions for newly established units;

- some exported goods taxed.

2. For private-sector units

- basic rate for manufacturing activity: 20%

- basic services and distributions: 5% (most service lines exempt)

- distribution: 1% as of May 1, 1990

- exemptions for some newly undertaken lines of activity (for specified periods);

- purchased production inputs exempt from taxation.

III. Real Estate Tax

1. Public-sector units paid at:

- 2% of value of buildings/structures

1. Taxation rules uniform for all economic units

- maximum rate for 1 sq.m. of usable floor area of buildings used for business purposes: ZL 8,000

- ZL for 1 sq.m. of land

- ZL 220 for 1 sq.m. of land use for business purposes;

- ZI 10 in respect of other land (detailed tax rates specified by the Finance Minister)

2. private-sector units and natural persons paid tax at:

- up to 0.1% of value of residential buildings;
- up to 0.3% of value of buildings for commercial use;
- up to ZI 500 for 1 sq.m. for apartments/commercial premises;
- up to ZI 1 for 1 sq.m. of land

IV. Road Tax

Uniform

Uniform (several fold increase in rates)

V. Payroll Tax

Only on public-sector units: 20% rate
For services: 50% relief

Only on public-sector units: 50% rate.
For services: no relief

VI. Wage Growth Taxation: Legal Persons

Element of income tax:

- an increase in tax by equivalent of 200% of the amount of wages in excess of norm;
- excess wages and all related pay components not counted towards costs.

A separate statutory Act; tax set at:

- where the norm exceeded by less than 3% the tax rate is 200% for each successive % of excess;
- where the norm exceeded by more than 3% the tax rate is 500% for each successive % of excess;
- firms owned (fully or partly) by foreign parties - exempt from tax.

VII. Wages Tax

(Compensation of Private-Sector Employees, Contracted Non-Employees, Royalties)

1. Legal persons outside public sector (on account of regular labour contracts)

- 13.5% of net wages paid
- 12% of gross wages

- 20% of net wages paid
- 17.5% of gross wages

VIII. Labour Fund Contribution

2. Natural persons (as above)

- all employees on income above ZI 3,696,000 (regular labour contracts, contracts with outsiders, pensions, etc.) ceiling on income taxation: 50%

- as in 1989 on income above ZI 16 million ceiling on income taxation: 40% most exemptions abandoned (e.g. responsibility allowance, holiday work).

IX. Labour Fund Contribution

1. For legal persons

- did not exist

- 2% of wage payments providing the base for ZUS contribution

2. For natural persons

- did not exist

- in respect of employees wage payments, as above.

X. ZUS (Social Security Contribution)

1. For legal persons

- in respect of employees, 38% of primary-fund wages (except for some pay components);

- in respect of employees: 43% of primary-fund wages (except for some pay components);

- 60 -

- concessional rate of 5% for disability and retirement pensioners

- concessional rate of 5% confined to the disabled persons employed at cooperatives of the disabled and PZG

- for own insurance 25%, depending on form of taxation;

- for own insurance 35% (change in base for calculation)

- for employees, 35% of wages (as in point 1);

- for employees 45% of wages (as in point 1).

XI Contribution to Central Fund for Science and Technology (CFRNT)

2. For natural persons

1. For legal persons

- as in 1989

- 1.2% of sales, required from all liable to income tax;

- foreign-owned firms and joint ventures exempt

- exemption of tax-payers wholly exempt from income tax

2. For natural persons

- contribution not required

- contribution not required

Review of the Private Small and Medium Scale Enterprise Sector

Table 1. Social Security rates in the private sector

No.	Specification	1989		1990	
		Calculation base	Rate	Calculation base	Rate
1	2	3	4	5	6
1.	Natural persons carrying out economic activity (paying contributions) for themselves)	Depending on form of taxation and line of activity (transport, distribution, etc.), no more than 5 times minimum public-sector wage	25%	Freedom to declare minimum 60% of average public-sector wage from the previous quarter	38%
2.	Private tradesmen (for themselves)	Depending on form of taxation no more than 5 times minimum public-sector wage	25%	as above	38%
3.	Agents (contracted by public-sector units)	Actual wages, no more than 5 times minimum wage	25% (11% paid by public-sector unit)	Actual wages, where incomes identifiable; if not, as in private trades	38% 50-50 between agent and public-sector unit
4.	Agents - timber carriers (state forestry)	Actual wages, no more than 5 times minimum wage	25%	Actual wages	38%
whole rate paid by public-sector units (in 1989 and 1990)					
5.	(filling stations, newspapers stands etc. actual wages.	38%	Actual wages	43%	
whole rate paid by public-sector units (in 1989 and 1990)					
6.	Legal and natural persons - for employees	Primary wage fund, excl. some pay components specified in Council of Ministers Ordinance	38%	Primary wage fund, excl. some pay components specified in Council of Ministers Ordinance	5%
		- Concessional rate for employed pensioners and disabled	5%	- Concessional rate for employed pensioners and disabled	5%

Edited by Piotr Mastukiewicz on the basis of data supplied by the Social Security Department of the Ministry of Labour and Social Policy.
Data provided by office of taxation, Ministry of Finance