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## Capacity-Building in Emerging Market Economies: The Second Wave of Reform

The demise of communist governments around the world in the late 1980s and early 1990s and the emergence of market systems in countries where the government had long played the dominant role in economic activities have crystallized the challenges that face all developing countries in creating market economies. The extensive economic and political reforms that are now taking place in Central and Eastern Europe, the former Soviet Union, the Balkan and Baltic states, and in such Asian countries as China, Mongolia, and Vietnam, often overshadow the less dramatic but no less significant transformations that are also occurring in many other developing countries. Governments have been adopting market policies in South and Southeast Asian countries where state enterprises have played an influential role in the economy, in former military dictatorships in Latin America, and in some African countries whose political systems have long been controlled by a single party or paramount leader. In all these countries, governments are privatizing state-owned enterprises (SOEs), reforming their economic policies, or redefining the relationships among public, private, and nongovernmental organizations in economic activities and processes of governance.

Although assistance organizations such as the World Bank and the International Monetary Fund

and most governments in transitional countries initially focused their attention on macroeconomic policy reforms as the key to creating markets, one of the most fundamental and important lessons to emerge from the experiences of the past five years is that macroeconomic reforms in themselves are neither sufficient to create a market economy nor adequate to sustain market development. In Central and Eastern Europe, it is becoming clearer that developing the institutional capacity to produce and distribute goods and services and to engage in international trade is far more important than reformers initially acknowledged.<sup>1</sup> Reflecting on the Asian Development Bank's experience, two of its leading economists conclude that "in terms of sequencing reforms, fiscal and monetary policies are less important in the near term and medium term than the standard policy prescriptions would make them appear."<sup>2</sup> They insist that "institutional reforms and price reforms are more important in the early stages."

Whether the changes from socialist to market systems have come through radical "shock therapy" reforms such as those adopted in Poland — and under consideration in Russia and other Eastern European countries — or through a more gradual transition to economic liberalization and private-

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enterprise development as in Hungary, China, and Vietnam, the experiences are yielding a better understanding of the types of institutional capacity that must be developed in any country that seeks to establish and sustain a market-oriented economy. In their attempts to transform their economies and politics, government and business leaders in most of the former socialist countries, having made major macroeconomic adjustments, now face the daunting challenges of a second wave of reform: building the institutional capacity to sustain market development. Capacity-building is the process through which individuals and organizations strengthen their abilities to identify and mobilize the resources to overcome economic and social problems and to pursue opportunities in order to achieve a better standard of living as generally defined in that society. Neither Western governments seeking to provide foreign aid nor multinational companies seeking to participate in emerging markets can achieve their goals unless they understand the challenges facing transitional countries in building their institutional capacities to develop and sustain market systems.

This article provides a framework for assessing and comparing the changes that are taking place in emerging market economies and synthesizes the lessons of experience in countries that are undergoing the transition from socialist to market systems. Studies cited throughout this article provide rich details on the experiences of individual countries in addressing economic reform issues. Identifying the capacities that are needed in the future to create or strengthen a market democracy and to sustain economic and social development will be done in three ways: first, by assessing the weaknesses and deficiencies in socialist and communist systems that leaders in emerging market economies are now trying to remedy; second, by examining the implications of the experience in emerging market economies for the types of capacities that need to be developed in the future; and, third, by examining the fundamental capacities that have accounted for the success of Western market economies in sustaining economic growth and democratic governance for more

than 300 years. This third approach does not imply that currently emerging market economies must necessarily follow the patterns set by older Western market democracies, but it does yield some general lessons about capacities that seem to be preconditions for the effective operation of any capitalist market system. All three approaches suggest an identifiable set of capacities needed to create or strengthen market democracies in transitional and developing countries.

### The Context of Transition: Deficiencies of Socialist Systems

It is clear in retrospect that the collapse of communist regimes in Eastern Europe at the end of the 1980s and the weakening of Communist Party rule in several Asian countries since the late 1970s came not so much from indigenous political revolutions as from the steady deterioration of their economies. The passing of communism as a viable system of governance can be attributed primarily to the inability of regimes relying on central planning and control to stimulate and sustain economic growth and to achieve an acceptable standard of living for the majority of their citizens.

The types of capacity-building in which transitional countries are now engaged have been shaped initially by the need to overcome the deficiencies of socialism. The inability of socialist central planning to sustain economic development became evident in the 1980s, but it is now clear that central planning and control could not efficiently or effectively guide national economies or the operations of SOEs in countries such as Poland, Hungary, Czechoslovakia, the Soviet Union, or China.<sup>3</sup> The general characteristics of communist systems provide some insights into the problems most post-socialist regimes are now seeking to remedy. Lindblom concisely summarizes the characteristics of communist systems as those with (1) a strong concentration of political power and authority in the hands of a single ruler or a small group of party leaders; (2) political lead-

ers committed to the achievement of collective goals determined largely by ideological criteria; (3) state ownership of all or most of the productive assets in society; (4) centralized organization and direction of the economy by the ruling party or government; (5) use of a wide range of controls (including coercion) to assure conformance to planned goals and targets; (6) suppression of both individual political freedoms and social pluralism; (7) use of a privileged mobilizing organization — the Communist Party — to guide society toward collective goals; and (8) the substitution of formal organization (large, complex and hierarchical party or government bureaucracies) for other forms of social coordination.<sup>4</sup>

The inability of central-planning authorities to comprehend and calculate the myriad interactions and interdependencies in any socialist economy quickly undermined their capacity to control it in any meaningful way. Thus, in most socialist countries scarce resources were allocated neither by efficient market signals nor by competent technical analysis and planning. Kornai points out that in place of market signals, resource allocations were made in centrally planned economies through a set of non-price signals emanating primarily from the national economic plan, but also from frequent bureaucratic directives, the exchange of information horizontally among authorities on the same hierarchical level, breakdowns and catastrophes, and grumbles or protests from subordinate bureaucratic units as requirements became unrealistic or intolerable.<sup>5</sup>

Nowhere were the deficiencies of central planning and control more visible than in the management of the SOEs that dominated the economies of socialist countries. Everywhere in the communist world, large enterprises were run much like government agencies, with little concern for profits and losses or for operating within hard budget constraints. Losses were regularly subsidized by the government. The primary objective of state enterprise managers in the Soviet Union, Eastern Europe, China, and Vietnam was to meet centrally established production targets. They paid little or no attention to the quality of the goods they produced or

to the costs of production. State enterprises in nearly all communist regimes were vertically integrated, retained large surplus-labor forces, compensated their workers with low wages and social benefits, hoarded materials and inputs, and accumulated large inventories in the face of chronic shortages of supplies. There was virtually no incentive for workers to increase their productivity or for managers to develop skills in marketing, quality control, product development, and finance or for either workers or managers to make their enterprises more competitive in the domestic economy.

Although the immediate task of post-socialist governments was to abolish the central planning apparatus and to divest the state of control over production enterprises, the complex challenges of implementing economic reforms and of developing the private sector have also helped define the capacities needed to complete the transition to a market-oriented economy. The difficulties that all emerging market economies are facing can be attributed to a combination of adverse external conditions; internal economic, political, bureaucratic, and structural obstacles remaining from the old system; and inadequate capacity to carry out new tasks. They include (1) the difficulties of implementing changes rapidly in an environment of worldwide economic recession and national economic uncertainty; (2) the continuing political ambivalence over the appropriate pace and scope of economic reform; (3) initial opposition by many managers and workers in SOEs to restructuring and privatization, and (4) bureaucratic complexities and delays in formulating and carrying out privatization procedures. Implementation of economic reform and privatization policies are also adversely affected by the weak market-economy management skills found among SOE managers and new business owners in many former socialist countries; by the incomplete restoration of property rights; by inadequate supplies of capital and credit to purchase SOEs or to start new enterprises; by weak business infrastructure to support enterprise expansion; by burdensome business taxes and regulations remaining from the communist period; and by lingering

social hostility toward successful entrepreneurs and business owners.<sup>6</sup>

## Capacity Requirements for Emerging Market Economies

Assistance organizations such as the International Monetary Fund and the World Bank have focused their efforts on convincing leaders in emerging market countries to adopt structural adjustment policies and much of their effort has been focused on economic changes. Reform leaders quickly discovered, however, that economic changes alone would not achieve their goals. As the Czech Republic's prime minister and leading economic reformer Václav Klaus now admits, "in such a fundamental change of the whole society there can be no pure economic solution."<sup>7</sup> Reformers must be prepared to cope with the complexities of both economic and political restructuring while at the same time developing a whole new set of institutional capacities that support the private sector's participation in emerging market systems.

## Capacities Required for Market Development

Figure 1 summarizes the types of capacities that experience suggests must be developed in order to create market-oriented systems. First, market development requires macroeconomic policies that provide an environment conducive to market transactions. Initially governments in transitional countries must enact structural adjustment and stabilization policies to curb inflation, liberalize trade, and deregulate the economy. At the same time, they must help establish a complex network of institutions through which market transactions can take place. These include financial and legal institutions, an education system that can prepare graduates to work effectively in a market economy, efficiently operating labor markets, a system of property rights, and effective distribution systems. Market development

also requires the expansion of foreign trade and investment, the development of small- and medium-sized enterprises, the restructuring of large companies, and the attraction of investments from multinational companies in domestic industries. In many transitional countries, nongovernmental organizations, civic groups, and foundations that form civil society must be re-created or strengthened. The success of the economic and political reforms as well as the survival and expansion of privatized enterprises depends ultimately on human development, that is, on the expansion of the pool of entrepreneurs, of market-oriented business managers, of a merchant and trading class, and of skilled technical and support workers. All these changes often have to be initiated quickly in order to create a momentum that will allow a market economy to come into being as well as to survive the dislocations and hardships inevitably accompanying traumatic political, economic, and social changes.

Evidence supporting the need to develop these capacities in transitional countries comes not only from their own experiences but also from those of Western market economies. In their comprehensive assessment of *How the West Grew Rich*, Rosenberg and Birdzell point out that the industrialized countries succeeded in achieving steady economic progress precisely because they were able to establish an economic and political environment conducive to private-enterprise development; that is, one that encouraged the emergence of a diverse set of institutions and organizations to carry out economic activities, and supported the development of skilled human resources to innovate and adapt to change.<sup>8</sup> The creation of this institutional capacity and human-resource base further encouraged the diffusion of authority, the widespread use of experimentation to find appropriate technology and effective means of production and marketing, and the discovery of new ways of organizing economic enterprises. Moreover, the economies of Western countries grew because many organizations could provide "incentives which combined ample rewards for success, defined as the widespread economic use of the results of experiment, with a risk of severe penal-

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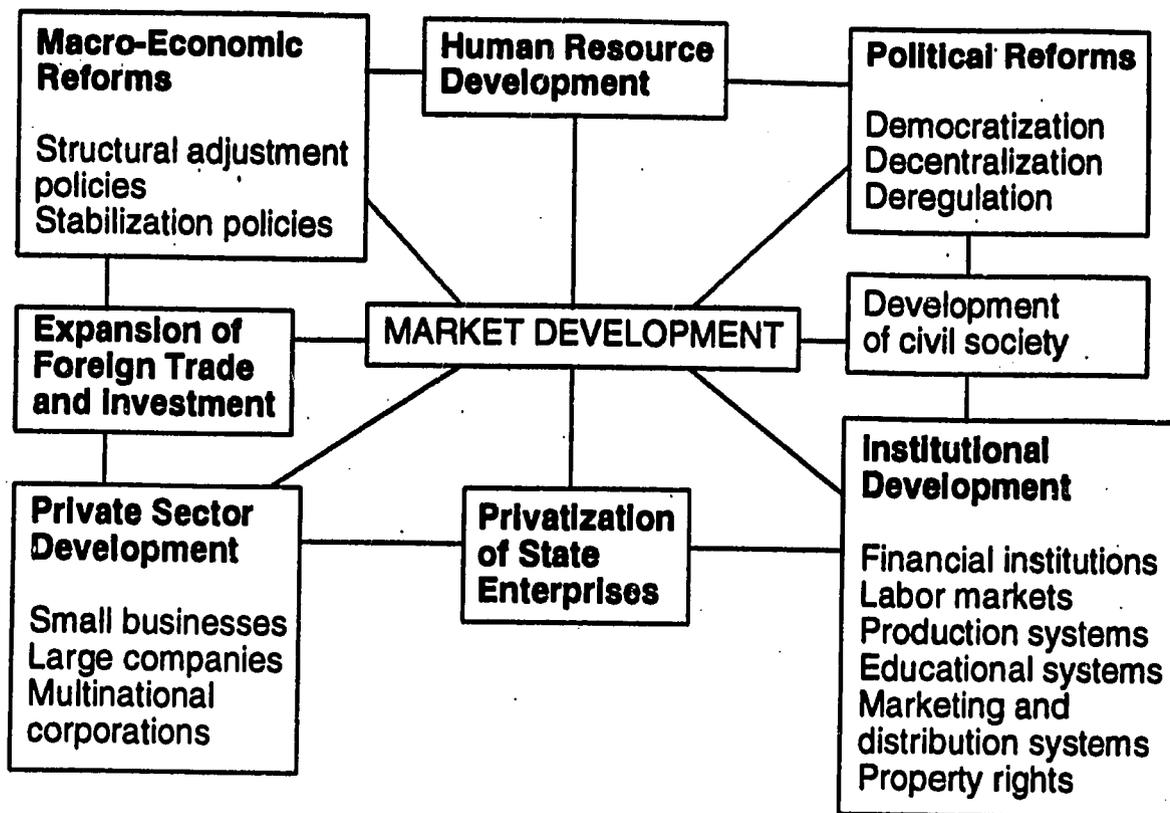


Figure 1: Capacity Requirements for Emerging Market Economies

ties for failing to experiment.” In sum, progress in economic development was based on three factors — autonomy, experimentation, and diversity — that socialist regimes tried to suppress.

Thus, the deficiencies of former socialist regimes, the challenges facing reformers in emerging market economies, and the experience of Western market democracies all point to at least nine capacities that seem to be essential for creating and sustaining market-oriented economic systems.<sup>9</sup> Progress in expanding these capacities may be the only reliable indicator by which Western businesses and governments can assess the prospects for a successful transition in emerging market economies.

*Capacity to Implement Macroeconomic Policies That Support Market Systems.* Although

most governments in the former socialist countries have adopted the standard IMF prescriptions for macroeconomic reform, many still face the tasks of dismantling macroeconomic policies that supported central-government planning and control of the economy and micromanagement of state enterprises. In order to create a market-oriented system, however, they must also begin to develop the capacity to design, enact, and implement a new set of economic policies. At the urging of the IMF and World Bank, almost all have begun with structural-adjustment policies that encourage the development of market mechanisms that can efficiently and effectively allocate scarce economic resources and set prices for both production inputs and consumer goods. This requires financial liberalization and the

reduction (and eventual elimination) of price controls. At the same time, many former socialist countries face serious problems of inflation and decline in national output that must be corrected by economic-stabilization policies aimed at reducing balance-of-payments deficits, rescheduling debt, controlling the money supply, reducing subsidies, and restraining wage increases. Developing the capacity to formulate, enact, and implement effectively structural-adjustment and economic-stabilization policies is, itself, a critical challenge facing emerging market economies.

**Capacity to Develop Liberal Trade and Investment Policies.** Because most communist countries traded primarily with each other, reformers face serious challenges in developing the capacity to expand export markets and engage in foreign trade and investment. This requires the capacity to develop and implement liberal trade and investment policies including programs for export promotion, foreign direct investment, exchange-rate adjustments, and the easing of investment restrictions and trade barriers.

The importance of developing international trade and investment capacity is seen not only in the economic problems of post-communist regimes but also in the pivotal role that foreign trade has played in the history of Western market economies. In the West, the extension of trade and the freedom of a merchant class to engage in trade substantially expanded economic opportunities, allowed new products and commodities to be introduced into the domestic economy (that were later produced locally or transformed into yet other products that found both domestic and overseas markets), and provided consumer goods for which no local or national source yet existed. The innovation by extension of trade and the discovery of new resources has been a major source of creativity and profitability for enterprises and for their suppliers and distributors in the West and continues to be a driving force of economic growth in market economies.<sup>10</sup>

**Capacity to Undertake and Sustain Political Reforms.** In the initial stages of transition, all the Eastern European countries have had not only to

dismantle the old communist government structures but also to establish new political systems based on some degree of representative democracy. They face continuing challenges in creating new political institutions, new modalities of governance, and new political capacities to formulate and guide national economic activities without undue intervention and control. They must create a political system that can elicit at least a minimum level of public consensus on social and political goals; can encourage political, business, and civic leaders to articulate social and economic priorities; and can guide the actions of public organizations toward economic objectives that benefit society.

One of their most difficult tasks is to shift the orientation of the political system away from planning and controlling economic activities — one of its major functions in socialist regimes — to facilitating and guiding economic development. Leaders of the new political systems must be capable of devising, enacting and implementing policies in four arenas: economic growth, social equity, international transactions, and public-sector management.<sup>11</sup> The political systems that emerge in former socialist countries should be capable of nurturing political leaders who are flexible, pragmatic, and responsive to changing economic conditions. Such leaders should be able to mobilize resources and shift priorities and directions as domestic and global economic conditions change, without such actions threatening the stability of the political system.

At the same time, political reforms must help to create new capacity for public-sector management — one with the ability and resources to deliver appropriate public services and infrastructure, regulate activities affecting the public health and safety, allocate public resources efficiently among legitimate competing claims, protect national security, and adjudicate conflicts among citizens and businesses according to equitable rules of law. Above and beyond the capacity of political systems to support governments that perform conventional public service functions, the experience from East Asian countries that successfully transformed their economies suggests that they must be able to recruit

and support political leaders who have a developmental orientation focused on building a business-friendly economic environment.<sup>12</sup> Capacity-building requires leaders with the commitment and ability to create the conditions that allow public and private institutions to establish and pursue economic and social development goals effectively within the context of societal values and aspirations.

**Capacity to Establish and Sustain Decentralized Systems of Government.** The structural adjustment policies of the IMF and World Bank have frequently assumed that the creation of market mechanisms would largely ensure economic growth and that the government's role had to be reduced drastically. Although many socialist countries do indeed suffer from large dysfunctional government bureaucracies, reformers sometimes ignored the fact that economic and political changes would have to be enacted and implemented initially by post-socialist governments that were still seeking political legitimacy. Moreover, they often overlooked the fact that in the newly industrializing countries (NICs) of Asia and in Western market economies, governments have played an important role in creating the conditions for economic growth.<sup>13</sup> In the Asian NICs and Western market economies, governments mobilized the resources needed to provide physical infrastructure, created new transport and communication linkages, and extended the public services and facilities that helped make private enterprises and local communities more efficient economic units.

Experience has shown that the successful implementation of economic and political restructuring programs requires far more than simply enacting new policies and removing restrictions on private enterprise, although both are essential. In order to implement economic and political reforms effectively, government leaders in emerging market economies must be committed to the philosophy of decentralization, privatization, and wider participation in decision making.<sup>14</sup> National political leaders in former socialist countries must be willing and able to transfer planning, decision making, and managerial authority to lower levels of administration and to the private sector.<sup>15</sup>

In countries where governments were highly centralized and authoritarian, reforms must focus on developing the capacity to decentralize authority, responsibility, and resources in order to create the organizational diversity that is essential to the efficient operation of markets. This implies that governments must develop the capacity to decentralize, for example, by strengthening the field units of national ministries; by creating or strengthening local administrative units; by delegating functions to regional, special-purpose, or functional authorities; by devolving responsibilities and resources to local governments; and by involving the private sector in infrastructure provision and service delivery.

Devolution of political and administrative authority can achieve a variety of goals in emerging market economies.<sup>16</sup> First, it can make the implementation of reform policies more effective by delegating to local officials greater responsibility for tailoring public programs to local conditions and needs. Devolution can also make it easier for local officials, interest groups, and businesses to cut through the enormous amounts of red tape and the highly bureaucratic procedures characteristic of planning and administration in socialist systems. By decentralizing functions to field offices or to local governments, more public officials can become knowledgeable about and sensitive to local problems and needs because they will be working at the level where these are most visible and pressing. Closer contact between local populations, businesses, and government officials can also allow the latter to obtain better information with which to formulate policies and programs that affect local economies.<sup>17</sup> New administrative capacities must be developed in former socialist countries, however, if public officials are to work effectively in a decentralized system of government.

**Capacity to Transfer Ownership and Control of State Enterprises to the Private Sector.** Most economic reformers in Eastern Europe and some in Asia have understood from the very beginning of the transition process that both developing the private-sector and privatizing state enterprises were essential for creating a market economy. The-

ories of privatization had been well developed by international assistance organizations by the end of the 1980s. The staffs of international assistance organizations argued that privatization could free for investment in infrastructure and social services those public resources that had been used inefficiently to subsidize money-losing SOEs; to increase the size and dynamism of the private sector; to distribute ownership more widely; and to attract foreign and domestic private investment.<sup>18</sup> The strong focus that international assistance organizations placed on privatization in transitional economies emerged from the realization that it can generate revenues needed by the state to create new jobs for workers displaced by industrial restructuring, can reduce the state's administrative responsibilities and the burdens of government intervention in enterprise management, and can provide consumers with more efficiently produced goods. At the same time, individual enterprises benefit from private ownership through increased productivity, expansion of productive capacity, and increased profits.

In the absence of appropriate and reliable models for the massive privatization required in former socialist countries, reformers are experimenting with several different approaches, including property restitution and reprivatization; spontaneous privatization; self-privatization; auctioning of small companies; corporatization and the transformation of large SOEs into joint-stock or holding companies as a precondition for mass privatization; management and employee buyouts; trade sales; and asset privatization and liquidation. The implementation of privatization policies, however, requires the development of substantial administrative capacity in both the public and private sectors in emerging market economies. Initial experience suggests that privatization can be slow and disappointing unless transitional countries can establish the appropriate procedures and administrative capacities to facilitate the process.<sup>19</sup>

**Capacity to Develop Social Institutions That Facilitate Market Transactions.** An equally crucial requirement for the transition to a market economy is the capacity to create new social and eco-

omic institutions to facilitate market transactions. Once macroeconomic policy reforms are enacted, much more attention must be given to developing financial institutions that can extend credit and provide the financial resources needed by investors and entrepreneurs; to rationalizing and reorienting labor markets; to establishing stock exchanges through which shares in privatized companies can be traded; to creating the system of legal institutions through which business transactions can be legitimized and conflicts can be settled; to strengthening the system of property rights; to developing new and effective forms of corporate governance; and to developing reliable and efficient marketing and distribution systems.

One of the most important institutions in a market-oriented economy is a reliable system of property rights that facilitates the shift of property ownership to the private sector. Czech prime minister Klaus concluded from his country's experience that "the economy cannot be restructured without a comprehensive shift in the property-rights structure. To expect a change in economic agents' behavior without privatization [of property] is unwarranted and never happens."<sup>20</sup> Investors interested in acquiring all or parts of state enterprises in Eastern Europe and in China, for example, have had difficulty purchasing property or protecting their acquisitions against conflicting claims. Although the governments in many Central and East European countries have opened property ownership to foreign investors, foreign companies often face difficulties in determining from whom to purchase land and assets that had been nationalized by communist regimes. Property rights in many transitional countries are still unclear, and title to land is clouded by potential restitution claims by former owners.

**Capacity to Expand and Strengthen Private Enterprise.** All emerging market economies must develop the capacity to expand and strengthen the private sector by providing incentives and support for the development of small- and medium-sized enterprises, by restructuring large inefficient state-owned companies, and by attracting investments in domestic industries by multinational cor-

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porations. The most important capacity that must be developed, however, is that of generating the jobs needed to raise incomes and strengthen internal markets by accelerating the development of small- and medium-scale enterprises. Although large manufacturing firms have contributed an impressive number of jobs in Western market economies and have played the dominant role in employment in former socialist countries, they have absorbed only a modest portion of the total labor force in most market-oriented countries. It is these large manufacturing enterprises that are most likely to be privatized and restructured in emerging market economies and, in the process, to displace large numbers of surplus workers.

Jobs in most market economies are being created by small- and medium-sized commercial and service enterprises.<sup>21</sup> They are not only an important source of livelihood but they also facilitate social mobility, economic stability, and market expansion by providing women and children with the opportunities to supplement household income. They offer poor and middle-class families essential goods and services and give technical and entrepreneurial training to workers. Small enterprises also mobilize savings for people with no access to formal credit. In most countries, small businesses flourish because they use a favorable mix of capital, labor, and energy and have commercial links to modern manufacturing.

Despite their critical importance for job creation and economic growth, many entrepreneurs wishing to establish or expand small enterprises in emerging market economies experience numerous obstacles, including limited access to and the high costs of credit, high hidden costs of start-up and operation, and limited managerial skills.<sup>22</sup> Many lack access to information and technology needed to improve production, efficiency, and product quality. They also face difficulties in establishing and maintaining adequate marketing networks, in reducing long marketing chains, and in responding quickly to changes in market demand. Most smaller businesses cannot compete effectively with larger firms that benefit from preferential government policies

and programs. Experience indicates that the expansion of small businesses depends on increasing the demand for goods and services produced by small enterprises. This requires steady economic growth and both supply- and demand-oriented policies that promote sustainable economic expansion. In addition, government and private-sector procurement programs that seek supplies from small enterprises can help them to increase their production.

The ability of small enterprises to expand and create jobs often requires regulatory and administrative changes that allow them to operate more efficiently, adequate public infrastructure and services, and educational and vocational training programs that improve the quality of the labor force. Improving the efficiency of small enterprises further depends on technical assistance, improvements in management and technology, and greater access to credit and materials.

The multinational corporations (MNCs) that are being attracted to emerging market economies can also be encouraged to play a significant role in assisting small enterprises through special programs that give them preference in subcontracting, procurement, and distribution. MNCs can use small businesses to distribute their products through licensing, franchising, and dealership agreements, and to provide support to customers. Multinational companies can create networks for small businesses to serve as distributors, thereby contributing to small enterprise expansion.

*Capacity to Develop Human Resources for Participation in Market Systems.* An important challenge in all emerging market countries is to develop the human resources needed for people to participate widely in domestic and international commerce by expanding their knowledge of how markets work and how businesses operate within them. Although some transitional countries had a long tradition of manufacturing and trade before communist regimes took power, most entered the process of transition to a market economy lacking the basic knowledge of how market systems operate and how private enterprises compete.

Although managers of state-owned compa-

nies were often technically skilled, most lacked the capacity to operate in a market economy. Surveys taken during 1991 and 1992 in the Czech and Slovak Republics, Poland, and Hungary, for example, identified a number of weaknesses common to managers in socialist countries.<sup>23</sup> Among the most serious problems were the lack of flexibility, accuracy, and timeliness in their business practices and behavior and their reluctance to take responsibility or risks. This should not be surprising, however, because in socialist countries workers and managers operated in an environment that rewarded obedience, conformity, and meeting planned targets. Many were not required to take responsibility for decisions. They did not know how to assess competitive opportunities, how to deal with risk, how to mobilize and invest capital to create market advantages, how to use information systems for business operations, or how to value the assets and liabilities of their companies. Managers of state companies were also unfamiliar with cash-flow management and international systems of accounting. New capacities must be developed to overcome all of these problems in emerging market economies.

Among the most urgent needs is the development of institutions that give enterprise managers and new small-business owners access to information about the business-formation process, business systems, business practices and procedures, and markets; that provide practical counseling and consulting services on the legal environment, business planning, financing, and marketing; that offer broad-scale business ownership and management training, particularly in short, practical workshops and seminar formats; and that create business-development facilities that can help overcome scarcities of commercial and production space for new businesses and that can provide training and management assistance programs.<sup>24</sup>

*Capacity to Develop an "Entrepreneurial Milieu" and a Value System That Supports Democratic Market Economies.* Finally, the most difficult capacities to develop in emerging market economies will be those that create a social environment — an "entrepreneurial milieu" — and

individual and social values that are essential for democratic market economies to thrive. All economic systems are based on social values, and capitalist market systems have their own underlying assumptions that must be recognized, accepted, and pursued if they are to function effectively.<sup>25</sup> Capitalist market systems in particular are based on a set of social values that encourage and reward individualism, entrepreneurship, innovation, responsiveness to change, and the belief that those who take entrepreneurial risks should be amply rewarded for success and allowed to absorb the penalties for failure. These are not values that were promulgated in socialist countries, and indeed, communist regimes tried to eradicate them in favor of an egalitarianism that stifled initiative and discouraged entrepreneurial activity for profit. As a result, reformers in former socialist countries face widespread public ambivalence about the values and assumptions underlying democratic market systems. Kornai notes that although the majority of people in transitional countries have rejected socialism and many loathe communism, this is not incompatible with "the observation that the great masses of people continue to adhere to moral values — attributes of a notion of a 'good society' — that their upbringing taught them to rate as socialist values."<sup>26</sup>

As a result, reformers in emerging market economies face the daunting challenges of shaping an entrepreneurial milieu in which values exist such as tolerance and respect for individualism and diversity; a belief in limited government rather than in one that is employer and benefactor of first and last resort; the acceptability of competition; a respect for private-property rights; the acceptance of unequal rewards for greater efforts; and a tolerance for the uncertainty that inevitably accompanies the innovation, experimentation, and risk of failure inherent in market driven economies.

Moreover, in many emerging market economies capacities must be developed for instilling in the population the values of democratic governance — however democracy is defined in that society — because capitalist markets depend on the autonomy, freedom to innovate, ability to experi-

ment, and willingness to change that have historically fueled economic growth in Western societies. The relationships between markets and democratic governance are subtle and pervasive; but as Lindblom points out, "... however poorly the market is harnessed to democratic purposes, only within market-oriented systems does political democracy arise." He emphasizes the fact that "not all market-oriented systems are democratic, but every democratic system is also a market-oriented system."<sup>27</sup> It is difficult to imagine that a nondemocratic society could accommodate the autonomy, diversity, and freedom essential for the innovation, creativity, and experimentation that sustain economic growth in market systems.

An entrepreneurial milieu and a value system that supports a market democracy will emerge only slowly in most transitional countries such as Russia where seventy years of communism simply reinforced values that have never highly prized entrepreneurship and democratic governance. Such an environment will not emerge quickly in any society unless the capacity is developed both to educate — in the broadest sense of the word — people about the benefits of economic competitiveness and social cooperation and to provide incentives, reinforcement and rewards for the expression of values supporting market economies. This requires a fundamental reorientation of many of the educational, religious, and social institutions in transitional countries that shape beliefs, attitudes, assumptions, and values. Economic policy reforms and the creation of market structures alone will lead to naught unless the capacity for reorienting values in ways that support and sustain market democracies is also enhanced.

### Sequencing Economic Reforms and Capacity-Building

Although the need for all of these capacities is becoming more widely recognized in emerging market economies, the problem of sequencing remains crucial because no transitional country has sufficient

financial and human resources to build all elements of capacity at the same time. The challenge is more difficult because there is also no universal prescription for sequencing. Central and Eastern European countries had to focus first on economic stabilization because rampant inflation, disappearing export markets, and plunging production threatened to undermine economic and political restructuring unless immediate action was taken to address these issues. Political restructuring was also an immediate concern because fallen communist governments had to be replaced quickly by some form of democratic governance. The World Bank-International Monetary Fund solution to sequencing reforms in Central and Eastern Europe was to give immediate attention to stabilization policies and to reinforcing the "social safety net" — policies protecting health and social benefits that workers had received under the socialist regimes — along with privatization of small businesses and private-sector development. Price and market reforms came next in the sequence followed by large-scale privatization, the creation of autonomous banking systems and, later, the creation of other types of financial markets.<sup>28</sup> Institutional reforms were to be undertaken throughout the process, but human-resource development, organizations facilitating market transactions, and development of civil society were given attention relatively late in the process.

Asian countries, on the other hand, placed more emphasis in the initial stages on gradual economic restructuring and paid little attention to formal privatization and political restructuring. China and Vietnam, for example, focused first on macroeconomic changes that allowed the private and non-state sectors to expand thereby reducing the dominance and monopoly position of state enterprises, then on trade liberalization, and then on gradual price and market reforms, leaving privatization to later stages in the reform process.<sup>29</sup> Institutional development has come slowly because the expansion of the private sector and foreign trade place pressures on communist regimes to create financial, labor market, and trade organizations in order to relieve bottlenecks to further economic

growth. They have given relatively little attention to human-resource development, political reform, and the strengthening of civil society.

One of the crucial lessons from the experience with transition is that institutional-capacity-building and economic reforms must be tailored to the specific needs, conditions and constraints of individual countries. Substantial evidence from the experience with structural adjustment during the 1980s and early 1990s suggests that the imposition of IMF-type prescriptions without a deep understanding of the social, economic, and political context in the countries in which reforms are being adopted can result in political backlash and resistance that seriously undermines capacity-building.<sup>30</sup>

## Conclusions

The long-term weakening of communist-controlled economies in Eastern Europe and Asia not only undermined the legitimacy and acceptability of those regimes but also undermined the intellectual foundations of Marxist ideology. All the governments in transforming societies and many of those in developing countries are now searching for new organizing principles for governance and economic restructuring. Although they have abandoned the concept of Marxist socialism, most are not yet willing to accept classical concepts of capitalism — that is, the idea of unfettered markets and laissez-faire principles. This should not be surprising because even Western democracies have been unwilling to accept many of the perceived deficiencies of classical capitalism: the focus of corporations on maximizing short-run profits; overexploitation of material and human resources; the willingness of powerful enterprises to eliminate competition and create monopolistic niches; the private sectors' apparent disregard for the social costs and "spillover effects" of its activities; the failure of some private companies to deal responsibly with social and ecological problems; and the seeming lack of concern by large companies for individual human development. Almost all Western

democracies have modified the principles of capitalism to address these deficiencies.

The search continues in emerging market economies and in other developing countries for a new set of market-based, democratic principles. These principles might be labeled, for want of a better term, "socially responsible capitalism." Although a new paradigm for socially responsible capitalism has not yet emerged, its general characteristics can be seen both in the aspirations of the reformers in transitional societies and in the policies of Western market societies. These aspirations reflect the search for a democratic system of governance that supports efficient market mechanisms, but that also *promotes both economic and human development*. Such a system must, of course, focus on promoting individual responsibility for both self and society. Such societies must develop public and private institutions that can achieve economic growth through market transactions and instill responsibility in individuals and organizations for the social consequences.

In sum, the types of capacities that seem to be essential for a system of socially responsible capitalism to evolve — and that must be encouraged by businesses and governments both in emerging market countries and in the Western industrial democracies that are seeking to help them — include those that can create and sustain:

- a market-based enterprise economy that encourages entrepreneurship and private ownership of factors of production;
- a system of governance based on some type of representative democracy that allows a large measure of individual freedom and political pluralism;
- political and economic mechanisms for protecting collective welfare and for assisting poorer segments of the population to attain access to jobs and income;
- mechanisms for assuring access to the market by maintaining equitable income distribution, reasonably full em-

- ployment, and diverse sources of investment capital; and to representation in the political system for all citizens by maintaining multiple levels of government through which diverse political interests can be expressed and citizens can participate in decision making;
- means of effectively developing human-resource potential through adequate and accessible systems of education, training, and health services;
  - institutions within society that can provide appropriate checks and balances against either economic monopolies that undermine the efficient operation of the market or the dominance of political factions that inhibit widespread political representation;
  - the institutions of civil society through which governments, the private sector, and nonprofit organizations can work together in achieving economic and social objectives essential to sustaining a commonwealth;
  - the development of support mechanisms for market transactions including appropriate financial institutions and social-overhead capital in the form of physical and organizational infrastructure;
  - institutions for promoting innovation and creativity through the development of science and technology and the arts and humanities;
  - diverse and decentralized economic and social institutions that allow en-

trepreneurs to innovate, experiment, assume risks, and reap the rewards for taking risks;

- institutions for promoting individual and corporate responsibility by encouraging the development of socially responsible corporate cultures, value-based education, and tolerance for religious and philosophical diversity; and,
- institutions and processes that foster effective participation of individuals and private enterprises in the international economy through a liberal set of foreign-trade and investment policies and practices.

In considering the challenges facing emerging market economies during the second wave of reform, it should be clear that governments alone cannot create and sustain market institutions. Private entrepreneurs and nongovernment organizations must be partners in the transition. It should be equally clear that no international assistance organization, regardless of the size of its resources and the scope of its "leverage," can develop all of the capacities needed in emerging market economies through foreign aid. Indeed, prime minister Klaus asserts that "what we really need from the rest of the world is not aid; it is trade and exchange." That will require from Western governments and businesses cooperation in building the institutions of production, distribution and exchange, but capacity-building, like all forms of human development, must ultimately be self-motivated and internally driven. External agents can assist, guide, encourage and provide supplementary resources, but those interventions must be carefully selected and strategically pursued.

## Notes

1. See Dennis A. Rondinelli, ed., *Privatization and Economic Reform in Central Europe: The Changing Business Climate* (Westport, CT: Quorum Books, 1994).
2. Pradumma B. Rana and J. Malcolm Dowling, Jr., "Big Bang's Bust," *The International Economy* 7, no. 5 (1993): 40-43 and 701-702; quote at p. 702.

3. See, for example, Dennis A. Rondinelli and Martin R. Fellenz, "Privatization and Private Enterprise Development in Hungary: An Assessment of Market Reform Policies," *Business & the Contemporary World* 5, no. 4 (1993): 75-88; and Dennis A. Rondinelli, "Private Enterprise Development and the Transition to a Market Economy in the Czech and Slovak Republics," in Perry L. Patterson, ed., *Capitalist Goals, Socialist Past: The Rise of the Private Sector in Command Economies* (Boulder, CO: Westview Press, 1993), 89-115.
4. See Charles E. Lindblom, *Politics and Markets: The World's Political-Economic Systems* (New York: Basic Books, 1977): chap. 18.
5. Janos Kornai, *The Socialist System: The Political Economy of Communism* (Princeton, NJ: Princeton University Press, 1992), 157-59.
6. See Rondinelli, 1994, chap. 1.
7. Vaclav Klaus, "The Ten Commandments Revisited," *The International Economy* 7, no. 5 (1993): 36-39 and 70; quote at 36.
8. Nathan Rosenberg and L.E. Birdzell, Jr., *How the West Grew Rich: The Economic Transformation of the Industrial World* (New York: Basic Books, 1986).
9. See the experiences described in Dwight H. Perkins and Michael Roemer, eds., *Reforming Economic Systems in Developing Countries* (Cambridge: Harvard University Press, 1991); and in Vittorio Corbo, Fabrizio Coricelli and Jan Bossak, eds., *Reforming Central and Eastern European Economies: Initial Results and Challenges* (Washington, DC: World Bank, 1991).
10. Rosenberg and Birdzell, 25.
11. The argument is made in more detail in Dennis A. Rondinelli and John D. Montgomery, "Managing Economic Reform: An Alternative Perspective on Structural Adjustment Policy," *Policy Sciences* 23, no. 1 (1990): 73-93.
12. The World Bank, *The East Asian Miracle: Economic Growth and Public Policy* (New York: Oxford University Press, 1993).
13. Rondinelli and Montgomery point out that "in Singapore, South Korea, and Taiwan, which have depended heavily for their growth on international trade, the central government played an extremely important role in providing public services and infrastructure needed for economic production, breaking the 'bottlenecks' to economic expansion, investing directly in productive activities during the early stages of economic growth, and creating favorable conditions for private enterprise development in later stages."
14. John Waterbury, "The Political Management of Economic Adjustment and Reform," in Joan Nelson, ed., *Fragile Coalitions: The Politics of Economic Adjustment* (New Brunswick, NJ: Transactions Books, 1989), 39-56.
15. See, for example, Dennis A. Rondinelli and Henry Minis, "Administrative Restructuring for Economic Adjustment: Decentralization Policy in Senegal," *International Review of Administrative Sciences* 56, no. 3 (1990): 447-66.
16. Dennis A. Rondinelli, James McCollough, and Ronald W. Johnson, "Analyzing Decentralization Policies in Developing Countries: A Political-Economy Framework," *Development and Change* 20, no. 1 (1989): 57-87.
17. Dennis A. Rondinelli, *Decentralizing Urban Development Programs: A Framework for Analysis* (Washington, DC: U.S. Agency for International Development, 1990).
18. The most concise statement of the case is found in International Finance Corporation, *Small Scale Privatization in Russia: The Nizhny Novgorod Model — Guiding Principles* (Washington, DC: IFC, 1992).
19. World Bank, *Privatization: The Lessons of Experience* (Washington, DC: World Bank, 1992).
20. Klaus, 39.
21. See Dennis A. Rondinelli and John D. Kasarda, "Foreign Trade Potential, Small Enterprise Development and Job Creation in Developing Countries," *Small Business Economics* 4, no. 4 (1992): 253-65.
22. The situation in the Czech and Slovak Republics, for example, is described in Dennis A. Rondinelli, Scott Daugherty, and Jerry VanSant, *Management and Technical Assistance Needs of Small Businesses in Czechoslovakia* (Washington, DC: Central European Small Business Enterprise Development Commission, 1991); and that in Vietnam in Le Ngoc Hung and Dennis A. Rondinelli, "Small Business Development and Economic Transformation in Vietnam," *Journal of Asian Business* 9, no. 4 (1993): 1-23.
23. Juliane Langenecker and Bela Papp, "Eastern European Human Resources: East-West Perspectives," *Business Eastern Europe* 21, no. 32 (August 10, 1992) 387-88.
24. Langenecker and Papp, 37-40.
25. The values underlying American capitalism, for example, are discussed in Jack N. Behrman, *Essays on Ethics in Business and the Professions* (Englewood Cliffs, NJ: Prentice-Hall, 1987); and in Stuart Bruchey, *Enterprise: The Dynamic Economy of a Free People* (Cambridge: Harvard University Press, 1990).
26. Kornai, 579.

27. Lindblom, 116.
28. See Stanley Fischer and Alan Gelb, "Issues in the Reform of Socialist Economies," in V. Corbo, F. Coricelli and J. Bossak, eds., *Reforming Central and Eastern European Economies: Initial Results and Challenges* (Washington, DC: The World Bank, 1991), 67-82.
29. See Dennis A. Rondinelli, ed., *Expanding Sino-American Business and Trade: China's Economic Transition* (Wesport, CT: Quorum Books, 1994).
30. See Joan M. Nelson "The Politics of Stabilization," in R.E. Fineberg and V. Kallab, eds., *Adjustment Crisis in the Third World* (New Brunswick, NJ: Transaction Books, 1984): 99-118; and Paul Streeten, "Structural Adjustment: A Survey of Issues and Options," *World Development* 15, no. 12 (1987): 1469-82.

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