

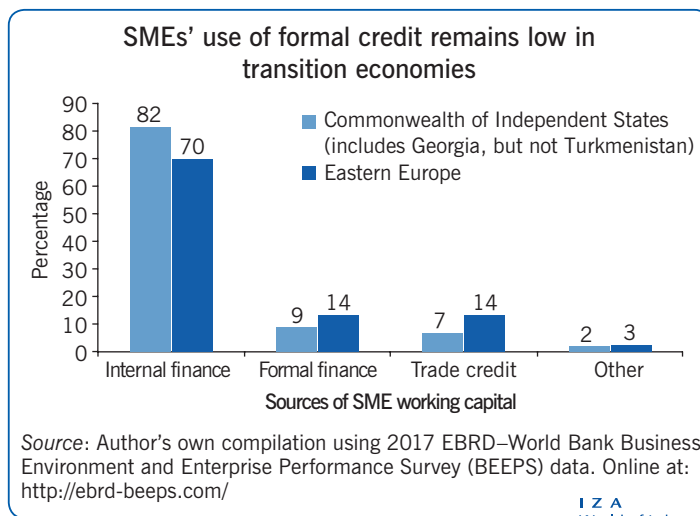
Political connectedness and formal finance in transition economies

Policies to increase formal finance to smaller firms requires improving the functioning of government bureaucracies

Keywords: transition economies, formal finance, connectedness, firm-level analysis

ELEVATOR PITCH

Although small- and medium-sized enterprises (SMEs) represent more than 90% of all enterprises and play an important role in employment generation, they lack access to affordable formal finance. Conventionally, market failures and information imperfections are seen as major causes of this misallocation. However, the role of social and political factors in resource allocation, including access to formal finance, has recently become more widely accepted. Firm-level evidence from post-communist economies, for example, shows that political connectedness improves access to bank credit, but is not associated with enterprise growth.



KEY FINDINGS

Pros

- + Access to formal finance is skewed against SMEs in favor of large firms.
- + Market failures and information imperfections do not fully explain why the distribution of formal finance is skewed against smaller enterprises.
- + Political connections play an important role in gaining access to formal finance.
- + Evidence shows that formal financing is associated with faster firm growth than informal financing, and that smaller enterprises benefit more from improved access.

Cons

- Recent data show that a substantial portion of SMEs in post-communist countries offer bribes to public officials relatively frequently.
- Political connectedness exacerbates misallocation of formal finance, often in favor of enterprises with closer links to government officials, which are usually larger and wealthier.
- Although political connectedness improves firms' access to formal finance, most recent country-level case studies find that the practice is not positively associated with firm performance and growth.

AUTHOR'S MAIN MESSAGE

Unequal distribution of formal finance between large and small enterprises has traditionally been explained by market failures and information imperfections, prompting policy intervention to increase the flow of bank finance to SMEs. But interpersonal political connectedness exacerbates this misallocation further, often in favor of enterprises with links to government officials. Traditional policy measures should thus be complemented with reforms to improve the transparent and impartial functioning of bureaucratic institutions, whose ultimate goal should be to facilitate, not hinder, market-based exchanges.