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**The Role of Small
and Medium Enterprises
in Transition: Growth and
Entrepreneurship**

Robert McIntyre

UNU World Institute for
Development Economics Research
(UNU/WIDER)

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This study has been prepared within the UNU/WIDER project on the 'The SME in Transition Economies', directed by Dr Robert J. McIntyre, UNU/WIDER, Helsinki, Finland.

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CONTENTS

LIST OF TABLES AND FIGURES	v
I INTRODUCTION: THE ROLE OF SMALL AND MEDIUM SIZE ENTERPRISE SECTOR	1
1.1 Market Realities and Free-Market Ideology	2
1.2 The Role of the SME in the Emerging Market Economy	4
1.3 The Historical Trajectory of the SME: Shall the First be Last?	6
1.4 Sharp Differences in SME-Large Enterprise Linkages in Japan and South Korea	10
1.5 Advantages of Small and Medium-sized Enterprises in Developing Market Economies	11
1.6 Inhibitions to SME Growth	11
II DEFINING AND ANALYZING THE SMALL AND MEDIUM ENTERPRISE SECTOR	13
2.1 Multi-Dimensional Connections: SOE's, Privatized SOEs and SMEs	14
2.2 The SME and Interlocking Markets: The Role of 'Social Assets'	14
2.3 The Informal Sector and SMEs	15
2.4 The Crucial Distinction between <i>Proprietorship</i> and <i>Entrepreneurship</i>	16
2.5 Missing Comparative Data: SME Size and Links to the Informal Economy	20
III MARKET SYSTEMS WITH DIVERSE PROPERTY FORMS: NEP, NEM AND TVE	21
3.1 The New Economic Policy in the Soviet Union	22
3.2 The New Economic Mechanism in Hungary	23
3.3 The Persistence of Small-scale Private Enterprise in the former GDR	24
3.4 China: New types of SMEs Result from an Evolutionary Transition Path	26
3.5 Finnish Co-operative Approach to Finance Barriers	31
IV CASES FROM RUSSIAN PROVINCES: EFFECTIVE MARKET REFORM BY ANTI-REFORMERS	34
V WHOLESale TRADE AND OTHER ASPECTS OF MARKET ACCESS	38
VI THE RELATIONSHIP BETWEEN SOE/PSOE AND SME: MORE THAN TRANSITIONAL	41
VII INDUSTRIAL DISTRICTS: POLICY-RELEVANT 'FACTS'?	43
VIII IS GROWTH ALLOWED? THE MACROECONOMIC CONTEXT OF THE SME SECTOR IN POLAND AND RUSSIA	45
IX THE COMPLEX CAUSATION OF SME SUCCESS AND FAILURE IN TRANSITION ECONOMIES	46

X	POTENTIAL POLICY IMPLICATIONS: EXPLICIT STATE POLICY TOWARD THE SME	47
	10.1 Liberalization without Adequate Institutional Development	47
	10.2 Market SME Development without Full Liberalization	49
XI	RESEARCH QUESTIONS: AN AGENDA FOR STUDY OF FUTURE SME DEVELOPMENT	52
XII	CONCLUSION: THE ENTERPRISE ECOLOGY OF THE TRANSITION COUNTRIES IS AN OPEN BOOK	54
	BIBLIOGRAPHY	56

LIST OF TABLES AND FIGURES

	Page
Table 1 SME SHARE IN TOTAL EMPLOYMENT	8
Table 2 SME SHARE IN MANUFACTURING EMPLOYMENT	20
Table 3 HERITAGE, INSTITUTIONAL DEVELOPMENT AND OTHER POLICY EFFECTS ON SME GROWTH AND SUCCESS	46
Table 4 POSSIBLE POINTS OF POLICY INTERVENTION	55
Figure 1 FORMS OF INDIVIDUAL SME ACTIVITY	17
Figure 2 THE ECONOMIC LANDSCAPE: LARGE, MEDIUM AND SMALL ENTERPRISES	41

...Entrepreneurs, people who start businesses and make businesses grow, are essential agents of change who accelerate the generation, application and spread of innovative ideas. In doing so, they not only ensure the efficient use of resources, but also expand the boundaries of economic activity.

Fostering Entrepreneurship, OECD 1998

...the growth of the small business sector in Eastern Europe offers little in providing a springboard for entrepreneurial enterprises that will create new jobs and develop innovative products which, in turn, will generate dynamic economic growth.

Richard Scase 1998: 14

I INTRODUCTION: THE ROLE OF SMALL AND MEDIUM SIZE ENTERPRISE SECTOR

Much the discussion of the transition process in the former socialist economies has focussed on the process of the divestiture of previously State-Owned Enterprises (SOE). This approach has been justified by the belief that, by creating strong efficiency motives on the part of the new owners, privatization will by itself resolve virtually all of the production and incentive problems of the old system. The benefits of privatization *per se* are now being reassessed more critically, while at the same time the recognition has spread that healthy small enterprises do not automatically emerge to fill the interstices of the new system. Both of these patterns have long been evident but the long-evident need for policy-level reappraisal has only become unavoidable with the final collapse of the spontaneous liberalization model in Russia after August 1998.

The Small and Medium Enterprise (SME) sector carries great hopes and great burdens in the evolution of all of the transitional economies. Sustained and healthy growth of this sector is obviously necessary, since it is difficult to imagine rising overall living standards and social peace without such a development. With the large-scale units of both the State-Owned Enterprise (SOE) and previously State-Owned Enterprise (PSOE) sector often at best stagnant, successful performance during the transition increasingly appears to be dependent on the expansion of this Small and Medium Enterprise sector. Even if the hopes that this sector will by itself have a systems-dynamizing and transformational effect prove to be false, its role in generating employment and an atmosphere of social stability is crucial (*EBRD* 1995).

1.1 Market Realities and Free-Market Ideology

Despite the centrality of the Small and Medium Enterprise sector in both the theoretical understanding and practical functioning of market economies, little attention has been paid to the conditions necessary for its new or expanded development. This omission appears to be in part the result of a tendency to assume that there will be a kind of *market automaticity*—that spontaneous processes can be counted on to arise which will create new, viable entities to fill the interstices between the large organizations.

All modern economists use the established body of neo-classical theory to describe and analyze small movements *within established market systems*. Unfortunately, these theoretical constructs do not turn out to be directly useful in deciding *how to construct new institutions*. When called upon to prescribe *de novo* remedies for very different conditions, there appear to be ideological correlates of neo-classical thinking which prevent the actual application of straightforward market logic to the transition situation and at the same time foreclose clear policy-level discussion about what was being done, why, and in whose name.

When Douglass North (1994) accepted the Nobel Award for work developing the so-called ‘new institutional economics’, he went so far as to assert that neo-classical training had the effect of disabling economists from being able to deal intelligently with issues involving the initial construction or transformation of institutions. He suggests that virtually nothing expected to occur in perfectly (or nearly perfectly) functioning markets which are already embedded in established capitalist market-type economies should be taken on faith as a guide to the complex transition policy tasks of simultaneously expanding the scope of markets (already there, legally, under the old system) and creating the complex array of formal and informal institutions necessary to allow their ‘self-organizing’ features to emerge in practice. Some economists had directly warned against the dangers of constructing transitional strategy on the basis of textbook simplifications. The arguments offered by the collaborative *Agenda ‘92* (1992), Murrell (1992), Koford (1991, 1997), McIntyre (1992) and others called for a carefully modulated and evolutionary approach to the transformation problem.

Most western analyses of ‘transition’ or ‘systems transformation’ have nevertheless reflected the dual presumptions that: (1) only large reforms (to the extent of near or complete systems replacement) could work in Soviet-type systems; and (2) mixed institutions are unlikely to survive. This conventional wisdom about markets and market reform provided the intellectual grounding for neo-liberal policies that were applied across a broad range of countries and conditions. The adoption of this so-called ‘Washington Consensus’ (Stiglitz 1998, 1999) has led most Western analysts to misunderstand or simply not consider: (1) the already mixed nature of Soviet-type systems; (2) the special characteristics of the constituent production/ settlement units; and (3) the potential for the coexistence of these old elements with the emerging new features of the transition period.

Understanding the possibilities and limitations of the SME sector in this context has been particularly difficult. It is important to look at both the *realities of the SME sector*

and their unfortunate *interactions of SME policy with transition ideology*. The SME sector is an implicit feature of all free-market reasoning and central to any assumptions about the spontaneous developmental capacities of markets and market systems. There is the groundless tendency to use the model of perfectly functioning markets as if it was real or about to be real. These implicit assumptions of small scale and flexibility are often applied quite directly in transition policy discussions. Even when talking about large SOEs or large former SOEs, reasoning will proceed on a basis that implies that these large entities will react like SMEs. Thus, standard explanations of the need for drastic (rapid and complete) marketization and privatization generally refer implicitly to models of atomistic individual decision-makers operating within the bounds of already existing markets which are highly, if not perfectly, competitive.

Enterprises, managers, and workers in urban and rural sectors are modern and 'fit to survive' if they behave like they were in such a model. As Stiglitz (1999) has argued, any analysis of the transition that takes these assumptions literally is detached from understanding of how real (non-commodity) markets operate. It has simply assumed that: (1) there will be mass emergence of successful small- and medium-scale family enterprises; (2) large enterprises will be privatized in a transparent competitive process with many bidders and clear information; and (3) the resulting new system will both emerge and function under perfectly competitive conditions (which exist nowhere in Western Europe).

The point to be emphasized here is that most advice came from analysts who had very strong presuppositions about how markets operate and these same presuppositions are not by accident built into the theoretical structure which forms the core of most analysis of transition economies. This is not bad or good, but it is important to notice. It is also important to note that the ideal-typical firm/entrepreneur at the center of neo-classical market models is a rootless, un-imbedded actor, making each market exchange in an impersonal, neutral way. The discussions below of *industrial districts*, *clustering of cognate enterprises* and role of the *wholesale trade* are particularly important cases where the conditions of actual SME development are far from the world of the perfectly competitive model.

Despite this wide spread tendency to think and talk about transition in terms of pure models, it is a truism of the formal discipline of comparative economic systems that all actually existing economic systems combine market, command and traditional elements. The argument that different types of systems cannot be mixed together (the *rejection of transplants* theory) and that there is *No Third Way* are seductive, but seem to be comprehensively rejected by real world experience. These are simply ideological assertions which directly contradict the developmental lessons to be drawn from: diverse eastern European experience before 1989; the historical patterns found in advanced capitalist countries for the last century; and rapidly accumulating evidence from the period after 1989 in eastern Europe and the Former Soviet Union (FSU). Although they lack any serious scientific content, they lie at the base of the standard transition strategies (*transition orthodoxy*) which has shaped the policies prescribed for ex-Soviet-type economies.

There is no evidence that mixed systems are unstable or tend to become 'more pure' through any kind of Darwinian selection process. The fitness and survivability of particular institutional combinations appear to be much more a question of the coherence and compatibility of the incentive and information flow characteristics of the components, the internal political situation and the surrounding world market conditions, which have as well a political dimension.

Since no such institutional preparations were made in some transition cases (Russia is the most vivid but not the only example) before effective control was passed to market forces, it was virtually assured that the destructive and developmentally dysfunctional aspects of markets would predominate. While this might at first appear to be only a temporary, literally 'transitional', phenomenon, the Russian case among others suggests that long-term developmental dysfunction results when the foundations of the new system have not been carefully laid (Kolodko 1999, McIntyre 1993). This glaring and comprehensive failure to conduct 'market reform' in a serious and institutionally plausible way is surprising because it is often associated with well-known and experienced economists. It appears to result from two main conditions. The tactical reason is straightforward—only speed and secrecy allow adoption of measures strongly rejected by much of the population. The second reason is that people with insider access (which allows personal appropriation and 'self-dealing' of public assets) wish to avoid both open public discussions of the terms of re-distribution and open competition for title to specific assets.

In order to make sensible policy in a transitional situation it is important to avoid a simplistic view of capitalism as a self-organizing system of natural equilibrium. That means not expecting atomistic competition, along with the requisite market infrastructure, to arise spontaneously.

Real markets function 'successfully' only when a fairly elaborate set of surrounding institutional, infrastructural and behavioral conditions are already in place and, equally important, are widely accepted as a cultural norm.

Unfortunately, when national or local governments did attempt to carry out policies that mediated, steered or limited the range of market relationships in the transitional period with the goal of allowing time to build market infrastructure they were generally accused of opposing 'market reform' per se. The lack of competent market-oriented policy at the national level assured that the 'market exchange' which emerged did not bring with it the beneficial features of real competition.

1.2 The Role of the SME in the Emerging Market Economy

In addition to the direct economic effects of making new services and products available and creating employment, the SME has several equally important effects on the functioning of transitional societies that move through more indirect channels. The development of this sector is essential to create the political and social 'environmental conditions' necessary to allow desirable changes to occur elsewhere in the system. The

SME sector must simultaneously absorb resources and workers from the large enterprise sector and at the same time help to create a labour market situation in which the process of reorientation and fundamental reorganization of the large enterprise sector can be carried through without threatening social peace. In addition to slowing down the restructuring process, the failure to develop the SME may increase the volume of required transfer payments for unemployment, early retirement and other programmes and (under certain fiscal policy assumptions) crowd-out investment and other employment creating expenditures.

The complexity of creating and sustaining the development of a SME sector in an emerging transitional economy becomes evident as soon as attention shifts beyond the more obvious retail and neighbourhood-level services and considers directly productive small enterprises. Preliminary comparisons among China, Russia, other FSU countries, Hungary, Poland, Czech Republic and Slovak Republic support this view. Existing institutions and ‘capabilities’, including the extent of formation and survival of *networks* and other *embedded relationships*, appear to interact with the active policy measures and the legal environment to determine the transition period performance of the sector.

Development of these types of small firm-large firm relationships appear to have played a major role in the highly successful business practices of the vertically integrated Japanese *keiretsu* financial-industrial groups over most of the post-war period. Similar linkages appear to be important in the more recent success of the Township and Village Enterprises (TVE) in the People’s Republic of China during the post-1978 reform period. Another quite different synergistic relationship, based on both horizontally and vertical linkages, is represented by the kind of local co-operative/competitive development common for hundreds of years in Europe and North America, but only recently dignified with the title of ‘*industrial district*’ and ‘*cluster*’. The kinds of *external economies of agglomeration and scope* that have played a large role in the post-World War II success of small-scale *industrial districts* and *clusters* in Northern Italy and Southern Germany are not new. They can be found (unnamed) in many other times and places, including 18th Century England and 19th Century New England.

In this paper we point to the experiences of some countries which throw useful light on the questions of: how the SME sector has emerged under past conditions; how it functions today in advanced capitalist countries; and how these historical lessons or precedents apply to the special conditions of the contemporary transitional economies. In the latter countries the wrenching adjustment from administratively controlled centrally planned systems to mixed market systems with little or no explicit planning, is proving to be more difficult and complex than at first anticipated. The results of transition thus far are sharply differential and difficult to interpret for purposes of SME policy because of the *over-determination* problem (they teach too many lessons, because there are too many alternative explanations, all of which can not be true at the same time, but all of which look plausible when presented as the sole independent variable).

One surprising conclusion that does seem to emerge from this now decade-long experience is that the small enterprise sector is not by itself enough to create successful economic growth. Unless the surrounding large enterprises have been successfully

commercialized (meaning that privatization has either been delayed or done in a way that does not sever their already existing working relationships) and overall demand conditions are not severely restrictive, no significant and sustained SME growth can be expected. The SME sector needs the large enterprise sector as a source of inputs, a market for its output and also (it unexpectedly turns out) as source of individual entrepreneurial leadership. This points to the need to create a synergistic relationship between the SME and the large enterprise sectors, rather than thinking of a zero-sum environment in which the success of the small can only be secured by destroying or disassembling the large.

Positive and mutually reinforcing interactions can be expected to emerge if ways can be found to encourage the formation of purpose-built alliances and sub-contracting relationships. In many different historical and contemporary economic systems large firms and small firms interact in complex relationships which confer reciprocal advantages. The combination of the ideological dynamics of the end of the Cold War (in which the new 'Western' path is defined as simply the opposite of each and every organizational feature of the Soviet-type system), an exaggerated sense of the role actually played by small enterprises in advanced capitalist economies and a fascination with the textbook version of market processes discussed above, have led many transitional economies to fail to directly address this issue. It is crucial to determine why successful small enterprise development has been achieved in some places and not in others. We will try to cut through the complexities and causal puzzles and point in the direction of SME development approaches that work.

1.3 The Historical Trajectory of the SME: Shall the First be Last?

Modern urban industrial society in a very real sense emerged on the basis of the SME as the dominant form of production. The early industrialization process was sharply different from country to country and product to product, but for a very long time the dominant scale of enterprise, even for technically complex products, remained within the boundaries of the modern definition of SME. A qualitative change occurred in the decades around 1800 when the synergistic interplay of the cost advantages of large-scale production and the application of science to the resolution of problems of production technology finally triggered the cumulative, cost-reducing, income-generating, market-expanding wave we now recognize as 'Modern Economic Growth' (Kuznets 1966).

This process picked up speed and rapidly spread from its Anglo-American roots and by the last half of the 19th Century had become a world wide although uneven process. Through most of the 20th Century economies of scale (where construction of larger sized production facilities by itself reduced average production costs) drove a global process of *large company industrialization*. Even under these conditions smaller scale units necessarily survived and in some cases dominated the provision of various services and specialty products.

When narrowly defined *technical economies of scale* appeared to be exhausted (or offset by non-production administration and/or co-ordination diseconomies), further increases in corporation size were justified or explained by *economies of scope* which are

connected to advantages that accrue to the firm by virtue of its total size rather than the amount of any specific product produced. These costs involve activities such as marketing, establishing dealer networks and brand identity, as well as technical synergies between completely different but still related products (passenger cars and delivery vans, auto and aviation electronic control devices, etc.).

Publication of *The Second Industrial Divide* by Piore and Sabel (1984) marked a sharp change, after which it became professional respectable to argue that a reversal, or at least moderation in the strength, of the trend toward ever-larger organizational size may have occurred. They argued that a series of *technical developments* (relative market saturation for many mass-produced products; the computerization of production processes and the rise of high technology 'flexible production') and *market segmentation* (which has been creating more and more 'niche' markets that do not function like 'commodity' markets) had together reduced or eliminated the advantages of ever-larger scale.

In banking and financial services, the energy and resource extraction sectors, and some manufacturing product areas such as passenger vehicles, the trend toward ever-larger scale has continued, but in the rest of the economy a different story seemed to be emerging. Of course even the most ardent advocates of large-scale production did not expect all products and services to follow this path. But Piore and Sabel were suggesting that even within the sphere of industrial production small might be the wave of the future, at least for non-commodity products. Piore and Sabel concluded that the SME sector may be developing a competitive advantage based on flexibility and speed of adaptation in areas where the possibilities of realizing further scale economies are weak or non-existent. Certain types of transactions, especially services, seem to have an automatic and self-limiting aspect, requiring face-to-face individual exchange.

Some of the seemingly safe retail and service preserves of the SME have in fact already been taken over by large firms. The establishment of bakeries, photo-finishing and auto parts departments and full service drug stores within large American-style food stores are examples. The European hypermarket carries these trends to their logical conclusion. Another example is the formation of large chains that employ highly trained professional workers on an hourly wage basis to provide optical, medical, dental or legal services. In some of these product areas a national or international brand identity has been established for products and services that once seemed to define personalized exchanges and SME scale.

The concept of the *virtual corporation* has also gained currency, involving the idea that almost all of the previously 'in-house' functions of the corporation can be contracted out or 'out-sourced', leaving only a small decision-making core (itself supplemented on an as-needed basis by consultants carrying out the functions of what had previously been highly paid career executives). It should be noted that most of the developments discussed in the last few paragraphs have a distinctly Anglo-American origin and flavour, with neither the concepts nor the practice moving so far in most other advanced capitalist countries.

The American exceptionalism emerges in another surprising way—the size of the SME sectors in this early industrializing economy is now at the low end of the distribution of international experience. The later industrializing countries, in particular Germany, France, Italy and Japan, have successfully adjusted to high technology modern markets and managed to maintain large vibrant SME sectors. This pattern is highlighted in Table 1 which shows SME employment as a percentage of total employment and manufacturing employment in various countries.

TABLE 1
SME SHARE IN TOTAL EMPLOYMENT (%)

	1990	c.1994	1996	1998
EU-12		69		
E-19 ^a			66 ^a	66 ^a
France		69		
Germany (West)		64		
Belgium		72		
Italy		80		
Georgia		58		
US		53	42 ^a	
Estonia		43		
Latvia				
Lithuania				
Czech Republic		37		
Japan			33 ^a	
Croatia		30		
Romania		27		
Hungary		24		
Slovak Republic		23		
Poland		23		
Slovenia		19		
Russian Federation		10		
Belarus		6		
Kyrgyz Republic		3		
Tajikistan		2		

Sources: *Transition Report 1995* (1995) London, European Bank for Reconstruction and Development, p. 140; *The European Observatory for SMEs, 6th Report* (2000) Luxembourg, European Commission Office of Official Publications, pp. 12 and 45

Note: ^a E-19 = EU-16 + Norway + Iceland + Switzerland. EU-19 data refer to non-primary private employment

Of course, very many newly founded small firms fail and disappear in all market economies, and that is part of the explanation to how so many new firms can be founded and yet their proportional role remain relatively small. But there is an important very different explanation – the special American feature may reflect the tendency for successful enterprises steadily to be pulled out of the SME pool as a result of being taken-over or bought-out by large, often diversified national corporations. These small firms no longer exist as separate entities, but certainly have not failed. France is often suggested as a sharply different model in which small-scale, localized production has been specially protected since modern growth began in the first half of the 19th Century, leading to a many successful niche producers but difficulties in large-scale industrial development. (Kemp 1985, Landes 1949). The latter criticism seems less valid after World War II.

Some have attributed the expansionary tendency of large American and British corporations to the unique role of the equities (common stock) markets in those countries. With the long established separation of ownership from actual enterprise decision-making and control (Berle and Means 1932, Lazonick 1991) and the post-World War II tendency to link managerial incomes to both firm size and equity-share value, the incentives for growth by acquisition were quite strong.

Also, since growth in the early-industrializing countries did have a plausibly automatic, self-generated character, they never developed the focus on public infrastructure development that was a defining characteristic of later countries such as Germany, France, Italy and Japan. These measures appear to be a stimulant to SME growth, and include various apprenticeship and training programmes, policies which protect small enterprises from the economic power of larger entities, and even seemingly neutral policies such as development of extensive public transportation systems.

In spite of policies to stimulate entrepreneurial start ups, less regulated labour markets, and better developed venture capital, the high rate of both hostile and friendly acquisition of successful small enterprise by empire-building corporate managers in the UK and US have kept small-firm shares relatively low in these countries.

(FitzRoy 1993, p. 239)

The nature of the relationships that have grown up between large and small firms in various continental European countries and Japan seem to have led to the adoption of corporate decision-making practices based on ‘stakeholder’ rights, fostered more co-operative labour relations and made them more resistant to take-overs. FitzRoy and Acs (1992) note, for example, that the long-term *flexible networks* that link together firms in Italian industrial districts and the *small firm-corporate parent linkages* in Japan are neither conventional arms-length market exchanges nor fully organized hierarchical relationships, fitting neither of the categories often treated (Williamson 1985) as exclusive alternatives.

1.4 Sharp Differences in SME-Large Enterprise Linkages in Japan and South Korea

The classical form of Japanese large firm industrialization has involved large industrial groups which include large numbers of companies within a familial grouping, held together by a holding company structure (called *zaibatsu* before World War II and *keiretsu* afterwards) cross-ownership relationships, and sharing the use of a common general trading company and group bank. The large companies of such a grouping formed elaborate long-term relationships with small supplier firms, usually not involving ownership but creating over several decades relationships of the closest co-operation and trust. Numerous aspects of the Japanese industrial model developed prior to the crisis of the 1990s are based on the existence of this close, and often exclusive, association of large Japanese companies with their subcontractors.

The development of the efficient system of ‘just-in-time’ (*kanban*) inventory management system is an example of the implications of this type of small firm-large firm relationship. As this system had been imitated all over the industrial world, it has become clear that it makes extraordinary demands on the parts suppliers, who are mostly sub-contractors. Similarly the ability of large firms to offer ‘life-time employment’ depends on the flexibility of employment at the sub-contractors who offer no such benefits. Close and well-established relationships between large companies and sub-contractors were probably a necessary condition for the original development of this production management system in Japan. Periods of slower economic growth, such as during the early 1980s and much of the 1990s, tend to strain these relations.

Since South Korea set out to learn from and adapt functional elements of the Japanese economic model, it is not surprisingly that the systems have powerful structural and policy similarities (Amsden 1989). Despite the similarities of the South Korean *chaebol* to the Japanese financial-industrial groups, there is a great difference in the way they deal with the small enterprise sector. The *chaebol* tend to produce everything internally and to depend very little on sub-contractors. It is possible to argue that because of the failure of the *chaebol* to form the Japanese style network of long-term relationships with small firms the South Korean economy now has a degree of inflexibility that is becoming a competitive disadvantage (Chon 1996).

It is also important to note that the existence and apparent utility of *long-term, extra-organizational links* of the Italian and Japanese type raises questions about the meaning of international comparative statistics (e.g., Tables 1 and 2) which rank countries on the basis of the number of small enterprises or the number employed in small enterprises, but do not take account of the degree of linkage to other entities (FitzRoy 1993: 240). It seems clear that a small Japanese firm which has a long-term supplier relationship to a large *keiretsu* is not really a free-standing entity in the same sense as a British or Canadian firm of the same size and production sphere. At least until the late 1990s the answer would have to be that the relationships are profoundly different. The same may be true of a single Italian or German firm that is part of a well established localized supply chain or industrial district. The individual TVE in China has similarly complex reciprocal links to local government that makes it far from an autonomous actor.

1.5 Advantages of Small and Medium-sized Enterprises in Developing Market Economies

From a theoretical perspective, SMEs have several advantages over both SOEs and large privatized SOEs (PSOEs). In SMEs the incentives for both managers and workers tend to be clearer and stronger than in larger organizations. Governance problems are less significant since in many cases the managers and owners are the same people. The small size of many of the SME firms allows owners easily to monitor the performance of managers while the cost of monitoring labour is also lower.

Under the special conditions of the transition economy there are several additional advantages. There is likely to be less behavioural carry-over of bad work habits (from the especially chaotic last years of the planned economy system) in SMEs that are either new or had worked outside the main channels of the planned system. Small firms appear to have greater flexibility and potential for innovation, which are especially important in the unsettled conditions of the transition period. To the extent that the SME firms produce the same products or services as SOE and PSOE, their small size makes them less prone to monopolist behaviour. Higher productivity is also likely in those product areas where there are no or few scale economies (e.g., services and specialty or niche manufacturing processes).

It should be noted that many or even most of the existing or emerging SMEs are not really new. These are entities, now classified as SMEs, which had a pre-transition existence as part of large, usually horizontally integrated, service, craft and distribution SOEs or co-operatives. The new sector of relatively small organizations is thus a mixture of many privatized sub-units of SOE, entirely *de novo* entities and in surviving pre-transition SMEs (see Chapter 3 below).

1.6 Inhibitions to SME Growth

Despite such potential competitive advantages, SME enterprises face a series of barriers that raise their operating costs and threaten their economic viability. They face higher costs for and more limited access to credit and other inputs, have greater difficulties in penetrating export markets and are vulnerable to harassment by criminal gangs. The criminalization of everyday life in many of the transitional societies has been the subject of much sensationalized discussion, but it is indeed a serious and complex problem. There appear to be set of systematic relationships between on the one hand: the extent and character of the work done in preparing legal and commercial infrastructure before privatization; the way in which privatization *per se* is carried out; the organizational and behavioural features of wholesale trade (and other market-access determining conditions); and on the other hand: the extent and character of criminal development that results.

While the condition of the SME sector is emerging as one of the key determinants of the success of transition, there is little systematic or reliable research which allows us *either* to explain the conditions which lie behind successful development in those cases where it has occurred *or* to propose policies which would facilitate its expansion in those

places where its record is thus far undistinguished. The various hypotheses and the related preliminary evidence need to be tested by rigorous analysis of the conclusions of the existing literature and carefully conceived and executed comparisons. The issue of the *direction of causation* is particularly troubling in cases where there is systematic *over-determination*, with too many plausible causes available to explain the successful cases such as Poland. The concept of *path dependence*, which was originally applied to narrow technical issues, has been usefully applied to describe the way in which historical conditions, physical, technical and organizational capital, as well as the particular sequencing of reforms, shape the trajectory of various transitional economies (David 1985, Stark 1992).

In order to clarify these causal issues and thereby answer some of these policy-relevant puzzles, it is necessary to address a series of concrete questions, seeking to: (1) document the differential development of the SME sector in the various transition economies; (2) understand the functional relationships of the SME with both the demand side and the supply side of the markets in which it participates, including explicitly their relationship with the large SOE and PSOE sector; and (3) identify policy initiatives which will maximize the positive contribution of this sector.

II DEFINING AND ANALYZING THE SMALL AND MEDIUM ENTERPRISE SECTOR

We set the definitions of the Small- and Medium-sized Enterprise Sector (SME) to include purely private firms, employee-owned ‘co-operatives’ and the wide array of entities that are fully- or partly- owned by local (regional and municipal) governmental authorities. Setting lower and upper size limits for inclusion in our ‘realm of concern’ is to some extent an arbitrary process, but we intend to concentrate on the space between the very small and very large. Exclusion of the large SOE and former SOE is obvious, but the lower boundary may be controversial since we wish to exclude from consideration much individual and other very small-scale trading and service-provision. These developments are often emphasized as the most visible sign of the marketization process in transition economies, as well as in other countries that do not have established advanced capitalist market economies. But much of this very small-scale activity (excluding of course the traditional skilled trades and professions) has a ‘dead-end’ and essentially subsistence character. At the individual level this type of ‘business activity’ holds out little promise of cumulative growth. At the broader level it is highly unlikely to provide the foundation for successful system-level growth. It is thus more properly considered as part of the poverty and health crisis aspects of the transition.

Two analogies, one drawn from the most developed countries and one from the least developed countries are commonly applied to the transition case. Both experiences are suggestive, but in the overall are not very helpful to the policy formulation process for Eastern Europe or the FSU. In advanced market economies, especially Anglo-American ones, there is a well-established social ideal of the solitary entrepreneur—in this story there is rapid development from ‘single entrepreneurs in a shed or garage’ to large high technology firms. This model is often reflexively suggested as holding the remedy for transition economy woes. Treating this as a practical policy approach requires us to ignore both the rarity of this phenomenon and the surrounding institutional structure within which it does arise. Also forgotten is the considerable extent to which the core technologies in the most famous ‘garage to great company’ cases have actually ‘fallen out’ of the research departments of large companies and government-funded military research.

From the opposite side of the development divide, analogies are often suggested to the growth of the ‘informal sector’ in developing countries (e.g. De Soto 1989). This ‘Latin Americanization’ model is, for structural and historical reasons, similarly misplaced in the urbanized, industrialized transitional economies. Instead of appealing to non-existent ‘historical cases’ or lessons drawn from fundamentally different social and economic systems, it is more useful to analyze the conditions of transition economies from inside their current institutional/behavioural universe. We note several general issues and then consider a series of specific country- and region-based comparisons. The inappropriateness of these ‘Latin Americanization’ analogies is highlighted by the surprising discovery of the roots and characteristics of the ‘new entrepreneurs’ in

transition economies. It appears that, in a number of countries, owners and managers drawn from the old state sectors are the sources of much of the productive, dynamic entrepreneurial activity that has emerged. The people whose formative experiences were in the 'old' private sector or illegal economy of the pre-transition system seem to adapted poorly to the new 'post-shortage' environment (Dallago 2000).

2.1 Multi-Dimensional Connections: SOE's, Privatized SOEs and SMEs

The first complex of issues considered in this study involves the analysis of the multiple connections between the existing large enterprise sector and the existing/emerging SME sector. Of central concern is the link between the way (the form and extent of) privatization of the large enterprise sector is carried out and the character of the SME sector that functions in the surrounding economic space. The large enterprise sector includes both those entities that remain state-owned (SOE) and those that were previously state-owned (PSOE) but are now in private hands.

The apparently firm legal distinction between SOE and PSOE is blurred in many countries. In Russia this has resulted from a conspicuously corrupt privatization process that has left current ownership arrangements open to future legal reversal; in the Czech Republic a particular form of voucher privatization led to large enterprise ownership being concentrated in the hands of funds controlled fully or partly by state-owned banks. It is necessary to explore how these and other patterns of privatization and semi-privatization affect the surrounding SME culture. Issues of timing and sequencing of reforms measures are familiar when viewed from within the privatization process of large SOE, but may also have implications for the surrounding, smaller institutions.

2.2 The SME and Interlocking Markets: The Role of 'Social Assets'

Consideration of the links between the Large Enterprise and SME sectors automatically raises the related issue of the so-called 'social assets' of SOE and PSOE. The marketization process in each of the transitional economies begins on the foundations of the highly complex industrial, social, and settlement structure left by planned State Socialism. A unique aspect of all societies strongly influenced by the Soviet-type planned economy model was provision of housing, medical care, education and a broad range of communal services by the SOE. Even where formally privatized, the new PSOE often carry out these same functions *de facto*.

As a result of these structural features, individual labour market participants must (at least in the short-run) decide between complete independence and a course of action that retains the benefits of association with the large entity. Directly relevant to this decision-making is the structural issue of the reversibility of movement between sectors. How can a SME sector be built up in light of the unwillingness of workers to break cleanly their links with prior SOE or PSOE employers? And, in any case, is breaking the large enterprise link in fact irreversible at the individual level? If so, are there flexibility-increasing approaches acceptable to both parties in this labour market relationship?

2.3 The Informal Sector and SMEs

In transition economies households (and individuals within households) may be simultaneously in more than one sector. This is obvious in a definitional way for the members of a multi-earner household, but under transitional conditions it applies even to individual members of such a household. This situation is also relatively common in many established market economies, but was extremely rare under various centrally planned systems.

Under the conditions of the early and middle transition period are the informational signals that the household perceives a reliable or false guide to rational conduct in the longer term? Does individual and social logic diverge in policy relevant ways? To the extent that this transition process begins without coherent structural preparation, an array of dysfunctional phenomena arise. Many of these negative developments are in effect 'externalities', imposing real costs on society in an irrational and capricious way. Russia provides a particularly sharp example in which the population has been required to cope at the household level with the catastrophic collapse of the large enterprise sector. At the same time there has been no effective state support for the rise of alternative forms of productive activity. The health and welfare effects of this approach are evidently disastrous (Cornia and Panicià 1999), while the political stability of systems under this kind of stress is also questionable.

Especially in those countries where the transition has been abrupt and chaotic (e.g., Russia, Bulgaria, Ukraine), independent economic life has emerged in specific forms that often involve a high level of 'self-exploitation' as well as exposure to physical conditions that are directly destructive to the health of the participants. 'Self-exploitation' as economists use the term is not automatically the sign of an undesirable situation. Even if the money earnings are less than available through paid employment, after taking account of the non-monetary income that flows from feelings of autonomy and self-actualization, an individual decision to work independently can still be entirely rational.

But the concept of self-exploitation carries with it a labour market model which assumes that there are available alternatives to be rejected: the self-exploiting decision-maker is passing up a positive flow of paid income from an existing employer in order to work independently. To the extent that depressed aggregate demand levels and disastrous employment market conditions accompany the transition process, such paid alternatives may not exist to be turned down. Thus a large proportion of the independent work force may simply be engaged in a desperate struggle to survive, perceiving few options to the course taken. This activity is admirable in its own right, but is not the kind of society-transforming entrepreneurship expected by advocates of market-automaticity views.

There is an emerging literature that treats this type of 'informal sector' as a healthy and possibly self-sustaining social process. The 'Latin Americanization' concept is sometimes suggested as a useful precedent for transition economies, but despite superficial similarities it is not very useful. Most of these East/Central European and FSU transitional economies (except in Central Asia) were already highly industrialized,

urbanized and in many respects 'hyper-modernised'. Assumptions about behaviour draw from the analysis of predominantly rural, non-industrialized countries do not fit this post-Communist environment. This is true because the nature of the informal sector that emerges is fundamentally different in previously state socialist countries.

The ideology which expects automatic emergence of successfully functioning markets (and automatic solutions by those market for the basic problems of organizing economic life) has played a role in the largely uncritical reception accorded to reports of the rapid growth of 'small trader' and 'shuttle' activity in these transition economies. But much of this measured growth represents pursuit of desperate survival strategies. These approaches are both destructive at the individual and family level and lack promise of a cumulative developmental effect. Self-perpetuating growth of the informal sector does not magically emerge, because the scale of individual response is generally not sufficient in an unprepared post-planning environment. Since Poland and the small Baltic States may offer exceptions here, they require specific analysis. Research issues include these differential results among transition economies, as well as comparison to informal sector developments in Africa and Latin America.

The two prior points are closely related. The previously state socialist systems appear to adjust to sharp decreases in aggregate demand and severely depressed labour market conditions in ways that are very different from those shown by established capitalist systems under comparable stress. The transition economies have tended to allow real wages to fall with relatively little increase in open unemployment—an anomaly that is directly connected to the function of the large enterprises in their role of holder of 'social assets' and provider of social services discussed here. Some new way of restoring the social net of the abandoned 'old system' may be a precondition for sound public health and the effective functioning of the kind of mixed market that is rising out of these institutional conditions. The research questions raised here involve how this transformation of the surrounding social policy environment affects: (a) the ability of individuals and small groups to form and successfully operate new SMEs; and (b) the behaviour and survival chances of those 'old' SMEs (which already existed in some of the planned systems) in this new environment.

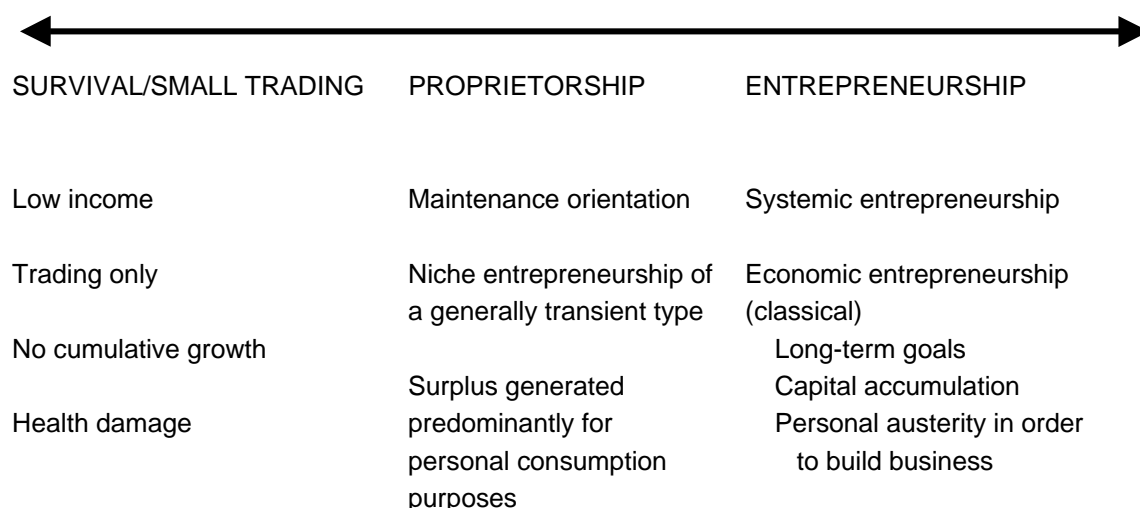
2.4 The Crucial Distinction between *Proprietorship* and *Entrepreneurship*

It is important to think of transition and development as entirely different processes and be alert to the ways in which the handling of the transition encourages or inhibits developmentally successful patterns and practices in the new society. As noted above, the description and analysis of the role of the SME seems inevitably to have an ideological element. The very existence of a retail and service culture featuring owner-shopkeepers and small premises is generally taken as the most fundamental sign of movement to a consumer-oriented market form of social organization. The extent of this change during the transition is often exaggerated in some respects (since many of these service and retail functions existed and were carried out as auxiliary activities of the large SOEs, and many of these even had a 'small premises' point of delivery), but the increased variety, especially of foreign goods, is indeed new and the atmosphere decisively different.

A calm assessment of the extent and nature of the change in the scale, function and importance of the SME is rendered difficult by enthusiastic *systems-level propaganda* and *individual-level identity-assertion* that occurs in the new 'after-planning' society. Governments point with pride at the numbers of new entities formed or existing and treat this number itself as a policy success. Individuals stress their entrepreneurial activities, multiple jobs and so on as a way of showing they have disengaged from the mind-set of the old-system and are fully in tune with the new world. These developments are seen (correctly) as evidence of successful adaptation and change at both the systems and individual levels, but both the statistical record and the understanding of the effects of these developments are clouded by the inevitable boosterism. These issues are discussed by Scase (1998, 2000).

Since so much weight is assigned to the development of adaptive, dynamic and forward-looking entrepreneurship, in the spirit of the quotation from the recent OECD (1998) study that begins this paper, it is important to use the term with some care and discrimination. In particular this means not treating self-employment or small business ownership as themselves necessarily implying entrepreneurial goals or activities. Scase (1998) has emphasized an analytically useful distinction between *proprietorship* and *entrepreneurship*. In real world situations the border between these two categories is diffuse and permeable. The other border between proprietorship and survival/small trading is similarly indistinct. Figure 1 shows a continuum of forms of individual activity within the borders of small- and medium-sized enterprise sector.

FIGURE 1
FORMS OF INDIVIDUAL SME ACTIVITY



The point has already been made above that much self-employment falls into two diametrically opposite categories. On the one hand are *low income/high cost personal survival strategies*. These often involve petty trading in a form that requires a way of life that causes high risk of health damage and provides very low income. At the other extreme are various *middle-high and high-income professionals* such as doctors, lawyers, notaries, plumbers and electricians. It is thus difficult to characterize the self-employed sector in any simple way. What is clear is that neither of these extreme but prevalent cases matches the hoped for dynamizing force implied in most descriptions of the role of the SME. Thus we need to look with care at reported small-scale activity to get a realistic sense of what lies behind the numbers.

Entrepreneurship is an honorific word with great modern weight. No one is against entrepreneurship, but this almost automatically means it is a term that is loosely used. In fact good managers of Soviet-type planned enterprises were often highly entrepreneurial, but were working against the fundamental dynamic of their system. Managers of successful large scale, growing capitalist firms are considered to be definitionally entrepreneurial, regardless of the technique by which that growth is secured (new product development, merger with or purchase of rival firms, successful acquisition of franchises and subsidies from the state).

In its classic sense entrepreneurship generally means *active efforts to build up ones productive property and business through capital accumulation*. It is generally understood to imply *a long time horizon*, and, at least in small-scale owner-operated businesses, *a relatively ascetic life-style* in which profits are largely reinvested and current consumption held to modest levels. This definition strongly resonates with the so-called Protestant work ethic, described with different degrees of warmth by classical political economists from Smith to Marx and J.S. Mill, and named for popular consumption by Weber (1904/1930) and Tawney (1926).

...Essentially, entrepreneurship refers to a person's commitment to capital accumulation and to business growth ... the entrepreneur is prepared to take risks in the pursuit of opportunities which he or she identifies in the market ... entrepreneurs (are) more committed to profit, re-investment and capital accumulation ... For the rational entrepreneur, the motive is the long-term accumulation of wealth by means of the constant expansion of productive assets ... (like) a miser since personal consumption is sacrificed for the longer term goal of expanding the economic enterprise ...

...Proprietorship ... refers to the ownership of property and other assets such that, although these can but not necessarily, be used for trading purposes and therefore to realise profits, are not utilised for the purpose of longer term processes of capital accumulation. Rather, any generated surpluses are likely to be *consumed* rather than re-invested in the business.

Proprietors ... probably constitute the largest segment of small business owners in (all) market economies and it is for this reason that very few small businesses grow (to) any significant extent ... Indeed, proprietors carve out

niches for themselves according to which they are able to sustain a level of trading which enable them to *survive* rather than to *grow* ... In view of the past experiences of state socialism, it would not be surprising if a major motive for business start-up is to *trade* in order to construct such spheres of personal autonomy ...

According to this view even those individuals in transitional societies who found firms *de novo* and show other signs of entrepreneurial energy are generally driven by short-term consumption and life-style goals.

... the growth of the small business sector in Eastern Europe offers little in providing a springboard for entrepreneurial enterprises that will create new jobs and develop innovative products which, in turn, will generate dynamic economic growth. Instead, proprietorship offers possibilities for generating cash flows that can be consumed for raising personal living standards rather than for business expansion ... even those who are committed to entrepreneurship will often only be motivated by the desire for short term financial gain rather than longer term, sustained accumulation

... there is little evidence to suggest that small scale business start-up in Eastern Europe is associated with the psychological motives associated with long term capital accumulation .. (and) little to support a view that (even) entrepreneurship... is related to the sacrifice of personal consumption ... The personal motives of entrepreneurship would appear to be more related to *trading* than to *production* for the purposes of acquiring resources than can be consumed rather than *reinvested* in business growth. Thus, the new entrepreneurs of Eastern Europe are unlikely to bring about fundamental changes in the ideological and the economic structures of these countries. As such, they cannot be regarded as a force of *indigenous* economic transformation ...

Scase (1998: 14-15)

Much of the transition period activity that is characterized as evidence of successful development of the SME actually fits within the proprietorship rather than entrepreneurship category, recognizing that there is an ambiguous border between the two and that individuals can obviously evolve or devolve from one to the other, possibly more than once. We will see that the former is reasonable and attractive behaviour at the individual level and is not bad for the system, however it is very different and more conservative in its system effects that would be the broader prevalence of real entrepreneurial activity. The confusion of these two very different dynamics makes intelligent analysis of or policy prescription for the SME sector difficult. In the concluding section on policy choices, some suggestions are offered for dealing with this problem.

2.5 Missing Comparative Data: SME Size and Links to the Informal Economy

There is much careless talk about burgeoning self-employment in transition economies. What this statistical phenomenon means is highly debatable in light of the way in which these statistics are collected. Table 1.2 provides comparative statistics on the share of total employment in the SME of a various countries. There are two sharp warnings to be noted in dealing with such statistical evidence. First, the dividing lines between size groups differ from country to country and from time-to-time within countries. Second, there is such large scale, but hard to measure, inflation of the numbers due to exaggeration of the number of enterprises founded (many never function or function briefly to serve criminal or subsidy collection motives) while the death of enterprises is never reported. Systematic bias of the kind that does now allow use of the so-called 'law of equal cheating'. Not only are the levels reported not useful, but even the year-to-year changes should not be taken to contain much serious information. Since everyone is happy to report SME success, there is a polite and sustained conspiracy to ignore these unfortunate facts.

TABLE 2
SME SHARE IN MANUFACTURING EMPLOYMENT (%)

Country	1937	1954	1970	1976	1978	1979	1980	1981	1982	1985	1986	1987	1988
FRG			54.8									57.9	
GDR											1.1		
Netherlands					>36.1						>39.9		
Italy													
North								>44.3				>55.2	
South								>61.4				>68.4	
Portugal									68.3		71.8		
Czechoslovakia		13.0											1.4
Poland	33.0									>10.0			
US				33.4								35.2	
UK						30.1					36.6		

Note: Small and Medium Enterprises are defined as having 1-499 employees, except in Italy (1-199) and in Poland (1-99).

Source: Acs and Audretsch (1993), p. 62.

III MARKET SYSTEMS WITH DIVERSE PROPERTY FORMS: NEP, NEM AND TVE

There is a long often ignored history of the successful market functioning by SMEs in the presence of extensive state ownership of large enterprises, and even of classic Soviet-type central planning. The dominant ideology of transformation presumed (and its executors often acted in policy directions that required society to make) a jump to a new set of basically *homogeneous institutions*. Thus, it is important in several subtle ways to take account of this past experience with *unconventional mixed systems* in order to appreciate the opportunities for SME growth in the presence of other-than-free-market conditions. There have been and are a number of economic systems in which ownership and management types are mixed together in unconventional ways but that were or are none-the-less successful.

Four of the five examples briefly discussed here fit that pattern: the New Economic Policy (NEP) in the Soviet Union; the Hungarian New Economic Mechanism (NEM); the GDR small enterprise sector; and Township and Village Enterprise (TVE) development in China. The Chinese example is then used in comparative perspective to call attention to the concept of the local developmental state (Johnson 1982). This model has been pervasive in successful post-World War II development cases, from Germany, Austria and Italy to Japan, Taiwan and South Korean, but has been conspicuously absent from policy or practice in the transition economies after 1989 (Bateman 2000, 2001). Then the Finnish (*Pellervo*) co-operative approach to local-level enterprise finance and production is presented, reinforcing the local developmental state conception without central planning, but illustrating a highly successful solution to the pervasive SME finance famine.

These five examples are not well known in general and have a special contemporary relevance to all of those transition countries where unconventional institutional mixtures and co-ordination mechanisms are likely to persist in coming decades. The key point is that each of these small enterprise systems worked around, with, and in the interstices of, a successful large enterprise system. This underlines the importance of healthy large enterprises in creating an environment in which productive SMEs can thrive (beyond subsistence, small-scale trading and service activity). Outside Finland, the large enterprises were all state-owned (SOE), although operating under very different conditions: no central planning at all in the NEP; shrinking central planning with much enterprise or regional autonomy in both Hungary during the 1968-1989 NEM and China from 1978 to 1990; and strict Soviet-type planning in the GDR from 1947 to 1989.

The Finnish co-operative approach is immediately and powerfully relevant to breaking the small enterprise lending barrier that is a feature of economic life in all of the CEE countries (especially outside the largest cities and narrow orbit of internationally supported programmes). Brief consideration of its background shows further functional overlaps with precisely the problems afflicting the most impoverished parts of the CEE

countries today. This paper also points to some SME-favourable institution-building policies adopted in various Russian regions, and briefly discusses the vital but often ignored issue of market access as a barrier to the development of productive SMEs.

Even among advanced capitalist countries there is a somewhat similar and highly relevant experience with diverse institutional mixtures. This is most obvious in countries such as Italy, France and Taiwan that carried high levels of SOE into the 1980s (and even 1990s), the latter two countries often in leading, high technology sectors. The point that can be drawn from this experience that is relevant to the situation of the transitional economies is that *working arrangements* were developed which allowed the successful coexistence within the same economic space of forms of organization and ownership generally used to define Weberian ‘ideal-typical’ opposites (Parsons 1937). It was a commonplace of comparative economic systems analysis to note that all economies consisted of a greatly varying mixture of command, market and conventional-traditional allocation mechanisms, but this point has been largely forgotten in the mainline transition discussions (Wiles 1977, Kleiner 2001).

3.1 The New Economic Policy in the Soviet Union

The NEP was announced by Vladimir Lenin on March 18, 1921, with motives that remain unclear and hotly disputed to this day. It marked the successful end of the extraordinarily bitter and destructive Civil War during which a comprehensive mobilization system called War Communism was developed. Much of War Communism was directly copied from German mobilization practices during World War I, but was carried much further in Russia. As the Civil War progressed, this resulted in almost complete nationalization, demonetization and centralized bureaucratic control of the economy. This resulted from the combination of the extreme desperation of the Civil War situation and of the views of many Communist Party members that these same dire conditions allowed the Soviet Union to ‘jump over stages’ to a superior post-capitalist form of organization.

The Soviet New Economic Policy (NEP) was in force from 1921-1928 and produced what was at the time an unprecedented type of *mixed market socialism*. It was a mixed economy with exclusively market exchange in the presence of state ownership of large-scale industry, transportation and banking. The NEP preceded the development and implementation of Soviet-type physical planning. The first national economic development programme (the GOELRO programme for electrification) also began in 1921, but it was not until 1924 that the Government Planning Office (GOSPLAN) was founded as an academic ‘prognosis’ entity. The state retained ownership of the *commanding heights* (heavy industry, mining, transportation and banking), but left management of these state enterprises in the hands of experts who were told to follow business logic in a decentralized fashion. State firms dealt with each other, with small private and co-operative manufacturing and retailing firms, as well as with the private agricultural sector on the basis of money transactions, rather than any form of administrative planning. Exchange occurred through markets with prices set largely by supply and demand forces.

The NEP was widely judged to be a period of great success in economic recovery and rebuilding. During the NEP, educational (mass literacy and all other levels) and public health programmes, were initiated and rapid technological progress resulted from selective import of capital and technicians from advanced capitalist countries. The overall pace of economic expansion was substantial. yet opinion on the viability of the NEP remains distorted to this day by the successful propaganda Josef Stalin used to justify his decision to abandon the NEP in 1928. This decision to create from nothing (although obviously with reference to the lessons of the War Communism and GOELRO) a system of centralized bureaucratic planning based on the material balances method is an unprecedented moment in modern history. Whatever the ultimate wisdom of this choice it is important to understand that this was a purely political decision—that the NEP was an unsatisfactory mechanism for rapid industrialization. There were dual roots to this judgement: externally the looming military danger from the West; internally the effects of the NEP in building up a significant business-based middle class. The NEP was in many ways a *promising alternative system*, but it could not produce the rapid industrialization that became a political-military priority. There is nevertheless little reason to doubt the viability of the NEP as a long-term economic model (Bandera 1963, 1970).

It was only in 1928, with the beginning of the Five Year Plan era, that the Soviet Union created a second unique economic system, this time based on physical (material balance) central planning, comprehensive price controls, collectivized agriculture, very limited use of markets (for labour, the distribution of consumer goods and retail sales in the collective farm market) and tight Communist Party control of the details of plan formulation and implementation. These institutions remained remarkably stable until the 1985-1991 period. Reform and rectification efforts sometimes had significant effects, but the essential features of the system and the incentive and related questions they posed continued fundamentally unchanged.

3.2 The New Economic Mechanism in Hungary

The Hungarian New Economic Mechanism (NEM) was formally adopted in 1968, but was preceded by a number of earlier small steps after 1956. The NEM aimed to create a mixed predominantly socialist economic system in which a variety of ownership forms coexisted. Hungary had a large degree of decentralization and used market mechanisms extensively, even though operating within the framework of a central plan until 1989. Enterprises were run by state-appointed managers, with most profit going to the state. The large industrial and agricultural producers retained respectively the SOE and collective/co-operative farm structure but moved to more and more market oriented forms of behaviour. While enterprise managers continued to be appointed by industrial ministries in Budapest, they were more and more put in the position of maximizing profits. It was an environment with little or no directive central planning (except for capital expenditure decisions) where intermediate material flows and product marketing arrangements were made on a contractual basis between enterprises with little central involvement. Since central influence was ideally to be exercised only by the use of 'economic levers', not command, the system came to resemble the French-type of indicative planning more than just superficially.

This type of fundamental modification of classical Soviet-type central planning was not unusual, but was simply carried a bit further in Hungary and Yugoslavia (and presented as being a desirable systems reform). In reality, all socialist economies used a mixture of plan and market, with the USSR, China, East Germany, Czechoslovakia, Bulgaria, and Cuba leaning more toward planning, while Hungary and Yugoslavia over time leaned toward greater use of the market. In Yugoslavia: each enterprise of any significant size was run by a workers council; all profits after taxes were used as the council decided (within certain constraints); and enterprises competed in a modified market, setting their outputs and sometimes their prices. All of the others were predominantly government directed, but in each of these pre-1989 Soviet-type economies of eastern and central Europe the mixture of property types (state, co-operative and purely private) and organizational forms were different.

Mixed systems with different proportions between large state and small co-operative or private enterprises developed, and in some cases prospered, in various parts of eastern Europe. In both urban and rural contexts, societies operating with Soviet-type large institutions and central planning found diverse ways of integrating smaller-scale and more market-oriented components (McIntyre 1989). Agriculture in Hungary, Czechoslovakia and Bulgaria, entrepreneurial small enterprise development in Bulgaria, and purely private small-scale industry in the GDR provide relevant examples (McIntyre 1988, 1989). In each case some kind of non-adversarial relationship emerged between the large state institutions and these other 'peripheral' bodies. When these systems failed, they did not fail because of their mixed characteristics.

3.3 The Persistence of Small-scale Private Enterprise in the former GDR

Despite easy access to information about the GDR, the structural-institutional realities of its economic system and its distance from the simple Soviet-type-economy model were not clearly understood. Western analysis concentrated on the well known fact that the GDR made large Soviet-type SOEs (*VEB*, later *Kombinate*) work relatively well, but this directed attention away from the overall mixture of institutions that developed. From 1946 to 1989 the GDR was a mixed socialist economy that was in some ways like the economic system of the NEP. It first tolerated and then nurtured a small, legal, private enterprise sector of surprising sophistication and complexity that amounted to about 2 per cent of the work force in the 1980s.

There was never a comprehensive nationalization and collectivization of private productive property. Capital owned by persons convicted of war crimes or who had fled the country was seized at the beginning of the post-war reconstruction drive. For many years a large variety of small- and medium-size enterprises continued to operate in all sectors of the economy as private or as shared private-state units. In 1972 there was a last nationalization round of medium-sized private enterprises (including some of the most famous mixed enterprises that were fashion houses, pipe organ builders, etc.). Small-scale firms were never nationalized—the bulk of these older enterprises consisted of bakeries, butcher shops, small specialty retail outlets and restaurants. A significant proportion of small production facilities were half state and half privately owned

(*halbstaatliche*) and were sufficiently free of state direction to be considered behaviorally private (Äslund 1985).

In the mid-1980's the GDR expanded the number of small privately managed restaurants and retail stores, on a lease basis much like what was used in Hungary. The expansion of small restaurants and speciality stores in urban areas was the most visible sign of the change in policy direction, but there was also a proliferation of small-scale garment production and the regularization of private market sales of agricultural products (and various handicraft products, pottery, etc.). This occurred in an atmosphere of institutional stability where the state was able to take advantage of the dynamism this small private sector in areas where it suited its interests. Consumers benefited from the enriched and extended the range of consumer goods and services available. There was tight control over the scope and profitability of these various small private enterprises. The combination of administratively set prices, strong enforcement of income tax laws and a cultural milieu that did not favour off-the-books transactions meant that the profitability of private ownership was relatively narrowly constrained.

Some of these private units operated beyond the boundaries of the service sector, including even some cases in classical 'heavy' industries such as chemicals. In the Leipzig area there were more than 30 private firms coexisting with a major national concentration of large state firms. The private firms varied from very small to sizes as large as 50 employees. They were legal, had been stable over multiple decades and could grow and be resold to other private owners. The relationships between these firms and the local SOE were complex and included private firms production of speciality products on subcontract from the SOE which were then marketed under the name of the state organization. The other output of the small private firms was generally sold through state retail outlets.

Both wholesale and retail prices were determined by the Price Administration Office, which applied the same price-formation accounting conventions to private firms and SOEs, although with a different allowed profit rate. Inputs were obtained from SOE producers at official prices. The small chemical firms in Leipzig formed a buying co-operative to enable them to secure inputs that were sold in relatively large units by state firms. Loans for expansion or for individuals wishing to purchase existing firms from their owners were available from a branch of the State bank, making the legality of this activity obvious. Formation of new firms in such an industrial branch was probably impossible (McIntyre 1989).

Some of the aspects of this local area relationship, both in the link between large SOEs and small private firms, and in the simultaneously competitive and collaborative links among the small firms, are at least suggestive of some successful Italian industrial districts. These were not economic reforms in the conventional sense of redesigning the organizational structure or incentive arrangements within the large enterprises of the entire SOE sector, but they nonetheless produced a significant difference in the performance and character of the economic system. A distinctive form of mixed economic organization did emerge in the GDR, made up of a large state enterprise sector (operating under classic Soviet-type coordination, information flow and incentive

conditions) and a very complex private and semi-private service and small industry periphery which dealt with the state sector in a well established pattern of non-adversarial interactions. The multi-decade organizational and legal stability of the GDR private and semi-private sector suggests that this set of 'socialist-mixed' economic institutions need not be viewed as a purely 'transitional' phenomenon, regardless of the historical fate of the GDR as a political entity.

3.4 China: New types of SMEs Result from an Evolutionary Transition Path

The emergence of mixed, 'unorthodox' ownership and governance forms in China is one of the most interesting aspects of its dynamic development since 1978. China now exhibits a distinctive type of 'mixed property' system, which is in some ways like the 1921-1928 NEP in the Soviet Union. It is important to understand the role of SMEs within this complex environment, specifically considering the ownership forms, relationships with large SOE and government authorities at both national and local levels. This system is still in active, rapid evolution toward unclear future forms (Sun, Gu and McIntyre 1999). Some consideration of the institutional developments over the last several decades is required to make sense of contemporary patterns.

The historical process of China's socialist revolution was entirely different from that of the Soviet Union. The Communist party built its base among the peasantry before the party took state power, and since rural workers comprised well over 80 per cent of the labour force, the Chinese Revolution was a real mass phenomena from the beginning. It produced: highly mobilized popular support among the peasants; a close identification of the peasant base with the party which claimed to represent it; and an ideology which made the peasant majority a real and natural part of the party constituency. Equally important, the last phases of the Chinese Civil War were mostly easy victories and so did not (as had the 1918-1921 Russian Civil War) decimate the ranks of lower level supporters and party activists. The winners in the Chinese case were already successfully governing a large part of the country, and took total control with their popular base intact.

After an initial period of attempting to copy in great detail the institutional arrangements of the Soviet Union, China abandoned the classical Stalinist model. It turned away from centralized decision-making carried out through a national administrative hierarchy, and experimented with construction of a new model of socialist development. Political mobilization campaigns and attacks on the privileges of the 'new elite' created economic chaos, but also avoided early institutional stagnation within a tightly organized Soviet-type party-state. After the death of Mao Tse-tung, China then moved toward market reforms beginning in 1978. This was quite late, compared to the diverse reform developments that had been carried out in Eastern Europe and the Soviet Union over the prior 25 years, but China has persevered with these reforms in a careful, pragmatic way over two decades. A common theme to each reform period is the tendency to build in greater decentralization in economic management, either through changes in the administrative structure of planning or through use of the market to take over some but not all of the functions of planning.

Setting the Stage for SME Growth: Unlikely Results of the Great Leap

A major decentralization of industry was undertaken in 1957 and 1958 (at the same time similar reorganization was occurring in the Soviet Union). Control of individual enterprise was transferred from ministries to provincial and local governments. In 1958 decentralization was extended by a wide-scale attempt to develop very small-scale rural industries (most famous of which were the so-called backyard steel furnaces). This programme was not meant to divert resources from the operation or construction of large-scale plants but was part of China's effort to industrialize by 'walking on two legs'. This meant simultaneously using technologically advanced, capital-intensive methods in the modern sector and intensifying the development of traditional, technically simple, labour-intensive methods in the other sector.

The attempt to develop small-scale rural industries was part of a massive nationwide movement to increase agricultural and industrial output dramatically in a few years by mobilizing the population in a semi-military way to intensify productive activity sharply. This coincided with the abrupt and shocking break-up of the close alliance with the USSR. The GLF itself constituted a break from the Soviet model of centralized planning and one-man management, but it preserved the concentration of investment resources on industrial development. The great bulk of resources used to underwrite the creation of small local industry came from the rural areas themselves (extensive labour mobilization and use of local raw materials). The further economic and social disruption of the 1966-1969/76 Great Proletarian Cultural Revolution left China with a legacy of problems.

During the reform period the emphasis on ideology of the Cultural Revolution was replaced by a more balanced appeal to both community/group interests and individual self-interest. The general trend of the reforms since then has been combining an expanded scope for market forces with reduction of the extent of planning so that it focuses increasingly on strategic rather than detailed microeconomic decisions. The central features of the Chinese reform model over the entire 1978-1999 period are:

- (1) gradual substitution of 'guidance' for more direct 'administrative' planning. with the State relying more on indirect financial levers, rather than administrative order or directives, to influence changes at the local level;
- (2) creation of increasing room for market forces to operate both in product and factor markets, including a substantial freeing up of the price system. Despite this tendency toward price 'liberalization', different types of administratively set and controlled prices have continued in force;
- (3) as party control over enterprises has declined, managers have been granted increasing control over daily enterprise activities and required to take greater responsibility for their decisions;

(4) wages and bonuses have become much more closely tied to individual performance in order to stimulate greater productivity and efficiency;

(5) experimentation with *purely private, small group and collective but non-national ownership of the means of production* has led to a great diversity of ownership forms; and

(6) foreign technology has been actively welcomed, but a tough bargaining position has been adopted, allowing very little 100 per cent foreign ownership and trying to extract maximum local effect from foreign involvement.

As part of the agricultural reforms the household-responsibility system was instituted and the communes—the higher level, larger collectives that were the distinctive feature of Maoist agriculture—were abolished. The production brigades assumed control over agricultural land, while government agencies and collective enterprises typically took control of agricultural services and local industry. The production brigade is still ‘collective’ entities and land ownership resides ultimately with it. There is private use of land in the form of the personal garden plots and there is use of brigade land by one or more household groupings under the responsibility-contract system, but in both cases this does not constitute private ownership of rural land.

With the abolition of the communes, village governments had to be newly created to take over their administrative functions, such as public health and education. They also took over many *purely local* directly-productive enterprises that had survived from the Great Leap period. These enterprises, along with newly created ones, make up what is now called the Township and Village Enterprises (TVE) sector. In a surprising and exciting way the TVE soon became one of the most dynamic elements of the reform period Chinese economy. The basic direction of China’s industrial reform so far has been to maintain the overall planning system while increasing the role of the market within it, leaving the market subordinate although of steadily increasing significance (Naughton 1995). The growing practice of state-enterprise bargaining reflects some movement away both from regulation by the plan and by the market. In this sense, behaviour in some parts of the Chinese economy resembles state-enterprise negotiation process in Hungary before 1989. Factory managers and government officials negotiate about what proportion of the profits a factory can retain; and they discuss which raw materials can be bought cheaply from the central government, which bought expensively on free markets and which bought at prices somewhere between. Companies with bureaucrats who have done favours for the manager of a local bank are usually first in the queue for cheap loans.

The rising power of local authorities over basic economic decisions is probably connected to the TVE phenomena discussed below. The resort to bargaining outside the plan reflects the growing prominence of local government in the Chinese economy—this means that local bureaucrats are increasingly usurping the independence and power of the managers. In theory managers of both large and small SOEs are independent. In fact, they still send regular reports about their factory’s output to the industrial bureau,

about wages and bonus payments to the labour bureau and cash-flow reports to the financial bureau of the province or county that controls them. The result is that the main economic unit is not the factory, but the local-level bureaucracy. Local officials have been able to manipulate the reforms to transfer even more resources to their own control, moving beyond the TVE to directly influence and in many cases control local branches of SOE enterprises (called local SOEs).

Township and Village Enterprise (TVE) are a key feature of the reform period, with peculiar and intriguing aspects. Rather than being new creations of the reform period, the TVE's are a relic of the 1958-1960 rural small-scale industrialization efforts of the Great Leap Forward period. While the Great Leap is generally seen as a comprehensive disaster which (in combination with the 1966-1969/1976 Cultural Revolution) cost China decades of lost development, aspects of the rural industrialization strategy survived and through time developed effective economic characteristics (Perotti, Sun and Zou 1999).

The TVE have proven to be unusually successful and dynamic economic entities, despite structural and behavioural features that would appear disadvantageous (if not profoundly disabling) when viewed from a standard perspective that emphasizes the need for clearly established property rights and individual incentives to secure effective performance.

(McIntyre 1998, p. 870)

Weitzman and Xu (1994) have provided a subtle, multi-level explanation/rationalization for how the TVE seem to work. They illuminate the working arrangements of these strange but highly dynamic entities in terms of an analysis of 'loosely defined' collectives, combined with 'informal, trust-based relationships'. They explain this behaviour in terms recognizable to the categories of individual motivation and choice of neo-classical analysis.

The economic success and dynamism of the TVE in the post-1978 reform period is remarkable. Already in 1978, 19 million workers were employed in TVE, producing simple implements and relatively crude products. By the mid-1990's employment had grown to more than 60 million and the array of products widely proliferated and moved to export-level quality. By 1997 the TVE sector accounted for more than 30 per cent of PRC GDP and the astonishing total of 46.3 per cent of PRC export earnings (Nolan 1995, pp. 221-222 and *People's Daily*, 5.02.1998 and 22.03.1998).

The period since Mao's death in 1976 has been characterized by a two decade-long policy shift back toward *the use of the market* and of *differential individual material incentives*. The current reform project has encountered many difficulties and has not moved in a straight line. The Chinese have, perhaps inadvertently, established a novel model of a *socialist mixed-property market economy* in which small-scale collectively owned entities are a dominant and dynamic part. Whether this is 'market socialism' or 'capitalism' is a complex fruitless debate. What is clear is that what is emerging is quite different from ideal-typical versions of either alternative.

After the death of Deng Xiaoping in 1997, his successors asserted a renewed commitment to market reform, promising to use market incentives to actually prune and reorganize the State Owned Enterprise (SOE) sector. Foreign reactions were quite extreme and revealing—most treating it as an epochal announcement by which even official ‘socialism’ was abandoned. This interpretation reflects both lingering Cold War impulses and discomfort with ‘mixed’ institutions. The nearly simultaneous South Asian financial crisis created a powerful counter argument against pursuit of a liberalization strategy that creates more internal unpredictability as a result of openness to the world financial system. Chinese economists and political leaders are horrified by the economic and social collapse that incoherent ‘free-market’ policy has produced in Russia and will likely go to great lengths to forestall any such developments in China. As Nolan (1995) has pointed out, Chinese economists and political leaders have made a careful, critical evaluation of relevant world experience, in which the post-Soviet Union experience stands out as a case of everything to be avoided.

The prevalent Western interpretation of China now ‘really ready to make the jump’ to ‘openness’ and ‘liberalism’ ignores the pragmatic nature of Chinese reform, the concentration of many of the most modern production technologies in those SOE considered beyond the reach of these latest reforms and also fails to take account of the already existing extent of the *non-state, non-private sector*. This last development is in fact a uniquely Chinese type of *municipal socialism*. The success and dynamism of this sector is important in understanding likely future developments. It points to the viability of a form of property ownership—‘*socialist*’ but *non-nationalized*—that is the likely fate of many of the small- and medium-sized SOE’s slated for comprehensive reform and the removal of national government subsidies.

One of the economic development lessons of this experience is that the original (not the evolved and most recent) form of Chinese Township and Village Enterprise (TVE) should be considered as a promising model for other countries. This is in essence a closed co-operative in which local government may either play only a supervisory and facilitative role or also act directly as partial owner. If the classificatory logic used by the World Bank is adopted, the latter arrangement even qualifies as ‘private sector development’ (no matter who owns it, if it is not the national government, it is considered ‘private’).

Many of the existing TVEs themselves changed legal form during the 1990s, becoming joint-stock co-operatives (Sun, Gu and McIntyre 1999). For most this is only a change of name, although large TVEs are thereby structurally prepared for the possibility of becoming autonomous publicly traded entities in the future. It is interesting to note a sharp movement by previously purely private entities to take on this same legal form. If the local SOEs are fundamentally reorganized it appears likely that many will end up under the direct control of township and local governments, with some degree of employee ownership. This path bears some considerable resemblance to what Stiglitz has advocated as ‘privatization to stakeholders’ (1999). Stiglitz and others (Nolan 1995, McIntyre 1996a, McIntyre 1998, Stiglitz and Ellerman 2000) suggest that this approach has wide potential application in all transition countries. When TVEs move from full local government ownership to joint-stock co-operative form (with mixed local

government and employee share ownership) they are indeed 'privatization to stakeholders'. In Russia, a similar category of 'employee-owned' enterprises was established by 1998 legislation, and has begun to grow rapidly and has interesting potential. It is structurally similar to Chinese joint-stock co-operatives and may be able to include local government as partial equity owner (McIntyre 2001).

It is easy to find reasons to avoid studying the Chinese experience. Barriers of culture, development level and political culture have made it convenient not to think carefully about its challenging and complex lessons. To reduce this inhibition it is useful to remember that the main Chinese institutional innovation is much like a multi-member partnership, which is a familiar organizational form in many other countries. The role of local government is also distinctive but not unique, directly following the logic if not the details of the other cases emphasized by Bateman (2000, 2001). A combination of these aspects could be useful as a feature of local-level revitalization efforts elsewhere. The other part of the story is that the dynamic, society-transforming growth that was set off and carried out by these local bodies, ended up producing less improvement in human development that might have been hoped. It is a question of great world significance whether China can combine planning with an increasing role for market forces and still maintain a system of property rights characterized as predominantly socialist rather than capitalist. The enormous regional differences in incomes and living standards and sharply increased inequality within regions pose the greatest threat to the continued success of this mixed model (Riskin 2001). Growth has been so rapid that despite this great inequality only relative not absolute poverty has increased. What will happen when overall growth slows down and absolute poverty rises remains to be seen.

3.5 Finnish Co-operative Approach to Finance Barriers

Finland provides an oddly appropriate point of reference for consideration of the problems of triggering economic development under very different (resource rich, sparsely settled, peripheral) conditions much like much of the FSU and part of CEEC. The Finnish co-operative tradition is a provocative addition to debates about SME financing and suggests new tools to support market-based economic growth in impoverished and remote areas of transition economies (Skurnik and Vihriälä 1999).

Over a period of a century, Finland used local-level co-operatively-owned financial institutions as part of a national-level economic development strategy. Contemporary Finland has been astute and vigorous in pursuing complex and subtle industrial and developmental policies while managing to appear a bastion of free-market rectitude. Banking is a case in point, since the success of the co-operative banking system traces back to direct initial deposits from the state treasury, overcoming the initial trust and scale problems, while combining local banks into regional alliances under a national confederation to assure political visibility. In parallel to and with the support of the banking system a wide array of production and marketing co-operatives arose and according to Kuisma (1999, p. 13) retain a large share of the contemporary Finnish market (in 1998: meat 69 per cent; dairy 96 per cent; egg 71 per cent; forest owners 33 per cent; livestock breeding 100 per cent; consumer co-operative 39 per cent; banking 33 per cent; insurance 7 per cent).

This type of interaction is not unique to Finland or the Nordic countries, but is especially strong there. The *European Observatory for SMEs* notes that across the European Union

Many banking/credit/insurance co-operatives and mutuals have their roots in the co-operation of SMEs and the objective of providing auxiliary services to these enterprises. Co-operation is an important strategy for SMEs to strengthen their market position against larger competitors. In crafts, retail, trade, transport and some production, co-operative members are almost exclusively SMEs. (M)any (co-operatives) have been founded by and for SMEs and are, on the whole, SMEs themselves.

(1996, pp. 351-352)

The *Observatory* (1996) also notes how hard it is to judge the scale of operation by productive co-operative SMEs, because of different, not explicitly co-operative, legal forms in many countries.

The possibility of combining co-operative saving and lending institutions with co-operative production, processing and service co-operatives is an idea with great promise in many transition economies. The formation of hundreds of 'new wave' co-operative during the severe Finnish depression of the early 1990s, and the large number of technology and technical service companies that resulted, is also a promising precedent.

National or local government engagement is generally required to start such institutions on a worthwhile scale, but this may be criticized as an unproductive subsidy or unfair competition to commercial banks. The idea that the market rate of interest, combined with banking conventions about acceptable risk, answers all necessary questions about what is wise and developmentally viable has been attacked by Bateman (2000) on both theoretical and historical-empirical grounds. The European Commission *Observatory for SMEs* puts the policy point precisely after appraising differential SME access to finance within the EU:

The financial structure of an enterprise seems to depend more on the financial system and the financial habits of the country in which it operates than on any other characteristics of enterprises such as size, sector, age and even profitability. Moreover, the smaller the enterprise, the greater are the international differences in financial structure. In other words, there seems to be a generalized convergence in financing patterns for larger enterprises.

(2000, p. 19)

It is useful to consider the implications of these findings for SME policy in transition countries, especially in light of the earlier statement from the same source about the felt policy imperatives within the EU:

The efforts aimed at meeting the Maastricht criteria have substantially narrowed the room EU countries' governments used to have for manoeuvres in the field of SME policy. This has not reduced the necessity to adopt new stimulating measures especially for SMEs and, in some case, has led governments to widen the scope of their enterprise policy.

(2000, pp. 249-250)

The example of Finland in using national policy to create the conditions in which local-level saving, financial services and other production, marketing, wholesale buying and other co-operatives could take root, is directly relevant to the solution of the puzzling failure of productive SMEs to play a significant role during the first decade of transition. For a bracing reinterpretation of the efficiency characteristics of co-operatives in light of new developments in agency and information theory, see Hansmann (1996, 1999) and Stiglitz (2000).

IV CASES FROM RUSSIAN PROVINCES: EFFECTIVE MARKET REFORM BY ANTI-REFORMERS

Russian provincial experience provides another, quite different challenge to orthodox views of how the transition should proceed. The conventional explanation of the center-regional dynamic has been that the greater the ability of the Moscow center to push the pace of reform, the better the outcome. Such an opinion can only be based on reform rhetoric, but nonetheless requires a breathtaking lack of information about the actual conduct, motives and wherewithal of the centre during the entire post 1991 period. The weakening of central control meant that regional and local governments were forced to deal with the fiscal-financial, economic-production and social consequences of policies that continue to be announced from Moscow. It is important to note the different ways in which regions managed the specific 'local' features of the national economic crisis. It is also useful to search local experience for clues to approaches or measures that might lead to improved national-level policies in the future. Both active and implicit policy forces become clearly visible if analysis is carried out at the local or oblast level.

A number of regions in Russia have sets of policies designed to slow-down, buffer or even prevent the intended effects of the liberalization, marketization and privatization policies adopted by the national government. The upper Volga region of Ulyanovsk has been treated as the arch-typical example of this 'Red Belt' tendency (McIntyre 1996a, 1998). These locally initiated measures had complex effects in the rapidly changing and unpredictable environment created by not carefully prepared policy actions taken at the national level. These measures came to be seen to contradict the neo-liberal transition orthodoxy, so the central authorities themselves sometimes took active measures to try to, at the least, reduce the inconvenient effectiveness of these local policies.

These measures were not without difficulties, but produced desirable direct (favorable supply and lower inflation conditions, better health and mortality results) and indirect (a low degree of monopolization and criminalization of the supply system) effects on economic performance. These tactics left the regional sub-divisions in question area economically and socially distinctive over a long period of time. It is especially surprising to economists (and other analysts strongly affected by the neo-classical tradition) that the effects of such measures could continue over a more than five year period in which the surrounding all-Russian economic space is believed to have become largely 'marketized'. The natural dynamics of simple markets work to reduce differences between adjoining or connected parts of a larger system. In resisting central government pressure to unconditionally accept these all-Russian conditions the local authorities were aided by the relatively weak lateral connections between Russian regions and the limited development of wholesale and other economic infrastructure, but nevertheless had to use the police powers of government to maintain sufficient economic autonomy to allow their semi-autarchic approach to function.

Study of the specific operational details of the original case makes concrete the economic policy implications of this ‘Ulyanovsk model’ and shows the self-reinforcing economic logic of the local supply and demand management measures adopted. A high degree of local-level autonomy was widespread in Russia at the time, but the consistent and organized logic of the measures undertaken in Ulyanovsk is virtually unique, as is its persistence through time. The economic reasons for success are reasonably clear and center on: the control and stabilization of local production for local consumption; use of a mixture of price-controlled and price-uncontrolled (but subsidized) markets for consumer goods; and prevention of the simultaneous disruption/corruption of the wholesale and retail distribution channels. While private enterprise was not forbidden in the food and daily supplies sector of the emerging market economy, it operated within strictly circumscribed conditions, and was taxed in a way which generated funds sufficient to allow continued local funding of important aspects of the old system ‘safety net’.

The array of policies adopted generally either worked directly on the supply-side, involved direct intervention to manipulate prices or worked indirectly on the demand side. These other measures were conducted (until July 1996) in an environment where direct rationing of a set of core products took some of the edge off subsistence fears. This affected the volatility of the demand side—retarding hoarding tendencies, reducing waste and making for somewhat more patient, less panic-prone consumers. The number of products covered by formal rationing fell steadily and the eventual end of the programme was well advertised in advance. The short-run calming and predictability effects of this approach may also have had favorable longer-term implications.

A strict, physically enforced, prohibition was established against the shipment of local output of various ‘essential’ products outside the Ulyanovsk oblast until local consumption demand had been satisfied. This was enforced by airport, train station and road inspections. As a long-time food exporting region, this meant that even with some decline in oblast output, supplies to the local population could be assured simply by reducing exports to other regions. Over a period of time this limitation on the market access of local producers was perhaps a perverse advantage, since it kept alive their linkage to local retail outlets by way of a local wholesale network. Maintaining a locally-grounded distribution system and preventing an atmosphere of lawlessness were both aided by the fact that rationing and price controls that were in force through the chaotic first few years of the Russian transition. Because this prevented rapid enrichment by the slowly emerging small business sector it avoided attracting irresistible criminal attention.

When wholesale distribution networks elsewhere in Russia were often refusing to carry local produce to market (due to: the higher profitability *to the wholesaler* of sales of doubly subsidized EEC surplus commodities; the ability of the *wholesalers as monopsonist* to simply exclude lower margin products; and interacting criminalization), Ulyanovsk producers faced no such problems. Loss of wholesale distribution has been a major cause of the decline of both agricultural output and small scale agricultural processing elsewhere in Russia. The effects of the continued health of local producers was reflected on the supply side of all three types of markets: rationed; non-rationed but

price controlled; and free market. These different markets coexisted, but because of the adequate physical supply of key commodities in the two controlled channels and the inability to export food products beyond the region until local sufficiency was assured, a dysfunctional dynamic did not develop between controlled and free markets. The regularity of supply further calmed conditions on the demand-side, making supplies for rationed distribution easier for the authorities to accumulate and lowering the local free market prices of those same goods.

This explicitly anti-free-market approach in the short-run allowed the persistence of price and consumption patterns far different from surrounding areas. This would not be true in an integrated market economy. While private firms were permitted to sell basic subsistence commodities they were not allowed to achieve the position of sole supplier of such goods at 'free' but monopolistically-set prices. Private stores were required to carry both rationed and price-controlled goods, along side of more expensive, often imported, alternatives. Private retailers were thus forced to sell some goods at loss- or no-profit-making prices in order to be allowed to sell their profit generating products. Either because of effective policing or due to the absence of the high profits generated by monopoly leverage on subsistence products, the criminalization of the distribution process characteristic of most of urban Russia did not occur in Ulyanovsk in the early 1990s. A key to this outcome may be the fact that the old retail distributed system was largely retained in non-private hands (in the main city Ulyanovsk, ownership was retained by the city government) for several years and then slowly privatized.

Transition strategies of this kind are often presented as being a form of dated opposition to the market per se. It is ironic that this approach was not in fact anti-market, but was a good preparation for healthy market functioning, once more normal conditions emerge. A more nuanced consideration of how markets really work in periods of disequilibrium systems transformation suggests that these measures are better understood as a form of *market-wise pragmatism*. This approach has proved to be well designed to allow the eventual emergence of market forces, but only after sufficient time has past to allow adequate infrastructural development to permit their successful functioning. The combined effect of the variety of price and supply control measures adopted in Ulyanovsk was crucial in preventing pervasive criminalization of economic life during the early stages of the transition process. Because criminalization did not develop and entrench itself earlier in the process, markets are better able to function now. Both supply restriction and (private) monopoly price setting have been largely avoided. This relationship is found in other places, not only in Ulyanovsk.

There seems to be a direct relationship between the speed of 'liberalization' and the extent of criminalization of the economic life. The economic logic of the policies pursued is substantial on its own terms but had the side-benefit of reducing the space for criminalization to take hold. This experience suggests ways in which market oriented reforms can be reconciled with Russian conditions (undeveloped market infrastructure and anti-competitive tendencies within the 'market'), while reducing the disruptive effects of liberalization measures adopted at the national level.

It is useful to consider the Township and Village Enterprise (TVE) in the Peoples Republic of China as a possible institutional arrangement under Russian conditions. The survival pressures bearing down on regional administrations are likely to encourage the adoption of certain features of the Chinese reform path, specifically the rise of some form of local social ownership of small and medium-sized productive enterprises. Both Russian and foreign analysts have resisted efforts to draw lessons for the contemporary Russian economy from the Chinese reform experience after 1978. This reticence often bears a stronger mark of self-interest (material and military-ideological, respectively) than serious analysis. Peter Nolan (1995) has argued that China faced much greater, apparently insurmountable obstacles, while the Russian situation was by comparison relatively simple. By this interpretation, the Russian transition disaster is simply an unmitigated policy error, not the regrettable path-dependent effect of being a highly integrated, industrialized planned economy. We refer here only to this regional self-sufficiency aspect, leaving aside systems-level issues here. As the current wave of small-scale de-privatization continues (due to the death or criminal conviction of original holders of privatized entities, the choice of re-privatization or oblast/municipal operation poses itself. It is reasonable to expect that in a few years that Russia (away from Moscow and a few other large cities) will have acquired something analogous to the Chinese mixture of local institutional forms.

V WHOLESALE TRADE AND OTHER ASPECTS OF MARKET ACCESS

Productive SMEs cannot succeed without access to potential customers. This is obvious, but unfortunately the role of wholesale trade and other obscure but absolutely vital aspects of market access are seldom directly considered. This is an area where neoclassical economic theory is generally silent—a hole at the center of our understanding of how the markets in which SME live actually function. Neoclassical market analysis assumes the existence of producers and consumers and by treats the distribution link between them as nothing special. By implication the buyer and the producer/seller meet directly.

We know this assumption of direct producer-consumer contact is generally not true, but perhaps we can make the charitable interpretation that producer-wholesaler and wholesaler-buyer markets work as simply and clearly as the ideal-typical perfectly competitive model (which has not dealt directly with these details). This assumption that wholesale distribution is just another layer of perfectly competitive markets is unfortunately not realistic in established (institutionally developed) market economies and is even further out of connection with reality in transition economies. In the transition process SMEs are struggling to establish themselves often in the absence of an adequate institutional framework, one key aspect of which is access to distribution channels.

Six illustrative cases are cited below, the first three from developed capitalist countries and the remaining three from transitional countries.

In this regard it is useful to consider the market-access aspects of two seemingly very different concepts of firm-to-firm relationship: the *Italian-style industrial district*; and the big firm-supplier linkage of the classic post-World War II *Japanese keiretsu*. What the relationship provides in both cases is an organized and reliable path of market access for small entities. In the Italian case, the small firms of an industrial district may explicitly combine resources to carry out marketing, design or export promotion projects none could afford alone. In Northern Italy (and Southern Germany) the pattern of small enterprise development, often described by the term ‘industrial district’, provides a number of examples of the development of synergistic relationships both within the SME sector and between the SMEs and the local-area large enterprises. Bateman (2000, 2001) points out that national-level success in rebuilding and modernizing after World War II was heavily dependent on local-level SME support measures, carried out by local-level governments.

External economies of agglomeration and scope have played a large role in the success of small-scale industrial development in other places as well (including eighteenth century England and nineteenth century New England). When Alfred Marshall first used the term, it was not presented as being a new insight, but simply a common sense, literal description of *regions where a particular industry was prevalent and where a structure*

of supplier, service and user small firms had arisen as a result. Once established this environment conferred certain advantages on each participant, even if they thought of themselves as rivals and market alternatives rather than colleagues in a co-operative enterprise. So, this was not a new idea, but simply a new term applied to an old fact of economic life. It is nonetheless often surprising to find such small firms successfully surviving in a world economy dominated by large firms—Northern Italy provides many examples of success along this path.

Within the Italian industrial districts purpose-built alliances and sub-contracting relationships have often developed, which include both horizontal and vertical linkages. Co-operation has been especially important in achieving export success for products such as speciality fabrics and other luxury goods and in niche markets for manufactured products such as packaging, processing and sealing machinery. It is important to look at the microeconomic features of such relationships and analyze the extent of their promise under transition conditions. The role of trust and long-term personal relationships in permitting or facilitating these Italian developments should be evaluated to determine the relevance to transition conditions. Informal networks and personal relationships from the planned system could perhaps be revived and reshaped to provide the basis for ‘industrial district’ type co-operation. Relationships like this can be found all over the world, often lacking only the formal name.

The Italian-type industrial districts and Japanese *keiretsu* both provide market access (and the organizational core the latter creates for associated small firms, including direct provision of technical and design assistance, quality control advice, credit and other financial services, etc.). A provocative additional example is role of the Lankide Aurrezkoa Bank in the functioning of the famous Mondragón system of locally-owned co-operatives, all of which were and many of which remain SMEs. The Bank provides borrowers with technical and management guidance when needed and sometimes has even moved employees between co-operatives in *keiretsu* style (Shuman 1998).

The Italian industrial district have unique features which are path dependent and have been built up slowly over time as successful working relationships developed, but they are nonetheless functionally like: some aspect of the production associations of 1970s-1980s within somewhat reformed centrally planned economy (the classic example being the GDR *kombinate*). The relationship between the *keiretsu* and their supplier network is also similar, especially after MITI, in the 1950s, forced large firms to abandon what had been an American-style large firm-small firm relationship (Johnson 1982). The Japanese (government-mandated) supply chain relationships soon came to be seen as a crucial competitive advantage for Japanese firms and were actively copied all over the world

A very different illustration of the importance of access to distribution is provided by the consumer product ‘UN-GLUE-IT’ in the United States market. UN-GLUE-IT is a universal, temporary solvent for stick-on price and other labels. It works, is patented and simple to produce, but proved to be impossible to successfully market in the US. Large chain store distributors work with a rule of thumb (no contracts with any supplier that does not provide them with at least three different products), that makes it hard for a

small firm to successfully market to a very thin market. This is a vivid, odd example of economies of scale in consumer goods ‘production’, defined to include marketing.

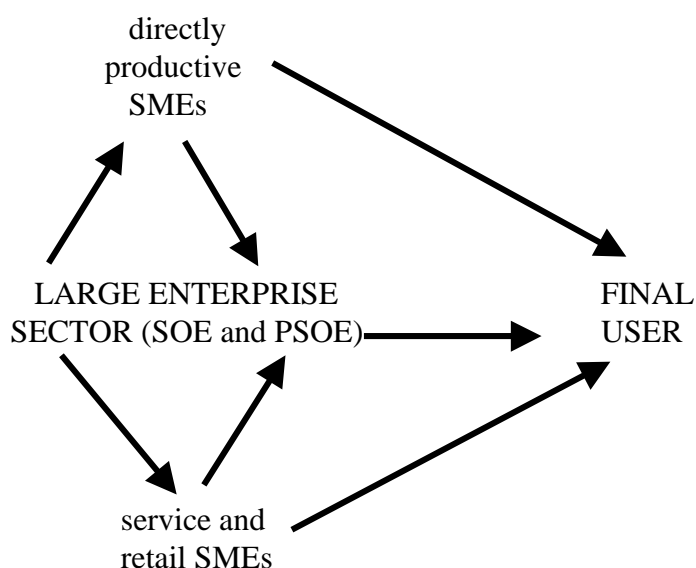
Central and Eastern European countries in the 1990s provide a number of good examples of the institutionally specific features of the distribution system and of the importance of market access in transition. There are a number of cases which illustrate *a pattern of movement from price controlled duopoly to unregulated private duopoly with foreign owners and foreign supply support networks*. In a series of countries, including the Czech Republic, Hungary and the former GDR, distribution systems for food and household products under the old system were price-controlled duopolies. Two complete national networks of retail stores existed, one in the standard form of state property and the other like a Western consumer co-operative—there were thousands of local retail sites, but each belonged to one or the other system. In the transition process the usual process was for each of these direct distribution and wholesale systems to be taken over by a single Western food company, resulting in a new duopoly arrangement with two crucial structural differences: (1) price controls were no longer in place; and (2) the western buyers made the new acquisitions part of their existing wholesale network which was based on large automated warehouses in Western Europe.

It was in some sense easier (the word efficiency must be used cautiously here) for the new owners to simply expand the volume acquired of existing Western products. The result was that local producers lost access to retail shelf space and exposure to the process of consumer choice in their own countries. Consumers in Budapest, for example, were offered only French milk and pork at one point—products in which Hungary was an established world-quality level producer. The implications for the local producers of all manner of food, processed food and consumer products (cleaning aides, cutting board, brooms, etc.) were strongly unfavorable. It was ironic that by the time consumer taste began to clearly express a preference for pre-transition formulations and brands, the resulting revival of ‘East’ brands often occurred when they were no longer locally owned or necessarily even locally produced. These ‘retro’ products were sometimes presented to consumers in a physically segregated setting.

VI THE RELATIONSHIP BETWEEN SOE/PSOE AND SME: MORE THAN TRANSITIONAL

Despite the tendency to think of and present the SME as an alternative to the former SOE, we have shown that, except for the face-to-face retail and service delivery sector, little can be expected from the SME without either: (a) actively organizational efforts at the local level; or (b) the survival or development of a healthy large enterprise sector which the SME can utilize as supplier, customer and provider of various social and technical externalities.

FIGURE 2
THE ECONOMIC LANDSCAPE:
LARGE, MEDIUM AND SMALL ENTERPRISES



Successful local-level efforts may possibly be self-organized, but are much more likely to reflect a significant role by city/metropolitan, county/commune or regional economic development authorities. This has been the case in successful economic development efforts in many advanced economies and there are even stronger reasons, connected to the absence of other intermediate structures and behavioural features of civil society, for this to be the dominant path in transitional economies as well. However nice it might be to see spontaneous effective self-organization emerge here, this is hardly realistic. Many of the examples presented of successful local-level activity in transition economies amount to (appropriate) self-promotion by the international or private charitable organizations that have funded and otherwise artificially mobilized these efforts. Even self-help conceptions such as micro-credit (which in principle, along the Grameen Bank

path, could be financed entirely by very small amounts of local savings), will not take hold without facilitative organizational and legal/institutional support at the national level.

This attention to productive SMEs is in no way a denigrate of the importance of the development and growth of what we are calling the face-to-face retail and service sector. It is however important to refer back to both the hopes for the SME role in the transitional societies and the set of examples that are normally drawn from advanced capitalist societies to demonstrate why SMEs can play such a positive role in the newly developing market economies. *In few if any cases are the 'clusters', 'supply chains' or 'industrial districts', that are usually cited as positive and hopeful examples, involved in retail or direct face-to-face service provision.* This is true in situations as different as northern Italy (and more recently other parts as well), southern Germany, northern Spain, southern England, the northeast and northwest of the United States and India.

For the set of reasons enumerated above, the status (ownership form, degree of organizational 'unpacking', and the behaviour pattern toward suppliers and customers) and well as future prospects to the SOE and PSOE are central to the likely fate of the productive SME sector. This connection requires us to make an uncomfortable jump from the micro-level discussion followed up to now to the surrounding macroeconomic conditions. Here the role of national policy decisively important and sharply different from country to country. It is useful to consider the extreme cases of Poland and Russia here, with Hungary as a supporting third point of reference.

VII INDUSTRIAL DISTRICTS: POLICY-RELEVANT 'FACTS'?

If digital technology means the 'death of distance', the days when companies benefitted from locating themselves in a cluster should be over.

(Beavis 1998)

It is clear that location is important, despite the alleged trend toward *disembodied commerce* and *virtual corporations* (conventional activities may all be contracted by the remaining central headquarters, but in many cases the proximity of the small units which are fragments of the former larger corporations remain central. It is possible to offer two virtual (opposite) propositions about computers, clusters and face-to-face relationships. First, that the benefits of existing clusters and other regional relationships of the industrial district type are not wiped out by the availability of computer-based instant electronic communications. Kumar, van Dissel and Bielli (1998) recount the collapse of a careful attempt to supplant face-to-face negotiation and information exchange in relationships among SME in the Italian city of Prato. In the Prato district a tradition of clustered co-operative competition has been established for hundreds of years and continues to function successfully in the modern technological era. It turned out that there are high technology advantages to face-to-face contact and proximity.

Second, there are great advantages to clustering even in the quintessential new industries that directly develop and intensively use these very cyber-technologies. The computer, electronics and media clusters associated with Route 128 west of Boston, Silicon Valley east of San Francisco, California and the suburbs of Seattle are both legendary and persistent. The use of computer technologies to do commodity-type service production at remote sites (e.g. credit card processing in rural Ireland and computer code writing in Northern India), both illustrate the strength of computer power over great distances and at the same time prove too much.

More careful evaluation indicates the work done in these 'remote' locations has a commodity-type character more akin in the former case to the work of key punch operators who entered data on paper card in the pre-disk era. In the later case computer code is written for specific applied uses within a technical system and computational approach worked out in one of the Northern hemisphere 'clusters'. In both cases portable income is generated and portable skills are learned or further developed—they are not development effects to be ignored or minimized, however they do not replace the high value-added 'creative' work on structural design and systems management that continues mostly to be done elsewhere. In the Indian case a full range computer cluster appears to be emerging as a spill-over from the large scale commodity type development emphasized here.

The 'death of distance' suggested above appears to be greatly overrated. The reason is supra-technological, since it turns out to be a 'myth that the new-media industry is full of

technologists occupying remote corners of cyberspace. In fact, many people operating in the sector of highly creative and not very technological. Without other people's (technical) expertise, they simply couldn't operate' (Beavis 1998). This appears to hold true for newly emerging clusters such as Sussex west of London, Oulu in northern Finland, and elsewhere. In all of these cases some form of centralized decision-making appears to be necessary to focus and articulate the benefits of clustering, and as discussed below, it virtually always is partly governmental. In Sussex it is the 'Training and Enterprise Council' of the local government, in Oulu it is the combination of Nokia and the local technical university working closely with the regional government, in Silicon Valley it is the massive effects of the US government research budget and the specialized institutes that grew up in and around the Stanford Research Institute, Jet Propulsion Laboratory and Livermore Laboratories.

The pattern of small enterprise development in Northern Italy, often described in term of 'industrial districts', provides a number of examples of the development of synergistic relationships within the SME sector and between the SMEs and the large enterprises. External economies of agglomeration and scope have played a large role in the success of small-scale industrial development in other places as well (including 18th Century England and 19th Century New England). This is not a new idea, but simply a new term applied to an old fact of economic life. It is nonetheless often surprising to find such small Italian firms successfully surviving in a world economy dominated by large firms.

Within the Italian industrial districts purpose-built alliances and sub-contracting relationships have often developed, which include both horizontal and vertical linkages. Co-operation has been especially important in achieving export success for products such as speciality fabrics and in niche markets for manufactured products. It is important to look at the microeconomic features of such relationships and analyze the extent of their promise under transition conditions. The role of trust and long-term personal relationships in permitting or facilitating these Italian developments should be evaluated to determine the relevance to transition conditions. Informal networks and personal relationships from the planned system could perhaps be revived and reshaped to provide the basis for 'industrial district' type co-operation.

VIII IS GROWTH ALLOWED? THE MACROECONOMIC CONTEXT OF THE SME SECTOR IN POLAND AND RUSSIA

Deflationary macropolicy and 'shock', with or without 'therapy'

In Poland a brief but widely noted period of serious 'shock therapy' occurred but with relatively small price liberalization shock (since so many prices had already been freed from administrative control during the prior decade) and avoidance of precipitous privatization of SOEs. After the political debacle of the first Solidarity government, Poland quickly adopted and maintains a modulated and socially sensitive strategy which concentrated on commercialization rather than privatization of SOEs, and helped by massive debt forgiveness and relatively generous access to Western markets moved to a gradual, politically stable transformational path. Shock therapy was a disaster in Poland in the first two years, but was abandoned in fact if not in rhetoric, before irreversible developmental damage occurred (Kolodko 1999, Kolodko and Nuti 1997).

In the Russian case the original shock theory measures were conducted in a careless and professionally incompetent fashion under acting Prime Minister Yegor Gaidar, then privatization was carried out in a way that was totally corrupt and destructive in its economic effects. This encouraged asset stripping and private appropriation (and flight abroad to personal accounts) of company revenues, while denying to the state the revenues necessary to continue to function in a normal civilized manner. Macroeconomic policy was equally disastrous, follow a weirdly intense and obsessional monetarist path to a point where (in addition to a catastrophic and unprecedented collapse in production, living standard and health) normal money-mediated exchange ceased to exist over much of the country. In all respects the very different policies followed in Poland and Russia had direct and sharply different implications for the SME.

Poland had—in addition to a long established and unbroken tradition of fully private SMEs in both urban and rural areas and transition period policies favourable to SME growth—the overwhelming important policy trio of generally expanding aggregate demand, healthy large enterprise and continued normal use of money as an medium of exchange and store of value. In Russia, to the extreme contrary, and especially unfavourable way to the SME, all of these conditions were reversed. The reasons why this is especially unfavourable to SME in Russia are obvious, once the structural features are made clear. No barter is possible for most SME firms, so for this reason alone they are at a very serious competitive disadvantage.

IX THE COMPLEX CAUSATION OF SME SUCCESS AND FAILURE IN TRANSITION ECONOMIES

The inter-connections and multiple layers of relationships that form the tissue of a functioning economic system make it difficult to clearly establish causation. Since our goal here to form policy recommendations which will facilitate the growth of this sector it is important to try to clarify these questions. Table 3 presents a schematic lay-out of the relationship between pre-transition conditions, the policy actions taken during the transition period (both directly addressed to and indirectly affecting the SME sector) and the outcomes.

**TABLE 3
HERITAGE, INSTITUTIONAL DEVELOPMENT AND OTHER
POLICY EFFECTS ON SME GROWTH AND SUCCESS**

PRE-TRANSITION STRUCTURE	TRANSITION PERIOD POLICY AND OTHER DEVELOPMENTS	OUTCOMES FOR SMEs
<ul style="list-style-type: none"> • ENTERPRISE FORMS <i>directly productive sector</i> Soviet-type enterprise in rigid central planning environment Production Association with devolution of planning details Commercialization of SOEs Degree of responsibility for social assets Government ownership what level is de facto owner? • service and retail sector government ownership what level is de facto owner? what co-operative ownership part-private ownership private ownership • wholesale distribution system access by small local producers warehouse supply chain • PROXIMITY OF VIABLE MODELS/PARTNERS • PREVALENCE OF CRIME • CULTURE OF ENTREPRENEURSHIP 	<ul style="list-style-type: none"> • MARKET DEVELOPMENT POLICY Legal development Commercial infrastructure Financial policy Short-term credit Long-term Role of community based self financing Micro-credit programmes Family/friendship networks traditions • INDUSTRIAL POLICY selectivity in attracting FDI and 'local content' requirements Form of privatization/commercialization speed rules social agreement on change transparency and accountability opportunities for dysfunctional criminality opportunities for rent-seeking • AGGREGATE DEMAND Extent and character of transitional recession Liberalization-monetarism with domestic demand suppression Expansionary aggregate demand policies • IMPORT EXPANSION Extent of foreign firms artificial or excess market penetration Transition chaos, disruption of viable local producers failure to provide domestic protection/subsidy buffers foreign purchases of domestic rivals to acquire brand name and good will but to close local production foreign control of distribution networks retail and service sector directly productive sector • TAXATION AND LICENSING Balance of benefits and costs to operating in the open and fully legal economy 	<ul style="list-style-type: none"> • LARGE ENTERPRISE SECTOR • SME SECTOR • LINKAGES BETWEEN SECTORS

X POTENTIAL POLICY IMPLICATIONS: EXPLICIT STATE POLICY TOWARD THE SME

The transition process has been sharply different from place to place, but in each it demonstrates strong *path-dependent* features—conditions in which actions taken at one time have effects and implications that cumulate through time, enabling and foreclosing options in ways that are not always easy to understand. Clearly institutions matter, but not in any simple sense of the words. At the micro- and mezo-levels, it is not the existence of a legal code and court system, but the broad acceptance of this system as the actual forum in which disputes are to be settled. It is not the existence of a wholesale distribution network, but the terms of access to this system by small-scale producers. At the mezo- and macro-levels, the foundation of small productive enterprises produces little or no ultimate effect if their putative customers are in a fiscal crisis which inhibits or prevents expenditures. This is true regardless of whether the demand reduction is on the part of SOEs that have been fragmented and damaged in a process of hasty privatization or on the part of the demand for consumer goods by the general public whose incomes have been repressed by contractionary monetary and fiscal policy. Policies which target the SME without attention to these surrounding conditions are unlikely to have substantial and long-lasting positive effects. Programmes designed to provide direct assistance to SME often end up mired in corruption, high overhead costs and efforts that ultimately serve other than announced programme interests (Wedel 1998).

In some transitional economies there has been a lack of market-facilitative actions by the state, despite active use of the rhetoric of the ‘market’. Some of these market friendly reputations come from manners western education or simple skill in telling Western advisors what they want to hear. Other countries or regions have an anti-free-market reputation but have nonetheless made some orderly step toward the market. Some of these anti-market reputations result from simple resistance to Western penetration or control of local resources on concessionary terms. It is important to look beyond these stereotypical images and try to see that actual connections between policies and outcomes. Certain main themes that have appeared in SME development during the transition process can be presented by means of the dichotomy presented below. *Liberalization without Adequate Institutional Development* and *Market Development without Full Liberalization* are presented as opposite policy approaches, each of which has suggestive lessons to teach.

10.1 Liberalization without Adequate Institutional Development

One of the clearest effects of liberalization without preceding institutional development is that it leads to a classic negative (dysfunctional) path-dependence where potentially viable but complex production entities may be destroyed and/or endemic criminality may be established during the more or less lengthy chaotic disequilibrium situation.

Once these become facts on the ground future developments are negatively affected, baring strong and costly 'repair' policies.

Destruction of Viable Productive Entities

Most Soviet-type economies adopted a *production association* (or *combine* or *kombinat*) form of organization, in which a number of related plant (sometimes geographically concentrated, sometimes in the case of the USSR thousands of miles apart and in multiple republics) were grouped under the control of a headquarters plant. The headquarters plant concentrated specialist functions (especially research, design and engineering) and took over much of the detailed planning responsibilities of the branch ministry in coordinating the activities of its branch plants. Both horizontal and vertical integration took place under this form of organization, which was often pushed further than would be expected on purely technical grounds by the forces (supply unreliability and a highly asymmetric incentive/reward system) that had long encouraged 'universalism'. This arrangement (absent the industrial ministry and Gosplan) is very similar to the structure of headquarters and research departments in American and other large corporations. The USSR production association reforms of 1967, 1969 and 1972 were at the time heralded both internally and externally as marking the adoption of 'American' models of enterprise organization.

In the early transition period these specialist functions of the production association often were victims of the first stages of 'commercial' reorganization before privatization. They were damaged or destroyed because their importance is not easily recognizable when the enterprises are approached with a theoretically based 'market economy' orientation accompanied by unfamiliarity with how large organizations actually work. Given the legendary role of 'over-staffing', an immediate effort to produce leaner organizations by cutting employment is understandable, but such cuts can only be made intelligently if the organizations themselves are clearly understood. The formal and informal networks that had held the organizations together centered in or required the major participation of the specialist headquarters departments. When sharp, indiscriminant staffing cuts and reorganization were imposed as the first stage of 'commercialization before privatization' they frequently simply wiped out these specialist departments.

These actions destroyed the value of many of the SOEs involved and left many of the surviving parts irreversibly crippled. The effects on SME sector are clear-cut and unexpectedly negative to those who think of large and small enterprises as alternatives rather than co-dependent entities. Instead of creating an array of new SME with both supply- and demands-side links to the remaining large enterprise core, both the core and the detached SME units tend to fail. A more orderly unpacking of these relationships leaves both large and small entities in better health and is more likely to produce a selection process that accords with the longer-term economic logic of the situation. The long delay in most SOE privatization in Poland and the Czech Republic produced this kind of orderly process with good SME effects.

'Functional' Aspects of Criminalization

Under chaotic transition conditions some criminal actions may even be functional in a short-term way, providing what could be considered a 'libertarian' approach of securing enforcement of private obligations (free contracting in the market, without direct engagement of the state, using hired 'thugs' or killers as a disincentive to contract non-compliance). But since the step from legally 'justified' to simply 'commercially convenient' murder is so short (and avoidance of the jump may be dependent of the inner standards of the thugs and contract murderers) this is at best a weak argument for assigning a positive role to organized criminal activity. It is none the less important in explaining the emergence and partial social acceptance of criminal 'enforcement' mechanisms.

The immediate short-run microeconomic effects of criminalization are raised costs and a foreshortened time horizon among SME decision-makers, not to mention the pernicious cultural effect of establishing the common belief that business success as evidence of criminal conduct either directly or through the use of hired services. This point is logically separate from the question of providing physical security for business premises which is a feature of economic life even in societies where organized criminal activity is absent. In transitional societies the suppliers of this premises security often work both sides of the law, making the distinction between 'protection money' and 'money paid for security services' less than clear.

The phenomenon of imbedded-criminalization-caused-by-transition is among the most vivid examples of the misguided character of policy driven by unprepared liberalization and shock-is-better ideology. Only when the institutional basis for protection of the physical premises and contractual rights of small business owners is already in place or is very quickly developed and assertively applied, does this criminalization dynamic not emerge. Once pervasive criminality becomes embedded in the informal working arrangements of society it negatively affects the future viability of small-scale activity. Large organizations can at least in principle afford to include security services among their administrative overhead.

10.2 Market SME Development without Full Liberalization

Some approaches which at first seem 'market resistant' or even 'anti-market', can in fact turn out to be sensible step-by-step elaboration of market institutions, under and around which SMEs gradually emerge. One example was provided above on the basis of Russian regional experience. Excellent systems-level examples can be found in the Polish, Czech and Slovak approaches after 1989, and on a much larger and long term basis in the People's Republic of China after 1978.

In the case the Poland, the decision was made to largely liberalize prices, significantly open up the economy, but to delay privatization of most large SOE until later. Later came to mean much later (the large-scale reorganization of ownership into the hands of mutual funds did not begin until 1998). By adopting the *commercialization-without-privatization* approach both the SOEs and the surrounding users and suppliers, including

SMEs, had time to orient themselves to market conditions and experiment with different management and organizational forms. The results were quite mixed—not all SOEs dramatically improved their performance and market orientation. But many did make just such an adjustment, the Polar appliance manufacturing company being a particularly good example. After resisting pressure to privatize, Polar reorganized itself, secured credit from commercial sources, developed new products, and opened new western European markets, all under the same management team it had inherited from the planned economy period. It is one of many examples of how managerial competence and flexibility can come out of the old system but function successfully under new market conditions when the old structures are given breathing space and time to adjust. The effect of the survival of many such large SOEs on the health of surrounding retail outlets and directly productive small enterprises is obviously favorable.

In the case of Czechoslovakia a highly developed small enterprise sector was 100 per cent nationalized in 1948/1949. Nationalization was however done in a way that created favourable conditions for re-emergence of a small premises business culture at a later time. Either small shops were operated as branches of larger state enterprises or co-operatives (in some cases retaining their previous owners as managers), or they were closed completely but with the premises left intact and many remained unused for 40 years. Since the state retail distribution system was largely based on small premises dating from before 1948, these dispersed outlets were easily revived as free-standing entities. An auction approach was used to privatize these small retail, service and productive enterprises. This was combined with restitution of some premises and going concerns. The auctions were explicitly structured to produce what was understood to be an ‘American-type’ of individual ownership (by explicitly forbidding the workers of an existing enterprise to bid as a unit). Thus the infrastructure for a new private retail sector was easily created. In the large enterprise sector a voucher approach was used which ended up placing SOEs under the effective control of newly created investment funds, most of which were controlled by state-owned banks. This was a form of false privatization, with few real changes in the first five years.

After the split of Czechoslovakia in 1992, Slovakia often was used as an example of resistance to reform and marketization. Slovakia however produced as good or better overall growth than the Czech Republic, without the enormous stimulus of mass tourism, and conducted a generally successful and honest medium enterprise privatization.

The People’s Republic of China has by accident, design or a fortunate combination of both, carried out a gradualist reform process which while highly empirical and pragmatic, has turned out to be institutionally dynamic. The manifest success of this process has heavily depended on SMEs. As noted in some detail above, local government ownership and effective control of first the now legendary *Township and Village Enterprises (TVE)* and then the *local SOE* came in an environment free of most the soft-budget constraint dysfunctions that economist normally use to characterize state-socialism. As a result of the distinctive inter-jurisdictional competition and the absence of subsidies from above, a market driven process has occurred in which local government has been a major dynamic force.

The reform process in China is accurately described as the development of a *socialist market economy*. It has been mischaracterized by some western commentators as a 'capitalist revolution from below', based on the common misperceptions that non-State activity must be private activity and that effective market entities cannot be socially owned. Most of the successful SMEs grew out of local and county ownership and even when transformed into *joint-stock co-operatives* or *joint-stock partnerships* retain large-scale 'social' ownership. Most of these new organizations fit in the clumsy category of 'public, but not national government ownership', although some are likely to become purely conventional open joint-stock companies. Sun, Gu and McIntyre (1999) have convincingly argued that these forms are likely to be stable and not simply a short-term transitional phase.

In Russia, 1998 legislation established a new category of 'employee-owned' firms which excludes predominant ownership by a few managers, requiring '75 per cent plus one share' of equity be owned by employees (including pensioners), while setting a 5 per cent maximum on individual ownership stakes. A considerable number of enterprises that were privatized on other terms (some healthy, other in difficult conditions) have been converting to this new form. The question of local-level governments as partial equity owners is not directly addressed in this legislation, but does not appear to be forbidden. This new Russian form is structurally similar to Chinese joint-stock co-operatives and for that and other reasons has interesting potential.

XI RESEARCH QUESTIONS: AN AGENDA FOR STUDY OF FUTURE SME DEVELOPMENT

A series of interrelated points emerge from the above cases and discussion, which make up an interesting and fruitful agenda for future SME research. These points are posed as questions below:

1. To what extent is the success of the SME determined by the development of formal institutions and the implementation of systems-level policy addressed directly to it? It is important to analyze the ways in which the development of surrounding institutions, especially those related to: (a) legal structures in the formal sense and at the level of enforcement of law; (b) provision of access to credit and policy measures, which determine the cost of credit. This requires consideration of the performance of both the old banking system and the foundation of new credit-extending institutions
2. How does the way in which the privatization of production, distribution and service establishments is carried out (both directly for small- and medium-size enterprises and indirectly in terms of the character and condition of the large units that emerge when SOE are privatized) affect the SME sector. It is important to consider here the emerging literature on establishing networks of suppliers, as well as subcontractor relationships with large enterprises
3. It is important to study a set of questions about the fate of the vast array of informal arrangements and networks that kept the large SOE functioning under the planning system. How (or to what extent) are these links re-established after the reorganization/commercialization and/or privatization of these SOE (which is likely to have resulted in the parcellization of these entities, not necessarily along economically rational lines)?
4. Crime and its effects on the cost of economic activity is a crucial microeconomic issue at the level of the SME. Crime is a complex concept under these conditions. There are both negative and 'positive' features of criminalization. The cost-increasing effects of corruption and the effects on competition, pricing policy and investment are obvious. However, in those transition economies where the state has often failed to carry out basic legal functions there may also be cost-lowering effects in terms of contract enforcement.
5. The macroeconomic conditions for micro and mezo-level success. To what extent does the surrounding macroeconomic environment determine where SMEs have succeeded and where they have failed to develop on a significant scale. It appears that the enthusiastic application of demand-repression policies associated with the 'Washington Consensus' approach prevents the emergence of a large successful SME sector. We need to know how this argument stands up in the face of careful comparative analysis of country cases.

6. To what extent does the foreign trade regime have similar macro-level effects on the viability of the SME sector? What is to be made of the argument that the entire SME sector should be treated as an 'infant industry', protected from foreign competitive pressure for a limited period of time on this basis?

In order to make policy sense of the different experiences among countries and regions of Central and Eastern Europe and the Former Soviet Union carefully designed sets of differential comparisons are required. This is necessary to reveal the affects of policy on SME success, separate from other fortuitous factors. A systematic attempt to determine the extent of path dependence and the 'tyranny of antecedent conditions' is a natural part of this policy appraisal approach. Some small enterprise promotion policies developed in Western economies may be useful and special attention should be paid to evaluating the applicability of the Italian 'district' promotion activities to transition economies. But it remains to be seen if these subtle entities can be created by policy under transition conditions. Table 4 suggests some of the most promising avenues for policy intervention. The most important issues involve access to credit, clarification of legal rights, control of criminalization and, for productive SMEs, the further consideration of securing favorable terms of access to distribution channels.

XII CONCLUSION: THE ENTERPRISE ECOLOGY OF THE TRANSITION COUNTRIES IS AN OPEN BOOK

This paper has discussed mixed systems in which SMEs functioned successfully in the presence of extensive state ownership of large enterprises. In these past and present examples, a small enterprise system worked around, with, and in the interstices of, large enterprise, even SOEs under centrally planned conditions. It is useful to consider these examples from two quite different perspectives. First, they suggest the value of studying the character of the actual links and working relationships between large and small enterprises. Second, they show that there are opportunities for SME growth in even those transition environments that diverge far from free-market conditions.

If SMEs could survive, and even in some cases thrive, under such fundamentally 'hostile' old system conditions, it is at least superficially puzzling that their experience in transition has been so difficult and at best mixed. One explanation of the extent of difficulties encountered thus far (McIntyre 2001; Bateman 2000) is that ideological predispositions and assumptions about what would happen automatically in transition, led to failure to build up the policy and institutional framework necessary for real SME success. Not only does SME 'success' not emerge automatically, but when surrounding conditions (aggregate demand, market access, fair competition, etc.) are not actively monitored with SME interests in mind, it is difficult to judge the connection between 'efficiency' and who in fact is seen to be succeeding or failing.

The discussion of co-operatives and the need for local-level financing fits directly into this equation. In institutionally incomplete environments it may be impossible for potentially promising SMEs to get financing on any non-criminal terms. In much of the transition region the concept of real worker- or employee-owned enterprises is naturally popular and largely untainted by sounding like a 'collective farm'. The combination of small co-operative production facilities, local co-operative savings and lending institutions and local-level government as nurturer/guarantor (and sometimes part equity owner) of both production and financial institutions is completely natural. It also not unpromising as a path to finally dealing with remaining 'dinosaur' enterprises left and not-entirely dead from the old system. That so little attention has been given to this path is a direct manifestation of the institutional homogeneity assumptions, now evidently discredited.

TABLE 4
POSSIBLE POINTS OF POLICY INTERVENTION

1. Credit and other forms of Small and Medium Enterprise ‘support’

Various forms of Small-scale Micro- and Group-Lending

Evaluation of micro-lending and group-lending approaches. Can these techniques be usefully applied to urban, industrialized transitional economies?

Evaluation of the *Fundusz Mikro* programme in Poland, which has strong structural similarities to LDC mini-lending programmes

Small Enterprise Banks and special Small-Enterprise Loan programmes and other Communist-period ideas

Yugoslav investment auctions (1950s)

Chinese sub-contracting relationships between SOEs and TVEs (1970s–present)

Bulgarian ‘Small Enterprise Investment Competitions’ (1970s–1980s)

Training and Mentoring Programmes

Small Business ‘Incubators’

2. Legal clarification

Taxation

Access to Premises: terms and conditions of rental/lease/purchase

Privatization and Inheritance Law

3. Crime and Criminalization: The special vulnerability of Small- and Medium-sized Business to criminal manipulation

To what extent does the form and pace of privatization and ‘liberalization’ determine the extent or form of criminalization

The importance of the wholesale trade and the related issues of market access to the development of competitive retail distribution markets

4. Market Access and Wholesale Distribution

Use of competition policy

Legislated ‘local content’ requirements

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