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1

Small Enterprises in Transition Economies: Causal Puzzles and Policy-Relevant Research

Robert J. McIntyre

Introduction

The small and medium enterprise (SME) sector carries great hopes and great burdens in the evolution of all transitional economies. It is difficult to imagine either rising overall living standards or social peace without sustained and healthy growth of this sector. While hopes that this sector would by itself have systems-dynamizing and transformational effects have not been realized, its role in generating employment and an atmosphere of social stability is crucial (EBRD, 1995: 139–52).

Despite the centrality of SMEs in both the theoretical understanding and practical functioning of market economies, little attention has been paid to the conditions necessary for their new or expanded development in transition economies. This omission partly reflects assumptions of market automaticity – that spontaneous processes can be counted on to create new, viable entities to fill the interstices between large organizations. Particular attention needs to be paid in this regard to the role of the ‘irregular economy’¹ and the evolution over time of the relationship between formal and informal institutions (see Chapter 4 and Radaev, 2001a).

Market realities and free-market ideology

Failure to conduct market reform in an institutionally plausible way appears to have both circumstantial and theoretical roots. Many transition country reformers and advisors shared an appreciation of speed and secrecy since this allowed adoption of measures strongly rejected by much of the population. In addition, local people who had insider access (allowing personal appropriation and ‘self-dealing’ of public assets) wished to avoid both open discussion of redistribution terms and competition for specific assets, so they eagerly applied ‘expert’ recommendations for fast action (Wedel, 1998). Theoretical and methodological causes are more complex but equally important.

The conventional wisdom about markets and market reform summarized by the 'Washington Consensus' provided the intellectual grounding for neoliberal policies applied across a broad range of countries and conditions (Stiglitz, 1998, 1999a). This orientation led many Western analysts to misunderstand or simply not consider: (1) the already mixed nature of most Soviet-type systems; (2) the special characteristics of their constituent production/settlement units; and (3) the potential for the coexistence or coevolution of these old elements with the emerging new features of the transition period (McIntyre, 1999, 1996a).

Analyses of 'transition' or 'systems transformation' instead generally reflected dual presumptions that: (1) only large reforms (near or complete systems replacement) could work in Soviet-type systems; and (2) mixed institutions were unlikely to survive. Some economists warned against transitional strategy constructed on this basis. Koford (1991, 1997), Dallago (1991), Austrian Academy of Sciences (1992), Pickel (1992), McIntyre (1993), Amsden *et al.* (1994), Taylor (1994), North (1994, 1997), Amsden *et al.* (1995), Murrell (1995), Poznanski (1995), Hausner (1995) and others, called for a modulated, evolutionary approach to the transformation problem.

The SME sector is implicit in all free-market reasoning and central to assumptions about the spontaneous developmental capacities of markets and market systems (You, 1995). Theoretical constructs economists use to describe and analyse small movements within established market systems offer little guidance in deciding which institutions to adopt or how to construct them *de novo*. 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 highly competitive markets. Despite lacking scientific content, these assertions lie at the base of a transition orthodoxy that shaped the policy environment within which SMEs evolved in ex-Soviet-type economies. As Stiglitz (1999a, 1999b) observes, *analysis of the transition that takes these assumptions literally is detached from understanding of how non-commodity markets operate in any economy.*

Arguments that different types of systems cannot be mixed together are ideological assertions that ignore the developmental lessons of: diverse Eastern European experience before 1989; advanced capitalist countries for the last century; China (since 1978); and other transition 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.

(McIntyre, 1996a: 11)

This widespread tendency to think and talk about transition in terms of pure models occurred despite the truism of comparative economic systems that all actually existing economic systems combine market, command and traditional elements. The ideal-typical firm/entrepreneur at the centre of neoclassical market models is a rootless, unembedded actor making each market exchange in an impersonal, neutral way. Discussions in this volume of industrial districts, clustering of cognate enterprises and the role of wholesale trade are particularly important illustrations of how sharply actual SME development diverges from this model.

In cases where adequate institutional preparations were not made before effective control was passed to market forces, the predominance of the destructive and developmentally dysfunctional aspects of markets was virtually assured. The Russian case is only the most vivid among many where, rather than temporary, literally 'transitional' phenomena, long-term developmental dysfunctions resulted from failure carefully to lay the foundations of the new system (see Kolodko, 2000 and Chapter 10; McIntyre, 1993).

Sensible policy-making in transition requires avoiding a simplistic view of capitalism as a self-organizing system of natural equilibrium. National or local governments that did attempt to mediate, steer or limit the range of market relationships, allowing time to build market infrastructure, were generally accused of opposing market reform. *Real markets function 'successfully' only when a fairly elaborate set of surrounding institutional, infrastructural and behavioural conditions are already in place and, equally importantly, are widely accepted as a cultural norm.* Without competent market-oriented policy at the national level, 'market exchange' does not bring with it the beneficial features of real competition.

The complex casuality of SME success and failure

If SMEs could survive, and even in some cases thrive, under fundamentally 'hostile' old system conditions, it is at least superficially puzzling that their experience in transition has been so difficult and at best mixed. This process has differed sharply from place to place, reflecting strong path-dependent features. Policies have effects and implications that cumulate through time, enabling and foreclosing options in ways that are not always easy to understand. The interconnections and multiple layers of relationships that form the tissue of a functioning economic system make it difficult to establish causation when many aspects change at the same time. Our goal is to clarify these questions, forming policy recommendations that will facilitate the growth of this sector.

The examples of 'survival under old system adversity' provided in Chapter 3 suggest that sectoral policy and large enterprise health are key to successful productive SME development. The external environment faced by SMEs in transition economies is very different, so precedents from the planning period must be treated with caution, whilst noting also that SME environments differ sharply, sometimes profoundly, between even apparently similar advanced capitalist economies. SMEs do not normally thrive without a set of continuing links to larger entities and measures to assure them market access. The failure of productive SME development in the transition period thus appears to be more a function of policy and missing institutional support, combined with the weakness of large enterprises, rather than something unique to transition *per se*.

The SME role in emerging market economies

In addition to making new services and products available and creating employment, several equally important economic effects of SMEs move through indirect channels. Successful development of this sector creates the political and social environmental conditions necessary to allow desirable changes to occur elsewhere in the system. It must absorb resources and workers from the large enterprise sector, helping to create a labour market situation in which the reorientation and reorganization of the large enterprise sector can be carried through without threatening social peace. In addition to slowing restructuring, failure to develop the SME sector may increase budgetary costs of unemployment, early retirement and other transfer programmes, reducing funds for investment and other employment-creating expenditures.

The complexity of sustaining SME sector development in an emerging transitional economy becomes evident as soon as attention shifts from the more obvious retail and neighbourhood-level services to directly productive small enterprises. Existing institutions and 'capabilities', including networks and other embedded relationships surviving from the planned economy period, appear to interact with active policy measures and the legal environment to determine the performance of the sector during the transition period (Grabher, 1992, 1995). These extra-market relationships between small and large firms played a major role in the postwar success of the vertically integrated Japanese *keiretsu* financial-industrial groups. Similar linkages appear to be important in the post-1978 success of Township and Village Enterprises (TVEs) in the People's Republic of China.

Another quite different synergistic relationship, based on both horizontal and vertical linkages, is represented by the kind of local cooperative/competitive development found (unnamed) in many other times and places, including eighteenth-century England and nineteenth-century New England, more recently dignified with the title of 'industrial district' and

'cluster' (Julien, 1993; You, 1995). The external economies of agglomeration and scope that played a large role in the post-Second World War successes of northern Italy, southern Germany and Silicon Valley are thus not new. Chapter 2 points to country experiences that throw useful light on: how the SME sector emerged in the past; how SMEs function today in advanced capitalist countries; and how such historical lessons and precedents apply to the special conditions of contemporary transitional economies.

One conclusion that emerges from this now decade-long experience is that the small enterprise sector is not by itself enough to create successful economic growth. Unless surrounding large enterprises have been successfully commercialized (meaning that privatization was either delayed or done in a way that did not sever 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 (unexpectedly) 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 where success of the small can only be secured by destroying or disassembling the large.

The policy tasks of transition are complex, requiring simultaneously expanding the scope of markets and creating the array of formal and informal institutions necessary to allow their self-organizing features to emerge in practice. Positive and mutually reinforcing interactions can be expected to emerge, if ways can be found to encourage the formation of purpose-built alliances and subcontracting relationships. In many contemporary (and prior) economic systems, large and small firms interact(ed) in complex relationships that confer(red) reciprocal advantages.

The combination of the ideological dynamics of the end of the Cold War (with a new 'Western' path defined as simply the opposite of each and every organizational feature of a Soviet-type system), an exaggerated sense of the role actually played by small enterprises in advanced capitalist economies, and fascination with the textbook version of market processes, led many transitional economies to fail to address this issue directly. Understanding the possibilities and limitations of the SME sector proved difficult in this context, but it is important to look at both the realities of the SME sector and the unfortunate interactions of SME policy with transition ideology.

SMEs in history: shall the first be last?

The early industrialization process differed sharply from country to country and product to product, but SMEs were the dominant scale of enterprise, even for technically complex products. A qualitative change occurred around 1800 when the synergy of cost advantages from large-scale production and the systematic use of science to refine production technology

finally triggered the cumulative cost-reducing, income-generating, market-expanding wave, characterized as 'modern economic growth' (Kuznets, 1966). Rapidly spreading from Anglo-American roots, this became a worldwide but uneven process by the last half of the nineteenth century.

Through most of the twentieth century, economies of scale drove a global process of large-company industrialization, but smaller units survived and even dominated niche markets for various services and speciality products. When technical economies of scale appeared to be exhausted (or offset by non-production administration/coordination diseconomies), further increases in corporation size were justified or explained by economies of scope. These savings (from marketing, establishing brand identity and dealer networks, as well as technical complementarities between different but related products) accrue to firms by virtue of total size rather than the amount of any specific product produced.

With publication of *The Second Industrial Divide* by Piore and Sabel (1984) it became professionally respectable to suggest that reversal, or at least weakening of the trend towards ever-larger organizational size had occurred. They argued that market saturation for many mass-produced products, new technical developments (computerization of production processes and the rise of high-technology 'flexible production'), and market segmentation (creating more niche markets that do not function like commodity markets) together reduced or eliminated the advantages of ever-larger scale.

In banking and financial services, energy, resource extraction, and a few manufactured products, scale continued to increase, but in the rest of the economy a different story seemed to be emerging. The SME sector was developing a competitive advantage based on flexibility and speed of adaptation when scale economies are small or non-existent. Piore and Sabel suggested that small might be the wave of the future, even for (non-commodity) industrial production.

Certain transactions have self-limiting aspects, requiring face-to-face exchange, yet some seemingly safe SME retail and service preserves have already been taken over by large firms (photo finishing, auto-parts departments, bakeries and full-service drug stores in large food stores or hypermarkets). Another example is large chains employing highly trained professional workers on an hourly basis to provide optical, medical, dental or legal services. National or international brand identity has been established for products and services that once defined personalized exchange and SME scale.

The concept of the virtual corporation also gained currency, suggesting that most previously in-house functions of the corporation can be outsourced (contracted out), leaving only a small decision-making core (supplemented on an as-needed basis by consultants carrying out what had been the functions of highly paid career executives). It should be noted that most of the developments discussed in the last few paragraphs have an

Anglo-American origin and flavour, with neither concepts nor practice moving so far in most other advanced capitalist countries.

Although the USA was an early industrializing economy, the size of the SME sector is now at the low end of the distribution of international experience. Germany, France, Italy and other later industrializing countries successfully adjusted to high-technology modern markets while maintaining relatively larger SME sectors. Because growth did have a plausibly automatic and self-generated character in the Anglo-American early-industrializing countries, they never developed the focus on public growth management and infrastructure development that were defining characteristics of 'second-wave' countries such as Germany, France, Italy and Japan (Gerschenkron, 1962). These countries stimulated SME growth by various apprenticeship and training programmes, policies protecting SMEs from the economic power of larger entities, and even seemingly neutral policies such as development of extensive public transportation systems. This pattern is highlighted in Table 1.1 that shows the SME share of total employment in various countries (Table 2.3 shows changes over time of manufacturing employment).

Table 1.1 SME share of total employment in 34 countries (%)

	1993-94	1998
EU-15	69	66 ^b
Europe-19 ^a		66 ^b
France	69	
Germany (West)	64	
Belgium	72	
Italy	80	
UK	76	
Japan	73	
Georgia	58	
United States	53	
Estonia	45	
Czech Republic	37	
Croatia	30	
Romania	27	
Hungary	24	
Slovak Republic	23	
Poland	23	
Slovenia	19	
Russian Federation	10	
Belarus	6	
Kyrgyz Republic	3	
Tajikistan	2	

Notes: ^aEurope-19 = EU-15 + Norway + Iceland + Switzerland + Leichtenstein; ^bnon-primary private employment.

Sources: EBRD (1995): 140; European Commission (2000): 12 and 45.

Many new firms fail and disappear in all market economies, providing part of the explanation to how so many new firms can be founded in the USA and yet their proportional role remain relatively small. FitzRoy (1993) points to a second explanation:

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: 239)

The expansionary tendency of large US and UK corporations is sometimes attributed to the unique role of equity (common stock) markets in those countries. With the long-established separation of ownership from enterprise decision-making and control (Berle and Means, 1932; Lazonick, 1991) and the post-Second World War tendency to link managerial incomes to firm size and share price, incentives for growth by acquisition were and are quite strong. While no longer existing as separate entities, these taken-over or bought-out small firms certainly have not failed.

The nature of the relationships that have grown up between large and small firms in various continental European countries and Japan led to the adoption of corporate decision-making practices based on 'stakeholder' rights, fostered more cooperative 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 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. They do not fit cleanly the Williamson categories (1985) often treated as exclusive alternatives.

SME-large enterprise linkages in Japan and Korea

In the classical form of Japanese large-firm industrialization, financial-industrial groups (*zaibatsu* before the Second World War, *keiretsu* afterwards) joined many companies together in a holding company structure, cross-ownership relationships, and shared use of a group bank and a general trading company. Large companies in these familial groupings formed elaborate long-term non-ownership relationships with small outside suppliers based on close cooperation 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 association of large companies with their subcontractors. The 'just-in-time' (*kanban*) inventory management system is an example of the implications of this relationship.

As this highly efficient system was imitated all over the industrial world, it became clear that *kanban* makes extraordinary demands on 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 sub-contractors offering 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. Slow economic growth during the early 1980s and much of the 1990s strained these relations.

Since South Korea directly set out to learn from and adapt functional elements of the Japanese model, powerful structural and policy similarities are not surprising (Amsden, 1989, 1991). Despite being modelled after Japanese financial-industrial groups, Korean *chaebol* tend to produce almost everything internally with little use of sub-contractors. It is even argued that because of the failure of the *chaebol* to form Japanese-style long-term relationships with small firms, the South Korean economy now has a degree of inflexibility that is becoming a competitive disadvantage.

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 of the type cited in Table 1.1. Ranking countries based on small enterprise numbers or employment ignores the degree of linkage to other entities (FitzRoy, 1993: 240). Clearly a small Japanese firm in a long-term supplier relationship to a *keiretsu* is not a freestanding entity in the same sense as a British or Canadian firm of similar size and production sphere. Even after changes that weakened or ended some of these links during the last decade, the Japanese relationships remain profoundly different. The same may be true of an Italian or German firm in a well-established localized supply chain or industrial district. The individual TVE in China has similarly complex reciprocal links to local government that make it far from an autonomous actor.

Market systems with diverse property forms

There is an extensive history of the successful market functioning by SMEs in the presence of extensive state ownership of large enterprises. It is important 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. Chapter 3 presents a series of examples, including the New Economic Policy (NEP) in the Soviet Union, the Hungarian New Economic Mechanism (NEM), the GDR small enterprise programme, Township and Village Enterprises (TVE) in China, and the development of savings and other forms of cooperatives in Finland. In all but the last, a *small enterprise system* worked around, with, and in the interstices of,

a large enterprise system made up of only state-owned enterprises (SOEs). In Finland, state funding of a core cooperative bank led to the emergence of a dynamic and diverse SME sector with a heavy cooperative weight, also in the presence of a large SOE and semi-SOE sector. These examples suggest the need for open-mindedness about the ownership forms able to create a context for successful SME development.

It should also be noted that many entities classified as 'emerging' SMEs are not really new, but had a pre-transition existence as parts of large, usually horizontally integrated, service, craft and distribution SOEs or cooperatives. While not 'free-standing', autonomous business in the Western sense, they were closer to that than the size of their umbrella groupings would suggest. The 'new' sector of relatively small organizations is thus a mixture of many privatized sub-units of SOE, entirely *de novo* entities and surviving pre-transition SMEs.

SME advantages in developing market economies

From a theoretical perspective, SMEs have several advantages over large SOEs and previously state-owned enterprises (PSOEs). Incentives for both managers and workers tend to be clearer and stronger than in larger organizations, and governance problems are less significant because in many cases the managers and owners are the same people, and small size allows owners to easily monitor the performance of managers and workers.

Under the special conditions of the transition economy there are several additional advantages. Regardless of whether they are new or had already been working outside the main channels of the planned system, SMEs are likely to have fewer bad work habits to carry over from the planned system (especially from the chaotic last years). Small firms appear to have greater flexibility and potential for innovation, which could be especially important in the unsettled conditions of the transition period. To the extent that SMEs produce the same products or services as SOEs and PSOEs, they reduce monopoly tendencies. Higher productivity is also likely in services or niche manufacturing where there are no or few scale economies.

Defining and analysing the SME sector

We use the standard EU definitions of SMEs having fewer than 250 employees (1–9 = micro; 10–49 = small; 50–249 = medium), including purely private firms, cooperatives and other employee-owned firms and a wide array of other 'social economy' entities ranging from foundations and mutual societies to those fully or partly owned by local (regional and municipal) governmental authorities. While we do not exclude micro-enterprises, we intend to concentrate on the space between the very small and very large.

A strong argument can be made for de-emphasizing much individual and other very small-scale trading and service-provision. These developments are often cited 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. Chapters 4, 5, 7, 8, 10, 12 and 13 stress that much very small-scale activity (excluding 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, making it highly unlikely to provide the requisite foundations for successful growth of the system. It is thus more properly considered as part of the poverty and health-crisis aspects of the transition.

Two misleading analogies are commonly applied to the transition case, one drawn from the most developed countries and one from the least developed countries. 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 'a single entrepreneur in a 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 arises. Also forgotten is that the core technologies of most famous 'garage-to-great company' cases are non-market phenomena that have 'fallen out' of the research departments of large companies and government-funded research.

From the opposite side of the development divide, there is an emerging literature (for example De Soto, 1989) that treats growth of the informal sector in developing countries as a healthy and possibly self-sustaining social process. Central and Eastern Europe (CEE) and Former Soviet Union (FSU) transitional economies were already highly industrialized, urbanized and in some ways 'hyper-modernized' before transition. The nature of the informal sector that emerged is fundamentally different, making assumptions about behaviour drawn from predominantly rural, non-industrialized countries suspect at best.

The characteristics of the 'new entrepreneurs' in transition economies (discussed in Chapters 6, 7 and 12) highlight the inappropriateness of 'Latin Americanization' analogies. 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. Equally surprising, many of the entrepreneurs formed in the 'old' pre-transition private sector or illegal economy adapt poorly to the new 'post-shortage' environment (Dallago, 2000 and Chapter 6). Instead of appealing to nonexistent 'historical' cases or lessons drawn from fundamentally different social and economic systems, it is more useful to analyse the conditions of transition economies from inside their current institutional/behavioural universe.

Multidimensional connections between SOEs and SMEs

The multiple connections between existing large enterprises and the existing/emerging SME sector (Figure 1.1) constitute a recurrent theme in this volume. The large enterprise sector includes remaining SOEs and previous SOEs now in private hands (PSOE). Chapter 11 explores the link between the way (extent, form, speed and degree of social assent) large enterprise privatization is carried out and the health and character of the SME sector in the surrounding economic space.

The apparently firm legal distinction between SOE and PSOE is blurred in many countries. In Russia this resulted from conspicuously corrupt privatization practices that leave current ownership arrangements open to future legal reversal; in the Czech Republic a particular form of voucher privatization led to concentration of large enterprise ownership in investment funds controlled fully or partly by state-owned banks. It is necessary to explore how patterns of privatization and semi-privatization affect the surrounding SME culture.

Despite the tendency to present SMEs as an alternative to SOEs, little can be expected without the survival or development of a healthy large enterprise sector (SOE or PSOE) which SMEs can utilize as supplier, customer and provider of various social and technical externalities. Timing and sequencing issues, usually viewed from within the large SOE privatization process, may have unexpected additional implications for the surrounding smaller institutions.

A related SME issue is the so-called ‘social assets’ of SOEs and PSOE. In each transitional economy, the marketization process began on the foundations of the highly complex industrial, social and settlement structure. All societies strongly influenced by the Soviet-type economy (STE) model provided housing, a broad range of communal services, and some parts of medical care and education through SOEs. In many countries formally privatized PSOEes still carry out these same functions *de facto*.

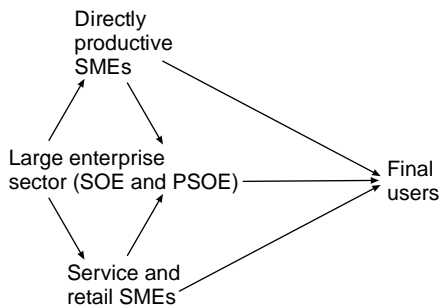


Figure 1.1 The economic landscape: large, medium and small enterprises

Households (and individuals within multi-earner households) may be simultaneously in more than one sector in transition economies. This situation is common in established market economies, but was extremely rare in centrally planned systems. Under early and middle transition-period conditions, the informational signals that the household perceives may not be a reliable guide to rational conduct in the longer term, with individual and social logic diverging in policy-relevant ways. As illustrated in many chapters, these structural features mean that (at least in the short run) individual labour-market participants must decide between complete independence and a mixed course of action that retains the benefits of association with the large entity. How can a SME sector be built up in light of the unwillingness of workers cleanly to break their links with SOE or PSOE employers, especially where reformers have failed to develop comprehensive and credible social support mechanisms?

The irregular economy, the informal sector and self-exploitation

To the extent that the transition process was abrupt, chaotic and proceeded without coherent structural preparations, an array of dysfunctional 'externalities' arise that impose real costs on society in irrational and capricious ways. Russia and Ukraine provide examples of populations required to cope at the household level with the catastrophic collapse of the large enterprise sector, with little or no effective state support for the rise of alternative forms of productive activity. Under these conditions, 'independent' economic life often emerged in forms involving a high level of self-exploitation, as well as physical conditions directly destructive to the health of the participants and their families. Beyond the evidently disastrous health and welfare effects of this approach, the political stability of systems under this kind of stress is questionable (Cornia and Paniccià, 2000).

'Self-exploitation' is not automatically an undesirable situation because lower money earnings from independent work may be balanced by sufficient non-monetary 'income' (feelings of autonomy and self-actualization) to make a decision to work independently entirely rational. But the concept of rationally chosen self-exploitation carries with it a labour market model which assumes available alternatives to be rejected: the decision-maker passes up paid income from an existing employer in order to work independently. When depressed aggregate demand and employment market conditions accompany transition, paid alternatives do not exist for much of the population to reject.

The ideological orientation which expects automatic emergence of successfully functioning markets (and automatic solutions by those markets 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-trader' (*chelnok*) activity in transition economies. Chapters 4 and 5 stress that a large proportion of the independent workforce is simply engaged in a desperate survival struggle, perceiving few or no options to the course taken. Much of this 'measured growth' is admirable in its own right, but is not the kind of society-transforming entrepreneurship expected by advocates of market-automaticity. It has no cumulative developmental effect. Self-perpetuating growth of the informal sector does not emerge because the scale of individual response is generally not sufficient in an unprepared post-planning environment. Chapters 6, 7, 10 and 12 explore this issue in the Central European states, which along with the Baltic States are sometimes suggested as exceptions.

The two prior points are closely related. Previously state socialist systems appear to adjust to severely depressed aggregate demand and labour-market conditions differently than 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 directly connected to the function of the large enterprises in their role as holder of 'social assets' and provider of social services (Commander and Coricelli, 1995). Reconstitution of some elements of the 'old-system' social net may be a precondition both for sound public health and for an effectively functioning mixed market economy to emerge from 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 operate new SMEs successfully; and (b) the behaviour and survival chances of 'old-system' SMEs in this new environment.

Propaganda, identity affirmation and missing or faulty data

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 economy, so description and analysis of the role of the SME seems inevitably to have an ideological element. 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 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 and multiple jobs to show they have disengaged from the old-system mindset and are fully in tune with the new world.

The extent of change is often further exaggerated because many of these service and retail functions existed and were carried out as auxiliary activities of the large SOEs, often with 'small-premises' delivery points. The increased variety, especially of foreign goods, is indeed new and the atmosphere

decisively different. There is evidence of successful adaptation at both the system and individual levels, but the statistical record for SMEs and understanding of their developmental effects are clouded by boosterism and careless talk about burgeoning self-employment.

The empirical record is further obscured by missing and false comparative data. Claims of continuing rapid SME growth are highly debatable in light of the way comparative statistics on the SME share of total employment (Table 1.1) are collected. The dividing lines between group sizes differ from country to country and from time to time within countries. More damaging, there is large-scale inflation of the numbers due to exaggeration of 'foundings' (many never function or function briefly to serve criminal or subsidy-collection motives), while 'deaths' are usually not reported. Systematic bias of this kind and extent means that reported levels are not useful and does not allow use of the so-called 'law of equal cheating', meaning that year-to-year changes do not contain much serious information. Since everyone is happy to report SME success, there is a polite and sustained conspiracy to ignore these unfortunate facts.

A crucial distinction between proprietorship and entrepreneurship

Much activity that is characterized as evidence of successful development of the SME sector in transition economies actually fits within the proprietorship rather than entrepreneurship category. Recognizing the boundary is ambiguous and individuals can evolve/devolve from one to the other, possibly more than once (Scase, 1997, and Chapter 5). While proprietorship is reasonable and attractive behaviour at the individual level, and is not bad for the system, it is very different and more conservative in its systems effects than would be a 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. Chapter 13 offers some suggestions for dealing with this problem.

Does the macroeconomic context allow growth?

As is stressed in Chapter 10 and elsewhere (Kolodko and Nuti, 1997; Amsden *et al.*, 1994; Taylor, 1994; Nolan, 1995; McIntyre, 1993), the very different macroeconomic policies followed in Poland and Russia had direct and sharply different implications for SMEs at multiple levels. Poland applied serious 'shock therapy' and deflationary macro-policy during the first two years of transition, but abandoned this course (in fact, if not in rhetoric) before irreversible developmental damage had occurred (Kolodko, 2000; Kolodko and Nuti, 1997). After the resulting political debacle of the first Solidarity government, Poland quickly adopted and maintains a modulated

and socially sensitive strategy which has concentrated on commercialization rather than privatization of SOEs, helped by massive debt forgiveness and relatively generous access to Western markets, moving to a gradual and politically stable transformational path.

In the Russian case the original inept 'shock' measures were followed by a comprehensively corrupt large-enterprise privatization process with almost entirely destructive economic effects. This encouraged asset-stripping and private appropriation (and flight abroad to personal accounts) of company sales proceeds, while denying the state tax receipts sufficient to support even minimum health, education and welfare functions. Macroeconomic policy was equally disastrous, following an obsessional monetarist path to a point where (in addition to a catastrophic and unprecedented collapse in production, living standards and health) normal money-mediated exchange shrunk everywhere and ceased to exist in some parts of the country for several years, recovering only after 1998.

While Poland–Russia comparisons often focus on the long-established and unbroken tradition of fully private urban and rural SMEs in Poland, Poland also had transition-period policies favourable to SME growth – the overwhelmingly important policy trio of generally expanding aggregate demand, relatively healthy large enterprises and continued normal use of money as a medium of exchange and store of value. In Russia, to the contrary extreme, and in ways especially unfavourable to SMEs, opposite conditions obtained until 1998.

Inhibitions to SME growth

Despite their potential competitive advantages, SMEs confront a series of barriers that raise operating costs and threaten their economic viability. They face higher costs for and more limited access to credit and other inputs, have greater difficulty penetrating export markets and are vulnerable to harassment by criminal gangs. The criminalization of everyday life in many transitional societies has been the subject of much sensationalized discussion, but is a serious and complex problem. Embedded criminalization caused by transition is among the most vivid examples of the misguided character of policy driven by unprepared liberalization and 'faster-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 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 better afford security services among their administrative overheads.

There appear to be a set of systematic relationships between on the one hand the extent and character of the work done preparing the legal and

commercial infrastructure before privatization, the way privatization *per se* is carried out and 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 (see Chapters 3, 4 and 10). This is another aspect of path-dependence in which historical conditions, physical, technical and organizational capital, as well as the particular sequencing of reforms, shape the trajectory of transitional economies (David, 1985; Stark, 1992, 1997).

While the condition of the SME sector is emerging as a key determinant of the success of transition, there is still little systematic or reliable research which allows us *either* to explain the conditions which lie behind successful development where it has occurred, *or* to propose policies which will facilitate expansion where the record is thus far undistinguished. It is crucial to determine why successful small enterprise development has been achieved in some places and not in others. The direction of causation is particularly troubling here because of systematic overdetermination. There are simply too many plausible causes available to explain successful cases such as Poland or Slovenia.

In order to clarify these causal issues and 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 illustrative transition economies; (2) understand the functional relationships of SMEs on both the demand and supply sides of the markets in which they participate, including explicitly their relationship with the large enterprise (SOE and PSOE) sector; and (3) identify some policy initiatives with which to increase the positive contribution of this sector. In this volume we try to cut through some of the complexities and causal puzzles of the current situation, pointing to SME development approaches that work.

Note

- 1 The term 'irregular economy' indicates all economic activities that are totally or partially outside formal institutions. As such, the irregular economy includes 'underground', 'informal', 'hidden', 'shadow' and 'criminal' economy, and the like (Dallago, 1995). Within the broader irregular-economy terminology some authors use subdefinitions of shadow and criminal sectors. The shadow sector consists of any type of economic activity which citizens deliberately or consciously conceal from observation in order to minimize costs, for example by tax evasion. The criminal sector includes any economic activity government enforcement institutions might act against forcibly to stop from functioning.

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