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Small Enterprise Policy in Transition Economies: Progress with the Wrong Model?

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Abstract: The paper starts by considering the neo-liberal approach to small enterprise development and why it was to underpin small enterprise policy in Central and Eastern Europe (CEE) from the very first years of the transition. Author briefly considers what other policy models or alternatives were realistically on offer at that time. His final concern is with the actual results of the neo-liberal policy interventions in CEE in practice. The paper focuses particularly on the programmes supported by the international assistance community, since they were largely responsible for both the financing and the design of the bulk of the interventions which emerged after 1989.

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Introduction

The relative absence of self-employment, small-scale private ownership and small and medium enterprises (SMEs) was widely seen in the west as a key contributory factor which lay behind the relatively poor performance of the majority of the

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planned economies in Central and Eastern Europe. Small enterprises[2] remained anathema to the planning authorities for several reasons: they over-complicated the planning process, they were unable to reap economies of scale and they could possibly be the harbingers of a return to capitalism. However, there was generally always some freedom to operate in the interstices of the planned economy and large enterprise sector, and so most of the Eastern European planned economies were not entirely without a small enterprise sector prior to the collapse of communism. For many years limited forms of officially-sanctioned small enterprise development were allowed as a way of ameliorating poor economic performance and lifting living standards, notably in the former East Germany, Poland, Hungary and the former Yugoslavia (Aslund, 1985: Patterson, 1993). As economic stagnation began to bite hard these freedoms were extended in the 1980s, and some government support came on stream. Sometimes small enterprise development took place using a little ideological camouflage, as in the shape of the 'Ko-op' sector in the former Soviet Union (Jones and Moskoff, 1991). Also, official toleration of the 'second economy' in many Eastern European countries represented a further concession to the potential contained in small-scale entrepreneurship. (Los, 1990; Brezinski, 1992).

But pragmatism had its limits, and the freedom for entrepreneurs to operate remained closely circumscribed by the planners and the political authorities. As a result, the small enterprise sector in Central and Eastern Europe remained a minor component in the industrial structure in comparison to the western European economies and generally elsewhere. Accordingly, once the decisive break with communism was made in Central and Eastern Europe in 1989, and two years later in the then Soviet Union, small enterprise development became one of the principal economic reform objectives to be adopted by the first post-communist governments. Governments responded by removing many of the main administrative barriers to entry, making quick work of the privatisation of the small-scale state enterprise sector, undertaking at least some of the most basic reforms to the banking sector, and began to allocate some direct financial support to small enterprise development programmes. The active labour market policies which were a feature of nearly all the transition economies were also important in supporting the unemployed into small (Godfrey and Richards, 1997). Crucially, western governments and the bilaterals and multilateral development agencies were quick to offer financial and technical support. The European Union, in particular, was a major provider of assistance through its PHARE programmes of support for SME development in the early reforming countries of Central and Eastern Europe, and later on in the former Soviet Union through the Tacis programme. A new bank, the EBRD, was also established to support the private sector.

The apparent result of this rapid liberalisation of the business environment and increased support for small enterprises was that the sector experienced a major boom.

Indeed, after nearly ten years of the transition, the small enterprise sector is now widely pictured as one of the great success stories in the move to the market economy. In all of the transition economies the small enterprise sector now accounts for a very sizeable share of employment, output, tax contributions, consumer goods supply and wealth creation (EBRD, 1994; Levitsky, 1996). Small enterprises have facilitated the introduction of a wide range of new technologies, managerial techniques and innovations (Dyker, 1995), and they have led to a new entrepreneurial business culture taking root in Central and Eastern European society, which is beginning to affect both small and large enterprises alike (Bateman, 1997a). Moreover, given the decline of the social welfare systems in many post-Communist economies, informal sector small enterprises have clearly played a vital role as a source of income for many who would otherwise be experiencing real poverty (ILO, 1995).

However, in spite of there having been unquestionable progress over the last decade or so, on closer inspection a significant part of the progress in the small enterprise sector is actually shallow and illusory. For a start, it is clear that in each of the transition economies the official statistics vastly overstate the numbers of, and level of employment in, the small enterprise sector (UNIDO, 1997; OECD, 1998).[3] We should also add that after the initial spurt associated with the collapse of communism, and particularly after the small-scale privatisation programmes were coming to an end, everywhere in Eastern Europe the growth trend of the small enterprise sector has begun to tail off quite dramatically.

But irrespective of the numbers and size of the small enterprise sector in many of the Central and Eastern European economies, what is of perhaps more concern is the fact that most active small enterprises are engaged in petty services, simple retailing and importing activities, with the corollary that very few are seriously engaged in manufacturing activity involving meaningful capital investment and new technology. For sure, it can be argued that the petty importing activities which boomed after the instant liberalisation of trading relations have actually seriously undermined the local industrial structure in many regions. By greatly facilitating very easy and early access to imported goods (often without regard to customs duties and tariff restrictions) the rush of importing businesses generated an instant competitive threat to the vast majority of local producers, who at that time had neither the time nor the capital to restructure, re-tool and re-invest.[4] But perhaps more importantly, there has been a pronounced 'too many - too small - too weak - too isolated' trajectory reflected in most parts of Central and Eastern Europe (Berg and Sachs, 1992; Arzeni, 1996; Hardy and Rainnie, 1996; Smith, 1996; Bateman, 1997b; Gabor, 1997). This is one of the most problematic aspects of small enterprise development in Central and Eastern Europe, because such a structure is unlikely to generate the most important positive development externalities in the local economy. Almost without exception, the most successful models of small enterprise development place a very high premium on small enterprises as technology-intensive manufacturers, sophisticated industrial service providers, and flexible and technically competent industrial subcontractors (see below).

One factor behind the problematic status of the small enterprise sector, particularly with regard to the essentially shallow nature of the progress made so far, relates to the structure and extent of the policy support which came on stream from 1989 onwards. Our argument in this paper is that the neo-liberal discourse was imposed upon small enterprise development policy in Central and Eastern Europe, and that this choice has proved to be decidedly problematic. Two issues will be raised:

- First, the neo-liberal agenda was sufficiently influential to effectively preclude from the policy debate any discussion of meaningful state intervention;[5] here, specifically, the lessons of earlier practical examples of state intervention with regard to small enterprise development in post chaos/post conflict situations.[7] Yet, careful analysis of the examples of post-World War II Germany, Italy and Japan, of East Asia from the 1970s onwards, and of China after the death of Mao, reveals a very successful policy model based on the local state developing what can be termed a strong 'transformative capacity' (see Weiss, 1998). This 'transformative capacity' enabled the local state to make an immediate and wide-ranging contribution to economic development through promoting high levels of SME entry, institution building and restructuring, technology transfer, local savings accumulation and disbursement, and so on. And, it must be stressed, this contribution was made in very similar conditions of major economic and political dislocation and system change to those experienced in Central and Eastern Europe since 1989. Notwithstanding problems of replicability and cultural and geographic specificity (see, for example, the discussion in Schmitz and Musyck, 1994), there is a strong argument that these very practical experiences could, and should, have provided many useful elements for inclusion in a policy framework for small enterprise development in Central and Eastern Europe after 1989. Instead, the neo-liberal approach effectively and quite strongly sanctioned non-intervention, short termism, and the widest possible use of market forces.
- Second, the neo-liberal approach to small enterprise policy has been beset with a number of inherent operational and strategic difficulties. Some of these problems could have been predicted from the emerging experience of local privatisation and public services restructuring elsewhere, for example in the UK (see, for example, Ramanadham, 1988). The difficulties in Central and Eastern Europe arose out of the neo-liberal cardinal beliefs that public policy intervention ought to be 'privatised' as much as possible, that markets should be created for the

actual implementation of any public policy interventions, that any financial interventions should follow a 'commercial approach', and that the local state should be as little involved in all this as possible. As with the interventions at the macro-economic level, what seemed to matter most was the creation of a free market *per se* and the withdrawal of the state from any form of intervention or supporting role.

Neo-Liberalism as Small Enterprise Development Policy

Neo-liberalism was the most influential political project in the 1980s and early 1990s, in both the developing economies (Colclough and Manor, 1991) and in the majority of the western democracies (Amin and Tomaney, 1995). It was most closely associated in the developed economies with the radical free market policies of Margaret Thatcher in the UK and Ronald Reagan in the USA, though other governments in western Europe and elsewhere came to accept many of its most important individual policies (e.g., privatisation) while eschewing its overall *laissez faire* approach to economic development.

By the late 1980s, however, the neo-liberal project was becoming increasingly associated in practice with unfavourable economic performance, industrial decline, rising social exclusion, uneven development, worsening labour conditions and massive employee insecurity, and substantial and growing inequities in wealth and power (Jessop *et al,* 1988; Liepitz, 1992; Peck and Tickell, 1994; Amin and Tomaney, 1995).

Notwithstanding this poor progress (particularly so in the country most associated with neo-liberalism's genesis, the UK), the neo-liberal agenda was nevertheless highly influential in informing the transition strategies adopted by governments in Central and Eastern Europe from 1989 onwards (Marquand, 1990; Sachs, 1990; Gowan, 1995). There was substantial pressure imparted by the UK and US political establishments to export this pure free market model regardless of the predictable negative social consequences, such as rising unemployment (*The Economist*, 1991). And, as pointed out at the time by such as JK Galbraith (1990), the crude neo-liberal agenda was also promoted regardless of the fact that the western economies providing the advice have historically had very little truck with the pure version of the market economy during their own periods of reconstruction and system change. The World Bank and IMF made it quite clear[8] that they were only interested in financially supporting the reform process so long as it accorded to their ideas of an 'appropriate' (i.e., the neo-liberal) model of restructuring (Amsden *et al,* 1994; Gowan, 1995; see also George and Fabelli, 1994, particularly pp 58-72, for the World Bank's actions elsewhere in defence of the neo-liberal orthodoxy). It helped, too, that many of the most senior Eastern European individuals with responsibility for reform (for example, Vaclav Klaus in the Czech Republic and Leszek Balcerowicz in Poland) were also committed neo-liberals, who could be relied upon to promote the free market and to resist all forms of state intervention (see Klaus, 1992; Balcerowicz, 1995).

At its root, the neo-liberal approach to small enterprise development essentially conflates slavish respect for the activities and freedoms of the individual entrepreneur (best exemplified by the 'enterprise culture' promoted by the Thatcher administration in the UK), with the wholesale acceptance of Chicago school textbook models of perfect competition and their explicit hostility towards all forms of collective endeavour and state intervention. Following Hayek (1944), entrepreneurs are seen as the main wealth generators in society: it is their unfettered freedom to do what they do best which results in progress and economic development, and any form of state intervention or regulation of their activities is therefore, by definition, counter-productive. It follows that the state should refrain from 'interfering' in the economy, and simply work towards ensuring a neutral competitive environment, property rights and the rule of law.

However, owing to the special conditions prevailing in Central and Eastern Europe, two broad policy interventions were considered necessary to construct a market economy out of what was left of the planned economy. These measures, both of which heavily involved the international assistance community in their design and financing, became the focus for much of the small enterprise development support activity in Central and Eastern Europe:

- institution building - this involved policy advice to government, often a national SME support organisation, and the establishment of business support centres[9] charged with supporting small enterprise development at the local level.
- financial support to small enterprises - this involved establishing programmes of financial support and providing support for private sector financial institutions to emerge to service the small enterprise sector. The latter objective was to be accomplished by channelling international financial support through private sector institutions (e.g., commercial banks) who would then take up the task of supporting the small enterprise sector on their own.

Post Chaos/Post Conflict Small Enterprise Development Policy

In spite of the claim that 'there was no alternative', the neo-liberal approach to SME development was certainly not the only possible policy discourse which could have been promoted in 1989 as the transition got underway. Indeed, just before, and in the very early stages of the transition, a great number of political parties and key individuals were strongly supportive of both co-operative enterprise and strong 'hands-on' local institutions for small enterprise support and local industrial restructuring. From around 1987 to 1992, for example, the famous Mondragon co-operative complex was host to a very large number of official visitors and senior government personnel from all parts of Central and Eastern Europe, all interested in its very successful blend of co-operative enterprise and institutional support structures (technical, finance, business planning, and so on) for supporting existing, and generating new, industrial co-operatives (see, for example, *The Guardian*, 1.10.1989). The lessons of the Emilia-Romagna region of northern Italy were similarly pored over. As we shall see, however, these early explorations of broadly interventionist policy models were later abandoned. Possibly, there could have been a number of possible alternative models for small enterprise support policies which could have been implemented in Central and Eastern Europe.

At first sight the experiences of post-World War II Japan, Germany and (northern) Italy, of the East Asian 'tiger' economies since the 1960s, and of China since 1979 should have been extremely useful to policy-makers in Eastern Europe because, uniquely, they also involved a major discontinuity, system change and the need for reconstruction and development from a very low base of economic activity. Japan represents probably one of the best examples of post-war reconstruction and development in which small enterprises played a pivotal role. The origin of the massive expansion of small enterprises after the World War II lay in the need for the post-war conservative coalition administration headed by the Liberal Democratic Party (LDP) to re-build a power base in the community, and to prevent further radicalisation of both the working and middle classes (Berger, 1980; Calder, 1988). Small enterprise development was also a cost-effective social policy response to the high levels of unrest, poverty and unemployment and the absence of a social safety net. The first phase of economic reconstruction from 1945 to 1955 involved substantial intervention and directed allocation of funds. In terms of the former, government at all levels introduced a staggering array of small enterprise support policies and legislation, established robust and publicly financed SME support institutions at the prefecture and local level, and enthusiastically promoted the climate of entrepreneurship (Kim *et al*, 1995; Kodama, 1995; MITI, 1995). There was an extensive provision of low cost finance, which supported vast numbers of new entrepreneurial ventures to become established by providing low cost finance for equipment and patent/license purchase (Kodama, 1995; Kitayama, 1995; Vittas and Cho, 1996). Moreover, this support was overwhelmingly disbursed at the prefectural and local level in line with local development plans drawn up by the local government (Kitayama, 1995). These interventions combined to make the entrepreneurship option something which everyone with motivation and a good idea could contemplate, especially blue-collar workers. The result was that by the 1950s and 1960s Japan had achieved a staggeringly high rate of new small enterprise entry, with the number of new small manufacturing enterprises each year amounting to around half of the total (Friedman, 1988). Of course, exit rates were high too, but the relatively low cost of entry meant that individuals experiencing failure tended to recover quickly and easily, often moving back into self-employment with another (better) idea. Critically, this great depth of small manufacturing enterprises fed into the operations of the large enterprise sector, through subcontracting arrangements, to form the system of 'flexible mass production' which was to become the backbone of the highly efficient Japanese industrial system (Kitschelt, 1991; Nishiguchi, 1994; Whittaker, 1997).

Northern Italy, in particular the region of Emilia-Romagna, has become synonymous with post - World War II economic success based upon small enterprise development. The policy of promoting the small enterprise sector was a major component of the reconstruction strategy of the newly elected communist/socialist administrations in the north. Ideologically it suited them to support the small enterprise sector because small enterprises seemed to stand four-square against the large monopolies, many based in nearby Turin, which were considered the main evil of capitalism (Berger, 1980; Brusco and Pezzini, 1990). Many of the regions in northern Italy suffered extensive destruction during the World War II and widespread closures of major industrial plant shortly after the end of the war (Capecchi, 1990). Because of their political complexion, several of the regional governments were unable to generate much support from the central government after 1945 to support their reconstruction and development efforts. This lack of interest forced them into relying on their own (only) resources and interventions to stimulate the small enterprise sector. Regional governments and quasi-government institutions throughout northern Italy thus became extremely active in promoting economic reconstruction and development. The early post-war years were marked by the rapid utilisation and renovation of whatever resources were available, such as abandoned business space and land, which was quickly passed over to large numbers of potential entrepreneurs (Perulli, 1990).[10] The establishment by the regional government of a small enterprise bank, the *Mediocredito Centrale* (medium term credit bank), was a key intervention which laid the foundations of the region's extensive system of decentralised, affordable financial support for small enterprises (Peluffo and Giacche, 1997). Comprehensive regional and local planning was a feature which allowed for the co-ordination of scarce reconstruction and development resources and the exploitation of local and regional comparative advantages. Major local and regional interventions were also undertaken with 'service centres' which were established to promote sectoral upgrading and new product and process development (Pyke *et al*, 1990; Pyke and Sengenberger, 1992; Pyke, 1992). Finally, an additional important part of the role of local and regional governments was to bring about a 'social contract' involving both flexible labour alongside the fair disbursement of the costs and benefits of local economic success (Trigilia, 1989).

The former West Germany, too, saw economic recovery fuelled by the consolidation and steady growth of the small and medium sized enterprise sector, especially family businesses. Though because of ideological reasons (US pressure, Cold War anti-Communism, etc.) it was generally reluctant to describe its 'economic miracle' as being anything other than a free market-led outcome, the state actually played a critical catalysing role in SME development, particularly at the regional (*Lander*) level. As Weiss (1998) has argued, the west German state was in fact a leading player in creating a developmental state apparatus which nourished key industrial sectors. A very dense and well financed institutional fabric at local and regional level emerged, and strong local and regional governments aimed to create the right conditions for the growth of the small and medium sized enterprise sector. These policies famously resulted in the clusters of medium sized enterprises (*Mittelstand*) which were able to both carve out international markets for themselves and very successfully sub-contract to the largest German enterprises (Piore and Sabel, 1984; Porter, 1990). The regionally-based state owned *Sparkassen* and co-operatively managed *Volksbanken,* in the most successful region of Baden-Württemberg for example, provided easy and affordable access to finance for small enterprises (Heidenreich and Krauss, 1998), while the federal level *Kreditanstalt fur Wiederaufbau* (KFW) was able to provide massive support for both start-ups and existing businesses. These conditions were the ideal background against which SMEs could develop to become the bedrock of the German industrial structure (Piore and Sabel, 1984; Porter, 1990; Schmitz, 1992).

Though many of the East Asian economies have experienced financial sector difficulties of late because of their opening out to global capital flows, the level and rapidity of industrial development success achieved in the last thirty years has been staggering, and small enterprises have played a major role (Rowen *et al,* 1998). Post-Korean War industrial development in South Korea is most often thought of as being led by large conglomerates (*Chaebols*), but industrial policy actually included many pro-small enterprise measures. A state bank to support SMEs was established and a plethora of other support policies were brought out. In order to de-verticalise industry and at the same time assist small enterprises, the government passed a law which made it mandatory to subcontract out a list of previously in-house produced components (Lall, 1996). Much of the government support went into developing industrial subcontracting. Singapore struck a bargain with the incoming multi-nationals: in return for 'adopting' a group of small enterprise subcontractors and providing them with training and technical support, the government for its part offered the subcontracting small enterprises grants and low interest loans for equipment purchase and complementary training programmes (Lall, 1996). Post-revolution policy towards industry in Taiwan was very much in favour of the development of small enterprises, and it very quickly developed an extensive support system for SMEs (Meyanathan and Munter, 1994). The government tolerated and, most importantly, extensively regulated a large informal sector credit market for small enterprises which supplied large quantities of affordable credit (Biggs, 1991). Industrial policy support to SMEs is particularly noteworthy for the way the government consistently took the lead in developing new technologies which fed through into the sector and allowed it to develop new markets, products and production-processes. Both domestic and incoming multi-national enterprises were both cajoled and incentivised into extensive sub-contracting arrangements with local small enterprises. Technology development was seen as particularly prone to market failure and as a barrier to subcontracting, and so government interventions were designed to do something on behalf of the bulk of the population of SMEs (though not all took advantage).

Arguably, small enterprise development in China since the start of reforms in 1978 has been even more impressive than the European and other Asian examples just noted, and thus also compares extremely favourably to the transition economies so far (see, for example, Henderson, 1998; Bateman and Tan, 1998). After the death of Mao in 1976, the Chinese economy was firmly pointed in the direction of liberalisation and increasing marketisation. Post-Mao micro-economic strategy focused on local economic development and, particularly, the promotion of new small enterprises in the rural communities and townships. Support was given to rural communities to first increase, and then recycle, agricultural earnings into new small private enterprises. This was important in terms of employment creation, but it was also a way of developing new sources of tax revenues outside of the agricultural sector and a way of compensating for reduced subventions from the centre. But it was the fiscal decentralisation after 1979 which provided the pivotal incentive structure at the local level. Local authorities became extremely entrepreneurial and began to encourage all manner of private business initiatives which paid local business taxes (Oi, 1992; Walder, 1995; Nee and Su, 1998). Local authorities were also encouraged to get directly involved in establishing their own enterprises, particularly in manufacturing, in the shape of the Township and Village Enterprises (TVEs).[11] These generated both steady profits and local taxes for the municipality, and so, not surprisingly, they very quickly proved popular throughout the country (Quian and Roland, 1994; Rana, 1995). Local authorities thus became relatively flush with cash and so were able to undertake a wide range of small enterprise-friendly infrastructural developments and institution-building which, in view of the financial problems of the central authorities, would probably not otherwise have taken place. The Chinese experience is very impressive when it comes to local government support for small enterprise development; local policies were very similar, in fact, to the sort of 'endogenous development' policies followed in northern Italy (Zeitlin, 1989; Hirst and Zeitlin, 1992; Chang and Nolan, 1995).

It is obviously impossible to distil the very varied experiences of quite different countries into any one set of policy prescriptions. However, there are some common policy-relevant points which emerge from this very rich experience:

- First, the role of the local authorities has been enormously important to the successful expansion and deepening of the small enterprise sector. Many local authorities were clearly able to develop a 'transformative capacity' (see Weiss, 1998) which in practice meant *inter alia* setting in motion a flurry of local economic development institutions, initiatives and policies. The promotion of technology upgrading, inter-enterprise networks, mechanisms for local capital accumulation, industrial clusters and the inculcation of local trust relationships, all involved the local authorities as orchestrator to one degree or another. Local government initiative is seen as very important to the Third Italy experience (Pyke *et al*, 1990). 'Third Italy-style' local government initiative was very much a feature of Chinese success, a point explicitly made by Nee and Su in their study of the lessons of East Asian reform (1995, p. 170), but it was clearly an important concept in many of the other East Asian economies too (see Meyanathan, 1994).
- Second, the most successful local governments recognised that their role in local economic development was not dissimilar to their role as the providers of local health, education and other essential community services. They were thus largely willing to incorporate a small enterprise support function into their budgeting plans as a key item of public provision and expenditure.
- Third, the incentive effect on local government obtained *via* a local taxation system was important. It feeds back into local government a significant proportion of the taxes levied from the small enterprise sector, and this greatly encourages them into offering support to the small enterprise sector. Fiscal decentralisation was a vital incentive underpinning the motivation behind, and ultimate success of, local economic development in the Third Italy and, critically so, in the case of China so far.
- Fourth, substantial financial support has been provided to SME development, including at the local level, in comparison with other programmes aimed, say, at the large enterprise sector. This is another way of saying that the 'invisible hand' was not considered sufficient to bring about the transformation hoped for at the micro-economic level in any meaningful time-scale. This support has also involved the provision of subsidised finance to reflect the fact that those small manufacturing enterprises with a good chance of flourishing in the medium term would find it extremely hard to service market priced finance in their first

few years of operation. In particular, it was keenly felt that in a free-for-all competition for financial resources small manufacturing enterprises would have been 'crowded out' by those wishing to establish basic trading, importing and retailing ventures.

- Fifth, comprehensive and easily accessible local support structures (financial, technical, marketing) for small manufacturing enterprises were an important prerequisite for small enterprise 'mass entry' to take place. This rapidly increased the quantity and quality of the manufacturing enterprise base. This is important because it was only once there was a very healthy population of small manufacturing enterprises that many efficiency-enhancing processes could come into play, such as industrial sub-contracting and horizontal co-operation and networking. For example, in Japan, large enterprises enormously benefited from being able to pick and choose from a very wide selection of possible small enterprise partners, to gradually reject those who were not up to standard, and to develop further with those who could prove their technical capabilities (Friedman, 1988; Nishiguchi, 1994). In Taiwan, also, it was the huge entry of new manufacturing SMEs, which from the 1960s onwards, very rapidly created its highly successful SME-dominated industrial system (Biggs, 1991).
- Sixth, there was comprehensive local government support for the local financial system to develop. Regional state-owned banks were one solution opted for, such as in Italy. In other countries the state, particularly the local state, was able to offer financial support directly to the best small enterprise projects. Also, a wide range of local actors were encouraged to come together to solve their common financial problems, through credit unions, savings clubs, local banks, and so on. Moreover, strong regulation of the local financial system was behind the successful local capital accumulation. Local savings was considered vital over the long term (and in the short term since there was often little coming from central government) but confidence had to be built up gradually through ensuring the maximum security for savings and transparency of credit disbursement.

In short, the above development models and policy interventions all heavily relied on the catalysing activities of local and regional governments. Sometimes this fact has been partially hidden by the country itself, as Weiss (1998) shows was the case in the former West Germany, or otherwise obfuscated and misrepresented, as was the experience of Japan and East Asia reported in the World Bank's 'Miracle report' (Amsden, 1994). But notwithstanding the negative slant put on the success achieved in these examples, the neo-liberal approach was firm in its adherence to the market and in its opposition to the state. Such models and policies were, thus, largely given short shrift in the Central and Eastern European context: instead, as we noted above, the neo-liberal approach to small enterprise development was promoted and largely accepted by governments in the region.

Small Enterprise Development Policy and Practice in CEE

To recap, if previous examples of post-chaos/post conflict small enterprise development were largely ignored, what was the shape and form of the model which emerged in Central and Eastern Europe? We now go on to examine the policy interventions which emerged in Central and Eastern Europe under the influence of the neo-liberal agenda and some of the distinctive implementation problems which arose. We restrict our attention to the two most visible areas of the support package which were considered necessary; business support centres and financial support programmes for small enterprises.

Business Support Centres (BSCs)

The most extensive support measure implemented by the first reform governments, overwhelmingly with the assistance of the international aid community, was the establishment of networks of business support centres (BSCs). In all the transition economies networks of such BSCs now exist, in one form or another, to support the small enterprise sector (Levitsky, 1996; UNIDO, 1997). The BSC networks were meant to provide support for new start enterprises, potential entrepreneurs among the unemployed, small growing enterprises, and in some cases ethnic minorities. More successful and larger SMEs were expected to tap into the growing indigenous private sector consultancy and business support services companies, incoming consultancies from the western economies, or the larger-scale international assistance programmes. There was also a regional bias to the BSC network, with many of BSCs being deliberately established in regions already experiencing, or expecting to experience, particularly high unemployment.

Overwhelmingly, the model for business support agencies throughout Eastern Europe was derived from the United Kingdom's experience with Local Enterprise Agencies (LEAs) and Training and Enterprise Councils (TECs).[12] The UK LEAs were established from the late 1970s onwards as non-profit business support bodies which were intended to rely on funding from local private industry (especially, in the early 1980s, those large companies making large-scale redundancies), central government, and some support from local government (sometimes in kind, such as redundant property) (Morison, 1987). They were joined by over 80 TECs in 1988, which were to operate as the main providers of a range of business support services which had previously been undertaken by local offices of central government ministries (Curran and Blackburn, 1994). A key initial feature was that the central government channelled funds earmarked for small business support through the TECs, who in turn invited the LEAs to bid for the financial package to undertake a particular range of support services for local small enterprises. In effect, the responsibility for the delivery of business support services was being 'privatised' (Moore and Pierre, 1988) and a 'quasi-market' for their delivery was being constructed (see Bartlett, 1995). Later on, as central government spending began to contract under the Thatcher government, and when it also became clear that private industry was unwilling to provide the requisite financial base, the concept of user-charges was increasingly promoted to underpin the revenue structure. This development was to have been expected, however, since the principles of full-cost recovery was making significant inroads into virtually all traditional local government services in the UK (e.g., transport, education, waste removal, health care, leisure services). These traditionally public sector services were being recast as private sector operations in order to extend the market into every possible corner of everyday life (Le Grand and Bartlett, 1993). Accordingly, the new entrepreneurship initiatives introduced in the early 1990s, such as Business Links, were very strongly exhorted to become self-financing (Devins, 1996).

It is important to emphasise that the UK's LEA model of business support services arose not so much because it was seen as the best way to create a comprehensive, responsive and sustainable small enterprise support network. Rather, it reflected the then Thatcher administrations over-arching ideological mission to reduce the role of the state. This strategic goal was considered at least partly attainable through the promotion of private sector solutions to every possible social, economic, business, educational and cultural demand in everyday life. It was to be operationalised through a 'commitment to privatisation, deregulation and the introduction of commercial criteria into any residual state activities' (Jessop *et al*, 1988, p. 171). In terms of small enterprise development specifically, the goal was to be achieved by devolving as much responsibility for small enterprise promotion as possible down to various self-help bodies in the community, which were to be financed locally and driven by the private sector. Where central government support was still required for the time being - the aim was that self-help would replace government spending in the long run - it should be allocated on the basis of competition between individual units operating within the SME support infrastructure. The model was given great additional political stimulus at the time because it was seen as being able to stimulate petty entrepreneurship within the community of unemployed - a key facet of the radical free market experiment being conducted by the Thatcher administration - while simultaneously marginalising Labour party controlled local authorities ideologically hostile to the Thatcher government and its neo-liberal political programme (Thomas, 1988).

The UK's LEA model was pioneered in Hungary by the European Union's large PHARE SME support programme which began very hurriedly in 1990.[13] Hungary was the first to tap into large-scale funding activities from abroad. The drive to use the LEA model in this context was essentially provided by the UK-based consultancy companies contracted by PHARE to put into place a business support services network in the shortest space of time. With neo-liberal cardinal principles still dominating the approach to business development in the western economies, the UK's LEA model was a pretty natural choice for many consultancy companies to make when extending their portfolio of work into Central and Eastern Europe. However, pressure to promote the neo-liberal vision also came from within the EU itself, since most of its senior advisors and host country officials at that time were essentially in agreement with the neo-liberal philosophy, particularly its emphasis on avoiding any form of state (central or local) intervention or economic development capacity building.[14] The LEA network was established under the auspices of the Hungarian Foundation for Enterprise Promotion (HFEP), an independent body established by the Hungarian government, business associations and the banks. The HFEP was specifically intended by both the government and the European Commission to be the implementing agency for the PHARE programme. It had to link upwards with government and responsible Ministries, and downwards to the LEA network.

With some changes and adaptations to take into account local conditions, essentially this model became the conventional wisdom for most of Central and Eastern Europe. For example, a central role for the private sector (and thus a much reduced role for local government) in both the decision-making and implementation of SME support programmes was a key prerequisite of the EBRD's SME support philosophy (EBRD, 1993). And, very much as in Hungary, local governments in the Central and Eastern European countries very quickly realised the way the wind was blowing and so helped to establish the sort of BSC which they knew would attract international financial support, at the same time hoping that some of this financial support would find its way into their activities. But in many cases this model had to be forced through against local resistance. This was so in Hungary, where the Hungarian government indicated a preference for international assistance to be channelled through the Chambers of Small and Medium Sized Enterprises linked to the Hungarian Chamber of Commerce (UNCTAD, 1993). In Slovakia, small enterprise support was initially channelled through the regional development department located within district government offices, but heavy pressure from western consultants to build private sector institutions was ultimately successful (Smith, 1996). In Slovenia, the EU's PHARE programme officials refused to support the Slovenian government's plans for a comprehensive network of state-led local SME support institutions, arguing instead for their own ideas for private sector-led institutions. This disagreement eventually led PHARE to withdraw a substantial amount of financial assistance earlier committed to the SME support programme in Slovenia (PHARE, 1996).

After between four and eight years of operation, what have been the consequences of this specific business support services model so far? While a number of internal studies give a generally favourable picture of the progress of the Eastern European versions of the LEA model (see, for example, EIM, 1997),[15] it is clear that there are also a number of problem areas which are becoming more apparent. We would argue that these are seriously detracting from the overall efficiency of the intervention.

- First, and most significantly, it is now apparent that the BSC networks in almost all Central and Eastern Europe countries are deteriorating rapidly, and in many cases are quite near to collapse. In some cases, some BSCs have actually ceased operations after the international funding ran out or will shortly be doing so, particularly in the former Soviet Union (European Union, 1998, p. 18). The main reason for this situation is that there has been a persistent shortfall of financial support for the BSC networks from the host governments, particularly at the local level, which was meant to take over after the international financial support came to an end. Although many central governments have been reluctant to offer support because they were short of cash, it is clear that those governments which have most resisted are also those which most fully bought into the neo-liberal idea that the 'invisible hand' was all that was needed for entrepreneurship to flourish. Local governments have generally tried to be more supportive, but they increasingly resist offering anything to an institutional structure which they now rightly perceive to have been deliberately designed to reduce their role and scope for local economic intervention. And, as very much in the UK (Hindle, 1996), relying on corporate largesse to finance such services has proved to be particularly difficult.

  Thus, the inability or unwillingness of the international community to ground the BSC networks in an institutional and political context which would encourage central and local government financial participation over the long term has led to a persistent threat hanging over them almost for their inception. The stake-holder approach imposed upon the policy design has been particularly problematic, since it really meant local governments were being held at arms length from the BSCs and, what was worse for them, at arms length to the enormous sums of money coming into the country to support small enterprise development. As a result, local governments have sometimes not treated the BSCs as a major part of their local economic development activities, and thus have largely resisted taking on the longer term financial responsibility for them. Worse, in some cases, the local government has lost all formal relations with the local BSC, particularly in the case of those which have evinced a very high-handed commercial approach towards their activities.[17] On the vexing question of local government's role in the financial sustainability of the BSC networks, UNIDO's major study on SME policy (1997, Vol. 1, p. 20) was forced to report that, 'Merely having representatives of 'stakeholder" agencies on the board of local or national enterprise development institutions does not solve this problem *and indeed may exacerbate it"* (my italics). The whole question of sustainability has predictably diverted most agencies' attentions away from the main objective of supporting small enterprise development, and towards urgently bridging the funding gap (see next section).[18] For example, the EU's PHARE supported BSCs have all experienced severe financial difficulties after the initial funding tranche expired. In the case of the LEAs in Hungary, they were able to exert significant political pressure upon the European Commission to secure additional PHARE funding after its original term expired.[19] Other PHARE networks have done likewise in order to continue in operation. Some BSCs are being recommended to try to think up creative ways to raise money to stay in business.[20] Many PHARE BSCs have successfully positioned themselves as Regional Development Agencies to tap into the huge flow of EU funds expected from the pre-structural funding associated with EU accession.[21]

• Second, as a result of the deficit of central and local government support, and absence of private sector sponsorship, there is now a hurried effort underway to restructure the BSCs into commercial bodies capable of competing for fee-paying work with the private sector. The US governments Small Business Development Centres in Hungary and Poland, where both the central and local governments were originally expected to provide longer term finance, have been quickly converted over to becoming revenue-generating bodies (Pricer and Blackman, 1995). The EU's PHARE supported BSCs are all becoming heavily involved in commercial revenue-generating activities, very often with large enterprises, particularly with multi-nationals, and increasingly with many of the multi-laterals themselves, working as consultants and researchers. The UNIDO sponsored BSCs have also moved into commercial activities in order to remain in existence after their international funding expires, very notably so in Romania (UNIDO, 1998). In fact, BSC staff everywhere are now routinely encouraged to spend a large proportion of their time touting for virtually any sort of fee-paying activity on offer. This trend is compounded by the fact that salaries in BSCs are very often calculated as a function of commercially-generated revenues, which naturally introduces an incentive to maximise fee-income in order to maximise salaries.[22] Thus, those BSCs which are set to survive into the future are doing so by becoming indistinguishable from conventional private sector consultancies. The result is that the majority of new start enterprises, very small enterprises and the unemployed, all of which were meant to be the target groups for the BSC, are increasingly being squeezed out of the client frame. Even when some of these clients indicate that they are willing to pay, the costs of such services are rising to reflect the opportunity costs involved in their continued provision (see next section). Moreover, the BSCs are already having a 'crowding out' effect on their private sector counterparts chasing after the same market, a trend which naturally undermines the extent to which one could argue that the BSCs have contributed additionality in business support services provision.

- Third, the all-engrossing search for outside funding and the most profitable business opportunities means that the BSCs are universally neglecting the wider externalities arising from small enterprise development activities. Of course, any notion that the BSCs should develop 'transformative capacity' cannot be reconciled with these trends: it is already abundantly clear that strategic interventions at the local level which offer little immediate financial return to the BSC, but which will benefit the local SME community considerably in the longer run, have been seriously neglected.[23] Moreover, those BSCs which are encouraged to undertake wider small enterprise development work thanks to the injection of additional financial subventions from the central or local government, or the international agencies, also run up against problems. The most obvious one is that the government effectively becomes the client of the BSC, rather than the small enterprise sector or the wider locality. [24] There is also the fact that central governments only partly understand what is most required at the local level for economic development, and so their programmes do not always address the real local problems. Also, the internationally sourced subventions are coming to an end, and there are few signs that host governments have been convinced of the usefulness or appropriateness of taking over this financial responsibility.
- Fourth, and essentially extending upon the point just made, there has been a significant opportunity cost to the current private sector-led BSC network structure. By channelling virtually all international financial support for small enterprise development into the BSC networks, the traditional economic departments located within most local governments in Central and Eastern Europe have effectively been allowed to atrophy. This side-lining of existing and potential local government capacity has taken place even though there was evidence at the start of the transition to indicate that local governments were actually very interested, active and efficient in promoting small enterprises. Local government economic development capacity was certainly not non-existent in the early 1990s, as some senior aid programme officials wrongly believe to have been the case.[25] It thus seems most likely that local governments could have signally benefited from financial resources and technical advice, particularly in developing a sound 'transformative capacity' which would have enabled them to

promote the basic longer run requirements for local economic success.[27] A further indication lies in the fact that in almost all of the transition economies local and regional government employment offices were very quickly and efficiently able to establish quite sophisticated 'active labour market programmes' to cater for the expected growth in unemployment, with the promotion of small enterprises one of the main tools utilised to good effect (OECD, 1996; Glas and Cerar, 1997; Godfrey and Richards, 1997). It thus seems likely that local government economic departments and local and regional government employment offices could have used to good effect a much greater share of the international financial resources devoted to the establishment of the BSCs, or at least they would have used it no less competently, honestly and efficiently than was expected of the BSCs at that time. Increasingly, because of the poor performance and cost of the BSCs, and/or their moves to re-position themselves as fully private sector entities, many central and local governments are now becoming resigned to have to set up 'their own' BSC networks.[28]

• Fifth, even in the case where central and local government eventually assume responsibility for the continued financing of the BSC networks, the costs of so-doing are likely to be much higher in future. Already, the cost to the government of supporting special small enterprise development projects is edging up towards the local opportunity cost, represented by the fees paid by their fully commercial clients and from other lucrative projects they are involved with. This upward pressure is also added to by the specific market power which accrues to private sector suppliers (i.e., the BSCs) once the public sector effectively exits from the market. As in the UK's experience with the privatisation of local public services (see Ramanadham, 1988) the longer term cost of ensuring that the BSCs undertake special longer term projects relating to small enterprise development could rise far above the level of the in-house equivalent (i.e., where such services could have been provided directly by local government itself). [29] Thus, one of the much-trumpeted benefits of private sector involvement in public services provision - lower costs - may not actually be in evidence over the longer run.[30]

• Finally, the stridently commercial culture promoted by the international assistance agencies[31] has given rise to the impetus and freedom for senior management to manage their BSC in a manner which maximises their own personal financial position. We have already referred above to the negative effects of the generally much higher salaries felt to be in order for BSC employees compared to their counterparts in local government, including those counterparts in a very similar economic development capacity. Personal enrichment can also be achieved by privatising the agencies *via* an employee or management buy-out, which is a course of action which has been pursued by several BSCs so far.[32] There are also the fee-paying activities which are gaining more and more ground within the BSC because they directly benefit the individual concerned, even though in many cases they offer nothing significantly additional to the local business community. Of course, if significant personal enrichment is not precluded by the institutional arrangements or by a variety of sanctions, then these are not at all unexpected developments.[33]

The plan to establish efficient, professional and focused BSC networks throughout Central and Eastern Europe looks not to have been overly unsuccessful so far. In comparison with many other post conflict/post chaos regions, the lack of progress is particularly discouraging; more so given that in these earlier historical episodes it took some years for their quite efficient and well-founded institutions to actually impact upon the local economy. In addition, seen from the standpoint of the governments and international assistance agencies which had a hand in the birth of the BSC networks in Central and Eastern Europe, their investment commitment so far has generated a very poor return indeed.

Financial Support to Small Enterprises

We turn now to the financial programmes which were promoted by governments and the international assistance agencies in Central and Eastern Europe. Small enterprises everywhere have relatively more of a problem accessing finance than large enterprises, with new starts having the most problems (Webster *et al*, 1994). Since the financial sector in Central and Eastern Europe was almost entirely geared up to supporting large enterprises, such problems were particularly severe at the start of the transition. In addition, it was to be expected that the emerging commercial banking sector would probably 'red line' the small enterprise sector, because of high transactions costs, high risks and associated collateralisation problems. Restructuring of the financial sector was therefore an urgent necessity (though, of course, not just because of its impact on small enterprises), and it became one of the major aspects of the reform programmes everywhere in Eastern Europe (Prindl, 1992; Kemme and Rudka, 1992).

However, it was expected that the restructuring of the financial markets would be a task which would take some considerable time: in the meantime, where was the emerging small enterprise sector supposed to obtain the necessary financial resources upon which it could become established and grow? As we have noted above in relation to several post-conflict/post-chaos countries, without the mass entry of small enterprises and strong bottom up development pressure, the whole process could be stillborn (see Goldman's (1994) now very apposite analysis with regard to Russia). Accordingly, as one of the first forms of assistance to the newly post-communist governments of Central and Eastern Europe, a large number of financial support schemes were introduced by the international assistance agencies to support the nascent small enterprise sector. In Hungary and Poland, the EU very quickly established a comprehensive array of financial support programmes. These were then replicated throughout the other transition economies. And, as Prindle noted (1992, p. 19), western European governments by themselves were also quick off the mark, with the 'Germans, Austrians, Italians and the French (.) swarming over the area, offering (.)assistance and credit lines'. Governments in the region followed suit and established a number of credit lines and loan programmes.

Not surprisingly, these financial programmes represented an intervention which created some unease in the neo-liberal establishment. In the World Bank, for example, there was already a strong campaign against lending programmes for SMEs on the grounds that policy and regulatory reform would be more than sufficient to ensure small enterprises obtained access to capital (see the discussion in Webster *et al*, 1994). Moreover, recognising that its mandate was moving in favour of poverty eradication, the World Bank was already becoming far more interested in micro-enterprise development than traditional SME support schemes. The EBRD, on the other hand, was specifically established to provide financial support to the SME sector in Central and Eastern Europe, so it could hardly argue against such a concept. In practice its SME support policy followed a straight-forward commercial approach: that is, it sought to provide capital to SMEs at the prevailing market price, mainly in order that the particular financial institution through which it worked could develop and survive (EBRD, 1993; Pissarides, 1998).[34] The EU disagreed with aspects of this analysis, largely because it was concerned about the repercussions which would follow the collapse of the economic base of whole regions along its borders. It essentially took the position that it was impossible to 'create capitalism without the capital', and that some risks would have to be taken in supporting SMEs. This is why the EU, perhaps more than any other international body, was quick to come up with financial support programmes for SME development in the region. Notwithstanding these disagreements, the various financial programmes put together by the above institutions, and others, have disbursed an enormous amount of money to the small enterprise sector in Central and Eastern Europe (see, for example, European Union, 1998, for some indication of just the EU's spending in Central and Eastern Europe on SME related programmes). However, there is enough evidence to date to indicate that these programmes too have run into serious problems.

- little additionality

One of the key performance criteria questions regarding the financial support schemes established by governments and by the international agencies, is the need to ensure genuine 'additionality'. Clearly, if the finance obtained by small enterprises through these schemes is simply substituting for that which would otherwise have come from the country's own emerging financial markets, then there is no net development effect attached to the financial support programme (other than the addition to the total volume of funds available, which is a very small percentage in practice). If it can be shown that financial support programmes for small enterprises *do* support entrepreneurs who have been unable to obtain finance from anywhere else, then the net impact of the programme is conventionally measured by the sum of the additional benefits (employment, income, tax, supply, etc) of that small enterprise, less the losses arising from the increased competitive/displacement effects on other enterprises.

However, it seems to be the case that the bulk of the recipients of too many programmes, particularly those which disburse loans to reasonable sized and/or well established SMEs, are those which would otherwise have been able to tap into the existing capital market for financial support. [35] In this case, very few financial programmes will evidence substantial additionality. Several reasons account for this feature. First, there is a project selection bias in operation. Almost all financial support schemes and associated institutions are encouraged to judge potential SME clients according to standard short term commercial return and payback criteria, [37]rather than the wider and longer term local economic development objectives which have often underpinned financial support programmes elsewhere (see, for example, Peluffo and Giacche, 1997 for post-War Italy; Whittaker, 1997 for post-war Japan). This is particularly the case when financial intermediaries, such as commercial banks, are expected to carry all the risk on any SME-related funds allocated to them from the international agencies. One reason for this is to ensure the sustainability of the institution which is disbursing the funds, but it is also the case that many of the international assistance agencies are extremely concerned to maximise the public relations value of their work. This is best done by supporting a number of potentially highly profitable SMEs, rather than focusing upon more difficult SME projects which only generate a pay-off in the longer term (and, one might add, after the international assistance agencies have gone home). Thus, though it is often precisely these 'more difficult' SME projects which generate the most benefit for the local economy over the longer term, the international assistance agencies tend to shy away from such cases.[38] Second, there is another external screening process at work: any sensible entrepreneur approaches the most favourable funding programme first, and, notwithstanding the strongly commercial approach encouraged by the international agencies, by and large the financial support programmes operated by governments and the international assistance agencies have the most favourable conditions (lower interest rates, longer repayment periods, free training and advice package, etc. Thus, there is a natural flow of the best projects to the financial support programmes before any approach is even made to the local private financial sector. Together, the above two factors lead to the phenomenon of 'cherry-picking', where the funding agencies and their appointed intermediaries try to work with only the very best business projects - that is, precisely with those which would have had no real difficulty in obtaining financial support from the emerging private sector.[39] Though some governments are now trying to move away from using only market-based commercial criteria as indicators of which businesses should receive support,[40] in general the idea of identifying and supporting those categories of, or individual, SMEs which have the most longer term potential to offer the local economy, and which would not otherwise obtain finance from the local private financial sector, has not taken root.

- promoting a limited number of new entrants

Overwhelmingly, the financial programmes operated by governments and the international assistance agencies have tended to promote a relatively small number of new entrants with the funds at their disposal. We refer here, particularly, to the various SME loans programmes offered by both governments and the international assistance agencies *via* the commercial banking system. There are obviously much higher transaction costs to be avoided by working with a small number of projects, while the pressures outlined in the section above also strongly encourages the concentration of effort on just a few of the very best projects. However, this limited entry strategy can very easily result in a small number of monopolistic/rent-seeking small enterprises, which overall will have a comparatively minor impact on local competition, the local industrial structure and production efficiency (Schmitz, 1993; Schmitz and Musyck, 1994, Schmitz and Furlong, 1995). There are many examples of individual SMEs being allocated substantial loans which has enabled them to effectively corner the market, when it may have been better, for local competitiveness reasons if for no other reason, to have divided the loan allocations between several SMEs working in the same field. More extensive entry would also undercut the links which sometimes develop between corrupt local officials and business-people which work to divide up monopoly profits between the two (Bateman, 1993). However, the heavy commercial emphasis in the loan programmes acts to overcome any consideration of these positive competitive effects, or indeed any other positive externality or leverage effects which may result from attempting to support larger numbers of new SMEs, or, better perhaps, clusters of new SMEs.

- lack of 'demonstration effects'

In spite of the desire to offer direct help to 'struggling' SMEs, many of the international assistance agencies realised that the amount of financial support they could provide for the SME sector was minimal in comparison with the amount of local resources. They have thus often argued that there is more benefit from the 'demonstration effect' which their lending programmes (complete with technical assistance) has on the emerging commercial banking sector. The idea is that the financial support offered to individual small enterprises through the commercial banks will instruct them (the commercial banks) how to profitably manage an SME loan portfolio. The commercial banks would then evolve into becoming active lenders to small enterprises in their own right.

Overall, however, little progress has been seen in persuading the commercial banks to develop serious loan portfolio operations involving SMEs. In many cases, many often contend, ignorance or inefficiency are not problems; rather, it is often the case that the commercial banks are simply not interested in working with the small enterprise sector because they have their eyes on more profitable business to undertake. First of all, most commercial banks retain extensive connections with the large enterprise sector and prefer to deal with them because they tend to have government backing. But very many commercial banks in Central and Eastern Europe very quickly become enamoured of many other speculative business opportunities, such as government bonds, forex markets, leasing, insurance, off-shore banking, currency swaps, derivatives and so on. These opportunities were opened up to the new commercial banking sectors by the extensive liberalisation and lack of regulation of the financial sector which was part and parcel of the neo-liberal macroeconomic approach undertaken in most countries. In Russia, for instance, many commercial banks threw themselves wholeheartedly into dealing in government bonds (so-called GKOs), and, though it was long recognised that they were building up frighteningly high exposures which would inevitably bring the system to its knees (Steele, 1998), the Russian government and its foreign advisors could only express surprise when this was indeed what happened in August 1998. Even where there is evidence that commercial banks are willing to deal with small enterprises, it has invariably been a certain strata of the small enterprise population - traders and importers - which have overwhelmingly taken the lions share of available credit. Unfortunately, most Central and East European governments were encouraged to give a wide berth to measures and regulations, *á la* East Asia, which could have acted to dampen down speculative activities or to channel at least a proportion of commercial bank finance into small enterprises, including into the industrial sector perhaps. The widespread liberalisation and deregulation associated with the neo-liberal project thus effectively gave commercial banks a relatively free hand to exploit a range of speculative business opportunities far removed from the SME sector, or indeed far removed from being any kind of industrial investment.

- avoiding state development banks and other local financial systems

The decision to attempt to energise the commercial banking sector effectively meant also a decision not to work with state development banks, and this has had a major opportunity cost. As Amsden *et al* (1994) note, the multilaterals have sometimes imparted strong pressure upon Eastern European governments to abandon their ideas to introduce state development banks, say along the lines of the Korean state banks. In spite of the overwhelming survey evidence that the existing lending institutions are simply not addressing the real financial needs of the average entrepreneur, still less the greater and more specialised needs of the nascent manufacturing SME sector, the international assistance agencies have been extremely antagonistic to the idea of promoting state involvement in the allocation and direction of SME credit. Thus, where development banks geared to small enterprises have been established in Central and Eastern Europe, it was by the less ideologically charged bilateral agencies and where strong historic ties were in evidence, such as in the case of the German development bank *KfW* operating successfully in Poland with its partner the Polish Development Bank (Genter, 1995). In Bulgaria, on the other hand, KfW was repeatedly refused the support of either the World Bank or EBRD to establish an SME Promotional Bank, and eventually had to go it alone.[41]

- property speculation.

It is clear that, because of the high price of business accommodation, a significant number of loans obtained by SMEs are being utilised to either renovate existing business accommodation or to purchase new facilities.[42] Given the extreme scarcity of finance throughout Central and Eastern Europe, one can make the argument that such spending is far less productive for society in comparison to spending on capital equipment and new technology.

- de-regulation

In spite of the overwhelming acceptance that the lack of affordable credit was a major barrier to small enterprise development, it is perhaps surprising to see that many traditional forms of community-based financial institutions have received comparatively little direct support from policy-makers in Central and Eastern Europe. Instead, the emphasis was on de-regulating the market as much as possible in order to allow private sector responses to emerge spontaneously. However, one could argue that the result of this extensive de-regulation and liberalisation of the financial sector in most of the transition economies has actually been a significant reduction in the chances of mobilising local capital through savings. The unwillingness to accept even comparatively weak financial sector regulation has been associated with most of the financial scandals, pyramid schemes, under-capitalised and semi-legal private banks, and general loss of local saver confidence which will take many years to restore.

Yet there was much evidence pointing out the folly of excessive de-regulation and reliance on the private sector. For example, after an initial damaging flirtation with de-regulation, the Japanese went on to develop a quite extraordinary range of extensively regulated and controlled local financial systems, and local savings and investment circuits. These were able to underpin the massive expansion of the small enterprise sector in the country (Whittaker, 1997). Later on, other East Asian countries followed suit (Biggs, 1997). It is thus no coincidence that the East Asian economies are noteworthy for their very high savings ratios. But some of the northern regions in the post-World War II Italian state were also extremely successful in promoting local capital accumulation, by maintaining an orderly and regulated financial sector development process. They were able *inter alia* to both encourage saver confidence in the local banking system and ensure reliable and transparent disbursement procedures to local entrepreneurs (Peluffo and Giacche, 1997).

Overall, and as with the previous case of the institutional support provided to the small enterprise sector, the financial sector support for small enterprises in Central and Eastern Europe has been problematic. The financial programmes often simply substituted for the financial support which would have been forthcoming from the emerging local financial sector. The emphasis on commercial criteria meant that many promising longer term business prospects were simply ignored, and continue to be ignored, while the state showed an inability or unwillingness to get more directly involved in the allocation of financial support to key small enterprise projects or sectors. This left the commercial banking sector to put its savers' cash into a range of speculative investments, with much of it being lost, while a range of phoney financial institutions took advantage of the lack of government regulation and over-sight to appropriate the savings of millions of ordinary savers.

Conclusion

The small enterprise policy interventions which have emerged since 1989 were heavily influenced by the cardinal principles of neo-liberalism. We indicated that the neo-liberal approach was not the only policy model which the Central and Eastern

Europe states could have followed in 1989; indeed, all the evidence at the time was that it was almost certainly *not* the best model for these states to adopt. Nevertheless, the neo-liberal model influenced the design of key aspects of the small enterprise support programmes which emerged. We then went on to point out just how important aspects of the neo-liberal approach have reduced the real impact of small enterprise development policies quite considerably. These drawbacks, we would argue, seriously compromise the many claims that the prevailing development programmes in Central and Eastern Europe are 'making a significant contribution' to the small enterprise sector.

Many increasingly assert that the neo-liberal approach taken towards the macroeconomic restructuring process in Central and Eastern Europe is now being exposed as an ultimately destructive transition policy, both economically and socially. We have identified some parallels at the microeconomic level. The neo-liberal approach to small enterprise development has not been vindicated in practice, but has instead generated a bundle of serious implementation problems and lost opportunities, which are increasingly evaporating any of the supposed gains it has been said to have made to date. As a result, we would argue that a new small enterprise development discourse is urgently required in Central and Eastern Europe. In particular, the role of the local state needs to be re-assessed in the light of the above deleterious experience attempting to marginalise all state institutions. Such a new approach should also be very much informed by the previous historical episodes of successful post conflict/post chaos reconstruction and small enterprise development, which have very much involved the local state as a pivotal catalysing institution. Conceptually, we would argue that there is a need for the local state to attempt to develop what Weiss (1998) terms 'transformative capacity' – the ability to nurture and support the transformation of the local economy towards key longer run growth areas. At the very least, in practice this would see the local state much more involved in designing, financing (ideally with much greater support from central government and from the international community) and undertaking a wider variety of strategic interventions and institution-building measures, in order to develop the longer run restructuring and capacity-building potential of the local small enterprise sector. The alternative to this - dogmatically attempting to implement 'free market solutions to free market problems' - would increasingly appear not to be the way forward.

NOTES

[1] Unless otherwise stated, we will use the term "small enterprise' to refer to self-employment, small-scale private enterprise and SMEs.

[2] To illustrate, consider Hungary in a little more detail. A large number of registered businesses are non-operational; most surveys in Hungary putting the figure at between 40% to 50% of the total of registered small enterprises (HFEP, 1996). Most businesses are sole proprietorships; only 28% of active businesses in 1996 had one or more employees (Futo, 1997). Many businesses are simply "second jobs'; just over 45% of sole proprietors in 1995 were undertaking business alongside a full time position or as a pensioner (HFEP, 1996). Finally, many small businesses are actually tax avoidance measures taken by individuals with the connivance of the larger firms which now "subcontract' to them (Futo, 1997).

[3] Though we should note that capital accumulation through small-scale arbitrage activities can naturally underpin the movement by many entrepreneurs into the manufacturing sector (see, for example Johnson, 1994)

[4] As Chang (1995) points out, for a long time Milton Friedman considered the East Asian success to be the apotheosis of free market economics.

[5] Leszek Balcerowicz, the architect of Poland's neo-liberal "shock therapy' programme, accepted the link between a strong SME sector and overall economic success in Germany, Italy and Taiwan, and thought that SMEs should be supported in transition economies. However, he makes no mention of the extent of state intervention, particularly at the local/regional level, which underpinned this enormous success, preferring to see macro-economic stabilisation and liberalisation as sufficient preconditions in themselves (Balcerowicz, 1995, p 246).

[6] Such as in the famous "Miracle' report (World Bank, 1993) which was widely criticised for its white-washing and misrepresentation of East Asia's industrial policy actions. See, for example, Amsden 1994; Singh, 1995.

[7] The name of these support institutions differs between country - local enterprise agency, business support centre, etc - but the function is largely the same.

[8] Unlike in Eastern Europe today, the socialist/communist regional governments then had few hang-ups about rapidly utilising abandoned private land and buildings, and non-functioning state owned facilities, for small-scale entrepreneurship.

[9] A World Bank mission to China in the early 1980s recommended that municipal and regional governments, which were developing a strong competency in economic development matters, should play a major part in the privatisation programme then getting underway (Edwin Lim *et al* (1985) China: long-term development issues and options, Johns Hopkins Press. Quoted in Gomulka S (1992, p 64) How to create a capitalist market in a socialist country for the purpose of privatisation, *in* Prindl (ed) (*op cit*))

[10] LECs (Local Enterprise Companies) in Scotland.

[11] The European Commission acted very quickly because it was concerned about the possible negative knock-on effects on those western European states bordering then rapidly deteriorating Hungary and Poland.

[12] A senior official involved in the early contracting out of the *PHARE* programme in Hungary in 1990 expressed the view to the author that the then capacities of local government in Hungary were "almost

nil'. *PHARE* therefore had no other option but to minimise its involvement with local government as much as possible (interview with the author, December 1998). See also footnote 22.

[13] However, a great many of these studies have been undertaken by the same consultancy companies and individuals which were responsible for the early policy work and, in many cases, are still involved in policy formulation work. It is, not surprisingly, very rare to see them come out against the model with which they are most intimately linked.

[14] One constant source of friction between the BSCs and their colleagues within the local government economic development departments has been the much higher salaries and benefits (car, expense accounts, foreign travel, etc) prevailing in the BSCs.

[15] As Hindle (1996) notes, this is the experience of the UK's LEA network.

[16] No doubt there is an element of moral hazard here since the government was fairly sure that the European Commission would be very keen to avoid the negative publicity which would be generated by the collapse of the high-profile *PHARE*-sponsored LEA network.

[17] A good indication of the lack of solutions on offer was given by a USAID representative who suggested that the USAID small business centres should consider selling UNICEF cards as a way of raising money to keep going (Pressley, 1995, p 48).

[18] While the BSCs may have certain skills and experience to offer in implementing regional development initiatives, their motivation for getting involved in such activities is first and foremost financial.

[19] A very interesting illustration of this comes from the county of Szabolcs-Szatmar-Bereg n Eastern Hungary, where an LEA was established in 1990. As early as 1991 Attwater (1992) could report that the LEA's managers were getting very heavily involved in entrepreneurial activities in order to maximise their own performance-related incomes. The LEA was also developing a joint venture with a major UK consultancy company in order to develop new lucrative lines of fee-based consultancy services to larger enterprises.

[20] However, some central governments have now recognised this as a serious omission. The Hungarian government, for example, is now channelling support to the LEAs to work on subcontracting promotion (HFEP Annual Report, Budapest, 1997)

[21] An increasingly important source of finance for many BSCs are the special projects put out to tender by government Ministries.

[22] For example, senior EU officials and advisors working on the first *PHARE* programmes in 1989-91 were generally of the opinion that local governments in Central and Eastern Europe were terminally inefficient and corrupt, and thus they had no choice but to avoid using them as possible instruments for economic development (interviews with senior EU officials and advisors conducted by the author in mid-1998).

[23] Many local governments in Central and Eastern Europe were particularly active in local economic development prior to, and just after, the collapse of Communism. See, for example, Bateman, 1987; Petrin *et al*, 1988; Coulson, (1995), particularly the chapters by Capkova on Slovakia, and Jepson, McDonnell and Mollov on Bulgaria; Hanspach and Vajdova, 1996). This potential was perhaps less in

the former Soviet Union, where local governments have been very slow to reform and become more business-friendly.

[24] For example, the Latvian authorities have reluctantly decided to cease financially supporting a significant section of its existing - in this case *PHARE* - BSC network because it has essentially become a network of commercial consultancy companies. They are now in the process of establishing their own network of field offices, attached to local government economic departments, to work with new starts, growth oriented SMEs, and the unemployed considering self-employment - i.e., introducing exactly what the original BSCs were supposed to be (National Programme for the Development of SMEs in Latvia, Ministry of Economy, 1997).

[25] One fairly standard reason for this is that once the public sector divests itself of the assets and accumulated skills required to undertake a particular public service (e.g., vehicles, property, machinery, skilled employees, institutional memory) and consumes the proceeds of any sell-off of these assets, the re-acquisition of such assets becomes prohibitively expensive for any public body to contemplate. The private sector can then safely raise prices knowing that the formerly cheaper public contractor faces an almost insurmountable entry barrier if it wants to get back into business once more.

[26] Perhaps this is no bad thing, since one of the major ways of making "cost-savings' through privatisation in the UK has been through job losses, combined with wage reductions, fringe benefit cuts and worsening working conditions for those employees remaining (see for example Hastings and Levie, 1983).

[27] Reporting on the experience of many Donor organisations, Gibson (1997) noted that the BSC employees should be entrepreneurial and should aim for a high degree of commercialisation in all their operations.

[28] Alternatively, by selling the agency to someone else. In a number of cases, entire networks of agencies have approached the major international consultancy groups asking to become part of their operations, with the existing agency managers becoming partners.

[29] This type of self-enrichment mentality is not confined to Eastern Europe. In the UK, for example, it was evidenced by the privatisation of the mutual society movement. Founded in the mid-1800s by citizens concerned to ensure that poorer people would be able to gain access to cheap credit for housing, the mutual societies were given free rein for profiteering under the aggressively selfish business culture given legitimacy by the Thatcher administration.

[30] Less charitably, Strange (1998, p 120) makes the point that the EBRD was only interested in normal commercial returns, plus investing its own cash in the money markets, so as to underwrite its pretensions - or those of its then head, Jaques Attali - to being a "heavy-weight' merchant bank.

[31] To give just one example, the author conducted interviews with a sample of ten established firms in receipt of *PHARE* loan finance in Bulgaria and Hungary. It was clear that at least eight, and possibly all ten, would have had no difficulty whatsoever in accessing financial support from the local banking system. In fact, several firms had turned down offers of financial support from the commercial banks at the same time as they were applying for *PHARE* loan support.

[32] However, in some financial programmes, such as the EU *PHARE* programmes in the first few years of operation, the efficiency measure which staff worked towards was "the rate of disbursement of loan

funds'. It would have been hard to design a more ineffective measurement of the impact of these programmes on the local economy.

[33] The phenomenon of "donor competition', where each agency seeks the most high profile projects to support, is well known and it often plays a role here. In addition, the short contracts or assignments in individual countries by the international assistance agency personnel militate against getting to grips with the more difficult SME projects. Even the contracted consultancy companies actually implementing the majority of the SME financial support programmes are keen to restrict their support to high-profile entrepreneurs, because it naturally makes their corporate performance look that much more impressive.

[34] Many venture capital institutions are privately unsure of the role of financial support schemes operated by the major international assistance programmes. This is precisely because they have a tendency to cream off some of the high growth "gazelles' for their own programmes of financial support, leaving many of the lesser projects to the venture capitalists. Of course, the preference of many Eastern European entrepreneurs for loan capital instead of equity doesn't help.

[35] In Estonia the government's SME Fund is explicitly directed to finance only those business proposals which have already been officially rejected by the commercial banking sector. *Inter alia* a business proposal must be accompanied by require proof that it was previously turned down by the commercial banking sector (Ministry of Economic Affairs, 1998).

[36] Interview with KfW official, German Embassy, Sofia, October 1998.

[37] For example, in interviews by the author with 28 small enterprises in Bulgaria, Hungary and Slovenia in receipt of financial support from an international agency, more than one half had used this support to renovate and/or purchase business space. One reason given by one (enterprising) respondent was that the coming accession of his country to the EU would result in a major price rise in business space, and he wanted to cash in when the time comes.

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