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## **The Role of the Rural Non-Farm Sector in the Reconstruction of the Balkans**

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### **Abstract**

The purpose of this paper is to improve our understanding of the role of the non-farm rural economy in assisting the rural reconstruction of the Balkans (specifically, Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania). The rural diversification, migration, employment, poverty and policy implications for this in terms of economic development and reconstruction as part of an integrated rural development strategy are crucial to both appropriate institutional and policy developments in the Balkans. We compare the Balkan States to China's Township and Village Enterprises (TVEs) because recent studies suggest that the rural non-farm economy (RNFE) may provide an important and dynamic contribution to economic growth, whether linked to the farm economy or not. While diversification into non-farm enterprise activities may provide important income smoothing and risk management strategies to rural households that are also involved in agriculture, enterprise activities located in rural towns and villages in China have eclipsed agricultural activities in terms of output and income. This paper examines the role that the RNFE may play in the development and reconstruction of the Balkan States, and seeks to identify factors from the successful Chinese TVE experience that are replicable to the Balkans. Recommendations are made concerning the policy and institutional environment that can best foster the growth of the RNFE, and the role of local government in supporting rural enterprise development.

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# 1 INTRODUCTION

During the central planning era, rural development in transition economies<sup>1</sup> was frequently associated with the agricultural economy. In recent years, the focus has begun to shift to also include the non-farm rural economy, defined as being all those activities associated with wage work or self-employment in activities that are not directly derived from crop and livestock production, but located in rural areas. Thus, non-farm activities might include manufacturing (i.e. agro-processing, commerce etc) and be accumulative (e.g. setting-up a small business), adaptive (switching from cash crop cultivation to commodity trading (perhaps in response to drought), coping (e.g. non-agricultural wage labour or scale of household assets as an immediate response to a shock), or survival as a response to conflict). Two processes are apparent in driving the rural non-farm economy (RNFE): *demand-pull*, where rural people respond to new opportunities; and *distress-push*, where poverty, strife, or other circumstances cause a lack of on-farm or urban-based opportunities, and drive people to seek non-farm employment. In the former Yugoslavia distress-push factors may play an important role in driving the type of non-farm activities and economic diversification strategies pursued by the rural population. In the majority of the Balkan states, the agricultural sector is failing to provide a decent source of livelihood for its workforce, especially the poor. Given this situation, the rural labour force cannot be productively absorbed in the agricultural sector and poverty is growing. For the rural population, this is where the rural non-farm sector has the potential to play an important role in poverty alleviation.

In the post-conflict Balkan states, the issue is not just development and transition, but reconstruction. Infrastructure, market networks, government, the institutional environment, civil society, and new enterprises are at the centre of reconstruction efforts in Bosnia-Herzegovina, Albania, Croatia and the Federal Republic of Yugoslavia.<sup>2</sup> In these countries the transition process was severely disrupted, and the informal economy assumed a greater level of importance than in other transition economies, due to the State's inability during recent conflicts to sustain even a reduced role in the economy. The experience of many Less Developed Countries (LDCs) (most notably China) demonstrates the important role of the state in fostering the process of both industrial and agricultural development. The excessive run-down of the state sector in many Balkan economies may in the long-run prove detrimental to reconstruction, industrial and agricultural development. Those Balkan States which have avoided conflict and significant internal strife have nevertheless been negatively affected by wars in neighbouring states, resulting in a sharp contraction in demand for traditional exports from established markets, disruptions to transport routes, falling foreign investor and tourist confidence, and refugee migrations are the main economic and social effects.

The purpose of this paper is to improve our understanding of the role of the non-farm rural economy in assisting the rural reconstruction of the Balkans (specifically, Albania, Bosnia-Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania). The rural diversification, migration, employment,

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<sup>1</sup> The term transition economies is used to describe the new political geography of the former CMEA, comprised of the CETE-5 (the Czech Republic, Hungary, Poland, Slovakia, Slovenia), the Balkans (Albania, Bosnia-Herzegovina, Bulgaria, Croatia, the FYR Macedonia, Romania and the Federal Republic of Yugoslavia), the Baltic States (Estonia, Latvia and Lithuania), the former Yugoslavia, and the Commonwealth of Independent States (Russia, Ukraine, Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Uzbekistan).

<sup>2</sup> Slovenia is not included here as a post-conflict state, as the very brief conflict in the early stages of the break up of former Yugoslavia left no significant or lasting economic repercussions. Kosovo and Montenegro are both incorporated within the definition of present-day Yugoslavia. While FYR Macedonia is not a post-conflict state, it has suffered economic sanctions at various points in the 1990s, and severe post-independence economic disruption due to its previously high level of integration into the former Yugoslavia economy and infrastructure.

poverty and policy implications for this in terms of economic development and reconstruction as part of an integrated rural development strategy are crucial to both appropriate institutional and policy developments in the Balkans. We compare the Balkan States to China's Township and Village Enterprises (TVEs) because recent studies suggest that the non-farm rural economy may provide an important and dynamic contribution to economic growth, whether linked to the farm economy or not [Reardon, 1999]. While diversification into non-farm enterprise activities may provide important income smoothing and risk management strategies to rural households that are also involved in agriculture, enterprise activities located in rural towns and villages in China have eclipsed agricultural activities in terms of output and income.

This paper examines the role that the RNFE can play in the development and reconstruction of the Balkan States, and seeks to identify factors from the successful Chinese TVE experience that are replicable to the Balkans. Recommendations are made concerning the policy and institutional environment that can best foster the growth of the RNFE, and the role of local government in supporting rural enterprise development.

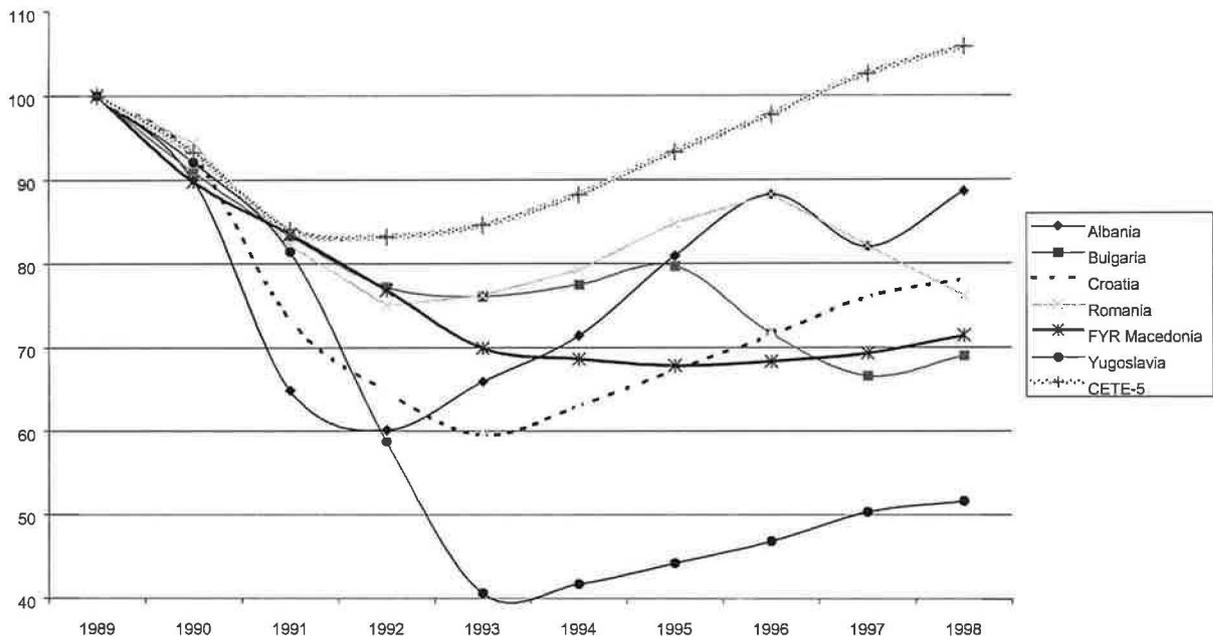
## **2 THE BALKAN ECONOMY 1989-1999**

The Balkans (south-eastern Europe) have been affected by conflict over the past 10 years, either directly in the case of Albania, Bosnia-Herzegovina and the Federal Republic of Yugoslavia, or indirectly as is the case for the remaining states in the region. Historically the Balkans has always been amongst the least developed regions of continental Europe. In general these economies have also lagged behind in the process of EU integration. Only Bulgaria and Romania have association agreements with the EU; the rest for a variety of reasons have been excluded from the process.

The regional economy has been destabilised for most of the last decade (1989-1999) by the break-up of the former Yugoslav Republic and the ensuing conflicts in Bosnia-Herzegovina. The negative side-effects of the UN sanctions on Yugoslavia were particularly detrimental for some of the countries in the region (Albania, Bulgaria, Romania and the FYR Macedonia). The effects of this amounted to a strong external shock that added to an already severe transformational recession, which in turn also deterred foreign direct investment (FDI).

Figure 1 shows that the last decade has been one of economic decline for the Balkans with the possible exception of Croatia (which has started to show signs of sustained economic growth). This shows that the cumulative decline of GDP in the Balkan economies has been much greater than in the CETE-5 and in 1998 was still below 80% of its pre-transition (1989) level. In the CETE-5, the depth of total output decline varied, but at its lowest point was roughly 75-85% of the pre-transition level. By 1998, GDP in most of these countries had regained its 1989 level, in Poland this was surpassed in 1996. Davis (1997) shows that by 1993 the CETE-5 had begun to recover and that by 1996 they had all achieved positive growth rates. Similarly, Table 1 shows that in terms of employment levels, employment is approximately 25% below its 1989 level and constitutes a considerably larger decline, and thus much higher rate of unemployment than in the CETE-5. The agricultural sector seems to have become a repository of much of the excess labour showing a significant increase in total sectoral employment in the Balkans over the decade (with the possible exception of Croatia). These negative economic developments have forced many people out of employment, or encouraged high rates of migration (much of it illegal). Although the data is not very reliable, widespread poverty, unemployment and social dislocation has helped encourage this process.

Figure 1: GDP in the Balkan Transition Economies, 1989-1999 (1989=100)



Source: OECD (1999) *Agricultural Policies in Emerging and Transition Economies*, Vols I and II.

Note: Central European Transition Economies (CETE-5) Czech Republic, Hungary, Poland, Slovakia, Slovenia.

## 2.1 THE RURAL ECONOMY

Comparing real standards of living is a very difficult thing to do in Central and Eastern European Countries (CEEC) (see Milanovic, 1999). However, if we compare average per capita GDP (on a purchasing power parity basis, PPP) in the Balkans to the CETE-5 and the EU average over the last decade, income disparities vis-à-vis the rest of Europe have increased. At present, the difference in average GDP per head (PPP) between the Balkans and the CETE-5 is comparable to that between the CETE-5 and the EU average income. Davis (1997) shows that correcting exchange rates for purchasing power parity (PPP) would bring CEFTA states up to about 1/3 of EU per capita income levels and the Balkans to 1/5 of EU levels. This seems a more realistic and meaningful comparison. However, even these gaps will take three to six decades of CETE-5 growth at twice the EU rate (6% per annum rather than 3% per annum) to eliminate. For the Balkans, the time required for such catching up is even more alarming, unless economic performance can be improved and sustainable economic growth achieved.

Conflicts in the Balkans have had devastating effects on agriculture. Pre-war agriculture in Bosnia-Herzegovina accounted for about 10% of GDP, and about 20% of permanent employment (World Bank 1999a). Agriculture in Bosnia-Herzegovina also provided part-time employment to 20% of the population. In pre-war Kosovo the active population engaged in agriculture amounted to over 50% of the active population and around 70% of the labour force, while the value of primary agricultural production was estimated at 30% of provincial GDP (Kodderitzsch & Veillerette, 1999). As a result of the war in Bosnia agricultural production dropped severely, up to 70% of farm equipment and 60% of livestock were lost, farm buildings were destroyed, forest roads suffered heavy damage, food-processing and marketing systems were disrupted, and experienced farmers migrated to urban areas while many urban dwellers with little farming experience moved to rural areas (World Bank 1999a). The impacts in Kosovo were similar, with severe damage to farm infrastructure and equipment and

significant losses to livestock. In conflict and post-conflict situations the importance of non-farm sources of income increases. In a survey conducted in Kosovo for the World Bank, it was estimated that while in 1997 50 per cent of farm household income had come from farming, in 1999 that had fallen to only 11%. The significance of remittances had increased over the same period (as had aid donations) (Kodderitzsch & Veillerette 1999).

During 1997- 1998 gross agricultural output declined across the region (with the exception of Albania), for example in Bulgaria output declined -6.2%, Croatia by -1.4% and in Romania by -7.6%. In development theory, the long-term inverse relationship between economic growth and the share of agriculture in total employment holds in most transition economies, but both the transitional adjustments and post-conflict problems in the Balkans have substantially affected this relationship over the last decade. The increase in demand for labour outside agriculture, shifting comparative advantage from agriculture to other sectors of the economy, and the introduction of labour saving technologies in agricultural, all of which are correlated with economic development and typically cause an outflow of agricultural labour does not appear to hold in the Balkan context (with the possible exception of Croatia). Table 1 shows that over the past decade the share of agricultural labour in employment and of agriculture as a share of GDP has significantly increased. Over the last decade, the share of agricultural labour in employment in Albania rose 32% and in Romania by 41%. Again, Croatia is a notable exception to the general trend as there agricultural labour over the period fell by 25%. The privatisation of land, price liberalisation and removal of subsidies have impacted on the wider rural economy. Negative trends in the agricultural sector have impacted on the non-farm economy, reducing its ability to absorb the excess resources (i.e. labour) no longer required in the farm sector. Not surprisingly, rural income levels have also in general been falling relative to urban incomes.

*Table 1: Balkans in comparison with CETE-5 and the EU-15*

Country	GDP Growth %		Inflation		Share of agriculture in GDP (%)		Average share of household income on food (%)		Unemployment (% of unemployed)		Share of agricultural sector in total employment (%)	
	1997	1998	1997	1998	1989	1997	1989	1997	1997	1998	1989	1997
Albania	-7	8	42	8.9	32	62.6	56.5	75	13.6	16.9	49	64.5
Bosnia & H			12.2						39	38.5		
Bulgaria	-6.9	4.3	579	1.5	11	18.8	38.1	54.3	13.7	13	18.1	23.3
Croatia	4.5	3	4	5.2	10.1	9.3	40	0	17.5	17.4	15.2	11.3
Romania	-6.5	-5.5	151	41	13.7	18.5	69.9	58.6	9	10	27.5	39.7
FYR Macedonia	0.8	1.5	4.5	-1					42			
Yugoslavia	7.4	2.6	10.3	45.7					25.6			
Region	Average GDP growth %		Average Inflation		Share of agriculture in GDP (%)		Average share of household income on food (%)		Unemployment (% of unemployed)		Share of agricultural sector in total employment (%)	
	1997	1998	1997	1998	1989	1997	1989	1997	1997	1998	1989	1997
Balkans	-1.3	2.3	114.7	16.9	16.7	27.3	51.1	47.0	22.9	19.2	27.5	34.7
CETE-5	4.5	3.7	11.5	9.7	9.5	4.8	24.5	16.7	10.5	10.2	14.9	6.7
EU-15	2.7	2.8	1.8	1.8	3.1	2.5	17.1	14	11.2	10.6	-	5.7

Source: OECD (1999) Agricultural Policies in Emerging and Transition Economies, Vols I and II; UN/ECE (1999) Economic survey of Europe 1999, No. 2.

Note: Central European Transition Economies (CETE) Czech Republic, Hungary, Poland, Slovakia, Slovenia.

The informal, or 'shadow' economy has increased in relative importance in the transition economies of central and eastern Europe, and markedly so in the post-conflict Balkan states. While the informal economy is estimated to account for between 10 and 15% of recorded GDP in more 'orderly' transition economies (for example the Czech Republic and Hungary), the figure is up to 50% for post-conflict transition economies (Milanovic, 1998). Even before the recent Kosovo conflict, the informal economy in the Federal Republic of Yugoslavia was estimated to have risen from 32% of official GDP in 1991 to 54% in 1993 (ibid.). The informal economy provides the dynamism to the RNFE that is crucial to the transition and reconstruction process, and is an important source of both rural livelihoods (as a source of full-time or supplementary income or employment) and enterprise creation.

In addition to the above, the rural economy of the Balkan states (to varying degrees) appear to share the following characteristics:

- damaged physical infrastructure (housing, roads, electricity supply etc)
- severe under-investment in physical infrastructure and utilities, leading to very poor state of repair
- dislocated populations, with uneven societal structures (particularly in terms of proportions of internally displaced, proportion of dependants within households)
- inadequate or underdeveloped institutional structures (particularly the case in Bosnia)
- refugee populations (including internally displaced persons in post-conflict countries), which place strain on the social and economic infrastructure
- disruptions to trade, especially transit trade, and a low level of demand in neighbouring countries for rural exports
- falling investor confidence, of local and foreign investors and also of consumers

### 3. RURAL NON-FARM ACTIVITY IN THE BALKANS

There is growing evidence that in the Balkans and Central and Eastern Europe (CEEC), rural households commonly depend on non-farm sources for 30-50% of their income (see Davis and Gaburici, 1999; Greif, 1997), which is a similar proportion to those found by Ellis (1999) in southern Africa (on average 40%) and in South Asia and Latin America where rural households are around 60% dependent on non-farm income (Lanjouw, 1999; Reardon et al., 1999). The share of population involved in non-farm activities varies quite widely, ranging from around 7% in Poland to 65% in Slovenia. In the CEECs the share of enterprises with supplementary activities is highest in regions with large-scale agriculture (15-20%). In countries with scattered rural structures the demand for additional employment is extremely high (e.g. Bulgaria, Poland, Romania and FYR Macedonia), however opportunities are less numerous. Creating more opportunities for off-farm work in the Balkans has become a formidable task for policymakers when the high levels of rural unemployed and depth of poverty in the Balkans is compared to that of CETE-5 and the EU (Milanovic, 1999). In the Balkans the agricultural sector is failing to provide a decent source of income for its workforce, especially the poor. Given this situation, the rural labour force cannot be productively absorbed in the agricultural sector and poverty is growing. For example, in Bulgaria and Romania despite steady GDP growth in 1993 and 1994, the poverty gap as a percentage of GDP rose to a level of nearly three times what it had been at the beginning of the transition.<sup>3</sup> For the rural population, this is where the rural non-farm sector has the potential to play an important role in poverty alleviation.

Arguments in favour of paying greater attention to the non-farm sector in the context of rural economic development in the Balkans centre around: the sector's potential to absorb excess labour from the agricultural sector and urban-rural migration; the importance of the sector in contributing to income growth and in promoting a more equitable distribution of income; and the need to promote enterprise activity in rural towns and villages as part of the transition and reconstruction process. In the Balkan states a sizeable part of the population still lives in rural areas (see Table 2). Although rural development policies and interventions have tended to focus on the agricultural sector, the rural population derives its income from multiple sources – even where the national economies are relatively undiversified. Income derived from non-farm activities is used to increase or smooth income, reduce risk (through diversification) or improve future employment prospects (by acquiring skills or capital). These livelihoods may exist in rural areas, or require daily travel to rural towns, or may involve migration and remittances.

**Table 2: Population in rural areas (% of total population)**

	1996	1997
Albania	62.4	62
Bulgaria	31.3	31
Croatia	43.8	43.4
Romania	43.6	43.2

Source: OECD (1999) *Agricultural Policies in Emerging and Transition Economies*, Vols. I and II.

A large proportion of the non-farm activities undertaken is livelihood-oriented, and is neither a source of innovation nor a provider of significant economic returns. These activities play a key role

<sup>3</sup> The poverty gap describes the average 'distance' of the poor below the poverty line, the greater the gap the deeper the poverty (Heinrich, 1998).

as diversified income sources within the livelihood strategies of rural households, a role which has become increasingly important in the context of a declining formal sector and the inability of the state to provide similar levels of social security support that were provided pre-transition. By providing an alternative or complementary source of income and employment to agriculture, non-farm activities may help sustain the viability of the rural economy, and in so doing reduce rural-urban migration which results in excessive or over-rapid urbanisation.

Diverse income portfolios often include income from agriculture, migration, remittances, daily travel to nearby urban employment, local wage labour opportunities or self-employment in trade, agro-processing, tailoring or services (see Table 4). Without this supplement of revenues a great part of the rural economy and society in the Balkans could not survive. However, reliable statistical information about income data, is scarce due to insufficiencies of the national statistical systems and because of a great deal of informal (hidden or illegal) activities as typical concomitant phenomena of transition economies.

Whilst labour allocation to non-farm activities has decreased on large-scale farms with the spinning-off of these activities during the transition period, part time farming and non-agricultural activities appear to have grown in importance for small-scale farms. For example, in Albania, which is dominated by small-scale private agriculture, non-agricultural incomes are very important and include mainly service activities and remittance payments to rural households from post-1991 emigrants mainly working in Greece and Italy. Similarly, Davis and Gaburici (1999) found that a number of small farmers in their survey of the development of rural financial markets and private farming in Romania have obtained non-farm income through non-farm wages and pensions<sup>4</sup>. The monthly average level of non-farm income per farm is Lei 948,400. Those farms having close links to the urban and tourist markets mainly earned incomes greater than the average.

The non-farm income component of family income was also prominent because only half the household members reported full-time employment on the family farm. Most of the others devoted the rest of their working time to off-farm occupations. Davis and Gaburici (1999) found that on average 35% of the sample earned non-agricultural incomes. Moreover, 57% of their non-farm income respondents were wage earners. In 1996 around 23% of the farms surveyed had at least one pensioner, 18% two and 5% 3. Table 3 shows that the value of pension income is around 10% of monthly off-farm earnings. Davis and Gaburici (1999) have ranked the primary and secondary sources of income according to their importance for total farm income in Table 3. Clearly, on-farm incomes are of prime importance to the financial viability of private farms, but off-farm wages (26.8%) are also an important primary source of income. Regarding secondary income sources the former trend is replicated, with the exception that small business (primarily the sale or trading of farm services, usually locally) at 15.5% are an important source of secondary income. Davis and Gaburici (1999) found that off-farm income accounted for as much as 45% of total farm income in Romania. In most CEECs an estimated 20% of family farms participate in non-farm activities, although this varies widely (see Table 5).

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<sup>4</sup> Their research was based largely on two detailed surveys of the development of rural financial markets and private farming in Romania conducted during 1996-1997. The analysis focused on the private farm and its relation to the financial market. Based on land title differences and organisational form of the farm, three private farm management types were identified for the Brasov, Dolj and Timis regions of Romania. The survey covered a sample of 220 private farms in nine villages (see Heidhues, Davis and Schreider, 1998; Davis and Gaburici, 1999).

**Table 3: Primary and Secondary Income Sources in Romania - 1997**

	Primary income source		Secondary income source	
	N	%	N	%
<i>Sale of vegetable products</i>	68	30.9	76	34.5
<i>Sale of animal products</i>	56	25.5	61	27.7
<i>Small business (Trade etc.)</i>	29	13.2	34	15.5
<i>Wages</i>	59	26.8	22	10.0
<i>Pensions</i>	8	3.6	12	5.5
<i>Others</i>			2	0.9
<i>Total</i>	220	100.0	207	94.1

Source: Davis and Gaburici (1999) - Romania: Rural finance survey 1997/98.

Results from Davis and Gaburici's (1999) logistic regression model of the determinants of farmer access to rural finance shows that the existence of off-farm sources of income from e.g. a small business (excluding the sale of agricultural products) would increase the probability of obtaining credit by 2.7 times. Access to sources of non-farm income in the form of wages and/ or a pension is of great importance to small private farmers in gaining access to rural finance. Romanian banks appear to prefer lending to these farmers because they consider them to be less of a risk, as they are not dependent on farming as the sole source of income. Therefore the development of additional rural industries and an adequate national rural development programme will be essential to the financial viability of small private farming in Romania<sup>5</sup> and other Balkan states.

Recent studies by Davis and Gaburici (1999), Brietschopf and Schreider (1999) show that there remains a lack of non-farm employment opportunities in the rural economy and that the Government needs to develop a coherent set of policies to promote local private activities downstream and upstream agriculture, such as agro-processing, input and mechanical service mechanism. This not only requires an adequate macroeconomic environment and institutional support in terms of credit, training, advisory services, information technologies and the simplification of administrative and bureaucratic procedures. Both Jehle (1998) and Brietschopf and Schreider (1999) show that business creation and development largely depends on the availability of credit and development of human capital (particularly educational levels). In the Balkan states the main issue of education is to foster employment and business on a regional basis. In Romania, current World Bank (National Training Board) and Government initiatives are focused on developing a new programme of rural comprehensive and vocational education which emphasises agricultural education (farm management, production technology, food processing), craft education (craft techniques, management, information technology, consulting), and services (marketing, accounting and business management).

As most of the new rural SMEs in Romania are in their infancy, the government is currently considering a number of potential interventions: investment grants for rural entrepreneurs starting or

<sup>5</sup> The development of projects such as the "Romanian-German: Establishment of a Farmers' Producer Association (FAMD)" during 1993 in Vatra Dornei, Eastern Carpathian mountains promoting rural development, small private farmers self help organisations, the purchasing, sale and use of farm inputs should be greatly encouraged. Perhaps the most well received aspect of the project has been a program for local women to encourage non-farm income generation, which began in 1995. This was promoted through the sale, design and improved marketing of traditional wool products, dress making and green houses for home food supply. Although the project is small, this type of activity has proved both financially successful and a useful tool for fighting rural poverty [FAMD, 1998]

developing a business; and the subsidisation of start-up activities provided by small business development centres or business incubators for the benefit of rural SMEs.

In Romania, but also most of the other Balkan states, some of the social problems related to agricultural reform, e.g. over manning or high hidden unemployment, an ageing rural demographic structure, low incomes and rural depopulation need to be addressed by an effective “job creating” rural development strategy. Commercially oriented and private farmer centred agricultural reform in Romania remains constrained by a poor enabling environment, a lack of political will, cronyism and macroeconomic instability. Less incentive distorting measures to support the private farming sector could be implemented, instead private farmers remain central to the national food security but poorly rewarded for their efforts.

**Table 4: Main sources of non-farm and additional incomes**

Country	Percentage share of farms involved				
	Second jobs		Self employment		Sales receipts
	I	C**	B	T	PM
Czech Republic	-	26	21	(3)	-
Slovakia	-	(25)	(25)	(3)	-
Hungary	< 1	30	(50)	(2)	(2-10)
Slovenia	14		17		(50)
Poland	-	38	26	(3)	7
Romania	-	(20)	(10)	-	(2-5)
Latvia	-	(20)	(10)	-	(5)

Source: Greif, F. (1997) *Off-farm income sources and uses in Transition Economies*, FAO/REU mimeo.

Notes:

I Commuting to work places in industries or abroad

C Work in construction and other services to agriculture

B Business

T Rural tourism

PM Processing and/or direct marketing of agricultural products

\*) Figures in brackets are rough estimates: Selected items in percent of farms involved

\*\*\*) To a high extent these activities consist of illicit work.

**Table 5: Participation in non-farm activities (1996-1997, estimated)**

Country	Rural population	Persons engaged in agric.	No. of farms & plots	Farms on subsistence level	Performing additional & subsidiary activities			Rural unemployed
	(1000)	(1000)	(total)	(%)	farms	%	persons	%
Czech R.	3,610	760	26,900	*)	4,170	15	120,000	(5)
Slovakia	2,255	580	8,900	*)	1,800	(20)	115,000	15
Hungary	3,690	1,900	1,200,000	80**)	107,000	9	250,000	14
Slovenia	736	350	156,700	10	100,000	65	180,000	8
Poland	14,700	8,800	2,048,000	60	162,000	5-7	480,000	40
Romania	9,490	2,750	3,190,000	75-90	320,000	(10)	275,000	35
Latvia	-	-	-	*)	-	-	-	(35)

Source: Greif, F. (1997) *Off-farm income sources and uses in Transition Economies*, FAO/REU mimeo.

Notes:

\*) Realistic data about small and private holdings or plots not published.

\*\*\*) About 1,100,000 “mini producers” normally produce for self-supply but are mainly a secondary activity of the non-agricultural population. This or a similar situation may be observed throughout most of CEECs and NIS but is not clearly registered.

Greif (1997) shows that in the CEE-5 and the Balkans the main utilisation of non-farm incomes are according to their relative importance as follows:

- consumption and improvement of living standards;
- investment into non-farm business in rural areas;
- investment into up- and downstream activities; and
- investment (or expansion) of farm business.

The key factors driving these non-farm employment changes are the impact of the macroeconomic environment and structural reforms on labour adjustment in agriculture. These factors in turn, depend upon how the reforms affect demand for labour in agriculture; how they affect the opportunity costs for farm labour (including the demand for labour outside agriculture and access to social benefits); and how difficult it is for farm labour to move to other sectors, either rural or urban (OECD, 1999).

There are now a growing number of studies on the rural situation in Central and Eastern Europe (Csaki et al., 1998; Breitshopf and Schreider; 1999; Halasiewicz et al. 1998; Heidhues et al, 1998), experience of pilot rural projects, and a growing body of world-wide evidence of what works. Although the degree of cultural and economic variation between the transition economies is quite wide, there are a number of factors that they share in common, though not to the same degree of intensity:

- There are many problems, in terms of unemployment, low incomes and lack of economic opportunity, direct or hidden;
- High levels of hidden- and under-employment
- Levels of human capital, in terms of education and skills, are dramatically lower than in urban areas;
- Demographically, there is in some countries a potential growth in the size of the rural labour force;
- Health and other social services are not adequate;
- A whole range of infrastructure including roads, telecommunications, water and waste management are in need of upgrading;
- A lack of access to suitable rural finance and SME credit facilities; and
- There is very little support for business in the form of information and mutual organisation.

All of the above contribute to a sense of alienation and a lack of rural entrepreneurship. Rural populations are often comparatively disadvantaged (due to urban bias) in terms of access to skills, knowledge based technologies and credit through banks (Heidhues, Davis & Schreider, 1998; Swinnen & Gow, 1999). For the most part, farm sizes in the Balkans are so small that it is often largely a subsistence based enterprise activity providing small amounts of income rather than a commercial business. Although there are some signs of improvement, there remain many examples of poor support for the rural economy, to which we will return later in the paper.

## **4 RURAL ENTERPRISE DEVELOPMENT IN CHINA: THE TVE PHENOMENON**

Township and village enterprises (TVEs) in China are either collectively established by or initially based on and closely associated with rural communities such as townships and villages. These rural enterprises have developed rapidly and have contributed to China's rapid economic growth. In 1995 the TVE sector<sup>6</sup> produced nearly 30% of China's GDP, and industrial TVEs produced about half of the total industrial value added, profit and output. (Perotti, Sun, Zou, 1998). Moreover, TVE activity increased dramatically, with real total output rising by an average rate of 21% per annum from 1978 to 1995, and TVE exports increasing from US\$8 billion in 1988 to US\$ 84.3 billion in 1997 (ibid.).

### **4.1 FACTORS CONTRIBUTING TO THIS SUCCESS**

Township, village, and private enterprise sector development up to the early 1980s has been attributed to financial support from agriculture and the abnormal growth in the supply of production inputs from agriculture (Du Haiyan, in Byrd & Lin, 1990). Government policy changes permitted the shift of key rural factors of production to non-farm activities, and changes in the macroeconomic environment and in market conditions created space for the survival and expansion after this period.

This analysis however does not examine the important role of the local state in the rural industrial/enterprise development that has taken place in China. The support to TVEs provided by the local state has provided TVEs with a sense of security that has promoted long-term investment and development. While markets were in an early stage of development, the local government played an essential role in the organisation of economic and political activities, and in many cases were the only local institutions capable of settling disputes arising. (Perotti, Sun, Zou, 1998) Local governments were also essential in gaining access to outside resources, particularly bank loans.

The decentralisation of power to local governments has been identified as an important feature of the successful Chinese rural enterprise development (e.g. Bateman 1999). Decentralisation processes transferring responsibility to the local state for providing local education, infrastructure and social welfare combined with strong motivating factors for the local governments to support and promote TVEs. Township and village governments have been able to introduce radical and comprehensive policies and local institutions to support TVEs. The enthusiasm of the local state for supporting TVEs was motivated by revenue generation, employment creation, and a strong desire by the community to improve living standards and increase wealth. As a planned economy, officials of government agencies and state banks provided all four trading requirements (information, finance, delivery and assurance) in both product and factor markets. Entrepreneurial behaviour by local government was therefore also motivated by a desire to defend the role of the local state, as much as it was by the need to compensate for poorly developed markets (Hubbard, 1994).

The gradual approach to reform followed by the government, with the lowering of subsidies and state support and increased exposure to market pressures taking place over an extended period, is widely identified as a key component in the success of TVEs (Bateman, 1999; Byrd & Lin, 1990). China fits uneasily in the debate between hands-off market led policies to encourage rural enterprise growth on one hand and an active role for the state in enterprise activity on the other. In its transition from central planning China has not yet privatised industry or services extensively, while it is the local bureaucracies, which substantially managed the former planned economy, that are heavily involved in developing market-oriented businesses (Hubbard 1994). The role in China of the local state in

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<sup>6</sup> Defined in this context in a broad sense, i.e. including household-run and jointly owned private enterprises.

enterprise management and enterprise promotion has been an evolving one, and one that seems to be declining in its effectiveness as markets develop. Market development provides firms with the means to finance, employ, innovate, advertise, sell, transport and insure independently of government agencies. The role of local government and government agencies in managing transactions is thereby reduced (ibid).

Exposure to market pressures and to 'hard budget constraints' are viewed by policy-makers such as the World Bank and the EBRD as necessary to promote healthy enterprise growth.<sup>7</sup> Studies in transition economies have observed that a hardening budget constraint can have positive effects on enterprise performance. The EBRD's Business Environment and Enterprise Performance Survey, conducted over the past three years, finds that firms that operate in countries with relatively soft budget constraints (as defined by level of payment of taxes) also expand more slowly, and that sales growth is higher in those firms that report significant pressure from customers or from foreign competitors to develop new products and markets (EBRD 1999). Song and Gao (2000) found that the reduction of state subsidies to state firms has positive effects on managerial incentives towards enterprise restructuring. Budgetary subsidies to producers and soft government loans act to reduce the potential efficiency gains and innovation that can result from increased competition. Enterprises with soft budget constraints are able to persist in the inefficient use of resources and can pay less attention to price signals.

While some would argue that a temporary soft budgetary constraint has played an important positive role in the development of enterprises in China, others point out that the TVEs have faced hard budget constraints relative to state-owned enterprises, and that this is a principal factor explaining the difference in performance between the two forms of enterprises (Perotti, Sun, Zou, 1998). Local communities, and their governments, face financial constraints due to their limited size, and are relatively open to external market pressures due to the small size of the local markets. As a result the extent of subsidies that the local state can give to TVEs is limited. This is evident in the number of TVEs (several million) that had to close down or were taken over during the period of economic austerity in 1989 and 1990. In contrast the losses among state-owned enterprises (SOEs) soared but only a small handful actually went bankrupt (ibid.).

In the early years of TVE development, considerable impetus was provided by market liberalisation, with the protected industrial sector opened to new entrants after 1979. Foreign investments have also played an important role in TVE development, and part of the growth in TVE output has been exported. Foreign investors provided marketing networks abroad (particularly through overseas Chinese communities), foreign capital, and technology and management skills.

## **4.2 REPLICABILITY OF SYNTHESIS OF MAIN FEATURES AND LESSONS**

While the success of TVEs in China and the key role that the local state has played in promoting their success, is widely acknowledged, there are questions raised about its applicability and transferability. The wider context of transition from a planned economy to a more market-led economy has direct relevance to the Balkan states, but there are notable socio-political differences between China and the Balkan states. In addition to this, the involvement of overseas Chinese investors, and the marketing networks they had access to, were perhaps a unique component of the TVE's success.

Perhaps the key lessons that can be applied to the Balkans from the China experience are:

- that local government should play a positive entrepreneurial and facilitatory role, rather than a more negative role focused on the control, taxation and monitoring of enterprises

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<sup>7</sup> The term 'hard budget constraints' essentially means financial discipline: firms expected to pay bills on time with sanctions against non-payment, phasing out of subsidies, and no expectation of government bailouts.

- that transition to more market-based transactions and principles should be phased, allowing enterprises to successfully transition from the planned economy
- that enterprises should be exposed to hard rather than soft budget constraints
- that as markets develop the entrepreneurial role of government diminishes, and the role of government agencies in managing transactions should be reduced

## 5 POLICY OPTIONS FOR THE RNFE IN THE BALKANS

### 5.1 CURRENT POLICIES TO PROMOTE THE RNFE

At the beginning of the transformation process in transition countries, economic policies focused mainly on macroeconomic problems. The increasing income disparity between rural and urban regions was ignored. We now know that the increasing inter-regional divergence in the transition economies is one of the major transformation problems. This is, among other reasons, why the World Bank, Organisation for Economic Co-operation and Development (see OECD, 1996) and the European Union (EU) have formulated special rural development strategies (see Breitschopf and Schrieder, 1999; Davis & Pearce, 1999).

The role of the RNFE is explicitly recognised in the EU Accession states through support for pre-accession measures for Agriculture and Rural Development (SAPARD<sup>8</sup>). SAPARD represents the first occasion when the EU is demonstrating its commitment to accession to many in the agricultural and rural communities of the CEECs. The proposed EU priorities as recently set out in its draft SAPARD regulations are:

- to improve market efficiency;
- to adopt EU levels of quality and health standards in order to take part in the single market and to act on behalf of the EU at external borders; and
- to introduce measures to create new employment in rural areas.

Although *rural job creation* is well recognised as an important part of the solution of the farm income problem and also a rational response to the labour shedding consequences of farm and food processing modernisation, the current SAPARD measures do not explicitly highlight this as a priority, despite it being a necessary component of a coherent rural development strategy in the CEECs. Investments and improvements in market efficiency should have strong multiplier effects within a rural economy. However, the specific measures that might foster job creation and should be consistent with the relevant *acquis* might be constrained to agricultural situations, with incentives for SME start-ups neglected.

Clearly, EU SAPARD funding is *accession-driven* and has to be consistent with accession partnerships and the national programme for the adoption of the *acquis*. In the context of the Balkans SAPARD only applies to Bulgaria and Romania. Countries such as Croatia, Romania and Bulgaria that aspire to being included in the next wave of EU accession will not be insulated from pressures to restructure the farm sector, and the non-farm sector will likewise assume increasing significance to the viability of households and communities in rural areas. The input supply, output processing and

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<sup>8</sup> A special fund of 520 million Euro per annum over the period 2000-2006 was agreed at the Berlin Council for special assistance between all the applicant countries for agricultural and rural development (SAPARD) first mentioned in the accession strategy paper of the Madrid Council of November 1995.

distribution components of the RNFE are subject to pressures related to the changing farm sector, as well as to wider economic pressures and industrial trends.

The World Bank's approach to non-farm rural development is primarily *problem-driven*. The World Bank has focused its assistance strategy for CEEC countries on supporting these countries in their preparation for eventual membership in the European Union (EU), and in this context on systemic economic issues [World Bank, 1997]. In the post-conflict states the World Bank has been particularly active in the reconstruction efforts, and has targeted: the reconstruction of physical assets, re-starting economic activity, building and strengthening institutions and initiating the policy reforms of transition. World Bank-funded economic re-start initiatives that have benefited rural enterprises have included credit lines to SMEs and employment generation programmes (World Bank, 1999a).

To date for most multilateral donors, the single most promising way of achieving greater RNFE improvements (particularly in income and equity) has been to put emphasis on employment and small to medium sized enterprise (SME) creation. In rural areas disguised unemployment in the agricultural sector due to declining productivity should lead to a shift into the non-farm rural sector. However, market failure in transition countries often leads to the misallocation of production factors resulting in excessive rural labour market stress because of:

- the slow expansion of the private sector which could absorb the excess labour (from disguised unemployment in the private agricultural sector),
- the low formal qualifications and high average age of the agricultural labour force,
- the high market transaction costs for goods, services and production factors, and
- mobility constraints, which are augmented by shortages on the housing, market in transition economies.

A non-economic factor, education, is one of the key elements for SME development and entrepreneurship. It influences a wide variety of other bottlenecks for SME-formation. Among them the main problem (far ahead of others) is the lack of operating capital. Besides development obstacles that may be associated with access constraints due to a lack of financial, social and human capital, there are other bottlenecks. For example, insufficient road, communication and market infrastructure, and widening gaps in relative prices. Apart from these bottlenecks, deficient price information systems as well as a lack of extension and other services offering technical expertise represent impediments for potential entrepreneurs and existing SMEs. As a result, most donors and NGOs have placed great emphasis on SME and microfinance development at the core of their non-farm rural employment interventions in transition economies.

## **5.2 POLICY AND INSTITUTIONAL ENVIRONMENT CONDUCIVE TO ENTERPRISE CREATION AND DEVELOPMENT**

It is important that biases at the economic policy level be removed (i.e. distortions in capital markets caused by government intervention in interest rates and socially-owned agricultural land). Effectively functioning markets will provide the correct signals to encourage investment and specialism in areas of comparative advantage, will encourage the development of the private farm and non-farm sectors, and will encourage the efficient and realistic allocation of financial resources. Incentive-distorting measures that have been implemented to support the rural economy should be removed, except perhaps where it can be shown to be compensating for past deficiencies that have impeded growth in key economic areas. With respect to the remoter rural areas, policy reforms are needed to encourage mobility, promote efficient rural markets, and better target social assistance.

The lack of adequate social safety nets, infrastructure, and suitable education opportunities in remote rural areas are clearly areas in which increased investment and attention is needed. This will help

promote the development of the private sector, and over time redress the imbalance between urban and rural areas. Also, attention should be paid to the type of employment creation being promoted in the rural non-farm sector, i.e. low-skilled and relatively paid, or more highly-skilled and specialised

Factors acting as a constraint to the development of the private farm sector, such as poorly developed or inefficiently functioning financial markets and lack of marketing information, should be recognised as also affecting the growth of the non-farm sector. Rural financial service provision is key to both the farm and non-farm sector, and it may be that a healthy non-farm sector attracts financial service providers who would otherwise have been put off by the increased risks and complications of agricultural credit.

Where privatisation and demonopolisation has occurred, it has been moderately successful, but probably needs to be deepened throughout the region. Also government policies which are incentive distorting can further worsen the situation. For example in Bulgaria the prevalence of cost-plus pricing behaviour throughout the food chain (largely at the expense of producers), but subsidised by the state, preserved inefficient former state integrator structures; whilst also crowding out potentially more efficient competitors (co-operatives, western investors etc.) [Ivanova, 1995; Davis, 1996].

The provision of public services and infrastructure to rural areas is key to attracting investment and promoting SME development. Population centres in rural areas can constitute key growth points. Incentives such as business start-up assistance for diversification of economic activities should be available for a range of rural businesses (usually SMEs). SMEs and small farms should also receive priority in publicly funded agricultural research, extension and in marketing and credit supply.

Barriers to entry to employment in the RNFE need to be addressed. Vocational training improvements should be utilised to assist those within agriculture to shift to other jobs or in the case of children from farms to have sufficient skills to avoid having to enter the agricultural sector.

Equity considerations logically imply the full participation of poorer people in rural policy formulation processes. They need to be consulted on the priorities for public investments from which they are expected to benefit or through taxation help finance. It is therefore important that methods are used or developed whereby this participation is facilitated both prior to a non-farm rural development project and through subsequent evaluations of it.

Institutional reconstruction to mitigate market and government failures and complement opportunities offered by the market and the state, is needed. However it should be noted that institutional change takes time and cannot be implemented in an abrupt way. NFRL development strategies should not only provide incentives for the rural population to engage in profitable non-farm rural employment activities but should also be based on a consensus among interest groups involved in or by the reform process. Consensus and credibility help form a strong base for successful reforms.

### **5.3 POLICIES THAT FOSTER POSITIVE LINKAGES WITH THE AGRICULTURAL SECTOR**

In order to foster the positive linkages between the farm and non-farm sectors that have been outlined in this paper the following general policy recommendations relate to agricultural support policies:

- the removal of distortions to rural markets (including the land markets, produce markets, financial markets, and so on) resulting from government policies or subsidies
- concerning the agro-processing sector, privatisation would promote competition within sectors, and should at the same time encourage investment
- policies that favour the farm sector at the expense of the non-farm sector are detrimental to the development of the rural economy and the livelihoods of those dependent on it

- agriculture needs to be brought fully into the market economy
- regional farm structures should be one of the variables for determining the regional allocation of any World Bank and EU funds, and there should be cut-off points (both a minimum and maximum) for farm based support. A more general measure to encourage a better farm structure would be farm amalgamation or even pre-retirement pension schemes.

#### **5.4 DECENTRALISATION ENABLING A POSITIVE AND ACTIVE ROLE FOR LOCAL GOVERNMENT**

The experience of China, and indeed of other countries such as Korea and Chile, demonstrates the important role of the state in fostering the process of both industrial and agricultural development. The excessive running down of the state sector in many transition economies may in the long-run prove detrimental to agricultural development.

Decentralisation of government functions to the district level is key to facilitating responsiveness in decision-making to specific local conditions, and thereby helping ensure better distributional characteristics. Decentralised decision-making may indeed be necessary due to the heterogeneity of the rural non-farm sector providing little scope for general broad policy descriptions (see Lanjouw, 1999). However, this process must be accompanied by capacity building of local government, local-level democratisation, and the transfer of fund-raising powers from the centre.

In a comprehensive study of decentralisation policies made by Bardhan and Mookerjee (1998), they found that decentralisation is more effective in providing services if the following four conditions are satisfied:

1. local governments are not vulnerable to capture
2. local governments have access to adequate local financing sources
3. there are no interjurisdictional externalities in service provision, and
4. local governments have all the bargaining power and access to relevant cost information vis-à-vis public enterprise managers.

If any of these conditions is absent, then decentralisation may actually perform worse than a centralised system.

## CONCLUSIONS

The RNFE in the Balkans has an important role to play in promoting the transition to a market-led rural economy, and in the reconstruction of the rural areas of post-conflict states. The non-farm sector has the potential to absorb excess labour from the agricultural sector and urban-rural migration; contribute to income growth and promote a more equitable distribution of income; and to promote enterprise activity in rural towns and villages. The relationship between the farm and non-farm sectors takes many forms, but on the whole is a beneficial one, with positive income and expenditure multiplier effects promoting a more viable rural economy. The RNFE also enables rural households to diversify income sources, smooth income streams, and more effectively manage risks.

In the transition from planned economies to market-led economies, and in the process of reducing the role of the state in enterprise and in controlling transactions, the Chinese example suggests that gradual phased transition is beneficial, with a key transitional role for entrepreneurial local government. Key policy-makers and donors now recognise the importance of institutional reform, development and strengthening at the earliest stages of the transition process. It is in this context that this paper would advocate a decentralisation of governmental functions that is accompanied by accountable fiscal decentralisation and effective civil society representation and participation. If any surviving interventionist and control tendencies can be avoided, then local government has a very important role to play in enabling and promoting private sector enterprise activity, for example through the measures outlined in section 5 of this paper.

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