



Natural
Resources
Institute

Social and Economic Development Department, Natural Resources Institute
Central Avenue, Chatham Maritime, Kent ME4 4TB, United Kingdom
Tel: +44 (0)1634 883449; Fax: +44 (0)1634 883706
Email: d.m.pearce@greenwich.ac.uk
WWW: <http://www.nri.org>

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'SME DEVELOPMENT AS AN ASPECT OF RURAL DEVELOPMENT'

Douglas Pearce
Markets, Finance and Enterprise Group

ABSTRACT

The rural population of Central Asia depends on agriculture for a significant proportion of household income. Yet production and productivity levels in the farm sector have fallen, and agriculture cannot continue to absorb excess labour without rural income levels falling still further. Small and medium enterprises have a key role to play in promoting equitable economic growth and reducing poverty in the rural areas of Central Asia. The small and medium enterprise (SME) sector is relatively dynamic, interacts favourably with the farm sector, and has the potential to absorb excess labour in the farm sector, and to provide rural households with key additional sources of income.

This paper assesses the significance of SMEs in the rural economy, and then builds on that assessment to analyse the policy and regulatory environment for rural SMEs. Policy responses to the particular challenges offered for SME development by rural areas are outlined. Practical recommendations for effective rural SME promotion by central and local government and governmental agencies are presented, with relevant examples and case studies where appropriate to provide a real world context.

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1. INTRODUCTION

The break-up of the Soviet Union has led to significant changes in the rural economy, and in the living standards of those that depend on it. Levels of agricultural production and productivity in Central Asian states¹ have fallen, sometimes dramatically, as have livestock populations. [Csaki & Fock, 1999; Csaki & Nash, 1998; OECD, 1999b, Schillhorn van Veen, 1995] While on-farm activities still constitute the backbone of the rural economy, non-farm activities and sources of income are increasingly significant for rural households.

Non-farm sources of income are varied, and are by no means limited to participation in the rural small and medium enterprise (SME) sector. Nevertheless, SMEs merit particular attention as potential sources of dynamism, factor and capital reallocation, economic growth, and rural employment creation. SMEs have the potential to absorb excess labour in the farm sector, and also to provide rural households with key sources of non-farm incomes. Household income derived from SMEs is used to increase or smooth income, reduce risk (through diversification) or improve future employment prospects (by acquiring skills or capital). By providing an alternative or complementary source of income and employment to agriculture, SMEs 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.

This paper will consider SMEs largely in the context of rural households diversifying from farm activities, as the farm sector is the dominant sector in the rural economy of much of Central Asia and other transition economies. Factors influencing participation in the SME sector through self-employment or through paid employment will be analysed, as will constraints on SME formation and growth.

Although official statistics recording the number of rural SMEs tend to include farms as SMEs, this paper will focus on those SMEs that are involved in any activity that is not on-farm production. This incorporates a wide range of sectors, including processing, trade, services, manufacturing and construction. Enterprise definitions used are the same as the definitions used by the European Union (EU) and increasingly by the European Bank for Reconstruction and Development (EBRD), which define 'micro' as an enterprise with less than 10 employees, 'small' as having between 10 and 49 employees, and 'medium' from 50 to 200 full-time employees. [EBRD, 1999a; EBRD, 1999b]

¹ Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan.

2. THE RURAL ECONOMY

In most transition economies² a sizeable part of the population still lives in rural areas, and the proportion of the total population living in rural areas in Central Asian countries is higher than that in many other transition economies. While between 30% and 45% of the population of Central and Eastern European (CEE) countries³ still lived in rural areas in 1994, the range in much of Central Asia was between 55% and 70%.

Table 1. Rural Population

	Rural Population
CEE states (1994)	
Bulgaria	30%
Czech Republic	35%
Hungary	36%
Romania	45%
Central Asian states (1996)	
Kazakhstan	44%(*)
Kyrgyz Republic	65%
Tajikistan	67%
Turkmenistan	56%
Uzbekistan	60%

Source: Csaki & Nash, 1998; World Bank, 1996, United Nations (2000).

(*) Year 2000

Rural development is central to efforts to reduce poverty. The proportion of people living below the poverty line in Central Asia is relatively high – ranging from 80% in Tajikistan to 35% in Kazakhstan. [Kudat, Peabody, Keyder, 2000] The majority of the poor in Central Asia are rural, with rural areas disproportionately impoverished. Wages tend to be relatively lower than in urban areas, reflecting in part the dominance of agriculture in the rural economy. A breakdown of the average monthly earnings in Turkmenistan, for example, shows that 28% of the rural population earns less than 80,000 manats a month, compared with only 9% of the urban population. [Turkmenistan LSMS, 1998] However, a mitigating factor for rural households that have access to land is the capacity to produce for domestic consumption, while urban households tend to be restricted from doing so due to a lack of suitable land.

The agriculture sector dominates the rural economy, and provides an important source of income and subsistence production for rural households. The agricultural sector contributed 23% of the GDP of the Central Asia region in 1995, compared to 12% for the CIS countries⁴ and 9% for the CEE countries. [Csaki & Nash, 1998] However, the agricultural sector in many transition economies has suffered considerable decline since

² The term transition economies is used to describe the new political geography of the former CMEA, comprised of the CEFTA/ CEEC states (the Czech Republic, Hungary, Poland, Slovakia, Slovenia), the Balkans (Albania, Bulgaria, Romania) 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).

³ CEE: the former socialist countries of Central-Eastern Europe, including the Baltic republics of the former Soviet Union, Albania, and the member republics of ex-Yugoslavia.

⁴ CIS: all the Commonwealth of Independent States (CIS) countries of the former Soviet Union.

1990, with the share of GDP produced in agriculture at the regional (Eastern Europe and Central Asia) level falling to about 60% of its 1989-1990 level by the mid-1990s. [Csaki & Nash, 1998] While the % decline in Central Asia has been less dramatic, and its relative importance in the Kyrgyz Republic and Tajikistan has actually increased, the situation in the agricultural sector in Central Asia is considerably less positive than that of Central Europe.

Agriculture is a major employer, with the agricultural workforce in four of the five Central Asian states comprising from 44% to 50% of the total workforce (see Table 2). Agriculture can also provide important export revenues, as is the case with cotton in Turkmenistan and Uzbekistan, and wool in the Kyrgyz Republic. [Schillhorn van Veen, 1995]

Table 2. Share of Agricultural Sector in Total Employment and in GDP

	Share in Agriculture in GDP		Share of Agricultural Sector in Active Workforce 1996
	1991	1997	
Kazakhstan	29%	11.4%	21.8%
Kyrgyz Republic	35.3%	43.4%	49%
Tajikistan	26.1%	27.1%	50%
Turkmenistan	46%	19.8%	44%
Uzbekistan	37.3%	29%	44%

Sources: EBRD, 1999b; Csaki & Nash, 1998

While on-farm activities still constitute the backbone of the rural economy, non-farm activities and sources of income are increasingly significant for rural households. Most rural households are not able to generate sufficient income from a single activity, and rely on a portfolio of income sources, both farm and non-farm based. Egamberdi et al (2000) note that in Uzbekistan (as throughout the region), for the majority of rural households, sustaining livelihoods requires juggling a mix of wages paid in kind and cash, self-sufficiency in basic foods and petty trade, in a context of declining social benefits. Rural households in transition economies commonly depend on non-farm sources for 30-50% of their income. [Davis and Gaburici, 1999; Greif, 1997a] In Uzbekistan, for example, the share of income from non-agricultural work amounts to 45% of total rural household income. [Kudat, Peabody, Keyder, 2000] Davis and Gaburici (1999) found that on average 35% of the Romanian farmers that they surveyed earned non-agricultural incomes.

The share of the rural population of transition economies involved in non-farm activities varies quite widely, ranging from around 7% in Poland (although this figure may well be an underestimation) to 65% in Slovenia. [Grief, 1997a; Davis & Pearce, 2000] In rural Turkmenistan 48% of the working population are employed in production or processing of agricultural goods, while 23% are involved in services, 8% in manufacturing and construction, and 3% in trade. [Turkmenistan LSMS, 1998] There is growing evidence that non-farm sources of income are significant for rural households. [see Davis & Pearce, 2000] Indeed, without these sources of income, the viability of the rural economy and society in transition economies would be threatened.

'Non-farm' activities are those diverse activities associated with waged work or self-employment in work that is not agricultural production but is located in rural areas. SME

and entrepreneurial activity encompasses agro-processing by SMEs, trade enterprises (retail outlets, traders etc), service enterprises (cafes, hotels, repair workshops, transport etc), and productive enterprises (carpentry workshops, textiles etc). Non-farm sources of income are not confined to self-employment or waged employment in SMEs, however. Wages earned in local government (including schools and hospitals), employment in state-owned companies, remittances from urban areas or from abroad, and income from pensions, social security benefits, and other transfer payments, are all 'non-farm' sources of income. Salaries and wages (60%), pension and allowances (8%), and income from self-employment activities (3.7%) compare to the private farm (17%) as sources of household income in two predominantly or significantly rural areas of Turkmenistan.⁵ [Turkmenistan LSMS, 1998]

Remittances can be the principal source of income for those rural households that receive them. While only 12% of rural farm households in Armenia receive remittances, the percentage of household income coming from remittances for those households is almost as high as 60%, and total household incomes are substantially higher than those households not receiving remittances. [Lerman *et al*, 1999]

There is still a lack of reliable data concerning non-farm activities in Central Asian economies, due to the data type and categories used by national statistical systems, and because of the existence of informal (unregistered or illegal) activities in the non-farm sector. The informal economy has increased in relative importance in the transition economies, and is estimated to account for between 10 and 15% of recorded GDP in more 'orderly' economies such as the Czech Republic and Hungary. In post-conflict transition economies such as Bosnia Herzegovina and Armenia the informal sector accounts for up to 50% of GDP. [Milanovic, 1998] The informal sector in transition economies is largely of a semi-formal nature, without the sharp dichotomy found between official and unofficial activities in Latin America and Asia. The informal sector in transition economies is mostly non-criminal, with the majority of 'unofficial' activity being to avoid the burden of administrative regulations and high taxation rates. [Kaufmann & Kaliberda, 1996]

⁵ Akhal and Dashkhovuz Velayats.

3. SMEs IN THE RURAL ECONOMY

SMEs can also be categorised by ownership and legal form. Rural non-farm SMEs in Central Asian states are a relatively small sector in terms of employment numbers. In rural Turkmenistan peasant associations and state-owned enterprises are the principal forms of economic entity in rural areas, employing 47% and 38% of the rural employed respectively. The percentage of persons employed by private companies (not including joint-stock or joint venture companies) in rural areas is only 1.3% (4% in urban areas). The contribution of non-farm SMEs to rural employment in countries such as Turkmenistan is still relatively low, with farms constituting the majority of private firms.

This pattern is also reflected in the Kyrgyz Republic. While there are estimated to be more than 154,000 active SMEs in the Kyrgyz Republic, over a third of these are farms. When the total number of persons employed in the SME sector in the Kyrgyz Republic is considered, about 76% of these work on agricultural, farm-type SMEs, while 15.7% work with other SMEs. [Hubner, 1999] These figures are national, not differentiated by rural-urban, and therefore the private sector in rural areas can be expected to even more farm-dominated. Of over 72,000 economic enterprises active in the agrarian sector in Kazakhstan, 68,000 are farms, 2,800 are production cooperatives, 375 joint-stock companies, and 1,600 are enterprises of various organisational types. [OECD, 1999a]

Participation in SMEs can be through ownership (self-employment) or through waged employment. The Turkmenistan LSMS Survey of 1998 indicates that 9% of households were engaged in self-employment activities. The proportion of rural households involved in self-employment activities was 7.6%, while for urban households it was slightly higher, at 10.5%.

While non-farm SMEs may not be the primary employer in rural areas, the new private enterprise sector is central to the health of the rural economy. It is new, privately owned start-ups⁶ that fuel the job creation process in the majority of transition economies, rather than privatised firms and state-owned enterprises. [EBRD, 1999b; Bevan, Estrin & Schaffer, 1999; Bilsen & Konings, 1998] Interestingly, privatised firms and state-owned enterprises (SOEs) have very similar levels of growth, creating employment at less than half the rate of start-ups. [EBRD, 1999b; Bilsen & Konings, 1998] Start-ups, or *de novo* firms, also have high job destruction rates, implying that the *de novo* sector is a dynamic one, with high levels of competition, and with unproductive jobs being replaced by more productive ones.

It is important to distinguish between *livelihood-oriented* enterprises, and (generally larger) more formal enterprises. While the majority (95%) of start-ups in transition economies are SMEs, 54% are microenterprises, and 27% are small enterprises. [EBRD, 1999b] Surveys in Bulgaria record that 99% of enterprises are SMEs, and that fully 95% are microenterprises with less than 10 employees. [FED, 1998a] The greater proportion of microenterprises in the Bulgarian figures may reflect the inclusion of unregistered and semi-formal enterprises. While a proportion of SMEs are risk-taking and growth-oriented, many of the smaller SMEs are more concerned with everyday survival than with innovation or growth. The majority of microenterprises probably take the form of *livelihood-oriented* enterprises, which play a key role as diversified income sources within the livelihood strategies of rural households. The role played by such

⁶ Start-ups in transition economies are, by definition, young enterprises, having begun activities since 1989.

enterprises 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. Starting-up an SME or seeking employment in an SME can be a rational response to uneven and uncertain farm incomes, in order to smooth income flows to the household, and to manage risk.

Livelihood-oriented enterprises can be conceptualised as productive investments that generate income for poor people and their households. Domestic-based income-generating activities – although generally not registered as enterprises – are also highly significant for the livelihood strategies of households and individuals, and provide important additional income to households. The gender dimension of SME activities can be important both for total household income and for intra-household income allocation. Women tend to be relatively well-represented in less formal income-generating activities, such as trade and handicrafts.

The income generated by the involvement of household members in informal and formal sector micro and small enterprises contribute to household security when it is used for basic consumption or for investments in assets, including savings, education and health. Assets, in turn, improve household stability and economic security by smoothing consumption when income flows are interrupted. Moreover they enable risk-taking and planning for the future.

Rural SMEs can be divided by sector: agro-processing, manufacturing, trade, services, and construction. Table 3 shows that agro-processing enterprises are by far the most significant rural employers in Turkmenistan. Manufacturing, services (including transport), trade, and construction enterprises are also represented in rural areas, although they are less significant than in urban areas.

Table 3. Distribution of Employed by Type of Work in Turkmenistan

Type of Work	Town (Urban)	Village (Rural)	Turkmenistan
Production of manufacturing goods	9.4%	4.6%	6.8%
Production or processing of agricultural goods	3.2%	48.4%	27.8%
Sale or resale of goods	6.2%	2.8%	4.4%
Automobile service	1.0%	1.7%	1.4%
Cafe/restaurant	1.5%	0.2%	0.8%
Home Appliance Repair	1.3%	0.4%	0.8%
Construction or Building Repair	8.5%	3.4%	5.7%
Transport and Communication	13.1%	5.4%	8.9%
Other Services (excluding medical, education, financial, and legal services)	33.7%	19.7%	26.1%

Source: Turkmenistan LSMS, 1998

A study of farms in seven CEECs and Baltic states conducted by Greif (1997a) recorded trade, construction, and agro-processing as the primary activities of rural SMEs. Specific areas of SME activity included hotels, industrial work, handicrafts, and direct marketing services.

A survey of rural SMEs in Romania conducted in 1997/98 found that most SMEs were concentrated in direct trading (stores, public houses, soft drinks) and retail trade (bakeries, confectioners, restaurants), which comprised 63% of all non-farm SME

activities. The majority of these activities have relatively low barriers to entry. Over two-thirds of firms in the survey (69%) employed fewer than 5 persons and many depended on family labour. Most of the firms were involved in low labour productivity activities serving as a residual source of employment. [Davis & Gaburici, 1999]

4. SMEs AND RURAL DEVELOPMENT

4.1 The role of SMEs in rural development

The importance of the SME sector to a healthy and diversified rural economy is being increasingly recognised.⁷ Growth of the SME sector in rural areas has potential to absorb excess labour from the agricultural sector. This is particularly important in the context of declining levels of productivity in much of the agricultural sector, and also of agriculture acting as a 'buffer' to the processes of economic restructuring. In many transition economies agriculture has provided a 'buffer role' by absorbing unemployed labour from other parts of the economy, and by providing a source of subsistence to vulnerable groups. [OECD, 1999b; Davis & Pearce, 2000] For example, while the contribution of agriculture to GDP in Kazakhstan has fallen from almost 30% in 1991 to below 10% in 1998, its contribution to total employment (as a % of the workforce) has risen slightly over the same period. [OECD, 1999b] The International Monetary Fund estimates that one million of the 3.5 million employed in rural areas of Uzbekistan are under-employed. [Egamberdi et al, 2000]

The buffer role of agriculture temporarily diminishes social problems in urban and rural areas by easing access to basic necessities for a large part of society, but in the longer run impedes farm restructuring, preserves subsistence farming, lowers agricultural productivity, and causes substantial hidden unemployment in rural areas. Under-employment in the farm sector leads to low agricultural wages, declining output per farm worker, and hinders necessary restructuring. [OECD 1999b; Serova, 2000] Growth in rural SMEs would provide alternative employment opportunities, and thus have a positive impact on agricultural productivity and on rural income levels.

Rural SME growth also contributes to rural development and to poverty reduction through the following means:

1. Income from rural SMEs can be used by farming households to reduce the total variance of their income, that is, the overall risk. Diversification of income sources can be an important risk management strategy for a rural household.
2. Involvement in SMEs can be used by households to increase the total returns to labour, to smooth income, or to improve future employment prospects (by acquiring skills or capital).
3. Increased SME activity can promote a more equitable distribution of income, by supplementing the incomes of rural households, and by creating new owners of enterprises.

⁷ In 1994, for example, the President of Uzbekistan declared that those who are not productively engaged in agriculture are to be 'transferred' to non-agricultural work such as industry and services. [Egamberdi et al, 2000]

4. The process of reallocation of resources and assets to more productive and market-oriented uses. Studies in transition economies indicate that *de novo* SMEs have high levels of employment creation and destruction. [see for example Bilsen & Konings, 1998] This may well indicate healthy levels of competition and – vital to the transition process - a continuing process of reallocation of resources to more productive uses.
5. Sustaining the viability of the rural economy, through providing an alternative or complementary source of income and employment to agriculture. In so doing SME growth can reduce rural-urban migration which results in excessive or over-rapid urbanisation.

A healthy rural SME sector can stimulate the development and expansion of the rural financial sector. Results from Davis and Gaburici's (2000) logistic regression model of the determinants of farmer access to rural finance suggest that the existence of non-farm sources of income from an SME would increase the probability of obtaining credit by 2.7 times. Access to sources of non-farm income is of considerable importance to small private farmers in gaining access to rural finance, as such income flows are often easier to document, may be less seasonal in nature,⁸ and are also less vulnerable to the weather. Romanian banks appear to prefer lending to these farmers because they consider them to be less of a risk, as they are not wholly dependent on farming as the sole source of income.

⁸ Although rural SMEs that depend on in part or wholly on the rural population for their market will be directly affected by upswings and downswings in farm incomes.

4.2 SME Growth Potential

Growth in rural SMEs can be expected in sectors that were under-represented in the centrally-planned economy, such as trade, distribution, and services. [EBRD, 1999b] Considerable potential exists for SMEs in agro-processing, agricultural input supply, and agricultural marketing. The elaborate division of labour and production during the Soviet era, which meant that only a small share of locally-produced raw materials were processed locally, has broken down. The exchange and marketing systems that existed in the Soviet era have also disappeared, leaving considerable potential for growth of small-scale locally based processing, supply, and marketing enterprises. Social assessments carried out for World Bank-financed projects in Central Asia and Turkey identified the development of agribusiness SMEs as a priority for rural households. Reasons expressed were that farmers could then have a local outlet for this produce (reducing transport costs), and that wage employment would be generated. Other priorities articulated were making well-organised and regulated local markets available, and reducing local corruption. [Kudat, Peabody, Keyder, 2000]

Serova (2000) charts the development of marketing channels for farms in Russia, noting a growth in 'new' marketing channels (principally traders, wholesalers and processing firms) during the period 1990 to 1995. As a result, farmers generally had several options for selling their produce. By 1997, she notes, the number of marketing channels had reduced. This can in part be attributed to a stabilising and maturing of the marketing and distribution chain. However, it is also due to a shortage of working capital, and to the growth of barter and payments in kind. This is particularly true for grain, for which Serova estimates that a quarter of sales are in the form of barter (payments with inputs, services, or even taxes), and for milk. The World Bank (1998) also notes a predominance of barter transactions in the agricultural marketing system in Kazakhstan. [World Bank, 1998]

Growth of SMEs in the trade sector has been noticeable, and trade is often the first SME sector to develop. This was the pattern followed in Poland, where subsequent rapid growth of the manufacturing sector has been driven by the new private sector. [Gomulka, 1997; quoted in Bevan, Estrin & Schaffer, 1999] In Russia in recent years there has been a notable growth in the activities of (largely unregulated) private small-scale intermediaries in the meat and dairy markets. These SME traders are conducting a distribution and intermediary function between farms and urban markets, between farms and processing firms, and between farms and input suppliers. [Serova, 2000] 2% of the rural population of Uzbekistan reported involvement in agricultural trade activities, (Egamberdi et al, 2000), although as much trade activity is not registered (partly to avoid taxes), the true number is probably much higher.

Small-scale agro-processing in dairy products and distilleries has developed in some Eastern European countries, but progress appears to be slower in the CIS states. Domestic agri-food processing in Russia received something of a boost from the crisis of late 1998, with imports of foodstuffs becoming less attractive as the rouble devalued. [Serova, 2000] The food processing industry in Russia and in other CIS states became more attractive for investments (including foreign direct investment), although investments in farm production remain less attractive. Investment in agriculture can often take the form of vertical integration, by processing firms seeking to stabilise and control their supply of raw materials. Such investors – in Russia at least – establish vertical integration through such mechanisms as leasing arrangements (of land, machinery, or

livestock), or contractual arrangements. [Serova, 2000] However, in many CIS countries the growth of agro-processing SMEs has been hindered by a seeming reluctance on the part of governments to fully relinquish control over the processing sector.

Potential for rural SME growth also exists outside the agro-processing and trade sectors. Section 3 of this paper outlines areas of rural SME activity, which include a wide range of service activities, manufacturing, and construction. While some areas of SME activity are location-specific, such as tourism and handicrafts, most are appropriate to rural areas across the Central Asia region. The growth of the SME sector in the rural economy of Central Asia is restricted by a range of factors, including but not limited to the health of the farm sector. Constraints on SME development are outlined in section 5.

4.3 Factors underlying decisions to diversify into the SME sector

Diversification into sources of income derived from self-employment or waged employment in the SME sector can be used by farm households to reduce the total variance of their income, that is, the overall risk, or to increase the total returns to labour. Economic theory suggests that risk-neutral farming households will divide their labour supply between on-farm and non-farm employment opportunities such that the expected marginal returns to all activities are equal. [Davis & Pearce, 2000] If farm households are risk averse, though, or if barriers to entry to the non-farm sector exist, then allocation of labour (or capital) to non-farm activities may not occur as expected, and the household may be willing to accept lower wages in the farm sector.

Two processes are apparent: *demand-pull*, where rural people respond to new opportunities; and *distress-push*, where rural poor are driven to seek non-farm employment as a survival strategy. [see for example Islam, 1997] Reardon *et al* (1999) suggest that when relative returns are higher in the non-farm sector than in farming, and returns to farming are relatively more risky, “pull” factors are at work. Conversely, when farm output is inadequate and opportunities for consumption smoothing, such as credit and crop insurance, are missing, or when input markets are absent or fail and the household needs cash to pay for farm inputs, “push” factors are at work. *Demand-pull* diversification can result from growth in agricultural earnings, while *distress-push* can be a response to falling productivity and income levels in the farm sector, or to privatisation and economic restructuring processes. Both processes can be a catalyst for growth in rural SMEs.

Additional factors that can lead to *demand-pull* include the increased income of lower and middle-income households and increased demand from urban areas for rural products. [Islam, 1997] Successive poor harvests can depress income and hence increase the need for alternative income opportunities offering low-skilled, low-wage employment as a *distress-push* factor. As evidence of *distress-push*, wages or incomes are likely to be lower in rural SME sector.

Table 4 “Push” and “pull” factors of diversification into the SME sector

“Push factors”	“Pull factors”
<ul style="list-style-type: none"> • Population growth • Increasing scarcity of arable land and decreasing access to fertile land • Declining farm productivity • Declining returns to farming • Household risk management strategy • Income- and consumption-smoothing strategy • Lack of access to farm input and output markets • Decline of the natural resource base • Temporary events and shocks 	<ul style="list-style-type: none"> • Higher return on labour • Higher return on investments • Lower risk compared to on-farm activities • Generation of cash in order to meet household objectives • Productive use of surplus farm income (particularly where the rural finance sector is poorly-developed) • Learning new skills (developing human capital) • Improving social networks (developing social capital) • Economic opportunities, often associated with social advantages, offered in urban centres and outside of the region or country (remittances)

A survey carried out by Nee and Keister (2000) in China found that rural households diversify labour allocations in order to take advantage of local opportunities and to reduce the risk associated with dependence on a single form of income. Rural households in China allocated labour to non-farm activities only after subsistence needs were met.

Much of the existing literature on diversification into non-farm activities suggests that the poorest groups (small subsistence farmers) tend to diversify into activities where wages are no higher than those in the agricultural sector, whilst higher income groups (larger farmers) also diversify, but into better-paid sectors. [Davis & Pearce, 2000] In the context of the SME sector therefore, distress-push diversification is more likely to be associated with semi-formal livelihood-oriented microenterprises, which may well constitute the secondary household income. Demand-pull processes, on the other hand, are more likely to lead to more formal, growth-oriented SMEs.

5. CONSTRAINTS ON SME DEVELOPMENT

5.1 Factors relating to the SME

5.1.1 Entrepreneur characteristics

A lack of managerial, technical, or marketing expertise can inhibit the growth of the SME sector. A diverse set of skills is needed to be a successful entrepreneur, and the division of labour and functions under the previous planned economy has not left potential entrepreneurs with an appropriate set of skills. A desire to minimise risks, reflecting livelihood objectives rather than an entrepreneurial outlook, is an additional constraint to SME growth.

The level of education is an important factor in determining the rate of creation and growth of rural SMEs. Those engaging in non-farm activities in Uzbekistan tend to be younger and better educated than the wider rural population. According to a World Bank household survey, 69% of those involved in non-farm activities are men, 65% are between the ages of 23 and 40, and only 7% have completed fewer than nine grades of school. [Egamberdi *et al*, 2000].

In a survey of Romanian farms conducted by Davis and Gaburici (1999), it was found that rural SME start-up is highly selective, with the watershed traditionally being entry into secondary education. Among the SMEs interviewed, the education and vocational training level of the entrepreneurs clearly lies above the average level for the three counties, as the figures in Table 5 reveal. These figures support the importance of education and vocational training for entrepreneurial economic activities. Compared to the national average, rural entrepreneurs are more likely to have a high school degree and/or a university degree. Thus for the establishment, development and promotion of rural SMEs, the general and vocational education levels play an important role. The rural population is in general disadvantaged in this respect.

Table 5. Level of education per county, Romania, 1997 (%)

	Secondary school	High school	Vocational training	Higher education
Counties 1997				
Timis	40	32	10	17
Dolj	42	33	7	18
Brasov	35	25	7	33
Interviewed non-farm entrepreneurs 1997				
Timis	22	37	22	20
Dolj	5	62	19	14
Brasov	7	61	7	25

Source: Davis & Gaburici, 1999

Note: Vocational training normally follows the secondary school degree.

The figures may not add up to 100 due to rounding.

5.1.2 Enterprise characteristics

Constraints related to the enterprise itself are closely linked to entrepreneur characteristics, and encompass poor quality product, insufficient product differentiation or branding (for both goods and services), and insufficient scale of production.

5.2 Environmental Factors

Environmental constraints can affect urban and rural SMEs equally, or can be specific to rural areas. They can be sub-divided into institutional, physical and logistical, and informational constraints.

5.2.1 Institutional constraints

Institutional constraints include:

i) Government regulations and policies

A survey conducted by the Foundation for Entrepreneurship Development (FED) in Bulgaria in 1998 to identify principal problems facing new or start-up SMEs, found that problems with enterprise registration and with Mafia interference were the second and third most widely quoted. [FED 1998a] Excessively bureaucratic procedures for registering and operating an SME have an important disincentive effect on the creation of formal sector SMEs, and encourage enterprises to remain in the informal sector. A survey of SMEs in five transition countries conducted in 1997 found that official and unofficial costs of doing business were substantial. Official costs of initial enterprise registration varied from \$120 in Romania, to as high as \$928 in the Slovak Republic. Unofficial payments ranged from \$25 in Romania and the Slovak Republic to over \$400 in the Ukraine and Russia. Continuing registration payments, fire and sanitary inspections, and tax inspections, added another \$612 to the operating costs of firms in the Ukraine, of which 72% were unofficial costs. [Johnson, McMillan & Woodruff, 1999a] In rural municipalities there may also be additional costs for would-be entrepreneurs wishing to register in the rural administrative centre, associated with higher transport costs (more dispersed settlements and poorer transport systems).

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.⁹ 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. Sales growth is higher in those firms that report significant pressure from customers or from foreign competitors to develop new products and markets. [EBRD 1999b]

The development of SMEs in Uzbekistan has been hindered by access to foreign exchange. Apart from a limited number of joint ventures and trading companies, it has

⁹ 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.

been mostly the state-controlled large-scale enterprises that have had access to the official segments of Uzbekistan's foreign exchange market. [World Bank, 1999a] As a result, SMEs have had to import capital and intermediate goods through unofficial channels at very high costs. The World Bank (1999a) estimates that this foreign exchange arrangement has resulted in a significant transfer of financial resources from rural to urban areas (an estimated US\$375 million in 1997 alone).

ii) Market distortions in the rural economy in favour of the farm sector

Agriculture underpins the rural economy of Central Asian states, and the health of the agriculture sector will directly affect the development of SMEs. During the central planning era, rural development in transition economies was frequently associated with agricultural development. The Ministry of Agriculture has therefore tended to have the overall responsibility for the rural economy, with the result that the needs of rural SMEs have to a degree been overlooked.

Several countries in Central Asia generate substantial revenue from agricultural export sectors through centralised state purchasing at lower-than-market prices. The cotton sector in Uzbekistan, for example, is taxed in this manner through price and marketing policy. [World Bank, 1999a] In seeking to mitigate the adverse effects on agricultural growth the government provides subsidies to the sector. However, subsidies can have the effect of diverting resources towards agriculture and away from the SME sector, thus hindering the development of a healthy, diversified, rural economy.

Table 6. Subsidies for Agriculture in Uzbekistan

Direct and Indirect Subsidies for Agriculture	
Credit subsidies and debt write-off	1996: special emission of credit to finance agricultural procurement and preparation for the following season. This was largely not repaid, and resulted in an increase in inflation.
Subsidies for capital investment and machinery services	Subsidies for capital investment and for machinery services in 1996 and 1997 comprised 3.8 billion and 5.4 billion soums, respectively.
Prefinancing for working capital	The cotton and wheat marketing agencies provide prefinancing in the form of interest-free payments for signed contracts for delivery of cotton and wheat. These amounts are shown as 4.5 billion soums in both 1996 and 1997 and 6.5 million soums in 1998.
Exemption from value-added tax	This exemption is estimated to be approx. 6.5 billion soums in 1996, 11 billion soums in 1997, and 15 billion soums in 1998.

Source: World Bank, 1999a

iii) Lack of depth and competition in the financial sector

A lack of depth or competition in the financial sector can inhibit the growth of the SME sector through:

- inappropriate financial services for SMEs
- a focus on larger SMEs, state enterprises, or the commercial farm sector, at the expense of smaller SMEs
- insufficient liquidity in product market systems and sectors to match supply and demand over time and space
- inefficient or non-trustworthy payment systems to facilitate transactions

Access to appropriate financial services is key for a healthy and growing SME sector. SMEs need access to financial services for covering the costs of new product development and of entering new markets, and for bridging loans between delivery and payment. Much of the banking system in transition economies is still oriented to providing short-term working capital loans to larger SMEs, backed by mortgage guarantees. Lack of access to term finance is one of the most important constraints for SMEs in transition economies, and restricts SME investment and growth.¹⁰ [EBRD, 1999a; Pearce, 2000a] A shortage of commercial credit for agri-business SMEs in Kazakhstan is noted by the World Bank (1998), affecting medium-term finance for equipment and buildings, and also working capital for raw materials and inputs.

iv) Poor legal backing for transactions enforcement

The court system may be too weak and over-burdened to adequately enforce supply or purchase contracts efficiently in rural areas. The World Bank notes institutional weakness in the court system in Kazakhstan, for example, with courts lacking funds and resources to process cases in a timely and effective manner. [World Bank, 1999b] Weak legal protection of contracts and payment transactions causes higher transaction costs (e.g. to verify stated weights or quality, or to instigate court proceedings) and a reliance on 'spot' transactions instead of a growth in distance trade.

If there is an absence or non-enforcement of standardised grade, varieties, qualities, weights etc which makes visual inspection necessary, this will inhibit the flow of meaningful information through prices, and increase costs. Distance trade will again be discouraged, in favour of face to face 'spot' transactions, and overall transaction volumes will be lower.

v) Continuing state control of processing, distribution, and market activities

Monopolisation/cartelisation of one or more market functions and/or geographical areas, for example wholesaling or transportation, often due to lingering state control and regulations. While prices of grain exports in Kazakhstan are in line with world market prices, locally imposed trade restrictions, poor price information, and a lack of competition in both output and credit markets put farmers and agri-business SMEs at a bargaining disadvantage. [World Bank, 1998]

¹⁰ Although security of property rights is perhaps a more fundamental determinant of investment levels (see Johnson, McMillan & Woodruff, 1999b)

In Uzbekistan, the government controls processing through a large number of regulations and practices. Although state processing enterprises have largely been privatised, growers are often allowed to sell to only one regional processor, and the government sets production quotas and even prices. However, this situation is changing, for example through the establishment of the Main Department of Antimonopoly and Price Policy to encourage competitive pricing, and this seems to be having positive impacts. Domestic banks have responded by financing new private enterprise initiatives such as textile mills, meat processing, bakeries, dairies, and fruit processors. [Egamberdi et al, 2000]

vi) Complicated or poorly-explained export procedures

5.2.2 Physical or logistical constraints

These can encompass poor transport infrastructure, sub-standard transportation facilities, a lack of market facilities, and a lack of adequate storage facilities, leading to product quality problems and to bottlenecks in the distribution system. The low volumes of production from often geographically dispersed rural SMEs contribute to these problems, and result in high cost transactions and handling. Such costs can lead to wide variations in prices between markets in time and space. As a result of the increased costs of operating in rural areas, and fluctuations in supply, rural traders may operate on high marketing margins, depressing the prices received by the SMEs.

Non-physical factors can also act as logistical constraints. Kudat, Peabody, and Keyder (2000) quote anecdotal evidence in Russia and in Central Asia that organised groups sometimes block farmers' attempts to market their produce if cash payments ('tribute') is not paid. They also refer to checkpoints located on transport routes in Tajikistan where informal payments in cash or produce are demanded, thus increasing marketing costs.

5.2.3 Deficiencies in the flow of information

Informational factors constitute the third set of environmental constraints. Price and market information may not be easily accessible or up-to-date. Market fragmentation can result from poor information, i.e. different prices obtained in different but equivalent transactions due to lack of knowledge of prevailing prices. Poor information flows related to price, supplies, and demand, inhibit SMEs from receiving and responding to price changes and trends in consumer demand, and can act as barriers to entry into profitable markets. Information deficiencies directly contribute to product quality and differentiation problems, and to poor marketing. When the types of enterprise support services demanded by Bulgarian microenterprises were analysed, market information (about suppliers and about domestic markets) was found to be one of the most demanded services. [FED 1998b]

6. THE POLICY ENVIRONMENT FOR RURAL SME DEVELOPMENT

6.1 The Regulatory Environment

It is important that the policy 'playing field' is level in terms of ease of registration, taxes, and investment incentives for small as well as large enterprises. [Levitsky, 2000] Enterprise registration procedures for SMEs in many CIS countries need to be streamlined, and attention paid to eliminating the unofficial costs of registering and operating an enterprise. The government of Kazakhstan introduced official measures to support SMEs in March 1997, including simplification of the registration process, the introduction of taxation and customs privileges and the sale of property on favourable terms. [Kazakhstan 1999 Country Profile] Uzbekistan has also introduced measures to reduce bureaucratic obstacles to registration and activity of SMEs. [Uzbekistan 1999 Country Profile] Such measures need to also tackle the unofficial costs of registering and operating an SME, which implies a change of attitude and in some cases even personnel within government departments and local municipality offices.

Reforms to the legal and judicial system may be needed that support low-cost contract enforcement, accompanied by investment in the capacity of the court system to serve rural areas.¹¹ Reforming and developing the rural institutional environment would be more effective in promoting a healthy rural SME sector than any existing incentives and subsidies that favour certain sectors while at the same time distorting incentives and discriminating against other sectors.

A well-regulated and competitive rural finance sector, with non-bank as well as bank intermediaries, can play a key role in stimulating the rural SME sector. The relationship is somewhat of a circular one, as a healthy rural SME sector attracts financial service providers who would otherwise have been put off by the increased risks and complications of agricultural credit. Measures to address the deficiencies of the rural financial sector include:

- reforms to the legal framework to recognise non-mortgage collateral, such as movable assets and inventory
- strengthening of the court system in rural areas to speed up default and debt collection proceedings
- development of leasing laws for agricultural and non-agricultural equipment
- revisions of financial sector regulations to incorporate and effectively regulate non-bank financial institutions
- strengthening of bank supervisory agencies
- establishing a single registry of land and other real estate¹²

The Agricultural Post Privatisation Assistance Programme in Kazakhstan, for example, is addressing deficiencies in the legal framework for rural finance. Measures introduced

¹¹ The World Bank and the Government of Kazakhstan are implementing a Legal Reform Project, which prioritises institutional development and capacity-building within the court system. [World Bank, 1999b] No mention of the particular challenges facing rural areas is made in the Project Document, though.

¹² The Government of the Kyrgyz Republic, for example, aims to improve the previously uncoordinated collection and maintenance of information on land and real estate through the creation of GosRegister, a new State Agency for Registration. The World Bank is supporting this through the Kyrgyz Republic – Land and Real Estate Registration Project. [World Bank, 1999d]

include laws supporting secured lending (e.g., through registration of moveable property) and legislation on bankruptcy of agricultural enterprises. [World Bank, 1998] Capacity-building of commercial banks through both training and credit lines is a further programme component.

6.2 Support to the Rural Financial Sector

The Kyrgyz Agricultural Finance Corporation (KAFC) was established with support from the World Bank in response to a diagnosed lack of depth in the rural financial market (only one bank, Agroprombank, previously provided rural financial services on any notable scale, and it was liquidated in 1996). KAFC has been focused on lending to private farmers, rather than non-farm SMEs, although since 1999 its lending to SMEs involved in agro-processing and other agri-business has increased somewhat. [World Bank, 1999c] While the KAFC has been important in increasing the supply of credit in the rural economy, its focus on agricultural credit at the expense of lending to the non-agricultural sector reflects the traditional approach taken by many governments to rural financial services. [Yaron *et al.*, 1997; IFAD, 2000] This may actually decrease the livelihood of developing a viable rural financial sector that can survive without continued subsidies.¹³ Diversified bank portfolios in rural areas enable banks to cope better with the fluctuations in farming sector incomes that are due to seasonal and other agriculture-specific factors, and to improve their asset management.

The formal sector (e.g. banks and finance corporations) often prefers or even insists on mortgage-based lending, which reflects more conservative banking techniques, and which has the effect of excluding poorer rural entrepreneurs. [Pearce, 2000a; Pearce, 2000b, World Bank, 1999c] In addition to lending based on non-mortgage collateral such as equipment and inventory, more innovative forms of cash-flow and character-based lending are needed to widen the outreach and client profile of financial institutions. Group-based lending techniques are being introduced to the KAFC in order to improve its poverty impact. [World Bank, 1999c] The role of credit unions and other less formal institutional forms is also important, as such institutions can be more closely linked to rural communities, and can take advantage of their greater level of client knowledge to introduce more flexible savings and lending technologies. [see Yaron *et al.* , 1997]

While credit lines through commercial banks continue to be a means of increasing funding available for SMEs, the World Bank is now starting to shift from lines of credit through banks toward the creation of interim sustainable non-bank intermediaries. [World Bank, 2000b] In countries such as Romania, Moldova, and Georgia, savings and credit cooperatives and similar organisational models have proved effective rural financial intermediaries. [see for example Hoonae, 2000]. Appropriate non-bank intermediaries can include finance companies, savings and credit cooperatives, and even NGOs (depending on the legal and regulatory framework of each country).

Insurance and savings products can assist SMEs in managing risks, and can enable livelihood-oriented enterprises to formalise and develop. Bank payment systems that facilitate commercial transactions as well as money transfers (including remittance monies) are also needed. Legal and regulatory reform needed to support the rural financial sector is outlined in the previous section, 6.1.

¹³ The Second Rural Finance Project in support of the KAFC explicitly mentions non-farm enterprises as intended clients, however. [World Bank, 1999c]

6.3 Privatisation

Where privatisation and demonopolisation has occurred, it has been moderately successful, but probably needs to be deepened throughout the region. Privatisation of SMEs is fairly well advanced in Tajikistan (where by May 1999 80% of small enterprises had been placed into private hands), the Kyrgyz Republic (with nearly 97% of SMEs in private hands by the beginning of 1999), and Uzbekistan. [EBRD, 1999b; and World Bank, 1999a] The notable growth in SME activity that has occurred in Tajikistan over recent years, particularly in the service sector (for example private catering and retail trade establishments), may in part reflect this.

6.4 Policies that foster positive linkages with the farm sector

In order to foster positive linkages between the farm and non-farm sectors the following general policy recommendations relate to agricultural support policies:

- removal of distortions to rural markets (including the land markets, produce markets, financial markets, and so on) resulting from government policies or subsidies
- with reference to the agro-processing sector, privatisation would promote competition within sectors, and should at the same time encourage investment
- government controls over processing and trade functions need to be fully removed, in order to allow private entrepreneurial activity to increase
- 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

Governments in the Central Asia region recognise that successful restructuring of the agriculture sector will contribute to the development of the wider rural economy. For example, the government of Uzbekistan plans to phase out subsidies of agricultural inputs, and other forms of state interference in agricultural production and processing. [Egamberdi et al, 2000]

The agricultural development strategy implemented by the Government of Kazakhstan, focuses on:

- i) intensifying reform in rural areas, structural improvements, and establishment of efficient forms of economic activity,
- ii) improving financing and lending policy, and
- iii) setting-up a market-driven management system in the sector.¹⁴

Improving the physical and institutional infrastructure is included under intensifying reform and structural improvements, and extends to support measures for SMEs involved in agro-processing. Specific measures to be introduced include setting-up a network of agricultural wholesale markets. The emphasis, though, is on encouraging farm production, with finance instruments directed at farm SMEs, and mini-production units to process agricultural products, rather than on encouraging SMEs involved in supplying inputs, processing, distribution, and trading. [OECD, 1999a]

¹⁴ 'Strategy for the Development of the Agriculture of the Republic of Kazakhstan until the year 2010', in OECD (1999a).

6.5 Infrastructure and Public Services

A minimum level of infrastructure and public services is necessary for enterprises to grow and to attract investment from urban areas or from abroad. Access to markets, and the necessary infrastructure and institutional environment that promotes access to markets, is a key element necessary for the development of rural SMEs. However, the rural infrastructure in many rural areas has deteriorated badly, affecting for example electricity supply, transport systems, education, and health services. [Kudat, Peabody & Keyder, 2000; Davis & Pearce, 2000]

State enterprises provided a broad range of free or subsidised social services, including health care, child care, education, housing, and even public utilities. [Thomas, 1997] How and whether to continue providing these services is a key question for governments in the context of public service provision. In Kazakhstan, for example, the availability and quality of social services has declined in rural areas, with some schools closed to reduce heating costs, hospitals and polyclinics on farms closed in some areas, and with the costs to the users of education and medical care rising significantly. Divestment of social infrastructure will require a response from local administrations, in order to ensure that minimum levels of infrastructure and services are provided (for example so that rural children are not disadvantaged in terms of access to schooling). [see Peabody, Gurevich & Aryal, 2000] Deficiencies in such key areas as schooling, electricity supply, and medical facilities can severely restrict the growth of the SME sector, and can also lead to the more educated and younger members of the population leaving to work in towns or abroad.

Transport accessibility plays an important role in the development of local industries as well as agriculture. Improved access in rural areas opens up potential new markets, improves the viability of rural service activities, and introduces higher levels of competition. While this can lead to a stronger and more productive enterprise sector, the pressure to specialise and consolidate in order to compete beyond the local area will lead to the less competitive and adaptable firms faring less well.

Addressing the lack of adequate social safety nets, infrastructure, and suitable education opportunities in remote rural areas should be investment priorities. The link between education and SMEs has been demonstrated elsewhere in this paper. With reference to the physical infrastructure needed to facilitate the necessary links between each actor along the production and marketing chain, the following are examples of appropriate responses:

- building and maintaining feeder roads, in conjunction with rural communities and the private sector
- providing basic market infrastructure, such as site and buildings
- building and managing storage facilities, where possible with the private sector
- removing controls on agro-processing and input supply, and encouraging SMEs and traders to become active

It is important that policy-makers make the distinction between *distress-push* and *demand-pull* diversification, as each may have different implications and require different policy responses. The former may require policymakers to develop appropriate social

safety net supports, and to provide enterprise support services to assist would-be entrepreneurs to acquire the necessary skills for running an enterprise. Where *demand-pull* factors are driving the process of diversification, policy-makers might seek to facilitate enterprise activity, ensuring that the environment in which new enterprises are being created is an enabling one, and one that is favourable to private investment.

Remoter and less economically favoured rural areas pose particular challenges for the provision of infrastructure and public services, with low population densities and low levels of economic activity, and a highly restricted tax base. Transfers from central government and even external donor support will in many cases continue to be essential to ensure a minimum level of infrastructure and public services. It is perhaps worth noting in this context that only *minimum* levels of infrastructure are needed, which are sufficient to allow SMEs to operate (electricity, passable roads, telephone communications), not *optimum* levels.

6.6 Decentralisation

Decentralisation of government functions to the district level is key to facilitating responsiveness in decision-making to specific local conditions, and thereby assisting government to respond more effectively to SME needs and comparative advantage. Rural SMEs are active across a range of sectors and activities, with SME activities and characteristics varying across regions. Decentralised service provision and decision-making is in many ways a rational response. However, decentralisation processes 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 only effective in providing services if local governments are not vulnerable to capture, and if local governments have access to adequate local financing sources. If either of these conditions is absent, then decentralisation may actually perform worse than a centralised system.

The decentralisation of power to local governments has been identified as an important feature of the successful Chinese rural enterprise development. [for example see Bateman, 1999] Decentralisation processes transferred 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 township and village enterprises (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. [Hubbard, 1994]

6.7 Government support to SMEs

Governments have a key role to play in supporting and facilitating the development of rural SMEs. At a more general level the government can promote a socio-cultural context that values entrepreneurship. A World Bank household survey in Uzbekistan found that most rural citizens lacked confidence in their ability to diversify out of traditional income sources into the SME sector. [Egamberdi et al, 2000] When asked to suggest ways to solve their income and employment problems, four of the six most common answers involved assistance from the government and others, and only two required initiative by the citizens themselves.

In this context a more open and positive attitude towards the informal enterprise sector needs to replace a more prevalent negative attitude that tends towards over-regulation and control rather than measures to support such enterprises and to assist them in joining the formal sector. While only a small proportion of any population have the ability and the temperament to start-up 'growth' SMEs, livelihood-oriented enterprises are less risky and act more as a household income supplement than the primary source of income. Due to their less risky nature, smaller livelihood-oriented enterprises are more accessible to the wider rural population, and, despite the lack of growth potential and the relatively low enterprise incomes, can provide an important additional source of income to rural households.

Enterprise support measures directly address those constraints relating to the SME and to the entrepreneur, principally through improving the entrepreneur's technical, managerial and marketing skills. Informational factors can also be addressed, through facilitating information flows, and through linking entrepreneurs with other entrepreneurs, and with other agents in the production and marketing system. Table 7 lists options for support measures in response to a set of principal SME constraints.

Mechanisms through which assistance to entrepreneurs can be provided include: business centres, business incubators,¹⁵ phased financial assistance to start-ups, advisory and networking centres, and training and consultancy services for SMEs (run by private firms, universities, or civil associations). It should be noted that a key source of information and advice for SMEs is often suppliers and buyers. A study of Bulgarian SMEs found that the primary sources of information for the entrepreneurs were clients and customers, friends and family, business partners, and suppliers. SMEs did increasingly use regional development agencies and business centres to access information though, with 30% of all small companies using such sources in 1997 (see Case Study 1). Chambers of Commerce were also used, but by a smaller number of SMEs. [FED 1998b]

¹⁵ Business incubators are locations provided for start-up SMEs with the necessary communications, electricity, and physical infrastructure for SMEs to operate. The SMEs are given access to (often subsidised) support services such as training, mentoring, advice, and marketing assistance.

Table 7: SME Support Services

CONSTRAINTS TO SME DEVELOPMENT	SME SUPPORT SERVICES
Entrepreneur characteristics	
Lack of managerial, technical, and marketing expertise	<p>Training courses through business centres, universities/colleges, and private sector providers.</p> <p>Mentoring arrangements with persons in industry or services, or with established entrepreneurs.</p> <p>Modify the legal and regulatory environment to stimulate the development of civil society and entrepreneur associations.</p>
Constraints related to the SME	
<p>Poor quality product, and/or insufficient product differentiation</p> <p>Insufficient scale of production</p>	<p>Agents providing technical advisory input in production processes</p> <p>Training, and provision of technical knowledge and techniques.</p> <p>Introduce a quality certification process, through setting-up recognised or licensed producer/trade associations.</p> <p>Providing incentives for large companies to outsource supply and construction contracts to rural SMEs</p> <p>Facilitate joint production and links with other SMEs.</p>
Informational constraints	
Deficient market networks	<p>Assist the creation or strengthening of networks and associations.</p> <p>Set-up trade fairs and market expositions (and then hand over to private sector or civil society operators once successful).</p>
Lack of information concerning prices and export markets ¹⁶	<p>Facilitate the flow of up-to-date and relevant information on price movements, export markets and demand patterns, through:</p> <ul style="list-style-type: none"> • trade fairs • databases (price and market information systems) located in Chambers of Commerce, Business Centres, and NGOs • extension agents or trade journals. <p>Facilitate contacts with importers (or exporters in home country).</p> <p>Commission and disseminate up-to-date Market Analyses of urban and export markets.</p>

¹⁶ SMEs not only face informational difficulties in accessing export markets, but also cost barriers due to the time and cost of complying with export procedures. The role of an Export Promotion Agency can be significant in easing these constraints, and the government can also develop consultative mechanisms with SME representative bodies to discuss customs and export procedures with a view to introducing reform.

Case Study 1: SME services through the BARDA network in Bulgaria

The Bulgarian Association of Regional Development Agencies and Business Centres, BARDA, has provided successful examples of sustainable and effective SME support service provision, underpinned by close consultation between the service providers and the SME clients. Several business centres have achieved or are close to achieving commercial viability and long-term sustainability. The BARDA member agencies bring together representatives from local government, chambers of commerce, branch unions, local business associations, vocational training institutions, academia, banks, NGOs, and private companies. The agencies and business centres encourage local initiative, diversification and foreign investment, as well as facilitating partnership building between the municipal authorities and the SME community.

Successful initiatives implemented by the business centres and regional development agencies include:

1. **Business Incubator, Vidin municipality.** Provides premises, a leasing scheme, and enterprise support services for SMEs located in the incubator site. Implemented by the municipality with financial support from USAID.
2. **Business Promotion and Support Centres** established in 4 locations, providing a range of training and consultancy services to SMEs. Almost 3,000 people have been trained, and 1,200 of these have found long-term employment in SMEs. Implemented by the National Employment Service and supported by the ILO and UNDP.
3. **Business Promotion and Support Centre, Razlog.** Has been operational for 3 years, and has become fully sustainable, principally on the basis of fees charged for services.

Sources: ILO (2000a), ILO (2000b), ILO (2000c), Pearce (2000b), BARDA (2000).

The second case study, of a Market Development Programme in Bosnia Herzegovina, is an example of market linkage and networking services provided in response to perceived informational deficiencies and market fragmentation.

Case Study 2: Market Development Programme, Bosnia Herzegovina

CARE International (an NGO) has set-up a successful Market Development programme promoting horizontal linkages between SMEs, and vertical linkages with buyers and suppliers. The services provided are:

1. A Market Linking service, through business development officers linking up entrepreneurs with suppliers and buyers. This linkage service is facilitated by a database of buyer and seller information that is continually updated. SMEs receiving loans from microfinance institutions are a notable group of users of these services, as finance is not the only constraint to be overcome by entrepreneurs. The aim of the market linking services is to develop market networks for SMEs, and to put entrepreneurs in contact with a range of possible suppliers and buyers.
2. Assistance in forming rural Entrepreneur Associations. Through such associations entrepreneurs can improve their bargaining position in the market chain, share technologies and lessons learned, and improve market access.

Services are provided through an NGO structure, many on a fee-paying basis, with affordable fees for microentrepreneurs. The long-term aim is to ensure commercial sustainability by setting-up a private firm to continue providing services to SMEs.

Source: CARE (2000)

The accepted role of government in the provision of enterprise support services is changing, with the ideas of *subsidiarity* and *core competence* gaining prominence. In this context these concepts essentially translate as 'who can do what best', meaning that responsibility is delegated to the lowest possible level and that government should focus on its own unique role (rather than getting involved where private sector markets should operate). [Gibson, 2000] The Guidelines for Donor Intervention formulated by the Committee of Donor Agencies for Small Enterprise Development advocate a shift of focus of public intervention away from direct provision of support services toward the facilitation of a sustained increase in the demand and supply of services. [Tanburn, Trah & Hallberg, 2000]

Governments need to shift from a model of direct service provision to working with private sector or civil society service providers, such as consultancy firms, marketing firms, NGOs, and entrepreneur associations. Moves in this direction have been noted in the Central Asia region, with the Government of Kazakhstan, for example, intending to work with and support local and private service providers wherever possible. [World Bank, 1998] Service provision can be done on a more commercial and responsive basis. Business centres and other service providers can introduce charges on services offered (for example fees for training courses or consultant visits), which would help ensure that the services provided match the demands and needs of entrepreneurs. Access for poorer entrepreneurs can be facilitated by providing support to the development of services that are affordable and relevant to microenterprises and poorer entrepreneurs, rather than by directly subsidising the cost of services.

Remoter rural areas and economically depressed rural settlements present a challenge to the long-term sustainability of enterprise support services, due to the dispersed nature of the SME clientele, and to infrastructural deficiencies. The government may therefore have to play a more active role due to low levels of demand for services, and an associated lack of interest and presence of private sector service providers. Civil associations such as NGOs and entrepreneur associations can still play a key role in partnering with local government in the provision of enterprise support services though.

Rural areas with poor or distant transport connections with urban markets, and without the potential for developing tourism or other location-specific economic activities, offer relatively few opportunities for SME development. In such areas SMEs will tend to be either involved in the supply, distribution, processing, or marketing of farm produce, or be livelihood-oriented enterprises involved in trade and services.

Microenterprises have a more simple organisational structure than more formal and larger SMEs, and tend to rely more on labour and on traditional technologies. The interests and objectives of micro-entrepreneurs may also vary, as many are motivated by household income diversification objectives rather than by entrepreneurial risk-taking. Enterprise support services directed at microenterprises (which after all form the bulk of SMEs) need to take such differences into account. Specialised consultancy services offered on an individual basis to enterprises, preparation of business plans, and management courses, are all suited to more formal SMEs. Microenterprises tend to be more concerned with market opportunities and access to microfinance services. Any training services offered to these smaller enterprises need to be practical, and standardised in nature. The timing and length of the training needs to fit with the busy schedule of the microentrepreneur, who may not have the luxury of having staff to operate their business while they are at a training course.

While models for microfinance provision in the region are being developed,¹⁷ there is often a gap in the provision of enterprise support services to microenterprises and to domestic-based income generating activities. For example, in Bulgaria, despite well-developed SME support models such as BARDA, services tailored specifically to livelihood-oriented enterprises are not being provided on any notable scale. [Pearce, 2000b]

¹⁷ For example, Opportunity International is an international NGO with programmes supporting microfinance NGOs throughout the region. The World Council for Credit Unions (WOCCU), the German DGRV, and Catholic Relief Services support credit unions and savings and loan cooperatives in many transition economies. The International Finance Corporation and the European Bank for Reconstruction and Development are supporting microfinance banks in countries such as Bosnia Herzegovina, Georgia, Ukraine and Russia.

7. CASE STUDY: RURAL SMEs IN CHINA

7.1 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 sector¹⁸ 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.]

Government policy changes permitted the shift of key rural factors of production to SME activities, and changes in the macroeconomic environment and in market conditions created space for the survival and expansion after this period. 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] The role of the local state in enterprise management and enterprise promotion in China 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.

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 investment has also played an important role in TVE development, and part of the growth in TVE output has been export-led. Foreign investors provided marketing networks abroad (particularly through overseas Chinese communities), foreign capital, and technology and management skills.

7.2 Lessons for Central Asia

The reallocation of rural household labour, typically from subsistence agriculture to non-farm work, is a critical component of economic development. The success of the TVEs in China has facilitated such a labour reallocation, shifting from dependence on subsistence agriculture to a diversified rural economy with non-farm SMEs playing an increasingly important role. While rural households responded to local and regional opportunities, differences in household responses can be accounted for by political capacity (related to social capital), human capital, and age (related to whether the person had lived through the Cultural Revolution). [Nee & Keister, 2000] Institutional change, increased rural industrialisation and the spread of markets have altered the opportunities facing rural households. [ibid.] As a result, they have been able to diversify into non-farm SMEs, and the resulting growth of rural SMEs has been impressive.

¹⁸ Defined in this context in a broad sense, i.e. including household-run and jointly owned private enterprises.

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 important questions about its applicability and transferability. The wider context of transition from a planned economy to a more market-led economy does have direct relevance to the Central Asian states, but there are notable socio-political differences between China and the Central Asian republics. The generally higher levels of population density in rural China may well mean that rural SMEs in their early stages of growth can more easily access viable local markets, before progressing to urban or export markets. In addition, the involvement of overseas Chinese investors, and the marketing networks they had access to, were perhaps a unique component of the TVEs' success.

The key lessons that can be applied to Central Asia from the China experience seem to be:

- that subsistence farming households respond favourably to opportunities that are available to them in diverse market settings (including labour markets)
- that the type of non-farm activity into which they diversify is affected by their level of political and human capital
- that subsistence households tend to maintain agriculture as a household activity, while at the same time diversifying into non-farm activities (Nee & Keister, 2000)
- that institutional change and rural industrialisation combined to provide the opportunities that fuelled the shift out of traditional agriculture
- 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
- that education is important in developing human capital levels to promote beneficial diversification
- 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. 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
- that as markets develop, the entrepreneurial role of government diminishes, and the role of government agencies in managing transactions should be reduced.

8. CONCLUSIONS

Institutional reconstruction is needed to mitigate market and government failures, and to complement opportunities offered by the market. However it should be noted that institutional change takes time and cannot be implemented in an abrupt way. The removal of institutional and policy constraints to SME formation and development is fundamental. Distortions to rural markets resulting from government policies or subsidies, and policies that favour the farm sector at the expense of the non-farm sector, are detrimental to the development of the rural SME sector.

A healthy and growing rural SME sector is central to the development of a diversified and ultimately more viable rural economy. SMEs also play a key role in the transition process. For SMEs in rural areas to thrive a minimum level of infrastructure and public services is needed. Enterprise support services can play an important role in assisting rural entrepreneurs. SMEs can in many cases contribute to the costs of those services, and introducing charging mechanisms helps ensure that the services are demand-responsive and useful. Governments need to move out of direct service provision and explore innovative partnerships with private firms and civil associations as service providers.

Of more fundamental importance than enterprise support services, however, are measures to improve the institutional environment in which rural SMEs operate. Legal reform, investment in the courts, a reduction in bureaucracy and taxation (both official and unofficial) for SMEs, and a reduction in state interference in the agri-business and agri-processing sector, are all necessary measures in much of rural Central Asia.

Central government has an important role to play in modifying the institutional and policy framework to ensure that rural SMEs are on a level playing field with larger enterprises and with the farm sector. Decentralisation of responsibility to local government – if accompanied by accountable fiscal decentralisation and effective civil society representation and participation – can enable local government to tailor support to the potential of the local SME sector, and to more effectively address the local constraints to its growth. Providing that any surviving tendencies toward over-regulation and control can be avoided, government has an important role to play in promoting the rural SME sector.

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