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**The Community as Actor in and Incubator of Economic and  
Social Revival: A Local-level Economic Development Strategy**

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*Summary*

Most discussions of decentralization ignore the role of local-level government in creating or expanding economic growth and instead focus on a narrow conception of “governance”. But sub-national governments can play a central role in the economic rejuvenation of the transitional economies of the CEE & CIS region. Successful efforts by local-level government both to create favorable conditions for private economic activity and to act directly (as owner, co-owner or part-equity holder in local service and productive facilities) are common in societies at all levels of development. In the most successful large-scale transitional experience, municipal and county authorities have played exactly this type of complex and multi-faceted role. This precedent has immediate relevance to the CEE & CIS region, where revival of grass-roots economic activity is a precondition for most other desirable developments.

## **1. Alternative Institutional Paths: Variety at the Local-level**

Comparative economic systems analysis and introductory economics textbooks routinely note that all real-world economies consist of a widely varying mixture of market, command and conventional-traditional allocation mechanisms (Gregory and Stuart various years, Pryor 1985, Wiles 1977), but this point was often largely forgotten in the mainline transition discussions. The dominant ideology of the transition presumed that the societies of the Central and Eastern European and Commonwealth of Independent States (CEE & CIS) countries would jump from central planning to a complete new set of basically homogeneous institutions.

Modern economic history shows that there have been and are a number of economic systems in which ownership and management arrangements are mixed together in unconventional ways but that were or are none-the-less successful. That many of these “successful” systems lived in a world far from free-market conditions suggests their adaptability. Recent experience with unconventional mixed systems serves to broaden appreciation for the opportunities for local economic growth initiatives based on small- and medium-sized enterprises (SME). It is time to reopen the question of: *what can be done at the local level to successfully revive grass-roots economic activity.*

This paper begins by exploring some of the recent experience with unconventional mixed systems in the most highly developed countries, in pre-transition CEE & CIS countries and then in reform period China. These diverse experiences highlight the opportunities localities have to promote economic growth by nurturing SMEs. Next, we consider some similar innovations that have begun to develop in transitional countries and cites a number of groundbreaking local policies from Western Europe and North America that are worthy of evaluating for use in the CEE & CIS region.

## **2. Institutional Variety in Advanced Market Economies**

Among advanced market countries there is a vast, diverse experience with institutional mixtures. This is most obvious in countries such as Italy, France and Taiwan that carried high levels of SOE into the 1990s, the latter two countries often in leading, high technology sectors. Norway, Sweden and Finland provide a related Nordic variant that is similarly technically progressive. The role of industrial policy, in many different forms, has been great

in both the countries where it is famous (e.g. Japan, Korea and France) and those where it is not (e.g. information technology in the United States and Finland).

A very different example is provided by the Mondragón system of locally owned cooperatives (Mondragón Corporación Cooperativa). They began in a small town of 8,000 (still only 25,000) in Spain during the 1950s, evolving from a technical school for local steelworkers into a small cooperative business manufacturing stoves. With funds collected locally they bought used equipment from a bankrupt company and refurbished it. A bank was opened to manage employee savings and pension funds, which then reinvested these funds into new business ventures owned by the workforce. Mondragón is today a network of 160 affiliated cooperatives, 90 of which are industrial producers and many have large export sales. Among them are Spain's biggest refrigerator and machine tool manufacturers, and its only producer of computer chips. The profitability of the cooperatives has often been twice the Spanish corporation average. Profits are distributed in (70: 20: 10) proportions (employee pensions: reinvestment: charitable contributions). The Mondragón Bank (Lankide Aurrezzkia Bank) played an especially important role, providing its borrowers with technical support and management guidance when needed and sometimes even moving employee between cooperatives in the style of Japanese *keiretsu* (Shuman 1998 and <http://www.mondragon.mcc.es/ingles/index.html>).

The lessons to be learned by transitional economies from these examples is that, in a variety of national contexts, a set of working arrangements were developed which allowed the successful coexistence within the same economic space of very different forms of organization and ownership. Even in the United States, which is widely thought to be committed to classical purely private solutions, there are many competitive modes of ownership: 47,000 cooperatives; 6,300 municipally-owned enterprises; 2,500 employee stock ownership plan (ESOP) companies in which employees own a majority of the shares (including some very large companies); and a myriad of “non-profit” entities that by themselves constitute 6.5 percent of the U.S. economy (Shuman 1998). Very often sub-national levels of government play an important role in supporting the successful functioning of these entities.

## **The Role and Scope of Local Government in Continental Europe**

An expansive view of the proper role of local government predominates in Western Europe, as shown by the “Charter of Local Self-Government”, summarized in Box 1. It is the *first multilateral legal instrument to define the fundamental principles of local autonomy* and was opened for signature by member states of the Council of Europe on 15 October 1985. It safeguards the rights of local-level government and asserts the right of citizens to participate effectively in the decision-making affecting their everyday environment.

The basic premises of the Charter are that: local authorities are one of the main foundations of any democratic regime, in which local self-government significantly contributes to reinforcing democracy and the decentralization of power; that the right of citizens to participate in the conduct of public affairs is a central democratic principle and can be most directly and best exercised at the local level; and that the existence of local authorities with real responsibilities can provide both effective and democratic administration.

A remarkable example of how municipalities can stimulate business without direct ownership can be found in the Emilia-Romagna Region around Bologna in northern Italy, where more than 1,800 cooperatives employ 60,000 workers. Many of these small businesses export high-tech products that compete internationally, forming several so-called *industrial districts*. Over several decades the regional and local governments have been able to creatively blend public-private partnerships with worker ownership and transform a once impoverished agricultural area into the fastest-growing part of Italy, with a per capita income ranking of 10 among the 122 official regions in the European Community.

## Box 1

### **The Council of Europe “Charter of Local Self-Government”**

#### The political context of member acceptance of the Charter

Individual provisions of the Charter are not legally binding, since in order to secure a realistic balance between safeguarding essential principles and achieving adequate flexibility, it takes account of the legal and institutional peculiarities of the various member states. Each country may select which of the non-core provisions it will be bound by. This compromise acknowledges the fact that local self-government affects the structure and organization of the country itself and that this is a matter of national policy. The Charter offsets this “choice” by establishing a minimum set of core principles that should be respected in any democratic system of local government. But each country may specify local areas or regional authorities where it intends to limit the scope of the Charter and complete exclusion of some territory is allowed as well.

In addition to the five features discussed in detail below, other provisions deal with: the constitutional and legal foundation for local self-government; protection of local authority boundaries; staffing of local authorities; elected local representatives (and conflict-of-interest issues) and encouraging the creation of *consortia* or *federations of authorities* to carry out tasks beyond the capacity of a single authority.

#### - **The nature of local self-government**

Local self-government has “the right and the ability (including adequate financial means) within the limits of the law, to regulate and manage a substantial share of public affairs under their own responsibility and in the interests of the local population”. This “right” of self-government must be exercised by democratically constituted authorities.

#### - **The scope of local self-government**

The Charter establishes general principles upon which responsibilities of the local authorities and the nature of their powers should be based. “The basic powers and responsibilities of local authorities shall be prescribed by the constitution or by statute” and should reflect the principle of *subsidiarity*, according to which “Public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen.”

To produce clarity and avoid any tendency towards a progressive dilution or overlapping of responsibilities, “powers given to local authorities shall normally be full and exclusive.” “Where powers are delegated to them by a central or regional authority, local authorities shall, insofar as possible, be allowed discretion in adapting their exercise to local conditions.”

- **Administrative supervision**

A “proportionality” principle requires use of the method that affects local autonomy the least while achieving the desired result. “Administrative supervision of local authorities shall be exercised in such a way as to ensure that the intervention of the controlling authority is kept in proportion to the importance of the interests which it is intended to protect.”

- **Financial autonomy**

The Charter guarantees that “local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers”. Local authorities shall not be deprived of the freedom to determine expenditure priorities and ‘financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.’”

“Part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate.” Central or regional statutes may set overall limits on the taxation powers of local authorities, but they must not prevent the effective functioning of a process of local accountability.

*“The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support.*

“As far as possible, grants to local authorities shall not be earmarked for the financing of specific projects. The provision of grants shall not remove the basic freedom of local authorities to exercise policy discretion within their own jurisdiction.”

- **Legal protection of local self-government**

“Local authorities shall have the right of recourse to a judicial remedy in order to secure free exercise of their powers and respect for such principles of local self-government as are enshrined in the constitution or domestic legislation.”

References:

Council of Europe (1985), “European Charter of Local Self-Government”, *European Treaty Series/122*, Strasbourg, Council of Europe.

Council of Europe (1996), “Explanatory Report on the European Charter of Local Self-Government”, Strasbourg, Council of Europe.

### **3. Variety even within Central Planning - Hungarian and other Examples**

Although operating within the framework of a central plan until 1989, Hungary had a large degree of decentralization and used market mechanisms extensively. The Hungarian New Economic Mechanism (NEM) was formally adopted in 1968, but was preceded by a number of earlier small steps beginning in 1956. The goal of the NEM was to create a mixed predominantly socialist economic system in which a variety of ownership forms coexisted. State-appointed managers ran all large and medium state-owned enterprises (SOE), with most profit going to the state. Large industrial and agricultural producers retained respectively the SOE and collective/co-operative farm structure but over time moved toward more and more market oriented forms of behavior.

In the NEM system enterprise managers continued to be appointed by industrial ministries in Budapest, but became more and more oriented to maximizing profits in an environment with little or no directive central planning (except for decisions involving significant capital expenditures). Intermediate material flows and product-marketing arrangements were made on a contractual basis between enterprises with little central involvement. Since central influence was ideally to be exercised only by the use of “economic levers”, not command, the system came somewhat to resemble the French-style indicative planning. This process of *commercialization* (market-oriented operation while remaining under state ownership) which occurred in Hungary in the pre-transition period then became a distinguishing feature of the so-called Polish transition path which avoided rapid privatization of large SOE (Kolodko 2000).

These fundamental modifications of classical Soviet-type central planning were not unusual, but were both carried further in some places (Hungary and Yugoslavia) and presented as being desirable systems reforms. In reality, all socialist economies used a mixture of plan and market. In Yugoslavia: each enterprise of any significant size was run by an elected workers council which had at least formal authority to hire and fire top managers; all profits after taxes were used as the council decided (within certain constraints); and enterprises competed in a modified market, setting their outputs and sometimes their prices. All of the other pre-1989 Soviet-type economies of central and Eastern Europe were predominantly government-directed, but in each the mixture of property types (state, co-operative, semi-private and purely private) and organizational forms were different. The example of the Republic of



Georgia within the USSR is also relevant, since many *perestroika* period initiatives were tried out there a decade earlier.

The point is that there was considerable variety even within central planning. Mixed systems with different proportions between large state and small co-operative or private enterprises developed, and in some cases prospered, in various parts of Eastern Europe. In both urban and rural contexts, societies operating with Soviet-type large institutions and central planning found diverse ways of integrating smaller-scale and more market-oriented components. Agriculture in Hungary, Czechoslovakia and Bulgaria, entrepreneurial small enterprise development in Bulgaria, and purely private small-scale industry in the GDR, provide relevant examples. In each case some kind of *non-adversarial relationship emerged between the large state institutions and these other “peripheral” bodies and a business culture arose with its own conventions and traditions*. When these systems failed, they did not fail because of their mixed characteristics, but because of the collapse of surrounding institutions (McIntyre 2000a).

#### **4. Market Reform by “anti-reformers” in Russian Provinces**

Russian provincial experience provides another, quite different challenge to orthodox views of how the transition should proceed at the local level. The conventional explanation of the center-regional dynamic in Russia was that the greater the ability of the Moscow center to push the pace of reform, the better the outcome. Although actual control of the center weakened during the decade, regional and local governments were forced to deal with the fiscal-financial, economic-production and social consequences of policies that continue to be announced from Moscow.

Different approaches were taken from region to region in managing the specific “local” features of the national economic crisis. It is useful to search local experience for clues to approaches or measures that might be useful in the future. A number of regions in Russia used sets of policies designed to slow-down, buffer or even prevent the intended effects of the liberalization, marketization and privatization policies adopted by the national government. Parts of the upper Volga region have been treated as the arch-typical example of these tendencies. These locally-initiated measures had complex effects in the rapidly changing and unpredictable environment created by poorly prepared policy actions taken at the national

level. Since the local policy measures came to be seen to contradict the neo-liberal transition orthodoxy, the central authorities themselves sometimes took active measures to try to reduce their inconvenient effectiveness.

These measures were not without difficulties, but produced desirable direct (favorable supply and lower inflation conditions, better health and mortality results) and indirect (a low degree of monopolization and criminalization of the supply system) effects on economic performance. These tactics left the regional sub-divisions in question economically and socially distinctive over a long period of time. It is especially surprising to economists (and other analysts strongly affected by the neo-classical tradition) that the effects of such measures could continue over a decade period in which the surrounding all-Russian economic space is believed to have become largely “marketized”.

The natural dynamics of simple markets work to reduce differences between connected parts of a larger system. In resisting central government pressure to unconditionally accept all-Russian conditions, the local authorities were aided by the relatively weak lateral connections between Russian regions and the limited development of wholesale and other economic infrastructure, but nevertheless often used the police powers of government to maintain sufficient economic autonomy to allow their semi-autarchic approach to function.

Study of the specific operational details of the original case shows the self-reinforcing economic logic of many of the supply- and demand-management measures adopted by local authorities (McIntyre 2000b). The economic reasons for success are clear and center on: the control and stabilization of local production for local consumption; use of a mixture of price-controlled and price-uncontrolled (but subsidized) markets for consumer goods; and prevention of the simultaneous disruption/corruption of the wholesale and retail distribution channels.

In some regions private retail trade was tightly controlled and taxed with proceeds used to fund partial continuation (with purely local funding) of important aspects of the old system “safety net”. This is the socially positive side of what is called “protectionism”. It should be noted that the city of Moscow has financed and paid a 100% supplement to state pensions to all legal residents since the mid-1990s. *Local financing of social policy measures* may seem

odd (if understandable under extreme conditions), but it is useful to note that it does fit within the conception of appropriate local authority expressed in Council of Europe “Charter” in Box 1 above.

### **Local-level “market-management” systems**

The array of policies adopted generally either worked directly on the supply side, involved direct intervention to manipulate prices or worked indirectly on the demand side. Direct rationing of a set of core products was widely used to take some of the edge off subsistence fears in several crisis situations. This affected the volatility of the demand side - retarding hoarding tendencies, reducing waste and making for somewhat more patient, less panic-prone consumers.

In some areas there were periods of strict, physically enforced, prohibition of “export” of local output of various “essential” products to other regions until local consumption demand had been satisfied. This limitation on the market access of local producers was in some ways an advantage, since it kept alive their linkage to local retail outlets by way of a local wholesale network. Maintaining a locally grounded distribution system and preventing an atmosphere of lawlessness were both aided by use of rationing and price controls in the chaotic first few years of the transition. Because this prevented rapid enrichment by the slowly emerging small business sector it avoided attracting irresistible criminal attention.

Wholesale distribution networks elsewhere in Russia were often refusing to carry local produce to market (due to: the higher profitability *to the wholesaler* of sales of subsidized EU surplus commodities; the ability of the *wholesalers as monopsonist* to simply *exclude lower margin products or small volume producers*; and interacting *criminalization of the distribution network*), producers faced fewer problems. Loss of wholesale distribution has been a major cause of the decline of both agricultural output and small-scale agricultural processing in many parts of Russia. This is the major reason why productive SMEs have trouble taking hold, along with powerful effect of generally depressed aggregate demand.

Transition strategies of this kind are often presented as being a form of dated opposition to the market per se. A more nuanced consideration of how markets really work in periods of disequilibrium systems transformation suggests that these measures are better understood as a

form of *market-wise pragmatism*. This approach allowed the eventual emergence of market forces, but only after sufficient time has passed to allow adequate institutional development to permit their successful functioning. There seems to be a direct relationship between the speed of “liberalization” and the extent of criminalization of the economic life. The economic logic of the policies pursued is substantial on its own terms but had the side-benefit of reducing the space for criminalization to take hold.

Because criminalization did not develop and entrench itself earlier in the process, markets are better able to function now. Small- and medium-size enterprises are especially vulnerable to these problems and so disproportionately benefit from a more civilized, law governed environment where the policing functions are not “privatized”. This experience suggests a way, in which market-oriented reforms can be reconciled with conditions of undeveloped market infrastructure and anti-competitive tendencies within the “market”, while reducing the disruptive effects of liberalization measures adopted at the national level.

## **5. Market Access and Wholesale Trade**

It is generally expected that much of the economic growth generated locally will come from SME firms, but productive SMEs cannot succeed without access to potential customers. While this is obvious, the role of *wholesale trade and other less visible but absolutely vital aspects of market access* are seldom directly considered. In many transitional economies SMEs must struggle to establish themselves in the absence of a fully developed institutional framework, one key aspect of which is access to distribution channels. Economic theory is generally silent in this area. Producers and consumers are simply assumed to exist and the distribution link between them is not treated as anything special. By implication the buyer and the producer/seller meet directly “in the market”.

Central and Eastern European countries in the 1990s provide a number of good examples of the institutionally specific features of distribution systems and their importance in determining market access in the transition period. A number of cases show a pattern of movement from price controlled state duopoly to unregulated private duopoly with foreign owners and foreign supply support networks. In some countries, including the former Czechoslovakia, Hungary and the former GDR, the distribution systems for food and household products under the old system were price-controlled duopolies. Two complete

national networks of retail stores existed, one in the standard form of state property and the other similar to Western consumer or producer cooperatives. Thousands of local retail sites existed, but each belonged to one or the other system. In some countries each of these direct distribution and wholesale systems was taken over by a single Western food company, resulting in a new duopoly arrangement with two crucial structural differences: (1) price controls were no longer in place; and (2) the western buyers integrated their new acquisitions into an existing wholesale distribution network which was based on large automated warehouses in western Europe.

It was easier (the word efficiency must be used cautiously here) for the new owners to simply expand the volume acquired of existing Western products. Also the double subsidies (producer country subsidies, plus EU export subsidies) on many of the products produced by local SMEs created a strong additional reason to retain “western” suppliers. The result was that local producers lost access to retail shelf space, meaning they lost exposure to the process of consumer choice in their own countries. Consumers in Budapest at one point had access to mostly French milk and pork - products in which Hungary was an established efficient world-quality level producer. The implications for the local producers of all manner of food, processed food and consumer products (cleaning aids, cutting boards, brooms, etc.) were highly unfavorable.

An added irony is that by the time consumers began to clearly express a preference for many pre-transition formulations and brands, the resulting revival of “East” products often occurred when they were no longer locally owned or necessarily even locally produced. These products were sometimes presented to consumers in a physically segregated setting as “retro” or “style” items. The partly artificial character of this initial demand collapse, together with the eventual recovery of demand for the old products (some of which were of a high standard) provides a strong argument for a “mediated transition” strategy. This mediated approach allows time for local producers to adjust to new conditions and local consumer to understand “loss-leader” and “penetration-pricing” retail techniques.

While the process described about is largely complete (and many of the more severe distortion have been at least partially remedied), it throws useful light on the current process in which SMEs are struggling to establish themselves, often in the absence of an adequate

institutional framework, one key aspect of which is access to distribution channels. *Consumers (and investors) are often willing to award some kind of preference to local alternatives, especially when freshness and local level employment effects are made clear.* Local governments can become active in support of local SMEs in many different ways, for example by requiring retail outlets to stock goods produced locally along side imported goods or requiring labeling of goods by place of origin, thereby moving consumer toward the “perfect information” often assumed in their behalf. Local governments can publish directories of local suppliers to encourage local purchasing.

Local government and/or collaborating local NGOs can identify new, viable local markets by conducting studies to determine the extent of local demand for specific goods and services, followed by “import-dependency” studies (at the locality, district or province level). Often high import-dependency will be discovered (contrary to “perfect market” assumptions) for products that are or could be produced locally with similar quality and cost features.

Local government can and should help to create favorable conditions for the foundation or expansion of new private enterprise, through: entrepreneurial training (both formal, using local universities, and informal, via community schools of the Mondragón type); credit provision (either directly by loans from the local government, or indirectly via local government loan guarantees, linked-deposits or other ways of supporting “community-friendly” banks); legal reform for small business (streamlining zoning and tax requirements for small firms, and permitting home-based enterprises); selective local government investment, of either pension funds or surplus revenues, in new local enterprises (several U.S. states like Michigan have “Invest Local” funds); and selective purchasing of goods, services, and contracts from locally-owned firms, like the “Oregon Marketplace” (Shuman 1998).

There are also more dramatic measures (Helleiner 2000) that have been taken by local governments in some parts of the world to stimulate local demand, including use of local currencies, local deficit spending programs, and use of “time dollar” schemes (which encourages unemployed and underemployed people to contribute more to the formal economy rather than the “shadow” economy). When and where private entrepreneurs are failing to meet basic local needs, local government can and should step in and launch its own enterprises, as suggested in the sections on China that follow. The discussion of China also

suggests that the public-private dividing line is itself flexible and amenable to both change and mixed solutions, depending on conditions and needs.

*Finally, there is some evidence that economies of scale are declining worldwide, opening up new opportunities for local enterprises.* Local activity may have growing advantages in light of: (1) the return of an era of high energy costs, making transportation much more expensive; (2) the often high marketing, shipping, refrigeration, advertising, and intermediation (“middle-man”) costs of many “global” products (perhaps 2/3 in the case of many food products); (3) the growing fraction of every economy made up by the service sector, much of which is inherently local; (4) the mobility implications of information technology (in which computers and telecommunications together allow a corporate headquarters to fit on a desktop); (5) the preference of a significant proportion of consumers and investors for local alternatives; and (6) the extent to which increasing environmental consciousness leads to greater “internalization” of the externalities associated with bigness (e.g., pollution charges and the “full costing” of energy use and transportation infrastructure), which together improve the relative cost-effectiveness of local-level activity. To take advantage of these opportunities local government requires far more power than it generally has in the CEE & CIS region (and more than the European “Charter” requires).

### **The form of nationalization/de-nationalization as a key to retail trade revival**

The situation of service and retail trade is simpler to manage, although access to premises is an essential problem. In some countries the physical form of nationalization and denationalization made the revival of small enterprises relatively easy. In Czechoslovakia a highly developed small enterprise sector was 100 per cent nationalized in 1948/1949. Nationalization was carried out in a way that created favorable physical conditions for subsequent re-emergence of a small premises business culture at a later time. Many small shops were operated as branches of larger state enterprises or co-operatives (in some cases retaining their previous owners as managers). Others were closed completely but with the premises left intact and in many cases unused for 40 years. Since the state retail distribution system was heavily based on small premises dating from before 1948, many of these dispersed outlets were easily revived as free-standing entities after 1989.

The restitution of some premises and going concerns was combined with an auction approach to either re-privatize or privatize other small retail, service and productive enterprises. The auctions were explicitly structured to produce what was understood to be an “American-type” of individual ownership (explicitly forbidding the workers of an existing enterprise to bid as a unit). Thus the infrastructure for a new private retail sector was rapidly created. After the division of Czechoslovakia in 1992, this successful small enterprise re-privatization was an important contributory factor to the relatively good economic/social conditions and adequate transition period performance of both the Czech Republic and the Slovak Republic. In Poland a purely private small trade and agricultural sector continued to exist throughout the post-war period and provided similar advantages.

As a general observation, we can conclude that markets do not automatically emerge in a healthy and functional form without some attention being given to shaping their institutional and structural features. Rapid liberalization does not allow time for local producers to adjust to new conditions and relationships, leading to the failure of what may be otherwise viable entities. Local government has often proved effective in managing crisis conditions, but experience in many countries shows a potential for much more active and creative results. Local government economic interventions - especially those that mediate and buffer but do not completely reject market logic - should not too quickly be labeled as “dysfunctional protectionism”. They should be appraised with reference to what is done elsewhere and what is successful, not by textbook visions based on “already perfect” markets.

### **Privatization, re-privatization and de-privatization at the local level**

Many large and small enterprises in Russia and other CIS states are “incompletely privatized”. Legal questions about the initial privatization, death of owners, artificial and real economic crises and other reasons have placed the problems and often the assets of many of these previously state-owned enterprises in the hands of local or *oblast* governments, posing the question of what to do next (McIntyre 2000b). Ellerman has pointed out there was and is an alternative to the generally disastrous voucher privatization which could have supported growth of the crucial small and medium-sized enterprise sector in all of the CIS countries. He calls this alternative scheme “Polish leasing”, although the same approach was developed during the *perestroika* period in the Soviet Union (Ellerman 2000).



The “lease buy-out” method had been organizationally perfected both in the indigenous cases during the 1980s and then in pre-voucher period (1991) pilot lease-buyout program supported by the European Bank for Reconstruction and Development (EBRD). Ellerman argues that this would have provided a better path to the market than the option actually pursued and quotes Bernard Black, the American jurist and principal author of the Russian corporate law codes:

It is ironic that the Russian Communists of a decade ago, knowing that central planning was a dead end but not fully trusting markets either, likely built through enterprise leasing a better means for enterprises to manage the transition to privatization and a market economy than the privatize-now approach that Western advisors later promoted and Russian reformers enthusiastically seized on. The Russians who blame Western advice for destroying their economy are not entirely wrong (Black, Kraakman and Tarassova 1999).

This homegrown privatization method (*lease buy-outs* or *enterprise leasing*) was more or less equivalent to one of the most successful of the Eastern European privatization programs; the so-called “*Polish leasing*” approach. According to Ellerman, this promising and extremely popular USSR period approach was

.....abolished by the reformers with the full approval and indeed insistence of the western advisors. Thus the reformers and their western counterparts not only pushed Russia along a disastrous path but deliberately blocked an alternative indigenous path that showed great promise elsewhere (e.g., Polish leasing and Chinese TVEs) (Ellerman 2000).

This approach is in effect the sale of an enterprise to its workers and/or managers, as well as other local “stakeholders”, with payments made over time out of future sales proceeds. Approaches like this are also called “sweat equity” sales. The Chinese experience discussed in the next section provides an instant answer to the question of who the other “local stakeholders” might be -- the town or district or *oblast* government. Former World Bank Chief Economist Joseph Stiglitz has proposed exactly this approach, specifically linking it to the current institutional dead-end in many of the CEE & CIS countries, calling for

*“privatization to stakeholders”* (1999). This concept has wide potential application in the countries of the CEE & CIS region as an approach to redeeming failed past or failing future privatizations.

## **6. Local Government Initiated Economic Revitalization in China**

Reform period China offers another example of the economic effectiveness of local-level government. There are many positive and negative lessons to be learned from the Chinese reform experience, both so strong and clear that it is sometimes hard to believe they come out of the same system at the same time. It is necessary to learn the local economic development and dynamism lessons of the remarkable Chinese experience (how local, somewhat democratically accountable, economic leadership was able to use mixed ownership forms, including a great deal of local-collective ownership of directly productive entities, to create vigorous, market-competent growth) but carefully study how to get such results without the abandonment of human development supporting activities (seen as universal citizenship-based rights or entitlements).

It is this connection between economic performance and human development that makes it so important to study the China experience as a point of reference in the formulation of wise policy in other “transition” economies. The nearly opposite features of the Chinese reform experience are real, but are not inevitably linked. We reject any implication that the positive results could only be achieved in ways that produced these specific negative effects.

### ***Para-entrepreneurship at the local level***

The nearly incredible reform period success of local authorities as facilitators and direct entrepreneurs (called here para-entrepreneurial activity) is extremely important to other transition economies. The local authorities in some CEE & CIS economies face structural situations that are similar in important ways (the collapse of the economic leadership role of the central state, stagnant local economies, effective responsibility for much local production and distribution) and often they have nearly identical ownership/partial ownership/effective ownership rights to some local goods- and service-producing entities. Even in countries where privatization and market reforms have gone quite far, such structural carryovers from the planned economy are at least a small part of the current institutional mixture. Thus, in addition to their potential role as facilitator of local economic development, local-level

governments in transition economies are already economic actors on a scale generally greater than in long-time market economies.

### **A “pragmatic” transition without an initial plan**

It is important for CEE & CIS to bring the experience of China into the discussion of alternative local-level futures. During the reform period the emphasis on ideology of the Cultural Revolution was replaced by a more balanced appeal to both community/group interests and individual self-interest. The general trend of the reforms since then has been combining an expanded scope for market forces with reduction of the extent of planning to focus increasingly on strategic rather than detailed microeconomic decisions. The central features of the Chinese reform model over the entire 1978-2000 period have been summarized (McIntyre 2000b) as:

- (1) gradual substitution of “guidance” for more direct “administrative” planning with the State relying more on indirect financial levers, rather than administrative orders or directives, to influence changes at the local level;
- (2) creation of increasing room for market forces to operate both in product and factor markets, including a substantial freeing up of the price system. Despite this tendency toward price “liberalization” different types of administratively set and controlled prices have continued in force;
- (3) as Communist Party control over enterprises has declined, managers have been granted increasing control over daily enterprise activities and required to take greater responsibility for their decisions;
- (4) wages and bonuses have become much more closely tied to individual performance in order to stimulate greater productivity and efficiency;
- (5) experimentation with *purely private*, *small group* and *collective but non-national ownership of the means of production* has led to a great diversity of ownership forms; and
- (6) foreign technology has been actively welcomed, but a tough bargaining approach has allowed very little 100 per cent foreign ownership while trying to extract maximum local effect from foreign involvement.

With the abolition of the communes at the beginning of the reform period, village governments had to be newly created to take over their administrative functions, such as

public health and education. They also took over many purely local directly productive enterprises that had survived from the Great Leap period. These enterprises, along with newly created ones, make up what is now called the Township and Village Enterprise (TVE) sector. In a surprising and exciting way for our purposes in CEE & CIS, the TVE soon became one of the most dynamic elements of the reform period Chinese economy.

### **Local-level initiatives result in new type of SMEs**

The rising power of local authorities over basic economic decisions is probably connected to the TVE phenomena discussed below. The resort to bargaining outside the plan reflects the growing prominence of local government in the Chinese economy - this means that local bureaucrats increasingly usurped the independence and power of the managers. In theory managers of both large and small SOEs are independent. In fact, they still send regular reports about their factory's output, wages and bonus payments and cash-flow reports to (respectively) the industrial bureau, the labor bureau and the financial bureau of the province or county that controls them. The result is that the main economic unit is not the factory, but the local-level bureaucracy. Local officials have been able to manipulate the reforms to transfer even more resources to their own control, moving beyond the TVE to directly influence and in many cases control local branches of SOE (*local SOEs*).

### **Township and village enterprises**

The Township and Village Enterprises (TVEs) are a key feature of the reform period, with peculiar and intriguing aspects. Rather than being new creations of the reform period, the TVEs are a legacy of the 1958-60 rural small-scale industrialization efforts during the Great Leap Forward period that survived and through time developed effective economic characteristics.

The TVEs have proven to be unusually successful and dynamic economic entities, despite structural and behavioral features that would appear disadvantageous when viewed from a standard perspective that emphasizes the need for clearly established property rights and individual incentives to secure effective performance. Weitzman and Xu (1994) offer the best explanation of how the TVEs seem to work, illuminating the working arrangements of these strange but highly dynamic entities in terms of an analysis of “loosely defined” collectives,

combined with “informal, trust-based relationships”. They explain this behavior in terms recognizable to the categories of individual motivation and choice of neo-classical analysis.

Already in 1978, 19 million workers were employed in TVEs, producing simple implements and relatively crude products. By the mid-1990s employment had grown to more than 60 million and the array of products widely proliferated and moved to export-level quality. By 1997 the TVE sector accounted for more than 30 per cent of PRC GDP and the astonishing total of 46.3 per cent of export earnings (Nolan 1995: 221-222 and *People's Daily* 5 February 1998 and 22 March 1998).

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

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

Many existing TVEs changed legal form during the 1990s, becoming what are called *joint-stock co-operatives*. For most TVEs this is only a change of name, although large TVEs are thereby structurally prepared for the possibility of becoming autonomous publicly traded entities in the future. It is interesting to note a sharp movement by previously purely private entities to take on this same joint-stock co-operative form. If the local SOEs are

fundamentally reorganized it appears likely that many will end up under the direct control of township and local governments (Sun *et al.* 1999).

It is a question of great world significance whether China can combine planning with an increasing role for market forces and still maintain a system of property rights characterized as predominantly socialist rather than capitalist. The enormous regional differences in incomes and living standards and the sharply increased inequality within regions pose the greatest threat to the continued success of this mixed model. For more than two decades growth has been so rapid that it is only relative not absolute poverty that has increased. It is not clear what will happen should an overall growth slow down lead to rising absolute poverty. Assumptions that the 1999 World Trade Organization accession agreement will lead to a rapid opening contradict the essence of the Chinese reform experience thus far. Chinese economists and political leaders are aware of the extent of the economic and social collapse “free-market” policy produced in Russia and are likely to go to great lengths to forestall any such developments in China (Nolan 1995).

#### **7. Local Government attention to Human Development is needed**

One of the economic development lessons of this experience is that the original (not the evolved and most recent) form of Chinese Township and Village Enterprise (TVE) should be considered as a promising model for other countries. This is in essence a *closed cooperative* in which local government may play either a supervisory and facilitative role or act directly as a partial owner. If the classificatory logic used by the World Bank is adopted, the latter arrangement even qualifies as “private sector development” (no matter who owns it, if it is not the national government, it is considered “private”). Regarding local provision of or partial responsibility for health care and social welfare, a similar point can be made: it is the earlier Chinese emphasis on preventive care and universal access that provides ideas for the type of fast-impact, low-cost reforms that could be effectively mobilized by local-level governments of the CEE & CIS countries.

It is easy to find reasons to avoid studying the Chinese experience. Barriers of culture, development level and political culture have made it convenient to not think carefully about its challenging and complex lessons. To reduce this inhibition it is useful to remember that the main Chinese institutional innovation is much like a multi-member partnership, which is a

familiar organizational form in many other countries. The role of local government is also distinctive but not unique, with parallels both within the CEE & CIS region and elsewhere, including advanced market economies. A combination of these aspects could be useful as a feature of local-level revitalization efforts elsewhere. Riskin (2001) tells this story more fully, explaining how the dynamic, society-transforming growth was set off and carried out by these local bodies, ended up producing less improvement in human development that might have been hoped.

### **8. Local-level Economic Development Initiatives**

There are a number of examples from the region that show the ability of city governments to effectively play a role in national-level policies, sometimes even in connection with central issues like the speed, character, and extent of enterprise privatization. In Budapest the city government was able to resist pressure from the national government for rapid and extensive privatization of city services, but successfully reorganized and improved the performance of those functions it retained. It was also able to prevent abandonment of construction of a fourth subway line. This type of transportation infrastructure has major human development effects because it directly allows commuting, job-seeking and health and social service access by low income citizens.

In Moscow the city government has carried out its own economic development policy, organizing orderly small enterprise privatization (including active SME support programs, credit access and other measures) and blocking the national large-enterprise privatization initiative (directly taking control of several very large enterprises as an employment and municipal tax revenue protection step). It also actively manages food supplies, using both short-run and long-run programs. An invisible but enormous “Ministry of Food Supply” buys and sells billions of dollars per year in food stuffs (using a self-financing revolving fund), serving to guarantee adequate supplies and prevent price manipulation (Helmer 1997).

It also carries out a multi-region food supply program, subsidizing investment in agriculture and food processing in surrounding *oblasts*, as well as guaranteeing market access. Moscow is a wealthy city, drawing tax revenues from the headquarters of firms that produce in other parts of Russia, but its degree of active engagement with economic development policy and

income support (which includes 100% city supplementary payments on top of national pensions for all city residents) reflects not just money, but good urban management.

### **Enterprise Revitalization**

A new “enterprise revitalization” program in Russia is an example of the kind of active measures that can mobilize economic development at the local level. With geographic targeting, these measures can have direct poverty reduction effects. UNDP co-sponsors this World Bank Institute program on “Improving Management and Performance at Russian Enterprises”, working with the Federation Council and Duma, the Russian Union of Employee-Owned Enterprises and the Academy of Self-Management.

This program is piloting application of *high performance management techniques* and *teamwork methods* for the revitalization of SMEs, paying particular attention to new and “mixed” types of enterprises. It draws on UNDP experience in Ukraine supporting local-level government in active provision of institutional and financial support for local SMEs. The Ukraine project began in 1994 and focuses on the role of local self-governing entities (mostly municipalities) in stimulating local SMEs by: training SME operators and local government officials; creating innovative forms of credit support (including the use of municipal property as *surrogate collateral* for loans to local SMEs); and developing public-private Municipal Investment Programs (MIP) to support SME investment. These new municipal credit mobilization techniques address the crucial SME problem in all transition countries -- lack of access to credit on “reasonable, non-criminal terms”. Information technology has been actively used to encourage inter-municipality sharing of experience.

*Many false hopes have been built on the assumption that, once market economy conditions are introduced, small enterprise development would both proceed automatically and by itself have system-dynamizing effects.* While SMEs are a potentially dynamic force in local economic revitalization and poverty reduction, they seldom are cumulatively successful (at more than subsistence levels) without active institution-building and “support” from outside the SME sector. The United Nations University/WIDER research project on “SMEs in the Transition Economies” strongly underlines these points, concluding that local-level authorities would be wise to follow the practice of regional and local authorities in western countries who commonly adopt a *local industrial policy* (McIntyre 2001a).



A healthy relationship with the surrounding large entities (State-Owned and Previously State-Owned Enterprises) is crucial for SMEs if they are to move beyond service provision and small-scale retailing. Local government can play an active role in stimulating constructive interactions between the large SOE/PSOE and small entities, improving the flexibility and competitive positions of both. There is a long list of successful precedents for such approaches, for example in northern Italy and southern Germany.

### **Enterprise Reorganization: Also an unexpected Local Role**

Local government can also play an extremely useful role in supporting the successful “unpacking” of bankrupt or unprofitable large enterprises in ways that salvage as many smaller production units and employment places as possible. The experience of the World Bank ARIA program in Moldova shows that the physical and human resources of financially non-viable large enterprises are a valuable source of “start-up” capital that, with the aid of technical assistance and local government support, can be reconfigured into viable smaller enterprises. The Russian enterprise revitalization program mentioned above also has a promising new technique of operating and reorganizing formally “bankrupt” entities under municipal protection.

### **Enterprise “Governance” and Local Good Government**

Concern with good governance must not stop with the internal rationalization of government. Good government is not possible without transparency and accountability on the one hand, and effective public policy on the other. This is the broader meaning of “governance. *Achieving significant positive effects of local living standards and the quality of life requires restarting economic growth and this requires effective local-level economic development policies.* The WBI-UNDP program in Russia sits astride exactly these connections between enterprise governance and local government performance. It attempts to develop ways of working at the local level that build in maximum transparency and accountability. While these features have well known advantages under normal operating conditions, they of special benefit in transitional economies. There is great conceptual and operational logic in connecting these programs, as well as in systematic sharing of good practices and other experiences.

Successful public-private cooperation at the local level reinforces the political legitimacy of local authorities by stimulating local employment, contributing to the growth of local tax revenues and supporting local provision of various services. At the same time this reduces the vulnerability of both the local SMEs and the local government to possible predatory intervention from higher levels of government.

Especially promising are efforts to trigger *local saving-investment cycles*, based on the visible use of local savings to fund effective local projects. It is necessary to explore different approaches to establishing local SME infrastructure and institutional support, and stimulate approaches to recycling of local savings to support local SME finance, emphasizing formation of *credit cooperatives* and considering establishment of *municipal credit guarantees for small enterprise loans* (McIntyre 2001b).

Localized programs of the type described above have a series of aspects -- high effectiveness, low cost and low dependence on external resources -- that strongly recommend them for use in situations of extreme government budgetary stringency. *The Russia program in particular emphasizes learning from local, often unnoticed, examples of operational excellence.* This approach should be applied much more widely. It has the strong advantages of credibility, low cost, and a high probability of establishing cumulative local “learning circles”. It builds capacity and reduces dependence on external consultants. This approach offers potentially powerful positive examples in an environment where direct copying of specific “western” models has often proved unsuccessful. Even in the most advanced CEE countries these approaches have a promising role to play in efforts to stimulate the economic and social development of lagging regions and reduce localized poverty concentrations.

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