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UDK 316.472.4:33

Trust, Contract and Small-Medium Enterprises (SME) development in South East Europe

POVZETEK (Zaupanje, pogodba in rast majhnih in srednje velikih podjetij v jugovzhodni Evropi): Socialni kapital je pomemben dejavnik razvoja malih in srednje velikih podjetij v jugo-vzhodni Evropi, in zato ključna spremenljivka, ki pojasnjuje ekonomsko rast v tej regiji. To potrjujejo tudi rezultati najnovejše študije (ACE, 2001) ekonomske rasti med malimi in srednje velikimi podjetji v treh državah: Sloveniji, Bosni in Hercegovini in Makedoniji. V tem članku pojasnjujemo vzročni mehanizem, ki vodi v statistično zvezo med socialnim kapitalom in ekonomsko rastjo. Ugotavljamo, da raven socialnega kapitala v neki deželi ustreza ravni medosebnega in sistemskega zaupanja. Prav tako obstaja zveza med ravnijo zaupanja v družbi in mehanizmom upravljanja ekonomskih transakcij, ki si ga izberejo ekonomski akterji. Mehanizmi upravljanja ekonomskih transakcij pa so ključen dejavnik pri rasti podjetja. Na podlagi teh rezultatov zaključimo, da ima socialni kapital vpliv na ekonomsko rast, ker spodbuja podjetniki in managerje, da prehajajo iz tradicionalnih oblik upravljanja ekonomskih transakcij na takšne, ki temeljijo na zaupanju. Socialni kapital torej ne samo da znižuje transakcijske stroške, ampak tudi širi okvir poslovnih priložnosti, kar je ključno za zagotavljanje ekonomske rasti.

KLJUČNE BESEDE: socialni kapital, ekonomska rast, zaupanje, pogodba, mala in srednja podjetja, Slovenija, Bosna, Makedonija, Jugovzhodna Evropa.

1. From culture to social capital

Economic development has always been discussed in the context of culture. A classic masterpiece by Max Weber speaks of the protestant ethic that propelled the northern parts of Western Europe toward rapid economic growth. Today, failures rather than successes of development policies in developing and transition countries are often explained away with reference to culture. While modernization theorists tried to get away from cultural explanations, by stressing strong correlation between culture and economic development, their demise in late 60's brought the culture back into the discussion of economic development. Postmodernist theories of the 90's have developed and radicalized the cultural perspective.

In recent years, the problem of economic development became increasingly related to social capital as scholars started to realize that the key aspects of culture could be captured in a much more tangible concept of social capital (Putnam 1983; Coleman 1988; Fukuyama 2001). A look at recent literature suggests that social capital has all but substituted culture as the key social factor of economic growth. Unlike culture that refers to symbols and values, social capital brings resources and their deployment into the equation of development and growth. Social capital consists of social ties that open the access not only to other peoples' minds but also to their vaults and bank accounts. The resources that can travel through social ties are familiar also to economic analysis: information, opportunities, referrals, advice, and old-fashioned cash. By conceiving social ties as conduits for the transfer of resources, social capital made it possible to integrate the key elements of social structure into the analysis of economic and social development (Wollcock 1998, Dasgupta and Serageldin 2000).

Social capital has three different types of effects. It has a direct effect as it brings additional resources into production function. It has indirect effect as an intervening variable because it steers, modifies and mediates the flow of resources through social structure. And it has multiplicative effect because it affects utilization of resources and thus either enhances or dilutes the effects of those resources (Burt 1992).

In the World Bank research, social capital is assumed to be the key social factor of economic growth in developing countries in general and in transition economies in particular. Where markets are underdeveloped they are inefficient and thus social capital can have much stronger role than in developed economies. Social capital creates social infrastructure for economic transactions. Because it generates trust, facilitates cooperation, and rises readiness to assume entrepreneurial risks in a society, it carries a large potential for the acceleration of economic growth (Zak and Knack 2001). Some well-known cases of the impact of social capital on economic development include East-Asian economies (World Bank 1993, Stiglitz 1996), northern Italy (Putnam 1983, Sabel 1989, Lazerson 1993, Bagnasco and Sabel 1995), and France (Lawrence 1988). Social capital is particularly critical in transition economies because their economic growth depends heavily on the rapid SME development. Dependence on SME growth in transition economies is a result of the culmination of two factors. On the one hand, the restructuring of large, formerly state owned companies resulted in necessary contraction in employment and output. On the other hand, regime change brought sudden liberalization that encouraged economic initiative, which has previously been hindered. With large companies contracting, the endogenous growth in transition economies could come primarily from SME sector.

Social capital plays an important role in growth of SME sector because small firms are more vulnerable to opportunism than larger ones. Small size always leads to the lack of diversification and consequently to a higher business risk. By generating trust, promoting cooperation and reducing both risk and transaction costs in the economy and society, social capital benefits SMEs, because it increases their willingness to enter into new business transactions and start new ventures. Cooperation is a key process because it has a potential of transforming small companies into big players on the world market. If a small firm enters a cooperative network of small producers, it gains the benefits of economy of scale while retaining the flexibility of a small company. Such cooperation is a key vehicle for SME development. Dependence of transition economies on SME growth is thus closely linked with the issue of social capital.

This paper examines the role of social capital and its impact on economic growth at three levels: first, interpersonal relations and co-operation among business partners, second, relations within business community at large such as memberships in business associations, and third, relations between economic actors and the state. Interpersonal relations among partners are the most rudimentary level at which trust and cooperation can spontaneously emerge. Membership in business associations and relations within business community at large promote sharing of information, access to each other and to new business partners, and facilitates coordination. And finally, relationships between the state and economic actors are the keystone for successful design and implementation of policies. As it is argued in the next section, the analysis needs to encompass all three levels in order to assess the importance of social capital for SME development.

2. Trust and confidence

There are two broad conceptions of trust that are often confounded but need to be carefully distinguished. Trust as lubricant of economic transactions in Arrow's famous statement is an asset that promotes economic growth by means of lowering of transaction costs (Arrow 1974, Williamson 1985). Economic life becomes simpler because we can make deals without lengthy and costly contracts, and insurance mechanisms against opportunism and malfeasance of our partners. The lack of trust can be therefore considered as a barrier to economic growth. It does not stop it but it slows it down. With increasing trust the barrier is lowered.

The second conception of trust comes straight from sociological classics, namely, Durkheim (1984). His view of economy as embedded in the society is expressed best by his notion of pre-contractual solidarity. In short, if contracting parties rely only on contract as an enforcement mechanism of their mutual obligations, contracts are not only inefficient because they are costly but they are also ineffective because enforcement of contract by external authority is delayed and restrained. Durkheim argues that social solidarity in a given society determines the extent to which contracts, explicit or implicit, are observed. In a society that is marked by a high level of social solidarity economic growth would be high because economic transactions are subject not only to legal but also to social norm. For Durkheim, a well integrated society makes people honor their contractual obligations to one another. If society is disintegrated, breach of contract becomes rampant because there is little social control. Durkheim thus argues that the key to economic prosperity is the existence of pre-contractual solidarity, i.e. social solidarity that exists in a given society.

Modern translation of social solidarity are social capital and trust. Trust and economic development has been a subject of Fukuyama's work in which he extensively dealt with the Durkheim's hypothesis of how trust brings about economic growth in a given society (Fukuyama 1995). The key hypothesis advanced in this book is that social capital and trust not only reduce transaction costs, but are much more fundamental because they make economic transactions possible. The lack of social capital and trust in the society determines whether there will be any economic growth at all. Trust is not just a lubricant that affects the intensity of resource utilization; It decides whether the resources are put on the market at all. The lack of trust is considered a serious barrier to economic and SME development because it discourages participation in the market economy.

The two theories could be neatly contrasted in terms of conceptual distinction between confidence and trust, proposed by Luhmann (1988). Confidence means that we enter into economic transactions believing that expectations will not be disappointed. We are confident about the outcomes and we neglect the dangers that are possible but not very likely. We go for a walk with confidence that accident will not happen although they do happen. We go to the bank with confidence that the bank will save your money although bank failures are possible. We enter into economic transactions confident that most of the people will not breach their contracts, although breach of contracts and scams are possible. Nevertheless we remain confident that things will work out. Confidence - or systemic trust - refers to the generalized expectations of how systems operate in a given society. And those expectations determine the degree of participation in the economy. Pre-contractual solidarity is the foundation of confidence which decides whether or not people will do business in a given society. Participation in the economy is decided by the level of confidence in the economic, financial, legal, and social system.

Trust, in contrast, involves choice and risk that originates in indeterminacy and freedom of actors. We take risk and trust a person. We have expectations about fulfillment of the contract, but we calculate and take risk. Trust could be compared with Arrow's ideas on trust as facilitator of economic transactions. If our experience with given business partners is positive, we tend to trust those partners more than others. We still take risk but we know what we are doing. We are using trust to facilitate transactions by reducing transaction costs. While confidence is related to the question of whether or not to enter economic transactions at all, trust invokes question of simplifying economic transactions, thus addressing the issue of utilization of resources. Participation in system requires confidence while utilization of opportunities requires trust. While confidence is a systemic thing that appeals equally to all participants in the economy, trust is interpersonal thing that can vary from partner to partner depending on calculations of risk of doing business with a given partner.

Both, confidence and trust are important for economic growth. Their absence represents a barrier to economic development in general and SME development in particular. For promotion of SME development each of the two barriers has to be lowered through SME policies. This, however, requires two different sets of policies. To increase confidence, the countries must improve the impartiality, reliability, and efficiency of their institutional, financial, and legal systems. The emphasis is on the quality of infrastructure that is required for doing business in a country. To increase trust among business partners, there needs to be an increase in face-to-face interactions among business people themselves. Business associations, fairs, clubs and other formal or informal settings that are capable of mixing people together are the vehicles that generate opportunity for contact. But sheer volume of contacts does not do the trick of increasing social capital. The volume is just a potential. The key is to build contacts with trustworthy business partners that can by virtue of their relationships convey the models and norms of trustworthy business behavior. Such partners can only come from the outside of the social system, namely, from abroad. Thus, the policies should attempt to bring trustworthy foreign partners into the countries and thus increase personal contacts with those foreign businesses that can convey a positive influence of trust based business relationships and serve as role models for domestic businesses.

3. Research questions and the data

This study explores the issue of social capital in the context of a broader analytical framework which defines the problem of SME development in terms of various barriers faced by SMEs (Barttlet and Bukvič 2001). The assumption is that growth is endemic to SMEs and that SMEs would grow if only barriers to growth would be removed. This framework is closely tied to policy formulation.

The data come from a survey of SMEs in Bosnia, Macedonia, and Slovenia (Bukvič et. al. 2001). The survey covered 794 small and medium sized firms in the three countries in all sectors except agriculture. It was based on an earlier survey carried out in 1993, which collected information about small firms in Slovenia and Bulgaria at an earlier stage of transition (Bartlett and Prašnikar, 1995; Bartlett, Prašnikar and Valenčić, 1995). A representative sample was drawn in each of the three countries. These were random stratified samples drawn from a population of firms that had at least 2 and not more than 250 employees. The exclusion of the firms with one or zero employees was necessary to make sure that the samples would include only companies with at least minimal motivation for growth. This was also done to avoid swamping the sample with a large number of micro firms, and to capture medium sized firms as well as smaller firms in the sampling frame. The strata were defined for firm sector and firm location. We restricted trade sector to 30% of the sample and firms located in the area of the national capital to 40% of the sample. The data were collected by personal interviews with owners and managers of the selected firms in the autumn of 2000.

Our focus is on social barriers to SME development. We pursued two objectives. The first one was descriptive. We aimed to give an in depth account of social capital from interpersonal level to the systemic level in the three countries. The second objective was to relate social capital to growth. In the comparative analysis we look at empirical evidence of effects of social capital at each of the three levels: interpersonal relations and cooperation among business partners, relations within business community at large, membership in business associations, relations between economic actors and the state. We first look at interpersonal trust and assess the extent to which individuals rely on trust in doing business with their partners. The key hypothesis here is that social capital promotes cooperation which is the key for SME development. We do not test this hypothesis directly, but examine the available evidence which seems to support the general statement.

The second level is to move from interpersonal business relationships to the relations of business community at large. This analysis is informed by the literature which sees the intermediary organizations such as voluntary associations as the key source of social capital in the society. If this is the case, membership in voluntary business associations should lead to increased social capital within the entire national business community which should further induce trust, cooperation, and SME development. We explore exiting evidence to examine this hypothesized relationship.

The third level is the systemic level. The literature refers to generalized institutional trust which is independent from the first two levels because its sources are rooted in the individuals' interactions with institutions (Rothstein and Stolle 2001). The more institutions are impartial, just, and non corrupt, the more generalized trust there is in the society. Generalized trust is proved to be associated with economic growth because it promotes trust that extends beyond kinship or friendship group and beyond immediate interaction setting to include people we do not know. Again, we examine the available evidence and look at the social capital on systemic level in the three countries with the aim to identify the causal mechanism through which social capital affects growth of SMEs.

4. Interpersonal relations among business partners

In general, Slovenia is a much more stabilized society than Bosnia and Macedonia. On the one side there are no ethnic tensions in Slovenia. On the other, market transition has lived out its wildest years and business environment has settled into orderly routines backed up with increasingly reliable institutions. This is how one should understand the fairness of institutions question in table 1.

Table 1: Business environment in three countries

		Slovenia %	BIH %	Macedonia %
Is competition fair	yes	59.1	31.2	42.3
Companies depend on long term partners	yes, at least 1 long-term partner	74.3	36.1	37.6
	no, you have to change partners	12.1	55.2	57.6
	no, you depend on more short term partners	13.6	8.7	4.8
Do you trust your partners	Not at all or a little	1.0	8.3	7.1
	Partly	15.8	24.8	19.3
	Quite or completely	83.1	67.0	73.5

Note: the numbers in the table are column percentages

The table shows that the majority of Slovenian entrepreneurs feel they work in a fair competitive environment where they can run business by developing long term partnership relations with one or more business partners. Business environment is much less favorably perceived by Macedonian or Bosnian entrepreneurs.

In stable Slovenian environment entrepreneurs tend to build trust with their business partners. On the one hand almost two thirds of them believe that long term partners are the key to business success. On the other, they are willing to trust their partners. In Bosnia and Macedonia, where entrepreneurs work in less stable environment, long term partnerships are considered an inferior option to opportunistic changes of partners with whom they maintain lower level of trust than their peers in Slovenia.

Although most of Slovenian companies operate in a more trustworthy social and business environment than Bosnian and Macedonian companies, there is no statistical association between company growth and perceived trust in business partners. The effect is expected for trust as a personal relationship when partners know each other well and thus build a personal trusting relationship around their business dealings which lubricates their business and help it grow. However, when interpersonal trust is measured by the actual strength of ties among business partners there is a clear association between growth and closeness of ties. In all three countries, growing companies have, on average, closer ties with their business partners than stagnant or shrinking firms (Table 2).

Table 2: Closeness of ties with business partners by country and growth

	Shrinking %	Stagnant %	Growing %	Average %
Slovenia	31.6	48.4	64.2	58.7
Bosnia	35.8	33.3	43.5	38.6
Macedonia	53.1	60.8	65.0	61.2

Note: the numbers in the table are percentages of close relationships for each category of companies. They do not add up to 100%. Each cell tells us what proportion of companies have close ties with their partners.

To understand why it is closeness and not trust that has effect on growth, the difference between the two indicators needs to be briefly fleshed out. Closeness of ties measures the intensity of concrete relationships in entrepreneurs' networks. Closeness is a result of time spent together in formal contexts such as contract negotiations and informal socializing at dinners and parties. Thus, closeness refers to immediate interactions among people and measures interpersonal trust between people who know each other and work together. Trust, in contrast, is a generalized attitude about the quality of relationships in a society as a whole. Generalized trust does not imply concrete people but is often evident in the degree we trust strangers (Iglič 2002). While personal experience with people is always the foundation for the emergence of generalized trust it has a different influence on actors' behavior.

While generalized trust applies to larger aggregates such as countries, interpersonal trust refers to concrete business partners with whom business is conducted. Thus, when one tries to predict individual behavior, one has to use interpersonal trust that varies from person to person. Using generalized trust, one would find little association because it applies equally to all the people in a given country or region. Indeed, when we looked at trust we found significant differences in the level of trust between the three countries, but no effect on a company level to predict its performance. But when we used closeness as a measure of interpersonal trust we found that it explains growth: the closer the relationship the stronger the growth.

What remains to be discussed is how interpersonal trust and closeness of relationships with business partners lead to business expansion and growth. Interpersonal trust can lower transaction costs and lead to better utilization of resources. If entrepreneurs need to stack resources to insure themselves against opportunism of partners and contingencies in their business environment, they may quickly tie down a large part of company resources as those are small companies. Interpersonal trust between partners helps to reduce the wasteful practice of stockpiling of resources or refraining from new business commitments. For example, partners that trust one another by virtue of close relations they have developed over the years, can agree on a large contract which would fully employ capacities of one partner. Without close relationship with a partner, entrepreneur would be weary to take on an order whose fulfillment assumes no breakdowns and no delays. But if entrepreneur reaches an understanding with his partner about the circumstances, the uncertainties may not need to be calculated into the contract, but may instead be subject to informal governance mechanism: if and when problems arise partners jointly seek solution. Thus, if a company has close trustful relations with its partners it can better utilize its resources and can experience faster growth.

5. Social capital as the foundation for cooperation

Literatures on industrial districts and economic sociology have pointed out that SME development depends largely on cooperation among SMEs and cooperation between SMEs and larger companies. When small companies have an opportunity to enter a larger network of producers, they can overcome the ‘liability of smallness’ because they are able to privatize collective opportunity by means of flexible specialization while at the same time socializing risks. Subcontracting is therefore the key issue because it allows companies to link their growth to the growth of a larger company. Since subcontracting relationship carries a high degree of dependence on a larger company, there has to be a high level of trust in a society and among the parties to subcontracting relationship.

Subcontracting and outsourcing are indicators of the level of cooperation between independent companies. The table 3 shows that almost half of Slovenian and Macedonian companies are included in subcontracting while there are only a quarter of companies in Bosnia that work as subcontractors. The result only partly corroborates the story about the influence of social capital on cooperation. Given that subcontracting in Macedonia is at Slovenian level, while not enjoying the same levels of trust in the economy and among business partners, there seems to be other factors at work.

Table 3: Firms engaged in subcontracting by country

	Slovenia %	BIH %	Macedonia %
Operate as a subcontractor	47.4	24.5	46.0
Outsource work to another firm	47.1	32.5	25.2

Note: Percentages in the table do not add to 100 because we report percentages of 'yes' answers on each question.

While many companies are subcontractors, subcontracting represents only a minor part of turnover of SMEs in all three countries (Table 4). About 60% of all SMEs in all three countries claimed that subcontracting represents only up to 25% of their turnover. While companies in Slovenia and Macedonia more readily enter the subcontracting relationships, they tend to keep their commitment of company resources at relatively low level.

However, the things become clearer when we look further. Subcontracting involves taking work from other companies and giving work out to other companies. Outsourcing, is particularly interesting because it indicates how far SMEs rely on other companies, themselves mostly SMEs, to complete their products and fill their orders. It is one thing to get business from a larger firm and become their subcontractor and quite another to execute their orders by relying on the inputs of other companies. In other words, outsourcing requires more trust than subcontracting because there are more parties involved in a single transaction.

The second part of table 3 shows that 47% of SMEs in Slovenia are outsourcing which is much more than in Bosnia (33%) and Macedonia (25%). Furthermore, the level of commitment to outsourcing is much stronger in Slovenia than in the other two countries. There are 23% of Slovenian companies that outsource up to 50% of their turnover compared with 11% in Macedonia (Table 4). Combined these results help resolve the puzzle initially posed by high level of subcontracting in Macedonia.

Slovenian SMEs are deeply engaged in both subcontracting and outsourcing which involves high levels of risk because they depend for their survival on both their customers and suppliers that are mostly other SMEs. Macedonian SMEs are involved in subcontracting at similar level as Slovenian companies but are much less involved in outsourcing. Given the lack of trust to business partners and the reluctance of having stable long-term business partners, it seems that subcontracting in Macedonia is induced rather than choiced strategy. In other words, Macedonian SMEs might be forced to take on subcontracting jobs that they themselves did not wish to take. Reluctance to work with partners whom they do not trust is evident from the fact that they avoid outsourcing, that would require them to bring new relationships and interdependencies into already risky environment.

If this is true than our results from tables 3 and 4 confirm the initial hypothesis that cooperation depends on social capital. Slovenian companies seem to benefit from a more trustworthy business and social environment that encourages them to get more deeply immersed in business relationships by taking work from and giving work to other companies. These interdependencies are risky but cooperation is much more readily embraced by Slovenian companies where trust in business partners is much more present than in the other two countries.

Table 4: Percent of companies subcontracting and outsourcing

		Slovenia %	BIH %	Macedonia %
Subcontracting as % of Turnover	Less than 25%	57.7	61.5	53.4
	26%-50%	17.5	16.9	23.7
	51%-99%	15.5	10.8	18.3
	100%	9.3	10.8	4.6
Outsourcing as % of Turnover	Less than 25%	69.1	80.2	84.2
	26%-50%	22.7	18.5	10.5
	51%-99%	8.2	1.2	5.3

Note: the numbers in the table are column percentages

While trust seems to encourage subcontracting and outsourcing among SMEs, there is also an important piece of evidence that suggests that trust leads to growth by encouraging companies to cooperate and enter into subcontracting relationships. We, found a positive relationship between growth and subcontracting: in Slovenia 51% of growing SMEs are outsourcing while this is practiced by only 31% of stagnant companies. Given that subcontracting and outsourcing in Bosnia and Macedonia may not be a matter of choice, it is not surprising that the positive statistical association has been found only in Slovenia.

In short, trust seems to encourage Slovenian companies to cooperate with larger companies and among themselves taking on subcontracting jobs and outsourcing their work to other SMEs. The strategy of outsourcing seems to be particularly important for growing companies, which suggests that outsourcing is a vehicle for growth without expensive capital expenditure. In Macedonia and Bosnia, trust is lower and the extent of voluntary cooperation is lower which has negative consequences for company growth.

6. Social capital and membership in business organizations

Social capital is generated in face-to-face interactions among living people. Since membership in formal organizations encourages interaction by providing a venue for meeting individuals and creating opportunities for contact, current theorizing on social capital takes membership in voluntary organizations as an indicator of social capital: membership in more voluntary organizations creates more social capital.

The results in Table 5 show that Slovenian entrepreneurs are more likely to belong to voluntary business association (in addition to the chamber of commerce where membership is compulsory) than their counterparts in Bosnia and Macedonia. This is a consequential for growth. Indeed, in further analysis we confirmed the positive relationship between growth and social capital measured in terms of memberships in voluntary business associations. In Slovenia, we found that entrepreneurs in growing firms tend to hold significantly more memberships in voluntary business organizations than entrepreneurs in stagnant firms. Thus, business growth is positively associated with social capital of managers - entrepreneurs.

Table 5: Membership in voluntary business associations by country

	Belong to a business association
Slovenia (%)	31.1
BIH (%)	18.4
Macedonia (%)	14.1

Note: the numbers in the table are row percentages
Chi-Square (Sig) 22.6 (.000)

The interesting point is that those memberships are not driven by attractiveness of services the entrepreneurs may receive. To the contrary, the managers of SMEs do not utilize their services very often. They also say that services rendered by voluntary business organizations are only moderately useful. This further underscores the above conclusion that memberships are not about providing business services but about building social capital. The results allow us to conclude, that Slovenian managers belong to business associations not only to obtain their services, but primarily to build up their social capital through networking. Their efforts seem to have been paying off because they experience faster growth than their colleagues who have fewer memberships in business associations.

7. Systemic trust

Social capital of a country (system level) is usually measured in terms of trust. However, trust in political institutions is different from interpersonal trust experienced in interaction with business partners, as was argued in the theoretical introduction to this section (Rothstein and Stolle 2001). To avoid the confounding of different forms of social capital, we distinguished between various social contexts and measured the level of trust in each of them. As the Table 6. reveals, there are two profoundly different contexts: institutional environment of the state and business environment. In all three countries trust in government, state administration, local government and chamber of commerce is much lower than trust in business partners, large or small firms.

This result is not surprising. In Western societies politics is treated with much more suspicion than business. In fact, the institutions of modern democracy were designed on the basis that government should not be trusted (Warren 2000). The key constitutional ideas such as division of powers and the system of checks and balances were designed to monitor and control rather than trust those elected to positions of power. The reason that trust in politics is lower than in business is normal and lies in a different personal experience. The state is universal, which means that it has to treat every citizen according to a single, universal set of standards. If the state is inefficient and bureaucratic, one can not get away from it without moving from one state to another. In business there is choice. If one business partner is unreliable, it can be replaced with another. Overall experience with business relationships would be therefore biased toward positive because entrepreneurs exercise choice in whom they meet for business partners on daily basis. The choice element in trust is evident from the levels of trust in table 6. In all three countries the highest levels of trust are reserved for business partners where entrepreneurs can exercise highest degree of choice.

Trust in banks is a special case because of the nature of recovery and transformation of the banking sector. Like elsewhere in the region the banks in the three countries inherited a large burden of bad loans that would have caused the banks to collapse if they had not been saved by state financed rehabilitation. During the rehabilitation phase, the banks were facing economic and political uncertainties and were consequently treated as political institutions. Once the banks cleaned their portfolios they could start working as business establishments. This was noted in the perception of the business public which reacted by displaying higher levels of trust in the banks. Transformation and stabilization of banks has been concluded only in Slovenia but not in Bosnia or Macedonia which explains the high levels of trust in banks in Slovenia but not in Bosnia or Macedonia where the level of trust in banks is on the par with trust in political institutions.

The second finding presented in the Table 6 pertains to consistent differences in the level of trust between the three countries. The lowest level of trust is found in Bosnia, in almost every context that we measured. The result is consistent with findings above that suggest that Bosnia suffers from a severe lack of trust on the interpersonal level. On systemic level, Bosnia has a similar variation of trust among different contexts as the other two countries, but the general level of systemic trust tends to be lower. The real surprise were the results for Macedonia, where levels of systemic trust tend to be highest among the three countries, with a single exception of banks where trust is lower than in Slovenia but still higher than in Bosnia. This result is inconsistent with the earlier findings which suggest that Macedonia is lacking in interpersonal trust. While systemic, institutional trust can have different origins than interpersonal trust, the results can not go in the opposite directions.

Table 6: Trust in ...

	Slovenia %	BIH %	Macedonia %	Average %
Government	36.5	33.9	44.6	38.6
Administration	30.8	32.0	41.9	35.4
Local government	49.0	34.8	44.1	42.1
Chamber	49.5	38.6	52.2	46.7
Banks	79.5	48.4	58.4	60.5
Large firms	70.9	54.2	70.1	64.7
Small firms	70.4	69.8	78.4	73.2
Business partners	93.3	87.4	90.0	90.0

Note: % of answers 'Completely', 'Mostly', 'Moderately'

In general, the level of trust is a result of cultural and institutional factors in a given country (Fukuyama 1995) that can be revealed only by means of comparative analysis of different countries. Systemic trust means that it has little variation within the country. Most of the variation is between countries. This makes systemic trust a useful factor in predicting economic success of different countries. Whatever variation there is within a given country, it should be randomly scattered across social groups and sectors to constitute white noise. Indeed, our analysis found no systematic variation in systemic trust within a single country. It is a matter of concern when systemic trust and distrust are spread unevenly throughout the population, because it signals the presence of strong particularism in economy and society. Such particularism is dangerous because it means that different categories of entrepreneurs are treated differently, which is somewhat acceptable in business (e.g. banks), but is not normal for political institutions. The problem is that different treatment can be secured by corruption.

Social capital of a country is closely related to the perception of fairness and impartiality of political institutions. If there is no corruption in a nation there will be a higher level of systemic trust and higher social capital. The data show corruption as perceived by entrepreneurs. In each country, about one third of respondents declared ignorance and opted for 'do not know' category, a large number given that in all three countries public debate on corruption has gained in prominence in the past two years. The remaining respondents seem to be in agreement that corruption of state officials is very high. In Slovenia about 53% of respondents believe that public officials are corrupt. This compares favorably with Macedonia and Bosnia where corruption is alleged by 62% and 73% of respondents respectively.

Table 7: Perceived corruption by country

	Slovenia %	BIH %	Macedonia %
No corruption	4.9	2.9	2.0
Low corruption	8.8	3.6	5.4
Moderate corruption	31.9	20.9	30.2
High corruption	21.1	40.6	31.5
Do not know	33.3	32.0	30.8

Note: the numbers in the table are column percentages

We also looked at those who declared ignorance. In Macedonia and Slovenia, the share of those who do not know whether public officials are corrupt is highest among the growing companies. In other words, growing companies in Macedonia are more likely to declare ignorance about corruption than other firms. This finding was not expected. Growing companies often have little contact with political institutions and display their self-confidence by being harsh in their criticisms of the state and its economic policies. The result contradicts this expectation and suggests the otherwise: the entrepreneurs in growing companies are reluctant to express their opinion on this matter as if they wish to stay neutral on this sensitive topic. But why would growing companies be concerned about expressing their attitudes about corruption unless they feel they were implicated in it and owe it their success?

Two questions arise from this analysis. First, what is the cause for such dramatic differences in systemic trust and distrust in the three countries. And second, how could we explain high levels of trust in Macedonia when there is evidence that the lack of interpersonal trust is negatively affecting the growth of SMEs in this country.

If the answer to the first question looks self evident to the observers of the countries under study - extensive analyses have been written about cultural and historical peculiarities of this region - it is the second question that presents a real puzzle. The results only complicate the answer to the second question about Macedonian lack of interpersonal trust and high systemic trust. Given the perceptions of corruption of public officials in Macedonia it is hard to understand the high levels of trust in that country.

8. Trust, contract, and interdependence as governance mechanisms of economic transactions

Social capital has consequences for economic behavior of actors. How business is conducted depends on which governance mechanisms economic actors rely on to convert uncertainty into risk. There are three basic governance mechanisms that regulate economic transactions: trust, contract, and interdependence among partners. They are not mutually exclusive. Each requires certain social conditions in order to be fully operational.

Interdependence of business partners is the simplest governance mechanisms which requires no trust between partners and no confidence in the external system of contract enforcement. Economic transactions are completed because the parties realize that their fortunes depend on one another, and it is therefore in their self-interest to fulfill their obligations from implicit or explicit contracts.

Detailed contracts are a more complex governance mechanism which make sure that the terms of the exchange are explicitly written down so that they can be enforced by external authority. This works in well established legal system which enjoys high level of systemic trust or confidence in the system. The external enforcement has to be impartial, fair, and efficient in order to be accepted by all the parties to the exchange. Effective implementation of contracts does not assume any interpersonal trust.

The most complex governance mechanism is trust. The key requirement is the existence of interpersonal and systemic trust. Interpersonal trust facilitates the negotiation of the terms of the exchange because any uncertainties that are left open can be agreed upon at a later time should they arise. However this governance mechanism would be very limited because it would be grounded in the community of business partners who know each other well and who can exert normative pressures on their members to fulfill their obligations. When systemic trust is in place, people extend their trust beyond their narrow group of regular interaction partners to include strangers because they have confidence that anyone in the system would pressure the other party into fulfillment of the implicit contract.

Given that the choice of governance mechanism depends largely on social capital of the country, to determine to what extent are trust, interdependence and contract used in each of the three countries reveals a lot about the structure and type of social capital in a given country. Table 8 presents the three indicators used for this purpose. We found strong differences among the three countries in this respect.

The strongest emphasis on interpersonal trust was present in Slovenia where 66% of entrepreneurs considered trust to be the most important for conducting business. In contrast, only 41% Bosnian entrepreneurs considered trust as most important. They were the most skeptical about trust as 33% considered trust as not important at all for conducting business. More importantly, Slovenian entrepreneurs attributed only minor role to contracts and even lesser role to interdependence. This suggests that they feel that social and business environments are sufficiently developed so that they can try to conduct their business based on trust whenever possible. It does not mean, however, that they neglect contracts. Rather it means that they perceive that in a Slovenian business environment additional leverage does not come from detailed contracts but from trust based relationships.

Table 8: Trust, interdependence, and contract as best way of doing business

		Slovenia %	BIH %	Macedonia %
Partners should trust each other	most important	66.3	41.4	47.1
	important	21.4	25.4	36.4
	less important	12.3	33.2	16.4
Interdependence between partners	most important	15.1	33.6	16.2
	important	49.5	41.4	37.9
	less important	35.5	25.0	45.8
Detailed contract	most important	20.2	52.5	47.0
	important	28.2	23.4	21.7
	less important	51.6	24.1	31.3

Note: reported differences are significant at .000 level (Chi-square)

Macedonian entrepreneurs view detailed contracts and trust as most important bases of doing business while they view interdependence with most disdain. These are the same entrepreneurs who do not trust their business partners and who see opportunism (no long term partnerships) as the key to success in business. It seems that they are aware of the benefits of basing their business relationships in trust but they probably feel that they need to protect themselves against malfeasance of others by means of detailed contracts. Given the high levels of systemic trust and lower levels of interpersonal trust in Macedonia, they are making most of the situation. It seems that they are confident that their judiciary is impartial, fair, and efficient so much so that writing detailed contracts makes a difference. Once contracts are secured, they are open to explore the advantages offered by doing based on trust.

Bosnian entrepreneurs have the most complex choice of governance mechanisms. It is not really a choice because they seem to favor all three mechanisms in large doses.

They are in favor of trust as the governance mechanisms for doing business but they like to see trust based deals written in detailed contracts. They feel even more confident when contracts are embedded in interest-based interdependence. What stands out is the fact that unlike Macedonian entrepreneurs who strongly reject interest based interdependence, the Bosnian entrepreneurs are the ones who most eagerly embrace it. It means that Bosnian entrepreneurs feel that business is sound when parties to a deal realize that their fortunes depend on one another, and it is therefore in their self-interest to fulfill their obligations from implicit or explicit contracts.

The result fits well with the above description of Bosnia as a country that lacks both interpersonal and systemic trust, and fleshes out the key implication of low levels of social capital for economic development. In a society where trust in institutions is scarce, one can not rely on contracts because institutions are powerless, corrupt, or at best, unreliable. Neither can one trust business partners because trust just is not enough widespread to offer the basis for doing business. In such an environment the best bet for entrepreneurs is to rely on demonstrated mutual interest. Business transactions are best conducted when in addition to trust and contracts, both parties demonstrate that they have interest in fulfillment of contracts. A demonstrated interdependence becomes the key insurance mechanism against opportunism. This type of regulation of economic transactions has no intrinsic weakness, but it poses a very high burden of proof on every participant in economic transactions, which further reduces the scope of available business partners and causes transactions to be less frequent. Both, narrow scope and low frequency of transactions have adverse effect on economic development in general and SME development in particular.

The ways economic transactions are regulated have serious consequences for economic growth. The following two tables demonstrate that the use of trust as a regulator of economic transaction between business partners is systematically linked with growth: growing companies rely heavily on trust in their dealings with business partners. In contrast, detailed contracts are heavily used by shrinking firms that are actually loosing business or are unable to expand it. The interesting point is that the same relationship can be found in all three countries: the growing firms rely on trust, the failing ones resort to detailed contracts.

Table 9: Trust among partners and growth

		Shrinking %	Stagnant %	Growing	Average
most important	column %	41.3	49.7	53.5	49.6
	a.s.residuals	-2.6	.0	2.2	
Important	column	25.0	33.8	28.9	29.0
	a.s.residuals	-1.4	1.5	.0	
less important	column	33.7	16.6	17.6	21.4
	a.s.residuals	4.7	-1.7	-2.7	

Note: when adjusted standardized residuals exceed the value of +(-) 1.9 the cell frequency is significantly bigger (or smaller) from expected frequency indicating significant result.

Causal order could be disputed: do companies grow because they trust their partners or do they trust their partners because they can afford to do so as growing companies with enough slack. One piece of evidence, which suggests that trust breeds growth is when we control for company size. Larger companies have more slack so they could trust more than micro companies. However, company size has no effect, which leaves us to conclude that the causal order is from trust to growth.

Table 10: Detailed contracts and growth

		Shrinking	Stagnant	Growing	Average
most important	column %	52.7	40.3	37.7	42.1
	a.s.residuals	3.4	-.5	-2.5	
Important	column %	22.8	19.5	25.8	23.7
	a.s.residuals	-.3	-1.4	1.4	
less important	column %	24.5	40.3	36.4	34.2
	a.s.residuals	-3.2	1.8	1.3	

Note: when adjusted standardized residuals exceed the value of +-1.9 the cell frequency is significantly bigger (or smaller) from expected frequency indication significant result.

The fact that the relationship between type of governance and growth holds across cultures and countries is particularly important for policy makers because it suggests a lever by which SME policies could more effectively promote SME development. It suggests a two-pronged approach to SME development. One prong of SME policies should continue to build institutional infrastructure in these countries. However, the emphasis should move from the provision of support services for SMEs, to the measures that build confidence in the SME markets. Such measures include development of standards and practices that assure that the courts, state administration and governmental agencies become more impartial, fair, and effective. The other prong should aim to educate entrepreneurs on how to combine contracts with trust based negotiation in order to gradually move them away from detailed contract to more flexible forms of cooperation. Support to SMEs could consist of legal support in writing enforceable contracts that would protect the parties but would also provide room for flexibility and informal renegotiations. A tangible measure of success of such policies would be a gradual move toward flexible and open ended contracting that relies on trust and promotes cooperation and SME development.

9. Informal ties and trust

One of the consequences of high level of trust in the economic system is the increasing importance of informal ties. Importance of informal ties is a sign of settled business environment. Entrepreneurs attach high importance to informal ties when they can easily develop trustful relationships with their business partners. In a society where there is little trust among people in general the informal business ties are much harder to form. General distrust to strangers leaves you with a very narrow choice of informal contacts, mostly kinship and friendship ties.

We looked at the role of informal ties in three situations: hiring a person, getting business, and the overall evaluation of the importance of informal ties. In all three cases the use of informal ties is legitimate and is well within the boundaries of proper business behavior. The results in table 11 suggest that it is Slovenian entrepreneurs who rely most on informal ties. Slovenian entrepreneurs are more likely than others to hire a person based on recommendation, they are more likely to give or receive business based on referral, and they are more likely than others to value informal ties as important. The strongest reluctance to use informal ties is among Macedonian entrepreneurs who overwhelmingly regard informal ties as not important.

Table 11: Reliance on informal ties by country

		Slovenia %	BIH %	Macedonia %
Hired based on recommendations	Mostly	38.0	24.5	26.1
	Rarely	62.0	75.5	73.9
	Did not employ	5.0	9.3	25.3
Give or receive business based on recommendations	Mostly	46.8	36.5	21.4
	Rarely	53.2	63.5	78.6
Importance of informal ties for doing business	Important	59.2	40.3	27.3
	Medium	23.9	34.6	31.1
	Not important	16.9	25.1	41.5

High importance of informal ties in Slovenia in comparison with the other two countries is a result that needs to be considered together with the prior findings on trust and social capital. In comparison with the other two countries, Slovenia was characterized by the highest level of systemic trust and the highest level of interpersonal trustful relations with business partners. It is therefore consistent with prior results that informal ties are considered as important vehicle for hiring, business acquisition and general functioning of the SME sector in Slovenia. It is significant that informal ties are highly valued by all entrepreneurs in Slovenia regardless of firm performance or any other attribute of the entrepreneur or their companies.

A surprise came from the comparison of Bosnian and Macedonian entrepreneurs. Given that Bosnia lack both systemic and interpersonal trust, one would expect that Bosnian entrepreneurs would be the most suspicious about the use and value of informal ties. It turns out that they consider informal ties more valuable than their Macedonian peers who, according to the data, enjoy much higher systemic trust. This finding remains unexplained.

Although it is sometimes suggested in anthropological literature that extensive use of informal ties belong to a transitional society where the traditional bonds of community have disintegrated while the modern bonds of trust in the state and its institutions have not yet emerged. In this vacuum people need to use informal ties to take care of their business. However, what consistently emerges from this analysis is the fact that reliance on informal ties requires high levels of trust in the first place. Importance of informal ties means that any business transaction can be conducted in an informal setting, which can be done only if there is generalized trust in a society that people we do not know personally can be expected that they will not try to cheat. If one can trust only select few, one does not give or get work through referrals very often nor does one attach much importance to informal ties in general.

Trust and informality go together hand in hand. The implication of this finding is that trust, informal ties and growth are related concepts that are highly relevant for SME development. Growth is facilitated by trust because it allows informal relations to mix freely with business ties. Informal relations open more opportunities than strictly formal business ties because they broaden the number of people one can draw on for information, advice or even support. Informal ties do not only lower transaction costs directly, but also indirectly by defeating small numbers bargaining and other factors that may lead to market failure and poor allocation of resources. The lack of reliance on informal ties may therefore be considered one of the more important barriers to SME development.

10. Institutions and SME development

It has been broadly argued that the third Italy phenomenon was in large part a result of a dense network of local institutions ranging from provincial government to city councils, from unions to local chambers of commerce. This mesh of supporting institutions, it is argued, created ample opportunities of contact and coordination of local economic agents, who created trust and encouraged the emergence of cooperative relationships.

Slovenia has developed an extensive SME support network which extends from the government to the local level. This was done on the assumption that thick network of supportive institutions increases social capital of the entire SME sector. In addition to much needed advice, such institutional network should serve as a clearing house for ideas, opportunities and contacts. Local offices were expected to be in daily contacts with entrepreneurs and should work as information and idea brokers introducing entrepreneurs with complementary ideas to one another. Their mission was to help SME development by directly promoting and stirring up cooperation directly in the field.

So far, no one has evaluated the effectiveness of this institutional network because it is hard to measure success of brokerage activities when the fees are not charged. However, based on our data on interpersonal ties, it is possible to establish to what extent are SME institutions integrated into the daily lives of entrepreneurs. We can do this due to the special sociometric module in our questionnaire. We asked respondents to name people with whom they communicate in various situations regarding their firm. We asked them with whom they discussed confidential business matters, who is the source of useful information, who gives them tips on business opportunities, and who might help them out of crisis. The questions were so broad that people from local SME network should be frequently mentioned. The results prove that this is not the case.

Table 12 suggests that local SME institutions are isolated from entrepreneurs. Slovenian entrepreneurs cited no one from the local centers of entrepreneurship and only 2 people from the regional centers of entrepreneurship out of total 964. Similarly, Bosnian entrepreneurs together cited 1907 people out of which only 11 belonged to the local SME instituions. The same was found in Macedonia where only 6 out of 1479 people were officials with local SME institutions. For comparison, entrepreneurs had many more contacts among national politicians than with local officials in local centers of entrepreneurship.

Table 12: Cited contacts by their environment of origin

	Slovenia	BIH	Macedonia	Total
Family	178	362	134	674
%	18.5	19.0	9.1	15.5
Owner of other firm	240	339	402	981
%	24.9	17.8	27.2	22.6
Business partner	283	541	408	1232
%	29.4	28.4	27.6	28.3
Employee	190	405	314	909
%	19.7	21.2	21.2	20.9
National politician	15	75	63	153
%	1.5	3.9	4.3	3.5
Ministry for economy	0	11	22	33
%		0.6	1.5	0.8
Ministry for SMEs	0	4	14	18
%		0.2	0.9	0.4
Chamber of commerce national or local	7	9	24	40
%	0.9	0.5	1.6	0.9
Local centers for entrepreneurship (PCMG)	0	11	6	17
%		0.6	0.4	0.4
Regional centers for entrepreneurhsip	2	7	8	17
%	0.2	0.4	0.5	0.4
Local government	18	53	28	99
%	1.9	2.8	1.9	2.3
Financial institutions	13	46	32	91
%	1.3	2.4	2.2	2.1
Institute or university	18	44	24	86
%	1.9	2.3	1.6	2.0
Total contacts	964	1907	1479	4582

Note: Numbers in the table are contacts respondents cited in the sociometric questionnaire.

These results suggest that while all three countries created institutional networks for SME support and development, they all share a similar experience, namely, that those networks are dead. It does not matter if there is a high density of institutions if entrepreneurs do not seem to know those officials much less use them as central information brokers in their environment. Brokers work through personal relationships.

They need to know entrepreneurs on a personal basis if they should be trusted with confidential information about their plans for business development and insert themselves as agents who bring people together to form cooperative ventures. Without personal contacts they can not emerge as central figures in their area which, sadly, seems to be the case in all three countries.

A lesson to be drawn from these results is that policy makers in all three countries and their donors should make a better effort at monitoring the actual functioning of their institutions. Too often institutions in transition countries are erected at the explicit insistence of European Union, which draws up templates and than pays for their implementation. As evidence suggests, this practice does not guarantee success. National networks for SME development in Slovenia, Bosnia and Macedonia obviously lack any clear sense of mission and direction and seems to be adding cost not value.

To help transition countries avoid the pitfalls of hollow institutions, they need to create measurable objectives that would tell donors and, more importantly, policy makers whether or not their institutional efforts actually work. We suggest that in case of institutional networks for SME development, donors should evaluate the institution building programs by looking at how well its personnel is integrated with (i.e. recognized by) their target audience. While policies can not force entrepreneurs to cooperate among themselves, they can force local officials to leave their desks and hit the field like salespeople sharing ideas, disseminating opportunities and promoting collective action in their areas. Once they start doing this, they will get noticed by entrepreneurs and the institutional network will start paying off.

The dedicated network of SME promoting institutions is only one fragment of a broad institutional structure that is engaged in SME development. In fact, in Slovenia the network was a brainchild of the ministry for SMEs and was meant to be a conduit of its various policies and promotional campaigns. While entrepreneurs seem to completely ignore local centers for entrepreneurship, they are by no means ignoring other relevant institutions to which they have high expectations for help and assistance. The state, its institutions and policies matter and entrepreneurs are keenly aware of it.

While a dense supportive institutional environment can create social capital, trust and cooperation a dense but non-supportive environment does create suffocating bureaucracy. A lack of support from various institutions can be a significant barrier to SME development. Table 13 presents institutional barriers as perceived by entrepreneurs. One of the most important barriers to growth of SMEs in all three countries is the lack of support from the state. In spite of the fact that the states are doing much to accelerate growth in SME sector, the entrepreneurs do not feel that amounts to much. The majority still believe that the lack of support from the state is the major institutional barrier. The complaints are less frequent in Slovenia where relative prosperity helped companies thrive regardless of the state. The result is telling and suggests two conclusions. First, the former socialist economies are still hung up on the state and breed huge expectations regarding its role in the economy. Entrepreneurs do not want the state to play a regulatory role but rather an interventionists one. They want direct help in money, cheap infrastructure, lower taxes and many exceptions in tax treatment and trade rules. They equate the regulatory state with bureaucracy over which there are serious complaints. This leads to the second conclusion, namely, that this equation of regulation and bureaucracy may be well deserved. Transition states have proved very efficient in installing new institutional rules and structures but showed much less skill in making them work. Regulatory function which is aimed at creating a level field for competition is thus quickly transformed into red tape.

In Bosnia, however, the key barrier is not the state but the lack of trust in the economy. Similar problem is noted by Macedonian entrepreneurs. These results underscore findings from previous sections, which show Bosnia and Macedonia as suffering from the lack of social capital. But Bosnia is a leader of gloom in our sample. In all but one occasion, Bosnia emerges as the state with the most dissatisfied entrepreneurs who are unhappy with the level of support they receive from all public and private institutions except from their family.

Table 13: Institutional barriers to SME development

	Slovenia %	BIH %	Macedonia %
lack of support from state	47.1	59.9	66.1
lack of support from local government	35.8	59.6	38.9
lack of support from chamber of commerce	35.5	48.6	44.6
lack of support from business association	30.5	46.1	35.5
lack of trust in the economy	30.2	63.5	53.3
lack of links with foreign partners	23.3	40.6	37.7
lack of consultancy services	24.0	28.1	26.3
lack of support from friends and family	10.8	17.9	18.6

Note: social barriers were measured on a 5 point scale from not important to very important. Here they are grouped into two categories: not important includes the categories 'not important', 'little important' and 'medium important'. Important includes 'quite important' and 'very important'. The basis for this clasiffication is empirical.

There is strong association between complaints over the lack of support and poor business performance. In all items, it was entrepreneurs from declining companies that expressed most concern about the lack of support from various institutions. This finding hardly needs explanation. Poorly performing companies are understandably seeking more support than good companies. While growing companies may use support they do not experience the lack of it as a barrier. This, however, suggests that the entire institutional support network is there not to promote growth but rather to prevent failure? If this conclusion is valid, it has very serious implications for SME policies.

The second question is Why Bosnia? One possible and likely answer is learned from the dependency of Bosnia on foreign donors. After destruction during the war, Bosnia was one of the first states in the region to receive generous support packages from donor states and agencies. This created expectations of support: the more support one gets the more one learns to need it to survive. This is expressed by Bosnian entrepreneurs that see existing support as a serious barrier to the development of their business. Presumably, with more support their business would take off.

What is even more important is the fact that institutional support by itself does not produce trust. In spite of numerous initiatives, foreign presence of experts and funds, strong support from a broad network of mostly foreign institutions, Bosnia suffers from the lack of trust in the economy and society. Given that their state is very weak and rife with ethnic tensions this is not too surprising. What is surprising, is the lack of trust among entrepreneurs that see themselves as being on the same side of ethnic divide. One factor that perhaps prevents the formation of trust in Bosnian society and economy is extensive donor support. We found that support creates expectations of support and dependence on non-market behavior. Competition for support encourages entrepreneurs not to cooperate as every company is trying to benefit from different donor programs. Thus, donors should consider a switch from direct support of SMEs to the creation of cooperative infrastructure for self-help that will both discipline the SMEs and encourage them to cooperate with one another. Such behavior will create trust the lack of which seems to be an important barrier to SME development. In short, *currently there is too much effort being invested in the formation of support institutions. What is needed is an infrastructure for self-help which will push risk and responsibility for company performance back to the SMEs while focusing policy intervention on building of confidence in the economy and society.* A reformed, efficient, lean and uncorrupt state could do much more for economy and SME development than all the policies that intend to support SME development through free money and advice.

11. Conclusion

Economic growth in transition economies of South East Europe largely depends on SME development. While growth and policy literatures call attention to economic factors, such as the lack of capital, or institutional factors, such as poorly developed institutions for contract enforcement, the key role of social integration, trust and social capital is often neglected. This paper tried to address this issue at length. In doing so we tried to go beyond the argument that society and its social capital are important. We also tried to demonstrate what causal mechanism lies behind social capital and economic growth. Two points arise from the evidence presented above. First, economic growth is affected by the choice of governance mechanisms that are available to the entrepreneurs in a given society. The companies that rely on detailed contracts or interdependence tend to be either in stagnation or in decline. Company growth seems to require trust rather than contract. Companies that based their economic transactions on trust were much more likely to experience growth. This proved to be true in all three countries under investigation. However, the countries differed in the availability of trust. Trust in Slovenia was much more common than in Macedonia and Bosnia. Thus Bosnian entrepreneurs were not only adversely affected by the ravages of war but also by the devastation of mistrust created by it which prevented their companies from fast growth.

Second, trust does not grow out of institutions but seems to depend on the quality of interpersonal relationships among business partners. Closeness breeds trust, and this old adage seems to hold also in the context of SMEs in the South East Europe. This finding in particularly important because it provides an insight in the relationship between interpersonal trust, systemic trust and economic growth. In a country, where systemic trust is high, i.e. where people trust not only their own business associates but also state officials and strangers, there can emerge a virtuous circle of growth. In a trustful society people trust a wider pool of people and willingly enter in economic transactions that are partly or mostly based on trust which further leads to faster economic growth. In contrast, consider the vicious circle in a society with low systemic trust. People tend to mistrust strangers, officials and anyone that they do not know very well. This shrinks the pool of available business contacts to a narrow circle of strong ties and thus limits the scope of business opportunities available to them. Vicious circle begins with mistrust, that leads to narrow business opportunity that leads to stagnation or decline which eventually feeds the exiting mistrust.

To conclude, the major innovation of this paper is the argument on *how* social capital affects growth. Social capital has direct influence on the choice of governance mechanism of economic transactions which is in subsequently related to growth. High social capital encourages entrepreneurs to base their economic transactions on trust which leads to faster economic growth of both companies and economies. While scholars from a variety of disciplines tend to agree on the positive relationship between social capital and economic growth, the causal mechanism has not been systematically explored. This resulted in policies that were multidirectional and often lacked a desired effect. In particular, the heavy investment by international community in institution building seems at least partly misdirected. Institutions seem to have limited power in creation of systemic trust and social capital. And whenever they become overemphasized in policy agenda to the extent they assume the importance larger than life they can clearly have adverse effect because they prevent rather than facilitate the formation of closer business relationships among entrepreneurs and their business partners.

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Rokopis prejet avgusta 2001, dokončno sprejet decembra 2001. Po mnenju uredništva je članek uvrščen v kategorijo: izvirni znanstveni članek (s kvantitativno argumentacijo).