

Innovations and Entrepreneurs in Socialist and Post-Socialist Societies

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By

Jouko Nikula and Ivan Tchalakov

**CAMBRIDGE
SCHOLARS**

P U B L I S H I N G

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This book first published 2013

Cambridge Scholars Publishing

12 Back Chapman Street, Newcastle upon Tyne, NE6 2XX, UK

British Library Cataloguing in Publication Data
A catalogue record for this book is available from the British Library

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ISBN (10): 1-4438-4237-0, ISBN (13): 978-1-4438-4237-2

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ACKNOWLEDGEMENTS

First of all, we would like to thank the Aleksanteri Institute for inviting Ivan as a Visiting Scholar in Spring 2010 - without that this book might never have come true. We are also grateful to Vladimir Vladov, who proofread the text with very high professionalism in a very short period of time. Irina Todorova kindly gave her permission to use one of her works for the book cover. Finally we want to thank the administrative staff of Cambridge Scholars' Publishing for all of their help and support while we prepared the manuscript.

FOREWORD

This is an unusual book, comprising the edited interviews with entrepreneurs from Bulgaria, Estonia, Macedonia, Latvia, Lithuania, and Russian Karelia. Representing two distinct regions of Eastern Europe – Balkan and Baltic countries, the interviews reveal both unique patterns and striking similarities in entrepreneurial activities during the administrative economy of socialism and the period of post-socialist transition towards market economy and democratic government rule. The book partially approaches the form of readers containing exemplary business stories on entrepreneurship, published by some of the leading business schools in US and some other countries.¹ However, the interviews presented are much more than that – in fact they are exciting life histories, through which the remarkable (often tragic) post-World-War-II history of small nations in Eastern Europe comes to life.

Socialism emerges in the selected stories not as a steel-armoured, non-modern control society, but a societal formation of its own in which market-type of relations also functioned, albeit in a strange and distorted form. An economic reality is revealed that goes beyond the simplified version of totalitarian society where the main characteristics are a single-party society with one official ideology, centrally directed economy, strictly controlled media, and strong state security forces, militia, security police, and army. True, all these did exist, but in addition to that the reader will find heroic entrepreneurs from the circles of the economic nomenklatura that were able to shake – even if temporarily – the very ideological basis of this society, bringing to life new industrial sectors, new organizational forms of making ‘business’, and unique innovative

¹ Such as Nick Tart’s & Nick Scheidies’s book on *What it Takes to Make More Money than Your Parents: 50 Interviews with Young Entrepreneurs* (Wise Media Group, 2010) or Brian Schwartz *50 Interviews: Entrepreneurs Thriving in Uncertain Times*, interviews with successful entrepreneurs in a variety of industries, etc. There are a number of Internet based sources in the field, such as the Harvard Business School online collection of interviews with leading entrepreneurs (see <http://www.hbs.edu/entrepreneurs/>), <http://www.50interviews.com/>, or <http://www.entrepreneurship-interviews.com/blog/>. The blogger Cristian Dorobantescu, an entrepreneur from Eastern Europe, also carried out and published a number of interesting interviews on his web page (http://entrepreneurs.about.com/od/interviews/Interviews_with_Entrepreneurs.htm).

products. They succeeded (or failed) not just because they found ways to get around the administrative system and devised informal ways of ‘getting things done’, but also because they used the system’s own mechanisms, thus deflating some of the well-established notions of socialism.

The stories of start-up entrepreneurs that emerged during the post-socialist transition also challenge some of the key neo-liberal principles and recipes, dominant for more than twenty years in the social sciences, among international experts, and in political circles. A typical example of this trend is Simon Johnson’s and Gary Loveman’s book *Starting Over in Eastern Europe: Entrepreneurship and Economic Renewal* (Harvard Business Press, 1995), where by studying a number of successful (and failed) entrepreneurs in Poland, in sectors such as shipbuilding, clothing, consulting, food, banking, and publishing, the authors recognized the emerging new private businesses as the main engine of economic renewal throughout the region and as a key factor for improving the international competitiveness of post-communist countries.

However, as some other studies have shown, this was not universally valid throughout Eastern Europe. It becomes clear that the reformers and a large part of the academics had a distorted and one-sided understanding of the structural features of the socialist societies, of the nature of enterprise in these societies, and of the ramifications these two had for the history and forms of development in post-socialist societies. They completely ignored the ‘hidden program’ of a specific wing of the former Communist nomenklatura that opportunistically used the dominant neo-liberal model, promoted by the Western experts, in order to implement a policy aiming to suppress the newly emerging economic agents (such as foreign investors, authentic entrepreneurs, etc.) and to impose their own rent-seeking and assets-scraping strategies that eventually transformed their former political power into the economic power of the new oligarchic groups. This happened in most of the so-called ‘second-wave’ countries of EU enlargement (Menske & Weber 2001), where the “political wing” of the communist nomenklatura preserved (although partially) its influence - the clash between the political nomenklatura’s ‘hidden strategies’ and the ‘official neoliberal program’ of transition introduces tragic overtones in some of the entrepreneurial stories in the book.

To help the reader better understand these processes and ‘see’ what we – the authors of the research projects for which these interviews were conducted – were able to see in the stories presented in the book, a detailed theoretical introduction is given. It outlines the different research traditions in studying entrepreneurship in Eastern Europe in the fields of

economics, sociology, political science, economic history, and science and technology studies.

The current views on Communism are still dominated by the theory of totalitarianism, involving concepts that predominantly focus on the static structures of the totalitarian/authoritarian power, as based on a rigid hierarchy, centralization of state functions, state-directed plan economy, and all-embracing control mechanisms. In this perspective, the communist society enjoyed a restricted space, where, under state-control, autonomous actions and bottom-up initiatives were discouraged. Only lately has this view been challenged by historical and sociological studies on the so-called 'second economy' and communist entrepreneurship (Romsics 2007, Bundzhulov 2003, Mozny 2007, Szeleni 1994).

These studies revealed that during the decades after WWII the 'indigenous' way in which innovations were outlined by the agents of socialist economies involved the notion not of entrepreneurship but of *technical progress*. This concept, however, reduces the role of entrepreneurs and considers technical changes as external to the economy proper, i.e. as an 'exogenous factor'. The process of innovation was conceived of as a rational process, subject to socialist planning. Interestingly enough, up to the late 1970s the notion of technical progress was dominant in Western neoclassical economics as well, where innovations were also treated as 'exogenous' to the economic system. Many leading post-WWII economists shared the views of the late Schumpeter about the gradual disappearance of the entrepreneurial function in capitalist market economy, where the increasing dominance of large corporations was allegedly transforming innovations into a routine activity of salaried employees (Langlois 1987). We believe this was one of the key reasons for the specific 'blindness' (or rather bias) in recognizing the role of entrepreneurship in the former socialist economies and its effects on the process of transition.

In contrast to these assumptions, we claim that the socialist society, by its very nature, produced and maintained structural features that gave rise to entrepreneurship and that have influenced the way in which private entrepreneurship has evolved in many post-socialist countries. Our claims are supported by some recent works by a group of economic historians, such as Karen Freeze, Valentina Fava, Riika Nisjonen, and some others. During the last fifteen years they made valuable case studies of the innovations in the socialist economies, which questioned the earlier studies, carried out in the framework of the neoclassical paradigm (Amann and Cooper 1982; Hewett 1987, Berliner 1988). We also found support in the pioneering research on the socialist enterprise carried out by Simon

Clarke in Russia immediately after the fall of Communism (Clarke 1994, 1994).

After 1989 the economic models of *post-socialist transition* can be broadly classified into two large groups - neo-classical liberal models and neo-statist models, both sharing the traditional market-state opposition. For the neo-liberalists, the state is an end in itself and is destined to be forced out of the field of economic activity and out of the theoretical schemes of analysis (Kosolowski, 1992; Sachs, 1996), while for the neo-statists, the establishment of a powerful and coherent state is the sole alternative to the weak markets, an efficient means of resolving the problems they have generated, and a reliable tool for reforming the entire society. The two approaches clashed during the first years of Eastern European transformation. However, the 'neo-liberal fallacy' (Hirszowicz, Mailer, 1994) was dominant, perhaps because it equated the triumph of capitalism with the triumph of the market. It took notice only of the market revolutions of Reagan and Thatcher (Stark, 1992), overlooking the industrial transformations in Germany, Japan, and France, which were neither solely market nor hierarchical ones. According to J. Kornai both models of post-socialist economic transition failed to take into account the set of practical problems required for normal operation of a market economy:

"...Once the laws are satisfactory, the key question is to ensure they are observed in a disciplined way. This requires that law courts administer justice quickly and efficiently and penalize breaches of contract and lapses of financial discipline. In warranted cases, courts have to declare firms insolvent, and if necessary order their liquidation. Lawyers are needed to represent debtors and creditors professionally, officials to implement court decisions and conduct auctions, personnel and institutions specializing in reorganization and liquidation, and so on. Socialist countries, before the start of the market-oriented reforms, possessed no trace of this kind of apparatus, which functions traditionally in developed market economies." (Kornai 2000: 1596-1597)

Since the mid-1990s, however, the so-called *path-dependency approach* became prominent, especially after the work of David Stark and Laszlo Bruszt on the so-called 'recombinant capitalism' established in Hungary in 1990s. As they put it, there is little sense in the idea of transition in the East European economies as a 'rational design of [new] economic institutions', simply because the capitalist economy and its institutions are not the outcome of a rational design (like the communist Utopia). The evolutionist approach, based on the concept of path dependency, has the heuristic advantage of examining what is happening here and now as a

constant activation of the existing (available) organizational forms, institutional mechanisms, social relations and products, used by the actors to answer immediate practical dilemmas” (Hausner, Jessop, Nielsen, 1995; Stark & Bruszt 1992, 1996).

Another promising research avenue was the *techno-economic networks* approach developed in the field of social studies of science and technologies (M. Callon, B. Latour, J. Law), whose notions of emerging and stabilised techno-economic (or socio-technical) networks allow tracing the complex web of cognitive, technological, economic, political, legal, etc. relationships in the process of innovation and its evolution. Applied to the economic realities of socialism and post-socialism, it provides rich resources for going beyond the market-state opposition, and for taking into account the science, technological, and institutional base of the studied societies.

These two research traditions, the recent studies of economic historians, the critical reading of the classical ideas of Joseph Schumpeter on innovations in non-market economies, and the original model of the communist ‘Sacred and Profane’, developed by Finnish sociologist Markku Kivinen, became the key sources of theoretical inspiration for the authors’ researches on post-socialist entrepreneurship, pushing us to leave the privileged position of *observers that already know the outcome*, and to try to revive the ‘open end’ situations, in which the past actors had striven to achieve their goals and realize their strategies. The original synthesis of these ideas into a general model about socialist and post-socialist entrepreneurship is presented in the introduction of the book. It simultaneously challenges *the common way of conceptualizing entrepreneurship* as something that is related only to production of goods or selling services/goods (i.e. the concept of innovation/innovative action); *the commonly held belief that there were no entrepreneurs under socialism*, or if there were, they were just black-economy swindlers and crooks (i.e. a belief that expands the range of entrepreneurs to include Party and KGB structures and others); and *the commonly held idea of post-socialism as an antidote of socialist order*. Viewed through this model, the data reveal a new picture of post-socialist transition, which appears richer in real-life opportunities and astonishing new developments...

Ivan Tchalakov, Jouko Nikula,
Sofia-Helsinki, September-November 2012.

PART I

INTRODUCTION

The idea of this book arose somewhere in the spring of 2010 when Ivan Tchalakov was a visiting scholar at the Finnish Centre for Russian and Eastern European Studies, University of Helsinki. During the regular joint lunches, we discussed our research interests and research histories and discovered that we shared the same research interests – and research history. Ivan had studied the emergent class of entrepreneurs in Bulgaria and Macedonia and I had studied the same class in the Baltic countries – Estonia, Latvia, Lithuania, and Russia at their later stages. What made a distinction between us was the starting point: while Ivan's studies were based on the theory of socialist entrepreneurs as a group distinct from the ideological or political nomenclature, my studies were based more on customary notions of entrepreneurs as products of the waste- and shortage-economy, informal practices and networks (*blat* relations, corruption and others) or grabbers of joint property in obscure privatization operations. Another difference was in our views of the core functions and competences of the entrepreneurs - for Ivan the core of entrepreneurship was creation and dissemination of innovations in the sense of Schumpeter, while for me the key issues were sustainability of the business, penetration into new markets, and ways to succeed in competition (through prices, quality). This explained also our difference in the search for relevant conceptual tools to account for the rich empirical data collected.

However, the point that we shared was the understanding of socialism as a social formation that was not a steel-armoured, non-modern control society, but a societal formation of its own where certain market-type relations also functioned, albeit in strange and distorted forms. This introduction presents the results of our efforts to bring together our conceptual frameworks for a better understanding of the (post)socialist entrepreneurship. There is no doubt that the stories told to us by the interviewed entrepreneurs go beyond any conceptual frame. Yet our understanding of these stories and the societies their heroes lived in may provide the reader with one more perspective on (or way of looking at) them.

* * *

The socialist system collapsed in Europe (and Russia) some twenty years ago. The “revolutions” in former socialist countries were, in a sense, accompanied by neo-liberalism, the Reaganist and Thatcherist ideology, which had been sweeping through Europe and USA since the mid- 1980s. In this thinking, the causes for economic problems were seen to be the Big State, the established structures of regulation of economy (publicly-owned enterprises, trade unions, etc.), the welfare state; the “cure” was to curtail these. There was also a longing for “fundamental values”, such as the worth of the individual, the importance of ambition, pursuit of personal wealth (even in China), and localism. The neo-liberal thinking with regard to the socialist countries was deeply rooted in a simplified version of totalitarian society according to which its main characteristics were a single-party society with one official ideology, a centrally-directed economy, strictly controlled media, and strong state security forces, militia, security police, and army. This would imply that the Soviet-type societies were tightly controlled and homogeneous unities in all socio-economic respects, oppressed by the Party. In a Soviet-type society, the argument goes, individual preferences and initiative were strictly controlled or banned. Collectivism prevailed in all spheres of life – in housing, in work, in culture. When this centralized collective began to dissolve, this happened through a number of processes, as illustrated in Janos Kornai’s (2010: 2) description of the key processes of the Great Transformation:

“The ‘Great Transformation’ is an ensemble of several processes. Firstly, there were changes in the political domain: the transition from a single-party dictatorship to a multi-party democracy. Then there were changes in the economic domain: the predominance of state-ownership was replaced by the predominance of private ownership. Associated with the transformation of ownership forms, the relative influence of various coordination mechanisms also went through radical changes. The impact of centralized bureaucratic control became much smaller, and the influence of market co-ordination and other decentralized procedures increased dramatically. These profound political and economic changes, associated with several other changes, jointly meant the change of the system, i.e., the transition from socialism to capitalism”.

It was exactly these things that the IMF and World Bank advisors proposed: a complete dismantling of collective, state ownership and withdrawal of the state from the regulation of the economy. Only through marketization, liberalization and privatization was it possible to “produce”

the optimal economic structures, boost entrepreneurship via creation of a viable stratum of small and medium-sized enterprises, and guarantee the smooth development of democracy.

Our starting-point is that the reformers and a large part of the academics who analysed the socialist society, have had a completely distorted and one-sided understanding of its structural features, of the nature of enterprise within it, and of the kinds of ramifications these two matters had for the history and forms of development of entrepreneurship in socialist and especially in post-socialist society. For us the socialist society, by its very nature, produced and maintained such structural features that gave rise to entrepreneurship and have influenced the way private entrepreneurship has evolved in many post-socialist countries.

The introduction is structured into seven parts. We begin with a brief discussion of the key obstacle faced by any social study of past events that pays attention to the indigenous actors' point of view – controlling the asymmetry between the worlds these actors were living in and our privileged position of observers who *already know* the outcome of those events.

The second section outlines the strange similarity in the ways Marxist political economy and neoclassical economics considered entrepreneurship during the decades after WWII, i.e. as a sign of the imperfection of the corresponding economic system, as something that plays an auxiliary, compensating role. We present the main features of the socialist society and economy (including the social relations within the socialist enterprise), which fostered the evolution of entrepreneurship in socialism and the forces that maintained its development.

The next three sections (3-5) deepen our understanding of the specific political, economic and cultural patterns that emerged and stabilized in the former socialist societies as a specific form of modernity, patterns that have a bearing upon the process of post-socialist transition. Sections 3 and 4 provide a critical reading of Schumpeter's implicit theory of economic development in non-market economies, which is juxtaposed (section 5) with an outline of the indigenous structure of power relations in communist economy, with their specific tensions and dynamics. Taken together, these three sections propose an original conceptual frame that significantly modifies the 'compensating' or 'auxiliary' notion of socialist entrepreneurship.

Section 6 explores the related 'cultural matrix' of former communist societies. It reveals the code of socialist 'Sacred and Profane' as a motivational ground underlying the actions of the former communist nomenclature and ordinary economic agents.

This is an important step, for it displays this code as radically different from the ‘Sacred and Profane’ of capitalist societies, thus providing the resources to think about its transformation during the post-socialist transition and its influence on the behavior of the interviewed entrepreneurs.

Section 7 briefly outlines of the transitional paths of Bulgaria, Estonia, and Russia during the last two decades, thus providing the reader with more resources for interpreting the interviews.

The Asymmetry that Makes the Study of (Post) Socialist Entrepreneurship so Difficult

During the decades after WWII the ‘indigenous’ way innovations were outlined by the agents in socialist economies was the notion of *technical progress*. This notion, however, reduces the role of entrepreneurs and considers technical changes as external to the economy proper, i.e. as an ‘exogenous factor’. The introduction of innovations was conceived as a rational process, subject to socialist planning. Interestingly enough, up until the late 1970s the notion of technical progress was dominant in Western neoclassical economics too, where innovations were also treated as ‘exogenous’ to the economic system.

There are striking similarities in the way technical changes were considered in neoclassical economics and in socialist political economy, which equally shared the so-called ‘diffusion model of innovation’ (Callon & Latour 1986). This model assumes that any (technical) innovation possesses ‘internal’ properties and that there exists a ‘social’ resistance against diffusion of a given technology or artifact, so that the clash between innovation’s own momentum of development and the resistance to it, leads to a certain delay in its introduction. Underlying these assumptions is the general ‘philosophical’ principle of *the asymmetry between past events*, which can always be explained by their (in)efficiency, profitability and necessity, *and the present situation*, which is always enigmatic to a certain extent. More than twenty years ago the new sociology of innovation emerged precisely by questioning this assumption, and by posing the questions: How to understand innovations in their ‘proper present’, before history has judged with its standard schemes of reasoning? How to analyze and trace innovations before they became efficient, profitable, and indispensable?

We believe these questions are relevant also in studying entrepreneurship in former socialist economies and the period of their transition towards capitalism after 1989 – here too we need to leave our privileged position

of *observers that already know the outcome*, and to try to revive the ‘open end’ situations in which the past actors strove to achieve their goals and to realize their strategies. As a number of studies have shown, it is not possible to judge between several competitive projects, on the basis of our knowledge about states of technology, type of economies and markets, or laws of physics – the states are changing, market are created, physics is constructed (or revolutionized). Hence, in their emerging and polemic state, innovative products and services are ‘under-defined’, vague and unclear (Hughes 1983). Yet it is at this ‘under-defined’ stage that the most important decisions about the destiny of the innovation are to be made – where is the money to be borrowed from, what is to be researched and developed, what marketing strategy is to be elaborated, etc. And this is precisely the environment *entrepreneurs* are faced with, including the socialist and post-socialist entrepreneurs. The interviews we collected in this book provide rich evidence of this challenging ‘real-world’ environment that the (post)socialist entrepreneurs were living in.

Were the Socialist Entrepreneurs at all Possible?

The Disappearance of the Entrepreneurs in Modern Economies and their Reduction to Auxiliary, ‘Compensating’ Economic Agents

In his seminal paper on *Entrepreneurship and Management*, Alberto Martinelli provides a compelling – if brief - historical outline of the concept, pointing out the importance of the three ‘classical’ interpretations of entrepreneurship in Karl Marx, Max Weber, and Joseph Schumpeter.¹ He stresses that Marx “...does not distinguish between the owner of capital and the entrepreneur, and does not offer much insight into the specific features and behaviour of entrepreneurs as collective actors” (Martinelli 1994: 477). Although Marx provided vivid descriptions of the role of the bourgeoisie at the earlier stages of capitalism, much of which could be considered as true entrepreneurial activity, the latter was not

¹ It is beyond the scope of this introduction to analyze the early contributions to economic theory of *Cantillon* (1755) and *Turgot* (1776), who first related entrepreneurship to the acceptance of the risk and uncertainty inherent in economic activity, or of *Jean-Baptiste Say* (1803, 1828) and *John Stuart Mill*, who introduced the distinction between entrepreneurial function and supply of capital. See also the overview by Tyson, Petrin, and Rogers (1994) of the definitions of entrepreneurship and their relevance for the study of early post-socialist economic realities, especially Jones’s and Sakong’s (1981) study of Korean entrepreneurship.

considered as something distinct in the large theoretical scheme of capital accumulation and growth. His analyses in *Das Kapital* of the automatic machines and the transition from manufacture to the factory system of production does not leave much room for the entrepreneurs either, considered by Marx as ‘managers’ or supervisors of production processes as opposed to the workers. This specific interpretation laid the ground of a tradition where, under the notions of ‘socialisation of production’, of the ‘alienation of labour’ and its ‘reverse appropriation’ under communist society, the specific entrepreneurial function was largely neglected. *For many decades entrepreneurship as a concept practically disappeared from the textbooks of Marxist political economy, and it was never used in describing the socialist economies.*

In his economic analysis Max Weber retained much of the basic Marxist assumptions, pointing out, however, the cultural factors that distinguished capitalist entrepreneurs from their earlier predecessors; among these factors were “...rational and systematic pursuit of economic gain, calculation based on economic criterion, the relation between trust and credit, and subordination of consumption to accumulation, etc.” (Martinelli 1994: 487). In his famous analysis of the Protestant ethic and in other writings, he managed to provide a much more concrete and detailed picture of the role of individuals in shaping the behavior of the capitalist class as a whole and in the functioning and development of modern institutions of capitalism.

It was Joseph Schumpeter (1912), however, who decisively linked the entrepreneurs with innovation, defining them as risk-takers, relatively independent of inherited property, and introducing new combinations of the factors of production, thus breaking the static equilibrium of the circular flow of the economy. He stressed that “...even if a businessman is owner of the capital, his function and position are not those of a simple provider either of money or of the physical means of production. *This is the profound error (which dates from Adam Smith but which was stressed by Karl Marx) of seeing nothing else in the activity of a captain of enterprise* (italics ours). Rather it is comparable to the role of a military commander; the businessman is essentially a worker who is the leader of other workers.” (Schumpeter 1991: 403)

Yet the ideas of Joseph Schumpeter have never been accommodated in the neoclassical economics that gained momentum after WWI. After the so-called ‘neoclassical synthesis’ with Keynesian macroeconomics, the latter became the dominant economic paradigm in Anglo-Saxon countries from the late 1940s till the 1970s. Hence the explanatory power of the concept of entrepreneurship slowly faded in the Western part of Europe

and North America. These theoretical developments went hand in hand with the rise of managerial capitalism and the expansion of the large corporations, which sharply reduced the role of individual entrepreneurial efforts. With the gradual establishment of monopolistic or oligopolistic markets in each industrial sector during the decades around WWI, authors like Rathenau (1918) described ‘organisierte Kapitalismus’ as based on de-personalization of property and as covering the same path as did the modern state, while Berle and Means (1932) claimed that the separation of ownership and control was an irreversible trend including the rise of the modern corporation, considered as an ‘organized social group based on interdependence of different economic interests – those of owners, employees, consumers, and the controlling group (managers)’ (Martinelli 1994: 488). Referring to this period, A. Chandler described the major trends in the economy as *transition from family to managerial capitalism*, powered by technological innovations, larger markets, international competition, industrial concentration, vertical integration, etc. (Chandler 1977). The Western societies also witnessed increasing involvement of governments in steering economic activities, especially after the experience they obtained during WWII (see Reich 1991, ch. 4).

The result was the gradual ‘disappearance’ of the entrepreneur in economic theory on both sides of the Iron Curtain. Barreto pointed out that “...with the advent of the modern theory of the firm, the economics lost track of the entrepreneur, [because] the framework assumptions – especially those of perfect rationality, does not allow for a consistent implementation of the entrepreneurial behavior. The role of the entrepreneur was reduced to a ‘static, passive and therefore redundant economic agent within a self-running firm” (Barreto 1989:84). In the decades that followed WWII, the ‘heroic’ entrepreneur appeared in mainstream economics in the paradoxical form of a *sign of underdevelopment and/or distortion of the markets*. As Martinelli put it, the dominant development economists at the time

“... shared the idea that pure entrepreneurial profit would be the smoothly corresponding reward that market conditions require and make possible. This approach assumes that factors of production are relatively mobile; that producers, consumers, and resource owners have knowledge of all the opportunities open to them; that risk and uncertainty are minimal; and that the influence of social institutions is neutral. The policy implications of this approach for development strategy are: let the market work, remove the barriers of traditional society, and entrepreneurs will appear from everywhere. When the above assumptions are relaxed and market segmentation, ignorance, impeded factor mobility, and pervasive administrative controls appear, the ‘extraordinary’ role of the entrepreneur

becomes apparent, as does the need to analyze more carefully the factors that can favor his formation.” (Martinelli 1994:485)

Hence, it was believed that little room was left for true entrepreneurship in the developed Western economies of the mid-20th century, dominated by large corporations. Joseph Schumpeter himself called this process ‘march into socialism’, stating that “...the perfectly bureaucratized giant industrial unit not only ousts the small or the medium-sized firm and ‘expropriates’ its owners, but in the end it also ousts the entrepreneur and expropriates the bourgeoisie as a class, which, in the process, stands to lose not only its income but also what is infinitely more important, its function. The true pacemakers of Socialism are not the intellectuals or agitators who preached it, but the Vanderbilts, Carnegies, and the Rockefellers.” (Schumpeter 1942: 134)

This was the context in which socialism as an economic system emerged in the decades after WWI; coupled with the tradition of Marxist political economy, it left no room for entrepreneurship as a conceptual tool for understanding the processes in the emerging administrative economies. The classical account of Janos Kornai in his “Political Economy of Communism” illustrates this: in his orderly theoretical scheme, the concept of entrepreneur is simply not needed (see Box 1 below).

It is interesting here to provide the comment by Włodzimierz Brus about the evolution of the notion of ‘enterprise’ in socialist administrative economies. According to him, when the foundations of the socialist economies were laid down in the 1920s and early 1930s, the “enterprise was elevated to the status of the main link in the system of management... but *without actual possibilities for taking allocation decisions*... [It is] an organizational unit designed to *implement*, in the most accurate way possible, decisions coming from *above* in the form of obligatory targets and plan-determined resource limits.” (Brus 1988: 100) Hence the author concludes that, under the socialist economic system, the enterprise as an organisational unit “...does not exercise the entrepreneurial function: it does not make choices either about objectives or means, and it does not bear the resultant risks and responsibilities” (ibid). Quite in tune with the predictions of the mainstream neoclassical economics of that time, Brus relates *the scope for entrepreneurship under socialism inverse to the degree of administrative regulation, as a sign of its imperfections and distortions*, and he finds *only relative differences* between administrative and (corporate) market economies.

Box 1 - Janos Kornai about key features of the socialist non-market economy

According to Kornai, the 'classical socialist economy' that took root in Eastern Europe has several interrelated characteristics:

1) The *common political structure*, whose distinguishing features are the inseparable political power of the ruling party, the reciprocal infiltration of party and state, and the suppression of all forces that distance themselves from or oppose the party policy; all these features legitimized by communist ideology.

2) The practical implementation of the principle of *supremacy of the state property*, imposed by the political structure, since "the inseparability of power and concomitant totalitarianism are incompatible with autonomy which exacts private property." The disappearance of the phenomenon of "business secrecy" constitutes a substantial after-effect of the supremacy of state property.

3) The specific constellation of co-ordinating mechanisms, *administrative co-ordination being the most essential component*. It consists of (a) elimination of free enterprise; (b) elimination of autonomous market agents and competition among them; (c) centralization of decision-making and information; (d) domination of hierarchical dependence (of vertical relations over horizontal).

4) The three distinguishing features of classic socialism have an immediate effect on *the interests and motivation of the economically active persons* - this, Kornai claims, is the fourth major characteristic. It gives rise to a number of typical phenomena such as planned contracting, striving for quantity, paternalistic behaviour of the people of high standing, soft budget constraints, weak reaction to prices, etc.

The socialist economy can be explained by these factors – the character of the governance, official ideology, prevalent state property, and administrative co-ordination. However, once they emerge, the factors gain independence and start in turn to influence and modify one another. Kornai calls this sequence of four elements (factors) 'explanatory chain'. Their interaction results in several lasting economic phenomena that are typical of classical socialism, the most important of them being *forced growth, deficit of manpower and hidden unemployment, economy of chronic deficit, specific role of foreign trade, etc.* (Kornai 1992, part II)

The Nature of Socialist Economy: Not Only Command, but also a Waste- and Shortage Economy

What was the economic context in which the socialist entrepreneurs emerged with their ‘compensating’ functions? In the system of ‘classical socialist economy’, outlined by Kornai, the emphasis was on extensive growth, i.e. maximal use of resources (labour, land), and not intensive growth, where growth is realized through increasing productivity. There was a lot of free labour and the productive capital was underutilized. According to Nove (1969), as the Soviet economy developed, it simultaneously became increasingly complex and increasingly difficult (or even impossible) to plan economic activities. This led to deficits and contributed seriously to development of the shortage- and waste economy.

In this context Simon Clarke defines the socialist enterprise as “a primary unit of Soviet society and the basis of the social and political power” (Clarke 1993b, 7). It was also a kind of *hub that nurtured various forms of informal economy and blat relations*. In the socialist enterprise the most important issue for the director was reproduction of the production process by constantly struggling and negotiating with central planning authorities over the financial, labour, and other resources. Marketing was not an issue for him, because markets were secure and regulated by the same central planning authorities. Enterprises produced goods according to orders and had no authority over the prices or the marketing of their products. The emphasis on quantitative growth meant that in investments as well, the main attention was paid to extensive reproduction of the means of production – enterprises invested in new machines, new production facilities, *but not in measures that would have improved their competitiveness in terms of product quality or skills of their employees*. This was the result of the fact that all the revenues of the enterprise went to central planning authorities, who distributed money according to past performance and future planning of production targets. Competition over the resources between different branches of economy and within the branches was fierce, and to guarantee their success in this competition, the enterprises were forced to overestimate their needs, underestimate their targets and hoard all possible resources. The result was a dislocation of many resources, ruptures and other forms of bottlenecks in the production processes, which in turn increased the power of the high-skilled employees to demand higher wages and more fringe benefits².

² See Nove 1993, Kornai 1992

In Clarke's account the third significant feature of the socialist enterprise was its nature as a means of authoritarian paternalism. The enterprises took care of almost all aspects of the life of their employees and many of those of the community where enterprises were located, in exchange for loyalty and consent to the demands of the management and Party. Enterprises gave employment, provided housing, health care, leisure and in many cases also provided a variety of consumption goods. However, the production of consumer goods was grossly underrated until the late 1950s – early 1960s, and serious problems in distribution of these goods existed until the collapse of socialism. The enterprises sponsored local community schools, sports activities, they built and maintained roads, provided transport services, etc. The trade unions functioned as a broker between the enterprise management, the Party, and the employees, negotiating on wages and benefits, and taking care of the distribution of benefits, where seniority and loyalty were important criteria.

The Sources of Informal Proto-entrepreneurship in Socialist Society

In the shortage- and waste economy, enterprises had larger autonomy to meet their target plans and recruit labour and other types of resources for sustaining the production process. Włodzimierz Brus outlines two types of such 'compensating' entrepreneurial activities: 1) The manipulation of the superordinate level of economic administration in situations of 'imperfect knowledge' – i.e. the centre has to rely on information supplied by an interested party: if an enterprise is rewarded for plan fulfillment and punished for under-fulfillment, it tries to hide its capacities (in order to receive a less demanding target) and exaggerates its needs (in order to get a more generous allocation of labor and material inputs); 2) Informal transactions between enterprises themselves – i.e. the mismatch between supply of and demand for production factors is corrected by enterprises arranging swaps, which only go against the rules of vertical channels of allocation (Brus 1988, 101). In organizing necessary inputs, the horizontal and largely informal network ties became stronger and more important. This meant that the economy as a whole moved gradually to "grey" or even "black" zones of economic activity. The shortages of goods and services³ nurtured different forms of the second economy, such as petty

³ The Bulgarian sociologists Andrey Bundzhulov notes that the official system of distribution, which was counterpoised to the 'second networks' and blat, was not uniform and homogeneous. The communist nomenclature created two systems of

trading, hidden incomes from unofficial jobs, or intra-firm barter (Sik 1995, 10). Finding niches and taking risks represented proto-entrepreneurship and were logical and necessary products of the economy that wasted resources and suffered from shortages of most consumption goods.

Socialist proto-entrepreneurs were an inevitable substitute for an official economy, because they diminished the bottle-necks in the distribution of resources and goods and therefore they were, at least unofficially, accepted. The actors who negotiated and took care of the exchange of resources between enterprises were *tolkachi*, a special group of lower management whose main task was to barter for materials they needed. Nell (2006) does not regard them as entrepreneurial because "...*tolkachi* were filling the gap in supply of inputs for state enterprises to fulfil their plan targets. Hence, the origin of this activity is the plan – not the entrepreneurial drive of these middlemen" (Nell 2006, 4).

Yet the researchers have found another group of informal and 'systemic' entrepreneurs – the so-called *tzehoviki* (*цеховики*), who secretly manufactured consumer goods and used their networks to get goods from the shops and markets. In the economy of shortage this attempt to satisfy public demand brought them huge profits. However, they had very little chances of reinvesting their profits because they were constantly crossing boundaries by acquiring necessary raw materials through theft or corruption. Also, the fact that they were using state shops for private transactions on a large scale could get them a long sentence in prison. Therefore it was a very risky yet fabulously profitable business. These "entrepreneurs" used all their power to mitigate risks, for example through bribes to get entry into the Party hierarchy and maintain mutually

distribution – official and unofficial. The former was apparent, encompassed all individuals and operated at a relatively low level. By Western criteria, it was ineffective both in terms of quality of the services and standards. To meet its own needs, the 'apparatus' created an additional ("special") system of distribution, *the system of privileges* – special shops with high-quality merchandise, specialized hospitals and rest homes that provided better treatment, comfortable flats in elite residential neighborhoods, privileges in obtaining higher education, traveling abroad, etc. Bundzhulov goes even further and distinguishes *three systems/levels of distribution* – 1) a system which caters to the needs of the apparatus; 2) an official system of distribution for the general public; and 3) official privileges for certain social strata [managers, Stakhanovite shock-workers, etc.] or regions (Bundzhulov 2006: 403). The difference between the first one and the other two is that the system of privileged distribution is *off the record* – "*the privileges of the apparatus are secret, they are not known to the public*" (ibid)!

beneficial ties with local Party leaders. In a sense, they were a win-win phenomenon, because for entrepreneurs themselves the shortage and waste economy created good grounds for profitable business. They were profitable also for some parts of the Party apparatus and the state administration, because the existence of *tzehoviki* depended to a great extent on the benevolence of a range of inspectors and law-enforcement officials and, naturally, on the amounts of roubles that these officials received from the *tzehoviki*. Being unofficial, these entrepreneurs were naturally at the mercy of unofficial “security entrepreneurs”, i.e. racketeers.

At the level of everyday life the Soviet-type economy forced most citizens to spend a lot of time and energy to find goods that were in short supply. This required organizing complex systems for exchanging goods and favours with the members of their social networks. This “private entrepreneurship of shortage” (Srubar 1991) gave birth to various forms of social networks between different social groups (workers/managers; managers/Party officials, etc.) and to an “economy of favours” or *blat* (Ledeneva 1998), which were complementary to the ‘official’ social organizing in the Soviet economy. Rehn and Taalas (2004, 237) argue that “*the Union of Soviet Socialist Republics might be seen as the most entrepreneurial society*” (italics original). True, the Soviet citizens (like the citizens of other socialist societies) were extremely innovative in finding new economic opportunities in the face of uncertainty and other obstacles (shortages of goods, threat of legal penalties, etc.), but it is also true that *blat* systems did not enhance the well-being of the community or region, not to mention the state. They were mainly about individual exchanges; usually there was no money involved, but a service was exchanged for another service or goods. Rehn and Taalas argue that *blat* had many positive impacts on the socialist economy; it increased flexibility and fostered trust and reciprocity between the members of the network, which entailed active participation and contribution from their members. (Rehn & Taalas 2004, 244)

Some sociologists studying the former socialist societies generalize the ‘blat’ phenomenon by introducing the notions of *second networks* emerging *on the borderline between the deficit of power and the deficit of goods*. The second networks (as opposed to the ‘first’, official relationships), they claim, may be regarded as a fundamental phenomenon of socialist society, a phenomenon defined as an ‘exchange of goods and power’.⁴ These networks do not duplicate the socialist state but are its opposite:

⁴ See also Elemer Hankiss’ notion of ‘second society’ (Hankiss 1988). Using Claus Offe’s idea about the two basic organizational principles operating in advanced capitalist societies to outline the differences between West European capitalist and

“In [socialist] society, there are real hierarchies besides the formal ones, because with an exchange of goods for statuses, it is normal to have central and peripheral points. Therefore public hierarchies emerge, which compete with the official ones and have an increasing influence over them. In this sense, we can rightfully define this process as colonization (Ivo Mozny).” (Raychev 2002, p. 4).

Hence, similarly to the developments in the Western countries since the 1970s, where, with the rise of neo-liberal economic theory, individual economic initiative and the role of the innovative small and medium enterprises were recognized as a key engine of capitalist economic development,⁵ in most socialist countries the reformist rulers openly supported the forms of bottom-up ‘socialist entrepreneurship’ as a remedy for the inherent shortcomings of the administrative economies and as part of the ongoing process of economic reforms. Just a few years before the 1989 velvet revolutions in Eastern Europe, Włodzimierz Brus wrote:

“...In the closing decades of the twentieth century, in most of the ‘real socialist’ countries (this is still the designation used in official Soviet language to describe the countries ruled by Communist parties), a frantic search is going on to find tools to revive the entrepreneurial function... This is true not only for countries like Yugoslavia where the search is already almost 40 years old, or Hungary, which introduced the (then) ‘New Economic Mechanism’ in 1968, but also in the two giants and ideological standard bearers of the communist world: China, where reforms have been in full swing since the end of the 1970s, and the Soviet Union, where from the platform of the Communist Party’s XXVII Congress and from pronouncements of Secretary General Mikhail Gorbachev, the repeated calls for socialist entrepreneurship can be clearly heard.” (Brus 1988: 99)

East European socialist societies, he defines “the second economy” as additional to the administrative economy and “only loosely integrated into it”, and not as a substantial – if complementary – part of it (ibid, p.18). It appears as a weakened version of the capitalist market economy that emerges inside the administrative one as its alternative. [We are indebted to Katalin Miklossy for pointing our attention to Hankiss’s work.]

⁵ See Kurzner’s notion of entrepreneurship as a process of discovery and his critique of the neoclassical notion of ‘maximizing behavior’ and the economic importance of other typically entrepreneurial features of the economic agents such as alertness, creativity, risk taking (Krizner 1997). See also Florida and Kenney about the role of financial innovation such as venture capital that created new opportunities for the individual entrepreneurs and, since the 1970s, made start-up companies and small and medium enterprises one of the key drivers of innovation and economic development in US and other Anglo-Saxon countries (Florida and Kenney 1988).

The “mundane entrepreneurship” experiences under socialism proved to be crucially important in establishing an enterprise, because many enterprises operated in the “grey area”, where formal rules and practises did not exist. In this operational environment enterprises utilized the *blat*-type networks for gaining knowledge about buyers, sellers, and money. Many of the new enterprises continued to fill the gaps in the provision of services and consumer goods; enterprises bought and sold used cars, pirate computer programmes, metals, tobacco, etc. Social networks with foreigners and foreign companies proved to be a vitally important precondition for a successful business; they provided entrepreneurs with starting capital, know-how and open doors to foreign markets. As noted earlier, for many entrepreneurs the enterprise was not just an opportunity to get rich, but a way to cope under very insecure economic and social conditions or even to avoid poverty. In the turbulent early years of post-socialism the entrepreneurs frequently changed their branch and type of enterprise. Typically, they started as owners of micro enterprises and gradually accumulated capital for a more serious business.

We would argue, however, that the *blat* positive impacts did not extend beyond the personal networks and, on the contrary, *blat* relations fostered closed social networks and limited trust or reciprocity, while creating and reproducing an attitude of suspicion towards the “outsiders”. The complex networks of *blat* did certainly play an important role in the establishment of private enterprises already during late socialism and during the first years of transition, when a large number of small and medium-sized enterprises were established by utilising social networks of friends, family members, and former colleagues. Yet the legacy of *blat* made difficult the establishment of larger business networks and of trusting relationships with those outside the ‘friendship circles’ and eventually the overall increase of trust as precondition for an efficient capitalist economy (see also Hsu 2005, 314-323).

Below we will consider in more details the different forms of entrepreneurship that took place in the former socialist countries in the late 1980s and, after 1989, with the legalization of private ownership, were transformed into true capitalist enterprises. Yet to understand how this painful transformation took place and the largely unexpected difficulties the post-socialist entrepreneurs had to face, we need to expand still further our understanding of the functioning of socialist societies and their economies. The understanding of socialist entrepreneurship only as compensating the ‘failures of the Plan’ cannot explain these difficulties or the specific dynamics of socialist economic development. Two critical issues are to be discussed here: 1) the ability of communist leaders (the

nomenclature) to fulfill the entrepreneurial function, hence to serve as the main engine of innovation and ‘forceful growth’ (Kornai) in the earlier stages of socialism, and 2) the specific ‘Sacred and Profane’ as the immediate basis and horizon of economic actions in socialist society. Both the social strata of the nomenclature and the socialist ‘sacred’ did not disappear overnight after the fall of Communism, and this fact had major effects for the process of transition.

Joseph Schumpeter’s Forgotten Ideas about Communist Leaders as Entrepreneurs

With its publication in 1912 (and especially its revised English edition in 1934), Schumpeter’s *The Theory of Economic Development* shed new light on the mechanism of economic development in the capitalist market economy, preparing the advent of the economics of technical changes as an autonomous economic discipline (see Rosenberg 1976, Nelson and Winter 1976, Dossi and Freeman 1988).⁶ In an earlier article, one of us argued that Schumpeter’s theory about the role of entrepreneurial activity as the driving force of economic development in the market economy contains major premises, concepts, and explanations that provide important keys to understanding the development in non-market economies as well, more particularly, the economies with centralized planning and state ownership in Eastern Europe, Russia, China, and some other countries (Tchalakov 2003). The first argument supporting this claim is the fact that Schumpeter explicitly compares the market economy with private property with non-market economies without private property, and he expresses in passing some ideas about the mechanism of economic development in what he calls ‘communist’ economy. Secondly, Schumpeter’s theory is relevant to the study of rapid industrialization (in fact ‘industrial transition’) in most of the former socialist countries, since it is not a theory of equilibrium, but of *development*, and “development”, “progress”, “leap”, “catching up with”, etc., were not only ideological slogans, but the core of the economic efforts of socialism. As Janos Kornai points out in his *Political Economy of Communism*, what he calls ‘forceful growth’ is “the

⁶ A few years later Frank Knight (1921) introduced the important distinction between risk and uncertainty in economy as a tool for distinguishing the truly entrepreneurial behavior. Martinelli adds to this line of development the contributions of Israel Kirzner, made many decades later, who defined the entrepreneurial competition as a discovery process and stressed the role of alertness, creativity, and judgment as inherent features of entrepreneurship and economic action in general (Martinelli 1994: 485-86).

type of growth typical of the system", one of the fundamental features of classical socialist economy (Kornai 1992: 193).

In brief, the main findings of Schumpeter's *The Theory of Economic Development* that bear on the problem of economic development in market economies could be summarized thus:

- The distinction between 'circular flow' and 'development' is fundamental for the capitalist economy. In the former, the economic system functions in a 'static' state, as a 'routine' along the beaten track of 'past cycles'. 'Development' signifies a specific class of economic changes - the radical, abrupt changes in production.
- The source of development is the 'functioning in a different way', i.e. the introduction of innovations (new combinations). Because the new combinations are always more profitable, a key aspect of 'economic development' is the competitive elimination of the old forms of production. This process of 'creative destruction' is a fundamental trait of capitalism.
- The introduction of innovations is impossible without the function of the entrepreneur. The only contribution of entrepreneurs is their 'will and action' in channeling the existing production resources along new tracks. But the entrepreneurs could not implement new combinations without resources, i.e. they must have
- Access to capital - already existing or created ad hoc; this explains
- The essentially different role of credits when the economy functions in a regime of development. Creating means of funding 'ex nihilo' (through an abundance of credit tools) and thus ensuring credit to entrepreneurs, the banker seems to 'suck value from the future' into the present economic cycles, and hence makes them more dynamic.

On the basis of this orderly theoretical scheme, Schumpeter considers the following *specificities of the innovation processes in the non-market (socialist) economies*:

- 1) The important difference concerns the *entrepreneurial function*. This specific combination of 'will and action' is a type of leadership; it demands qualities possessed, as a rule, *by a limited circle of individuals*. This leadership is needed not only to break the routine and tradition, but also to overcome the adverse reactions of the social environment in which the new combination is carried out: the resistance of endangered producers ousted from the market

by the new combination, winning over consumers, finding allies, etc. Precisely because these are rare qualities, providing the possibility for *every potential entrepreneur* to possess [though temporarily] the resources necessary for the implementation of new combinations, i.e. access to credit, was a key condition for economic development.

In the *Theory of Economic Development* Schumpeter quotes two cases of non-market economy: a) the isolated kingdom where all the means belong to the lord, b) the isolated communist society in which the central authority possesses all commodities and labor resources and determines all commodity values. What is common to both of the two cases is that *some individuals enjoy absolute control* over the means of production. They expect no production cooperation, nor do they provide possibilities for making profit to other economic agents. So the problem of access to resources necessary for carrying out the new combinations "... does not exist in a non-exchange economy even if new combinations are carried out in it; for the directing organ, for example a socialist economic ministry, is in a position to direct the productive resources of the society to new uses exactly as it can direct them to their previous employments". (Schumpeter 1934: 68) Hence follows the assumption that 'communist leaders' or the 'central organ' can play the role of entrepreneurs *directly*, without using bankers as middlemen. In the case where the banking system is formally preserved but is controlled by the leaders, the latter combine both functions: of entrepreneurs and of bankers.

- 2) This leads, however, to the *narrowing down of the social basis of entrepreneurship*. The direct and absolute control on behalf of the communist leaders over resources deprives the remaining economic agents of the possibility to carry out independent entrepreneurial activities. They are economically unable to become entrepreneurs. Having in mind that only a limited circle of individual possess the qualities needed to become entrepreneurs, the narrowing down of the social basis has major long-term effects on the rates of innovations and hence on the rates of economic development in a communist economy.
- 3) The direct control by the communist nomenclature over the necessary resources creates *an essentially different situation as regards risks and the speed of introducing innovations*. In the market economy the entrepreneur must first persuade the banker and gain his confidence before getting the necessary credit. The conjuncture on the credit market has a strong impact on the rates