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The Generic Private Sector in an Economy of Transition: Developments and Impacts on the Czech Economy

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Contents

Abstract

The long-lasting problems of the Czech economy, which have become apparent since 1996, have their roots in the behavior of a significant part of the domestic enterprise sector. These problems were called into being by a very intensive, nevertheless deeply non-standard mass privatization. The authentic (generic) private sector cannot be based on a command coming from the upper hierarchies of the social organization. It can arise only from gradual acts at the level of economic agents making their decisions autonomously at the grass roots of the economy. Soft market environment set by the Czech mass privatization policies was counter-productive for the development of entrepreneurial activities as defined by Schumpeter. The lobbies of pressure groups, defending the privileges of former socialist corporations, became dominant in shaping Czech politics, fiscal and banking economic policies and the build-up of economic institutions. The authentic private sector that evolved mainly from small and medium-sized enterprises was driven from its start to a position of an outsider.

Notwithstanding the lack of government support, market imperfections, bureaucracy and failing judiciary, the sector of newly established businesses has shown a high degree of viability and at the end of the 1990s it became a dominant player on the market side of the Czech economy. The future of the Czech economic development cannot be separated from the situation in both the enterprises under foreign ownership and the small and medium-sized firms under indigenous owners. The economic policy-making should be based on these facts and provide for the requirements of these two progressive segments of the Czech authentic private sector. This also implies that merits of mass privatization should be subject to a fundamental overhauling on both the academic and the economic policy sides.

JEL classification numbers: D73, L33, M13, O17, P26

Keywords: privatization, private sector, entrepreneurship, restructuring, economic transition.

Foreword

This study is a part of a larger project whose aim was to analyze "The new entrepreneurial private sector in more advanced transition economies of Poland, Czechia and Hungary". The work on this paper commenced while the author was not associated with IIASA. The authors of the remaining two country studies were Jan Winiecki from Europa-Universitaet Viadrina in Frankfurt (Oder) and Mihaly Laki from Economic Institute of Hungarian Academy of Sciences in Budapest.

Even though the rise of new entrepreneurial class and their newly founded businesses are at the forefront of transition, paradoxically they received only marginal attention both from the economic research and the policy-making. The dynamic, newly established private firms (so-called generic or *de novo* private sector) therefore developed sideways behind the bulk of attention given to privatized state-owned enterprises. The research in this paper had to cope not only with the lack of data about newly established firms but also it had to establish a theoretical framework which would allow to describe the differences in behavior and performance of the new generic sector from the old privatized sector.

The structure of the study is methodologically based on an approach following from abstract principles to concrete phenomena encountered in the Czech economy and ending with empirical evidence and data:

- Philosophy of privatization and evolution of the private sector
- Roles of the generic private sector in a national economy and its relationship to small and medium enterprises
- Evolution of Czech transition and its policies for the development of private ownership
- Alternatives to mass methods of privatization – gradual evolution of the private sector "from below"
- Empirical evidence about the performance of Czech *de novo* private enterprises
- Institutional barriers to new entrepreneurial private sector in Czechia
- Supplements explaining the theoretical inferences, data, tables and figures with own empirical findings and an overview of empirical material from other studies of the generic private sector.

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The Generic Private Sector in an Economy of Transition: Developments and Impacts on the Czech Economy

Vladimír Benáček

1. The Philosophy of Privatization

It is now a generally accepted fact that private ownership of capital for producing private goods is more efficient than the public ownership because it has superior incentives for governance, decision-making, risk bearing, competition and innovation. The private capitalist ownership in advanced market economies was borne in a gradual evolutionary process, lasting in many countries over 150 years, subjecting the owners and efficiency in their firms to long-lasting tests of viability that became an undisputed standard of their performance and environment. On the other hand, the private ownership in transition economies was created by a "privatization shock" and the selection of both owners and the property privatized was to a large extent random. There were borne various types of "private owners" whose motives and incentives for the usage of capital became extremely varied and in many ways incompatible with the behavior of standard private owners. Not surprisingly, there are many ambiguities in the process of privatization (Frydman, Rapaczynski, 1994) leading to a conclusion that "… the concept of privatization … obscures important cress-sectional variations, since the performance effects of ownership transformations are significantly different depending on the type of owners to whom control is given during the privatization process" (Frydman, Gray, Hessel, Rapaczynski, 1999, p. 1154).

In order to find workable analytical concepts, we should turn to definitions of two typologies of the evolution of the private sector: from **"above"** and from **"below"**, as utilized by Gruszecki and Winiecki, 1991, and Winiecki, 2000. The first of these two methods is based on turning **existing state-owned enterprises** (SOEs) into private hands, for the achievement of which the **activism of the government and its state hierarchies** is paramount. The alternative approach to the rise of the private sector leads through the establishment of the **authentic** ("genuine" or "generic") private sector by the **creation and expansion of *"de novo"* private firms**. In the strategy "from below" the mainstream of activism comes from the grass roots of the economy, i.e. at the autonomous firm level and the activism of their owners. The difference between the two concepts rests in the difference between the *de iure* and the *de facto* meaning of "privatization". The idea is embedded in the tradition of German philosophy, saying that there may be crucial differences between the external phenomena (form, appearance and labeling) and the intrinsic **real contents** of "privatization".

This whole problem has also deep roots in the economic literature. Hayek, 1973, came up with a supposition that all functioning economic systems must be based on a concept of "order". He distinguished two sources of order: Cosmos and Taxis. The former is given exogenously (i.e. spontaneously) and is represented, among others, by free markets, informal rules and behavioral patterns. The latter is created artificially, reflecting the aims (i.e. the vested interests) of certain social groups. Taxis is represented by organizations, their hierarchies and institutions. Hayek claims that it is impossible to introduce a new order by force - by manipulating Taxis. We can use Hayek's reasoning and argue that mass privatization was an attempt to introduce a new economic order unilaterally by mere decree, while Cosmos was still not tuned that way and even the remaining parts of Taxis were still reflecting a different stage of evolution. The inertia of path dependency is another approach to the same thing.

A hasty and superficial mass privatization thus could cause a "crowding-out" in the natural processes evolving from Cosmos and even choke the self-sustaining processes of privatization and reallocation of resources. The development of small- and medium-sized enterprises (SMEs) could have been one of them, repressed by an ordained bias of the society towards mere redistribution of some formal ownership entitlements (usus or usus fructus), while neglecting the crucial importance of governance (abusus). If we accept Hayek's methodology of development and order, then we must conclude that the Czech "conservative" approach to privatization was to a large extent a result of misunderstanding and/or a direct abuse of his ideas.

The criterion for privatization should rest in the behavior of the owners as its actors. While the privatization "from below" is consistent with the principles of microeconomics (i.e. the autonomous decision-making of individual economic agents that is their own cause), the privatization "from above" is **normative** and **exogenous** to these actors. The processes that are so triggered from the top hierarchy of the social intervention have difficulties in transcending its form of being mere legal acts. The form becomes so dominant that the contents of privatization (i.e. restructuring and competition) remain entangled in the **virtual reality** of bureaucracy, into which the acts of privatization were borne. While one of the crucial reasons for privatization is to make the owners sensitive to competition and restructuring (Brown and Earle, 2001), the "nominal" privatization from above may miss this point because the new virtual owners may not be motivated in restructuring and using the existing assets efficiently since their interest can be oriented to very different domains. For example, it may be acquiring debts, asset stripping and private consumption.

The dual classifications presented above are also in line with approaches to transformation strategies by other scholars. For example, Kornai, 1989, distinguished between strategy A of an "organic development" and a strategy B of "shock therapy" by speedy privatization. In Kornai, 2000, these strategies were again assessed with a perspective of 10 years and it was concluded that the role of strategy A in the transformation of former Comecon countries was generally less important. The opposite was true for China. Similarly Sato, 1995 and 2000, distinguishes between two strategies where the first one is evolutionary (gradual), concerned with corporate governance, low cost and SME development. The other strategy is biased towards an "ownership obsession" and attempts to swiftly transform the state-owned corporate sector by giving it a label of a different legal group. While the former slow strategy has a higher chance of succeeding in qualitative economic terms (while political activism remains subdued), the latter strategy was more preferred by political parties and led to deeper political reforms (while the economic transformation did not bring a breakthrough in the growth of output).

A similar idea was proposed in the Czech literature. Mlcoch, 2000, concluded his long-lasting study with a general observation that a speedy (i.e. shock) mass privatization in European post-Communist countries created a conflict with the inherited institutional arrangements from perversely functioning markets under central planning. The failure to introduce performing markets and the enforcement of property rights caused a reversal in the process of transformation which got stalled in the conflicts of interest between owners, quasi-owners and various powerful agents. Mlcoch proposed a gradually evolving privatization strategy, which would follow the slower speed of accommodating transformation of economic institutions.

A very important message in this respect came from the World Bank (Selowsky, Mitra et al., 2001. A large part of its assessment of experiences from the 10 years of transition is devoted to the *de novo* firms. The emergence of new firms, especially as "green field" start-ups, is taken there as the quintessence feature of transition. It is directly juxtaposed to the privatization of existing state corporations. The authors derive from the theory of governance, what they also empirically confirm, that *de novo* firms are more efficient than the privatized giants and their role is to be engines of growth, together with the enterprises established by means of FDI. These firms will grow as the spin-offs from contracting segments of the economy. One should not have doubts that in the Czech case, where the majority of state-owned firms were transformed into non-state (quasi-private) hands by mass privatization schemes, it is these privatized companies, which represent the shrinking sector and which have revealed during 1992-99 a syndrome of a low immunity to competition.

It is also discussed in the World Bank Report that governments are very often inclined to apply adverse policies in order to keep the former SOEs alive. Instead of standing by the policies defending market discipline (hard budget constraint, pro-investment climate and competition) and encouraging the agents to enter and sustain their development on such a path, the governments protect the old enterprises, levy high taxes on successful firms, build investment barriers and engage in anti-competitive practices. In Appendix B we show and discuss some of the evidence provided by the World Bank study. Though in its theoretical stance for discussing the new and the old enterprises the World Bank study is not referring to hierarchies (i.e. "from above" versus "form below"), the implicit principles of its methodology are compatible with our approach.

Even though it is not disputed that both of our strategies must be absolutely exclusive (i.e. they cannot run in parallel), once the act of transformation became a top national priority, the issue of economic long-term development rests on the proviso which one of these two strategies dominates [1]. In another words, **development is**

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[1] It is characteristic for human organizations that they may be ruled by a marginal majority (e.g. with 51% of votes). It is a rare exception that the governance is subject to rules requiring a proportional representation of interests. It is even more characteristic that the decision-making

determined by the spin-offs that the dominant approach to privatization generates: such as the institutions (e.g. legislation), the economic policies, the market organization and the ethics guarding the rules of the game [2].

Once the alternative approaches to privatization exist as a trade-off, and once their demands on institutions, economic policies, competition and ethics are at conflict, there must be present an **onslaught for dominance between vested interests at the political level**. The winning slogan of the 1992 Czech polls was the "voucher privatization". The Czech way to capitalism was therefore forged by the opportunism offered by this experimental scheme. Its impact on both the strategic and the operative issues was crucial and its time horizon should be expected to span over a very long period. Late in this study we will analyze what the motives were and the outcomes of that particular privatization strategy. In line with Winiecki, 2001, we may conclude that both high and low Czech politics paid for long little attention to the far-reaching consequences that alternative privatization policies could bring about. The belief that "privatization" has only one contents was reflected in practically no concern about the existence and the conditions for the development of generic private sector.

There is another aspect of privatization that is associated with game theory. While the functioning of markets and institutions is based on repetitions, i.e. on repeated games (supergames), **privatization is by its nature a game that is unique and not repeated**. While it is the property of repeated games that its agents learn, co-operate and finally achieve optimal allocations of the whole system, a one-time game lacks co-ordination and learning, and leads to antagonistic individual strategies. Its natural result ends up in so called "prisoner's dilemma" that is notoriously sub-optimal. Therefore a privatization aiming at speed, massive one-time transfers and a lack of competitive bidding [3] can acquire the properties of a single game and can lead to a hysteresis that will adversely influence the allocation of resources for a long time.

The game-theoretic aspects of privatization come out from its risks and uncertainty. **The privatized property is so unique and complex that it is difficult to assess its market value.** The information abounds with asymmetries and the validity of any information can be easily reversed because it is subject to changing institutional environment. As is known from the markets for "lemons", the average purchasing price should be expected to be undervalued. However, some bidders can buy more than the property itself – e.g. the access to government subsidy, bank loan and prestige – and

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and passing of laws is under control of a well-organized minority representation. Privatization in transition is such a dominant feature for the social behavior that that its dominant strategy and its dominant pressure groups rule the whole society.

[2] This is again in line with the main topic of the last study by M. Olson, 1998, where he inquires the causes of the wealth of nations. "So what is it that makes some market economies rich while other market economies are poor? **What policies and institutions** does a country need to change from a market economy of peddlers and bazaars to a market economy that generates a cornucopia of riches"? (p. iii) We may add that the same must be added to the notion of a "private entrepreneurship" that may differ enormously in its economic contents between various practically existing forms.

[3] One of the most infamous principles of Czech privatization was the slogan of "switched off lights" (i.e. privatization without legal rules) that was officially accepted as a means of speeding up property transfers.

they can bid the price much higher. **Ideally, privatization can be considered a speculation on future asset price increase**. That would be reflected by a scheme:

Low purchasing price → restructuring → investment → high profits → asset appreciation → high selling price (e.g. to a foreign investor).

However, the opposite strategy can become a reality, as the **speculation can turn to a future asset price decrease**. Then the scheme would look as follows:

Too high purchasing price → no restructuring → asset stripping → high losses → indebtedness → asset depreciation → bankruptcy.

The quality of privatization and the legal liabilities of the governance do matter. The mass privatization techniques are so superficial in these aspects that they are not able to introduce an institutional environment that would guarantee perfect contract enforcement and exclude the moral hazard accompanied by imperfect contracts from becoming the salient features of their schemes.

2. Authentic Private Sector and SMEs

Let us turn now to the problem how the authentic (*de novo*) private sector evolves at the level of indigenous (domestically owned) firms in a country undergoing transition. We cannot expect that such new firms will be large firms because the lack of financial capital of households is a characteristic feature of transition economies. Therefore we should draw our attention to small and medium sized enterprises (SMEs).

The economic statistics of the OECD countries for the last 20 years show that the role of SMEs has retained its important position in the world in spite of a rapid ascent of multinational corporations (MNCs). Since 1986 there was even observed a trend in the economies of EU that the share of SMEs on total employment was rising. SMEs may not only provide employment to the majority of work force but they may be in many developed countries the most important net provider of new jobs. The network of SMEs, functioning as flexible and efficient suppliers of semi-finished products and services to big firms, has been also an essential factor behind the competitiveness of the OECD member countries on world markets. It is becoming accepted that there is a “division of labor” between the large and the small business sectors. This can be generalized into a hypothesis that the **sectors of large and the small businesses have a different role in modern market economies**. Their role should be judged from two different points of views in respect to:

- the competition between them inside the same industry;
- the complementarity of their functions.

As to the former, the competition on globalized world markets is subject to dominant roles of MNCs and large domestic companies. The relationship between them is theoretically explained by oligopolistic Cournot or Bertrand adjustments of prices and market shares. The functioning of such imperfect economies can be, however, Pareto-improved if some fringe (outsider) competitors pose a potential threat to collusive behavior of dominant firms. The mechanism of fringe competition from the side of SMEs and the functioning of the EU competition policies are discussed by Pelkmans, 1997. Its principles are explained in more detail in Appendix A.

As to the complementarity, the interaction between large and smaller firms can be explained by economies to scale. In some production lines the technologies can be effectively applied even at a family-firm scale. The advances in electronics and the expanding share of services on GDP opened new potential for SMEs. In difference to traditional domains of SMEs (such as in agriculture, clothing, wood-working or construction), which were labor intensive, the modern domains (such as semiconductors, electronic design and testing, applied science, information, specific chemistry, healthcare, etc.), are generally capital and human-capital intensive.

As it was first extensively documented in Silicon Valley, SMEs can even build on economies to scale that are external to the firm (Saxenian, 1994, or Porter, 1990). The mutually interlinked Figures 1a and 1b explain how such an evolutionary process can be explained. The upper part of the figure depicts the situation in the whole semiconductor industry that consists of a cluster of many SMEs. In the lower part the situation of one small firm is described. First the equilibrium is in points A and A'. Then the demand for semiconductors rises from D_1 to D_2 what is seen in the firms as a shift from d_1 to d_2. Thus the price will increase to P_1', what will increase the production to Q_1' and q_1' at the level of firm, respectively.

The expanding demand is an incentive to invest and apply R&D into improving the technology. Except for R&D there are other factors that decrease the costs and shift the supply curve downwards. They are associated with externalities and spillovers (Krugman, Obstfeld, 1997, p. 147, especially if the firms are geographically concentrated and information technologies are in the core of innovation. The "agglomeration effects", causing the decrease of the short-run marginal cost (and thus the average cost) in time, can be traced to the existence of networks of specialized suppliers of inputs, equipment and design, labor market and human capital pooling, and knowledge spillovers. Taken as a development in time, we can estimate a long-run average curve that has all properties of increasing returns to scale, notwithstanding that the industry's supply curve is always upward sloping.

Another argument supporting the complementary existence of SMEs and large firms is the dependence of large companies on flexible supplies (so called "backward links") that are acquired by outsourcing. It was confirmed recently that the importance of spillovers and networks has become a crucial condition for a growing and high-wage economy. The spillovers are usually directed from large firms (e.g. MNCs coming as foreign direct investment - see Blomström and Kokko, 1994) into indigenous firms, many of them SMEs. On the other hand, it is required that the indigenous firms do not lag too much in technologies, R&D and human capital behind MNCs.

To conclude, we can make a supposition that a high growth of a modern economy requires the existence of the following conditions:

- A balanced division of labor between large firms and SMEs;
- A competitive environment where SMEs, as fringe competitors, play an irreplaceable role in cutting the rents of colluded oligopolies;
- A contestable environment where SMEs have a chance to gain the market share of firms with market power;

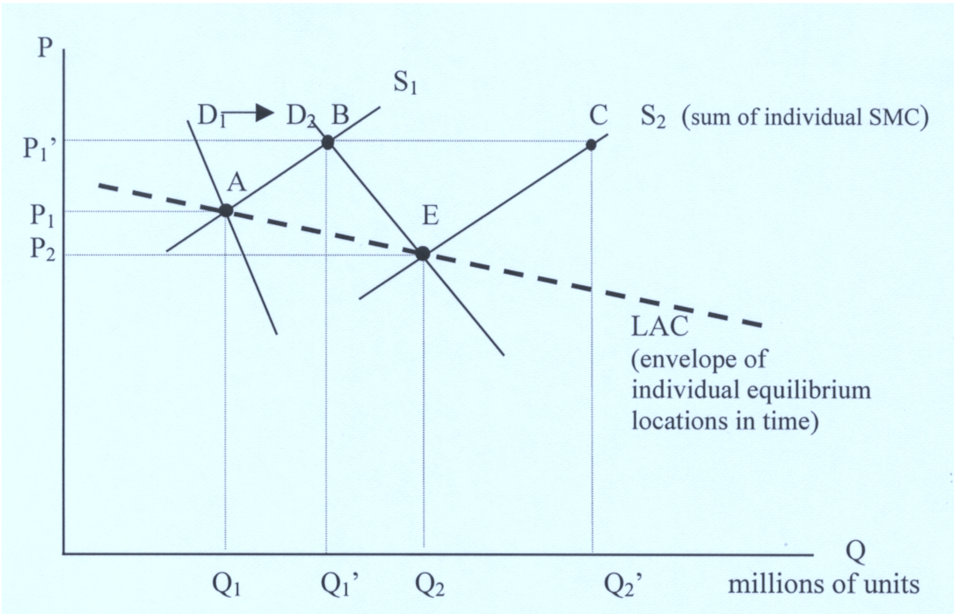

Figure 1a: External Scale Economies: Situation in the whole industry with many small competitive firms

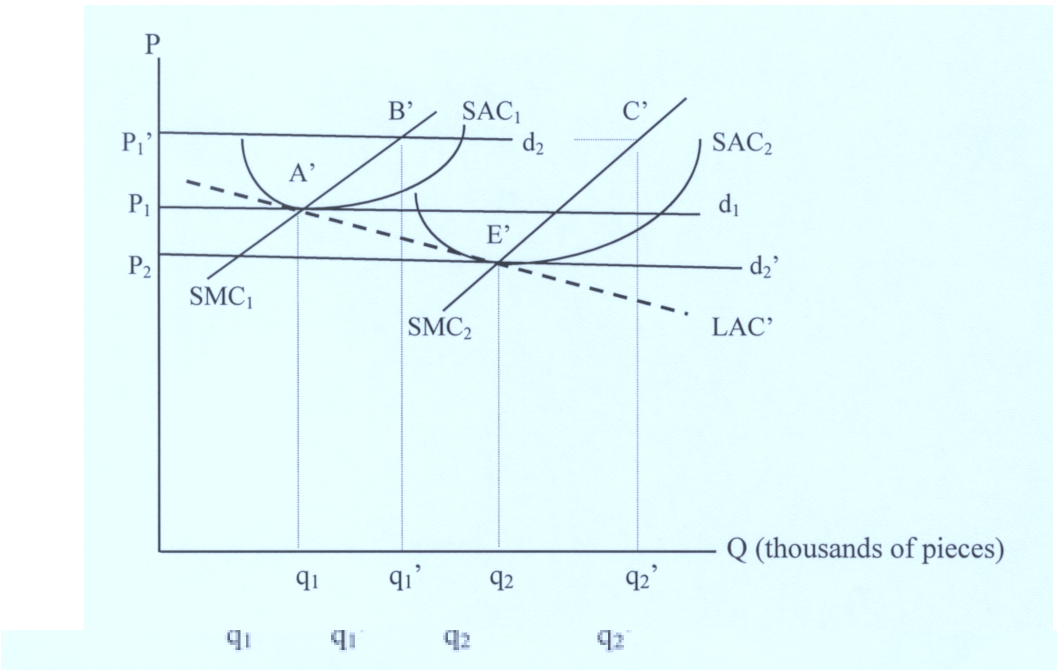

Figure 1b: Situation in one particular small firm out of a set of many firms from the previous figure.

- An institutional environment that precludes the existence of barriers to the development of SMEs – such as the burden of bureaucracy, over-regulation and its high transaction costs;
- An institutional environment that supports the smooth and non-discriminatory functioning of:

  * markets – such as capital markets, banking and insurance;
  * R&D;
  * supply of skilled labor and human capital;
  * provision of public goods and public procurement;
  * infrastructure – especially concerning the public information, legislation and the judiciary system.

3. The Czech Economy under Central Planning and throughout the 1990s

It is very important to commence with a remark that the small firms in former Communist centrally planned economies played a marginal role. In some countries, like in the Soviet Union, an even negligible role. Czechoslovakia of 1989 was in that respect one of the laggards, having a tiny 1.5% share of the private sector on GDP (practically all of it self-employed businesses). That was a serious drawback for a start of transformation, in regard to the advantages of some other transition countries. The share of private SMEs on GDP was at that time 8.5% in Eastern Germany, 14% in Hungary and 26% in Poland (Janacek, 2000). The last two mentioned had also an advantage in larger openness to the West, both cultural and economic.

In Czechia prior to 1948, however, the SMEs played a very important role, since the SMEs were highly developed outside the agricultural sector – in industries such as textile, clothing, food, mechanical machinery and financial services. Though the large and medium firms were nationalized already in 1945, the small firms were nationalized only during 1948-1956. The institutional economics put an important weight to the concept of **“path dependency**”. It is believed that the past experience with industrial organization, competition, industrial structure, objective functions and incentive schemes determines the future behavioral patterns of firms. It was argued in Czechia during 1990-91 that the entrepreneurial culture of SMEs prior to 1949 was forgotten and that the dominant behavior was that of large enterprises controlled by the Communist Party. That was the reason why **privatization schemes supporting SMEs (such as auctions of small plants and real estates suitable for SMEs and restitutions) were not given priority and high expectations were associated with mass privatization schemes**.

The transition in Central and East European countries (CEECs) has become a cyclical process. Their growth was challenged by new crises following their recovery from the initial production downfall. The majority of these countries did not recover the levels of GDP before the transition commenced even after 10 years of adjustments. It became evident that the role of SMEs could be much more important for the development of these societies than was originally supposed. Then it was realized that the experience of OECD countries and of some NICs should be taken into account. The emergence of a strong SME sector could thus act as a catalyst for the rise of competitiveness in the remaining yet not restructured sectors of the economy – former state-owned enterprises and the public sector. It could even increase the efficiency of the large international corporations. The positive externalities, that could be generated by SMEs and passed into the economic, political and social environment, have hardly other substitutes.

Unfortunately, Czech new businesses could not have played the pioneering role in entrepreneurship. The policy of transformation, adopted already in 1990-91, shunned them to a sideline. Czech privatization strategy crowded out the space of maneuvering for any new businesses. In order to understand the role and the position of authentic private sector in the Czech economy we have to explain how the process of transition was evolving and what policies caused that the massive spontaneous emergence of new businesses could not become the engine of Czech growth.

Though the Czech transition was often quoted during the period 1992-96 as an example to be followed internationally, its unexpected economic languor during 1996-1999 unveiled the shaky foundations stemming from the domination of the economy by large former SOEs. The severe Czech recession, after a period of seemingly inexorable stabilization (1993-95), was quite unexpected, as was also the peculiar "Czech way" preceding it. Nevertheless, similar problems, rebounding on the whole economy (although at a minor scale), can be observed in all economies of transition (Poeschl, 2000). The policy of putting too much stress on transforming the large firms, while neglecting the sector of authentic small and medium firms, can be very myopic, as the Czech experience can show. This is a statement of a fundamental importance for the policies of economic transformation in any post-Communist country. The role of SMEs was also underestimated in the set of policies recommended by advisors of IMF and the World Bank in the so-called "Washington consensus" [4]. If the stabilizing functions of SMEs at the grass roots of an economy of transition would be of a universal nature, our study could point to an underlying building block underpinning the policy of economic transformation. Let us therefore commence with the description of the Czech developments in the past 10 years of transition.

The Czech political scene since 1990 until 1998 was dominated by liberal pro-market parties. In the period 1992-97 it was the conservative party of Civic Democrats (ODS). Unfortunately, after the partitioning of Czechoslovakia in 1993, the practice of liberalism got under a severe pressure from the vested interests. The strongest lobby came from the beneficiaries of privatization. There was a paradox present in politics after 1992: the more the real policies departed from the free market model [5], the more

[4] The Washington consensus was a set of rules, associated with the recommendations of the IMF and the World Bank to the countries of transition that stressed the importance of macroeconomic stabilization, liberalization and privatization. Though these policies are definitely necessary, they are not sufficient for a long-term recovery if the microeconomic and the institutional conditions for restructuring have not developed satisfactorily. It is argued in this paper that SMEs play a pivotal role for the sustainability of those conditions. It fact it is the SMEs that give the microeconomic and institutional conditions its meaning.

[5] The most characteristic feature of policies in the period 1993-97 was their discretionary character and a lack of general rules. It was accompanied by nearly non-existent property rights enforcement, "shaded lights" for privatization, bias to support large privatized businesses, easy money provided by banks intentionally left unprivatized and corruption of political parties.

pro-liberal sounded the rhetoric of political proclamations. With the Social Democrats entering the government in 1998 the recession was already mounting. Though first very slowly, the real policies of the Social Democrats were moving, in some aspects, more to the liberal side than what was seen in the previous 5 years. Albeit it was generally accepted by nearly all analysts that the Czech approach to transition failed, there remained a wide dispute about the alternatives. Some parties affirmed that the recession was caused exclusively by restrictive monetary policies of the independent Czech National Bank, once the external balance in 1996 was dashing to an unsustainable disequilibrium. The view in this paper on this matter is fundamentally different. The whole problem had deeper roots than a mere liquidity crisis. **The Czech economic crisis evolved as an outcome of the highly unorthodox way how the privatization strategy was conceived and implemented.**

4. The Nature of Czech Privatization "From Above"

The main attraction of the voucher privatization rests on a very enticing and simple idea of becoming rich by mere decree [6]. Quite surprisingly, there was not a public demand for such a move in the Czech society even at the beginning of 1992. The people were prepared for a toil and belt-tightening when one of the newly established parties came with its proposal. It became its winning slogan for the June 1992 elections. The "instant capitalism" offered by vouchers was later extended into a slogan of a "Czech way". Under its auspices, foreign direct investment was turned down – becoming a marginal factor in the whole privatization strategy. Indeed, until 1997 the FDI acquisitions comprised a mere $ 6 billion (168 billion CZK) or 17% of all property privatized (964 billion CZK by June 30th, 1997), while the total value of all productive physical assets was 1600 billion CZK at their 1990 book value. Another 3% of assets were privatized under competitive bidding of small-scale public auctions and 7% were left for restitutions. On the other hand, 35% of the total property officially privatized went through a voucher give-away scheme and 5% were donated to municipalities. The remaining 33% were given away by "direct sales" (i.e. by sales to hand-picked exclusive beneficiaries), managerial buy-outs or by domestic tenders (i.e. closed envelope bidding) [7].

If, by following the above classification, we set apart domestic and foreign competitive sales and restitutions, then remaining 73% of all property privatized fell into the category of mass-privatization schemes. These schemes suffered of intransparency and their aims were not motivated primarily by restructuring, what was discovered unfortunately much later. One should also remember that 40% of all

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[6] In a very similar political style, but in an inverse direction, it was the policy of nationalization that brought the Czechoslovak Communists nearly 40% of votes in 1946 and a silent public support in 1948 when the democracy was dismantled. The idea was that a mere change of property could increase the productivity and bring the economy on a growth path. Though the official average growth rate of the Czechoslovak economy during 1948-1989 was around 4%, the real growth is estimated in the brackets of 0.43% up to 2.6% (Benacek, 1997d). The spread varies if the GDP is measured at commercial or at the PPP US Dollars. The relative position of the Czech GDP per capita among countries has fallen from the rank of 11th – 14th in 1949 to 28th – 30th in 1996.

[7] For more information about the Czech privatization see Mejstrik et al., 1997, pp. 55-67.

productive assets were excluded form privatization (public utilities, electric power stations, railways, etc.) and in many industrial firms the Government retained its share. Thus the **insiders** could get in Czechia an exceptionally wide space for their privatization activities (both formal and informal). The ensuing intransparent corporate governance was allowed by asymmetric information and signaling after 1994 that asset stripping would not be an activity prosecuted by the law.

We can see from these figures that the voucher scheme, which was often blamed for being the culprit of the Czech privatization failure, was not an exclusive representative of the Czech non-standard privatization (Bornstein, 1997). Even a larger amount, than the one devoted to voucher privatization, was privatized by other intransparent methods characterized by a lack of financial capital, managerial expertise and/or a will to transform the enterprises. Voucher privatization could have served as one of the minor schemes of privatization, e.g. as was used in Poland under the Minister of privatization Lewandowski. Voucher scheme could have become an intermediate stage of asset privatization, postponing the process of finding final owners and still not keeping the property in hands of bureaucrats. The governance impotence on the part of individual voucher owners could be bypassed by concentrating the equity in mutual funds or investment funds. That would have required, as a pre-requisite, the existence of legal rules, judiciary, trained management of funds and a system of fund corporate governance. The supervision of funds should have been very strict. It was most probably not a random occurrence that in the Czech case none of these conditions was present.

The whole opaque circumstances of the Czech privatization received a further setback by the possibility to get an **easy access to credit –** a policy that at first looked quite helpful and the support of which was taken as one of the top priorities of the government. Table 1 shows that Czech banking policy differed from all transition countries throughout 1994-99. In average the credit was 2.5-times more available relative to output as it was in other transition countries. Similarly the monetary policy of the National Bank was more expansionary than in other transition or even OECD countries. The mounting opposition from the independent Czech National Bank to monetary expansion demanded by the Government was growing after 1995. No surprise that the political clash between the supporters of a more prudent policies and the Prime Minister brought the country to a government crisis in 1997. The two waves of austerity measures, that followed for a short period afterwards, unveiled that the Czech success in growth and employment had very shaky foundations.

The favorable extremely high Czech saving rate (nearly 32% of GDP in average during 1992-98) could indeed turn restructuring into a success. But this potential asset recessed suddenly into an unexpected liability. A large part of savings were used for the underpinning of privatization transfers by means of bank loans for unspecified acquisitions, instead of using them strictly for productive purposes, such as restructuring, R&D, new investments, new skills training, etc. The crowding-out effect diverted both the private and the public savings into uses that had little common with restructuring. Even though only a minor part of the privatization credits were granted without a proper collateral or without any supervision of the bank over the corporate governance, the enforcement of their recoupment was nearly impossible even in the other cases, given the state of legislature and judiciary.

Table 1: Credits to households and enterprises over GDP (in %) and the money stock

Country	Credit availability, % of GDP						M2/GDP, %
	1994	1995	1996	1997	1998	1999	1999
Czechia	**52**	**55**	**56**	**60**	**62**	**56**	**67**
Estonia	11	13	15	20	24	26	32
Hungary	25	22	21	21	23	23	44
Poland	11	11	13	16	17	21	40
Slovakia	26	24	28	36	42	39	62
Russia	7	8	7	8	11	10	19

Source: IMF, International Financial Statistics, 2000

Thus the state-owned or voucher-privatized Czech commercial banks became the main actors in the privatization gamble. Their portfolio of loans was composed by 34% of classified credits in 1998, reaching 375 billion CZK in 1999 [8]. In addition, Czech net inter-enterprise debts were estimated to amount 180 billion CZK in the same year. If we add to that the debts to the National Property Fund, tax arrears, unpaid social security and health insurance and outstanding wages, than we can find out that **approximately the equivalent of the full value of assets privatized under the non-traditional schemes** (estimated at approximately 600 billion CZK) was counter-balanced by very problematic debts. That means, on one side there was an extensive property given away by the state, while on the other side there appeared IOUs in hands of the semi-state banks, closely linked with privatization, that could hardly be brought to maturity. Neither the bulk of the mass privatized property, nor the loans for its stabilization has shown a satisfactory economic performance. At least one of them was wasted.

The privatization of property under soft-budget constraints (transferred either freely or through a soft loan), that was dominant in the Czech Republic during 1992-95, did not bring about conditions that would lead to well-defined corporate governance, stable ownership, dominance of principals over agents and to entrepreneurship that would have long-term productive aims. Restructuring, profit maximization and market competitiveness were not objective functions of owners generated by the process of privatization directed "from above".

What was the philosophy behind privatization "from above"? To answer this question one has to turn to the structure of values that rested behind such a paramount strategic political decision. Taken from the theoretical point of view, the central concept of production in any economic system is represented by production factors. Traditionally these are represented by natural resources, physical capital, labor and

[8] The proportion of accumulated bad loans per total loans in 1999 was 31.4% in Czechia. It was comparable only with Slovakia (40%) and Romania (36.6%), while in Hungary and Estonia it was 3% and in Poland 15% (see IMF International Financial Statistics, 2000, The World Bank Database on Financial Development and Structure, 2000 and The EBRD Transition Report, 2000). Various subsidies and bailouts paid by the government or by other State institutions (like the Fund of National Property, Czech National Bank, etc.) are excluded from these estimations of "implicit subsidies".

human capital. The decision as to how those limited factors should be allocated is subject to the quality of ownership. The question is therefore two-pronged: "who are the entrepreneurs" and "what do they own?" There was a Czech national consensus that **by intensive and rapid privatization everyone would get a chance to become an entrepreneur**. But what state property could have been released and transferred to these entrepreneurs ?

Restitutions would be a natural solution but they did not receive wide public support. This was particularly true of the potential restitutions to Sudeten Germans, Jews and large industrialists expropriated in 1945. Very little would be then left to eager outsiders. It would be a loss to politicians, as their role in the process would be marginalized. Thus even the land restitutions of co-op farms did not become a priority. The property of state-owned small businesses that could be sold in auctions was too small. The resulting sales, undertaken during 1991-93 under the "small-scale privatization act", comprised of only US$ 1.3 billion as a result.

Czech politicians were finally tempted by opting for "instant capitalism" by means of de-etatising as many state-owned enterprises (SOEs) and as quickly as possible. Their assets were valued at US$ 50 billion. It was the Voucher Privatization Act that satisfied both the demand of the population and the aspirations of politicians for an economic power. By giving symbolic chances to 8 million potential capitalists (out of the population of 15 million) it also offered a political triumph to politicians who could orchestrate the grand distribution from their hierarchies. Although private ownership would be dispersed, it was assumed that the redistribution of property to final owners/users would take place automatically and smoothly. Since this did not actually come true, let us turn to that crucial point more closely.

It was argued theoretically, by using both the theory of factor location and the Coase theorem, that the initial misallocation of resources did not matter, once market negotiations and trade could lead to their more efficient redistribution. The desired outcome would require that transaction costs be very low both in acquiring the liquidity and in trading of equity. It was somehow forgotten that there was a third condition: that property rights be clearly defined and enforceable. The first condition (concerning money liquidity) seemed to be solved by the continued extremely high level of national savings. The Czech National Bank was also yielding to pressures for an expansionary monetary policy and the commercial banks were inclined to provide easy credit [9]. The second condition, concerning unhampered equity trading, was also satisfied, once there was political opposition in creating one stock exchange[10]. Indeed, until 1998 there were virtually no enforceable rules for equity trading.

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[9] It was publicly admitted by former Prime Minister Klaus in 1998 that this was the reason why his ODS party explicitly refused to privatize banks to foreign owners throughout 1990-97 and kept them under political control.

[10] There were in fact created three stock exchanges – Bourse, RM-System (for retail security trading) and SCP (the Center of Commercial Securities set especially for extra-market trading – sic !). As there were nearly 3000 stock titles traded and there was no regulation on the business practices, these stock exchanges did not generate prices that would be related to real market values of the enterprises traded. As over 85% of stocks were traded through SCP, without revealing their prices to the public, the arbitrage was either impossible or it was not stabilizing. The information asymmetry became a rule. By using fictitious trading, the big traders could set

The objective to trigger off a privatization scheme that would be orchestrated by the government required the creation of various institutions and conditions that would bring the privatization into compatibility with markets. The golden rule is clear here: the institutions should be driven by the demand side and the requirements of competition. In another words, they should not be responsive to the vested interests on the side of supply, governance and politics. In the first place the privatization would require the creation of regulatory commissions for auctions, tenders and public bidding, such as the Ministry of Privatization, National Property Fund, departments for privatization at ministries, Regional Privatization Boards and the network for voucher bidding. Though the idea to simulate markets by introducing elements of competition in bidding was set in good faith, the whole institutional arrangement of the mass privatization could not get rid of its bureaucratic nature. The resultant privatization hierarchies integrated very soon with different hierarchies: political parties, central government, regional public administration, state banks, state-owned enterprises and its networks of vested interests.

The moral hazards of Czech privatization backfired on the State, which became burdened with mounting debts. As it became very difficult to vindicate the Government from its responsibility for privatization, a larger share of the public budget had to be released for various rescue operations and guarantees. Contrary to political proclamations state paternalism could not be relinquished. That is why the share of public revenues per GDP could not decline significantly below the magic barrier of 50% [11]. As was found by Coricelli et al., 1997, this problem challenged all transition countries where government was bound to be an active player in the economy [12]. Though the original share of the Czech state budget revenues in GDP decreased from 67.2% in 1989 to 43% in 1999 (measured by the tax quota method), which is only slightly above the average EU level, it is still far above the "natural" level pertaining to its economic development. If the revenues of the state budget are consolidated with revenues of extra-budgetary institutions [13], the share characterizing the burden of the Czech state would rise over 50%.

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any price that was then masquerading as an official "market" price. Any fraudulent insider trading then became a legalized transaction, what set virtually no transaction cost burden to speculative transactions or to asset stripping (in Czech it was called "tunneling"). On the other hand, that very arrangement caused a serious transaction cost on transactions with productive aims. The Czech equity market became a typical bear market. Its prices fell throughout 1993-98.

[11] According to the World Bank studies (see its World Development Report 1997: The State in a Changing World), the empirically observed share of public revenues per GDP is an exponential function of GDP per capita. Because Czech GDP per capita varies from 5 to 12 thousand USD according to commercial or PPP exchange rate, the Czech "natural" level of the indicator of public revenues per GDP should vary between 28% and 38% (see Benacek, 1997a).

[12] The exceptions were countries where the alternative hierarchical structures (i.e. "oligarchs" or "mafia") took over the role of the State, as it was in some transition countries of Central Asia. Privatization was thus extended to such fields like the "privatization of privatization" or to the "privatization of the State".

[13] Here we mean such institutions as the State Health Insurance, Fund of National Property, State Consolidation Bank, Czech Financial Institution and Czech National Bank. We could extend the list to include unpaid taxes, waived taxes, inflation tax and seignorage - see Benacek, 1997a. They all represent certain potential (forgone) revenues and expenditures that increase the power of the state administration over the economy.

A strong and wealthy state means a strong government sector and an over-sized sector of public administration. Therefore it should not be a surprising fact that the number of employees in the Czech public administration increased after the introduction of a "liberal" market economy from 95,743 in 1990 to 177,770 in 1999, i.e. by 86% [14]. At the same time one should not presuppose that this growth implies an increase in the quality of government services. High public revenues allow the state to maintain larger public employment, which leads to higher bureaucracy and to a rise in transaction costs for running private businesses. Those who will be hit most adversely are SMEs and the firms under intensive restructuring.

An easy access to credit combined with non-existent equilibrium market prices of equity stocks and high information asymmetry on the capital market resulted in the creation of perversely-functioning capital markets [15]. There the economic agents' objectives differed diametrically from the objectives of agents acting in stabilized market economies. Firstly, the information asymmetry, loopholes in legislation and the non-enforceability of property rights caused the looming of adverse selection. The new equity owners recruited to a large extent from the ranks of people with a low sense of business ethics. The success of particular entrepreneurial activities depended therefore significantly on the ability to use the informal information, insider trading and bureaucratic networks – i.e. on the ability to make deals off the market. There the corruption became a means of settlement. Thus the "skills" required for this kind of entrepreneurship could differ widely from the skills needed for restructuring, strategic planning, R&D and marketing. That is why the Communist "nomenclature" became so successful in becoming large-scale capitalists (Benacek, 1994).

Secondly, the new capitalists did not (and could not) aim at long-run capital gains. Instead of raising the discounted future yields of assets by restructuring and improving the efficiency, a large part of owners and managers bet on asset stripping. Why did the objective of moral hazard become so prevalent in the Czech economy? The dominant way of privatization "from above" created neither functioning property rights nor stable ownership. Notwithstanding that the Czech government succeeded in minimizing the "wild privatization", i.e. the asset stripping by employees or managers, already during the pre-privatization phase, it did not preclude from its wide practicing in the post-privatization phase. The position of new owners (principals) was often very weak and enforcement of property rights was not backed by relevant institutional arrangements.

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[14] See Statistical Yearbook of the Czech Republic, CSU, Prague, 2000, p. 289. The sharpest rise of "new capitalist" bureaucracy happened at the regional or municipal offices, so that the central authorities could have more "efficient" control over the society. It is a paradox that central planning required a smaller network for doing the same job even without the help of the markets.

[15] Under such circumstances one should not be tempted to describe the resultant environment as fully-fledged capital "markets". They either collapsed by failing to provide effective information about the prices of assets traded (there was missing the link to their yields), or these markets were not created at all and the allocation of capital resources had to rely on other channels than on free and contestable markets. Bureaucratic negotiations, corruption, political loyalty, nepotism and criminal favors were some of the non-market alternatives.

The structure of new “capitalists” was transient by its very nature. They were represented by a very wide spectrum of players:

- millions of voucher holders who had no decision-making powers,
- managers of investment funds, who, in principle, acted as agents of “principals” coming from the previous group and who later converted into informal principals,
- managers of former SOEs who retained independence and decision-making powers,
- bank officials (from the top up to the clerks at low positions) who controlled the accounts and the process of credit allocation,
- bureaucrats who were recruited from ministerial supervisory bodies, tax administration, political parties and the regional administration,
- lawyers who had to cover-up transactions that under normal laws would be declared illicit or criminal,
- “de iure” indigenous owners with concentrated equity stakes, who had to take loans from banks and who depended on the “clearing” of their privatization liabilities on agreements with bureaucrats and lawyers,
- restitutors of firms originally nationalized after February 1948,
- small self-made entrepreneurs,
- foreign owners investing their own financial funds into the direct investment ventures.

With the exception of the last three, all others were either quasi-owners or owners with powers limited by various exogenous interferences.

Real owners are those who control both the assets’ principal and its yields, and have the legal right to sell both of them freely on their own account. By privatizing “on debt”, the real ownership of the property was limited by collaterals and by interest payments. Since the collateral was often higher than current asset’s market value [16] and the interest on loans was higher than current profits, it was very difficult to find another party that would purchase the property and pay for it a higher price. Such an ideal secondary owner would have to be able, after discounting for risks, to secure much higher future yields than the primary owner was able to achieve.

Such a resale deal would be possible only if the firm was restructured and the penetration on world markets was guaranteed. With the lack of experience in both fields among the indigenous entrepreneurs and with the institutional environment not designed for restructuring, the only party fitting to that treat could be found among the foreign strategic investors. Once the foreign investors were reluctant to enter into such deals during 1991-98, the only way out for the domestic owners was **extending the original redistributive objectives with the destructive ones** [17]. How was it possible?

[16] The asset price overshooting became a standard practice during the tenders for takeovers when the bidders found out that the disbursement of their liabilities was not fully enforceable.

[17] The core of these problems is compatible with the hypothesis of Baumol, 1990, that entrepreneurship and its aim for profit or power is omnipresent in all societies. The problem is into which alternative economic fields - productive, redistributive or destructive - the entrepreneurship

It is true that the destructive approach to property, though typical for wars, is not a feature characteristic for normal market economies. We have to proceed further into the nature of specific forms of mass privatization in order to uncover its destructive effects.

5. Privatization, Sunk Capital and Restructuring

The answer to the issue of destructive entrepreneurial motivation is closely associated with the privatization “from above”, how it particularly evolved in the Czech case. **One of its intrinsic features was that it turned an excessively large part of assets into sunk physical capital**. Sunk capital is defined as the value invested into those physical assets that cannot be recovered when the firm leaves the industry. Sutton, 1991, has extended the definition even further. According to him, sunk costs are those fixed outlays, which are associated with acquiring a single plant of minimum efficient scale (set-up costs) and/or developing and establishing a product line (R&D or revamping outlays).

There are three types of sunk costs associated with privatized SOEs. First, the costs of past investments (from the centrally planned period) that cannot move immediately and without cost to another industry. Second, the costs of purchasing these assets by a privatizing party. Third, the costs expended on restructuring (e.g. on new technology and R&D), especially if the returns on them are risky. These costs represent so-called **specific factors**. According to Krugman and Obstfeld, 1997, p. 39-62, the factor reallocation due to restructuring always hits the owners of that factor that is specific. By privatizing on debt, proportional to the book value (as different from the often lower market value) of the asset privatized, the risk of losses is shifted from the government on privatizers.

But privatization has a full meaning only if it is associated with restructuring and restructuring requires that physical assets could be either intensively reallocated or intensively replaced. However, with given sunk costs, none of these moves are possible, and the money expended for the acquisition of the property is at risk. Privatization on debt, with its scope artificially enlarged by political arrangements, exposed unexpectedly a large part of national physical capital to a risk of destruction because the aims (or conditions) of privatization got into a conflict with restructuring.

By its very economic nature, the market price of a sunk capital is zero because it has no alternative uses. This outcome went against the original aim of privatization – to turn the accumulated old physical capital into hands where it would be used more efficiently. Thus, by asset stripping, only a part of the assets could be transferred into alternative uses. As an outcome, we could observe a behavior that can be branded as a gradualist “graceful demise” (Benacek, 1997b or Benacek, Shemetilo, Petrov, 1998).

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is allocated in the given period. The causes of such moves must be then traced into the conditions and incentives for such decisions. First, we can cast doubts if the Czech large-scale privatization was consistent with Schumpeter’s views on the role of entrepreneurs as destructive creators. The original aims of Czech privatizers were underpinned by conditions that were compatible with redistributive behavior only. However, it was too late when it became apparent in 1997 that the formal entitlement to property through privatization was not leading to a stable development. The asset stripping (tunneling) at a minor or larger scale became in many cases the only activity that would be rational, given the endowments of skills and institutions.

The burden of sunk capital can be ameliorated only if its value can be gradually recouped, for example by depreciation**.** That means, in the optimal case the sunk capital's full physical capacity should be retained (i.e. it should not be scrapped) and the restructuring should proceed mainly on the side of organization, employment, incentives and marketing [18].

However, if **a part of the capital is immediately recyclable**, for example by selling it to another enterprise (e.g. a SME) or to final consumers, it is sooner or later either sold by the principals or embezzled by a myriad of agents around them. Under weak property rights, this will happen notwithstanding the fact that the remaining property could lose all its productive functions. It is a suboptimal outcome typical for situations ruled by prisoner's dilemma, even if there are more productive alternatives subject to long-run co-operation, such as the recoupment of assets through depreciation. If the property rights enforcement plunges into anarchy (e.g. the ownership is indeterminate and/or the property rights are not socially sanctioned) the kleptocracy becomes a standard. As was pointed out by Olson, 1982 and Olson, 1998, the rent-seeking behavior can have various degrees of intensity. The most detrimental of them is set when the property rights can be claimed by anyone, what Olson described as the case of "roving bandits". There is no encompassing interest in the property from any of the competing claimants – either principals or agents or employees.

As was mentioned previously, the Czech large-scale privatization of SOEs generated an excessive number of competing property claimants. The procedures for becoming a claimant were easy and also the procedures of asset stripping were not challenged by punishment. That resulted in non-productive objectives of owners, capital losses and rigidities on the supply side. As the majority of assets of an enterprise are complementary and if only their transferable parts are stripped away (at what-so-ever positive price) the remaining sunk capital becomes derelict, burdened with debts and turned aside of production. Since it also loses all its functions as a collateral, the burden is shifted on creditors – on banks, suppliers, passive equity holders, social insurance funds and workers. From them the burden is shifted on the Government, the State and the whole society.

The soft market environment and the importance of vertical networks in the socio-political hierarchies, that the Czech mass privatization brought with itself, did not offer much scope for the entrepreneurship in the Schumpeterian sense. It did not lead to links between ownership and decision making, risk bearing, innovation, re-investment of profits and the reallocation of factors in accordance to perfect market signals. On the contrary, the mass privatization brought about the Schumpeterian degeneration in entrepreneurship where firms are too large, their agents dominate the owners and where the short-term vested interests lead to rent-seeking, decline and the dominance of the state bureaucracy over the private sector.

[18] This approach is different from the shock therapy, as was practiced e.g. in Eastern Germany. This kind of a gradual approach to transformation was successfully practiced in Vietnam (see Van Tho, 2000) and partially also in China (Wu, 2000). According to Murrell, 1991, p. 43, the state sector should be reduced only slowly, at a pace consistent with an "optimal capital replacement policy".

There are many studies which try to assess how the alternative privatization schemes could influence the performance of enterprises and the behavior of their owners. For example, Djankov, 1999, offers a highly simplistic picture based on data from Moldova and Georgia that managerial buy-outs are a more efficient way of privatization than the mass-privatization through vouchers. While the latter is perceived as a windfall profit where the moral hazard becomes the ruling post-privatization strategy, the former insider-dominated ownership is more prone to restructuring and productive orientation. This is hard to believe if the experience of some other countries is considered.

A more persuasive view is provided by Alexeev, 1999, who treats even the managerial buy-outs as a rent-seeking contest where the incumbents (e.g. the managers and their associates) become the highly problematic winners. The superiority of chances for the dominance of former "nomenclature" in mass privatization schemes is given by their access to informal property rights over assets prior to the reform, information asymmetry and the network capital invested in the hierarchy of state bureaucracy. The higher is the deviation from the competitive standard of privatization, what Alexeev calls a "genuine reform", the more likely it is that privatization will degrade into a rent-seeking event pervaded by moral hazard. The legacy of privatization dominated by rent-seeking is generally counter-productive even in the long run due to spin-offs into political lobbying, corruption, ethics, institutional distortions, income inequality, redistributive taxation and a lack of motives for restructuring.

The main weakness of the privatization "from above" therefore does not rest in potential frauds, insider trading and appropriation but mainly in the inefficient usage of the property so acquired. Not only that owners skilled in winning bureaucratically contrived privatization deals are seldom efficient in restructuring its productive assets, but the whole institutional environment, designed for such deals, hampers the process of finding the final owners motivated by productive aims and restructuring. Let us pose another question: would it be advisable, having learned that "the king of mass privatization is naked", to introduce a hard budget constraint for all firms? That would imply that both the Government and the banks would have to persist on an absolute financial discipline and punish the trespassers by bankruptcy procedures.

This problem is widely discussed by Frydman et al., 2000, and Maskin, Xu, 2001. We can agree that this would be the optimal policy for those enterprises whose objective function is restructuring and efficient governance. However, if the domestic economy is split into two or even three sectors guided by different behavioral conditions (foreign enterprises, indigenous firms under authentic private ownership and the sector of mass-privatized or state-owned firms), this general strategy would be suboptimal. It would only speed-up the process of non-creative destruction that commenced by formal privatization, virtual restructuring and deficiencies in corporate governance. The objective of transformation rests in the exact opposite: in rescuing of the property subject to sunk cost and their transfer to more productive alternative uses. There, by means of a depreciation, recoup at least a part of it into a cash-flow that will be reinvested. The imposition of a soft-budget criteria from the side of creditors, such as taxation and depreciation incentives, credits and subsidies to those firms in which remained a chance of their productive restructuring, is not necessarily irrational. It prevents the demise of firms that are capable of at least partial restructuring through medium-term bankruptcy procedures or ownership changes.

The impotence of Czech indigenous firms that were privatized by non-standard methods [19] can be revealed by comparing them with firms under foreign ownership. In 1997 70% of the profits in the manufacturing sector were earned by international firms which had 17% share of employment and 28% share of output. If we take all 994 Czech manufacturing enterprises with employment over 249 workers (as in 1998) and exclude both the domestic monopolies and the international firms, we can find only a couple of dozen among them that would be profitable in a long-run or otherwise credible from an economic point of view.

Privatization can thus lead to very unexpected results. Some firms can improve their performance while some others may sink into worse problems. As was confirmed in the study of the Russian privatization (Perevalov, Grimadi and Dobrodey, 2000), the quality of privatization and its methods are crucial. There is nothing like the “privatization on average”. Some mass privatization techniques (the exemplary is the voucher privatization) are not superior to keeping the enterprises under state governance. The privatization technique can have specific impacts on performance. The impacts on profitability, labor productivity and innovation need not be positively correlated and can depend on the techniques chosen.

As was explained above, privatization orchestrated by the government bureaucracy is marked by information asymmetry, moral hazard, adverse selection and dead-weight losses inside the privatized firms. The losses easily spill over into the banking sector and bring a burden on the public finance. In a vicious circle the taxes cannot be lowered and thus the efficient firms “finance” the bad firms. With the majority of privatized firms immersed in debts and its profits sinking to red figures because of slow restructuring and asset stripping, the lobbyism for bailouts threatens to destabilize the government. However, the government can defend its position by postponing the bankruptcies by weak judiciary for bankruptcy procedures. As an outcome, the gap between the legal infrastructure and the need for economic reforms widens.

The reasons why the government should put up with loopholes multiply after each round of bailouts. The laws regulating the banking supervision, mortgages, collaterals and capital markets get stalled. The judiciary “suddenly” loses control over frauds and the disbursement of debts is enforced only symbolically. The burden of the transition finally spins away from weak firms onto competitive firms that brought its restructuring into a successful stage. These firms have higher taxes and higher public bureaucracy. They run a higher risk of payment defaults from their customers and the resources absorbed by stagnating firms are not released for their more efficient usage elsewhere. Low GDP growth implies that wages remain low and thus the aggregate demand is low. The social disappointment leads to political instability. The expectations

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[19] The non-traditionality of the “Czech way” concerns both the contents and the form. In the former, the financial sector was left to a large extent both unprivatized and without proper supervision and the public administration was left in the hands of bureaucracy. As to the forms, the voucher method, the direct sales and the public tenders were superintended by bureaucratic networks. Thus these methods represented a risky approach liable to moral hazard and an allocation of property to intermediary insiders. The risks increased enormously once the institutional framework went off handle of the government and its procedures became “touted” by speculative privatizers themselves.

for growth are low and thus the dynamics of such an economy will remain low. One simple decision about the strategy of privatization may turn from a temporary problem to chronic malaise.

6. Privatization from Below

The question of whether there was a fundamentally alternative approach to Czech privatization scheme is usually dismissed as irrelevant. Why should one ask such questions once the privatization has been already finished? And what is a fundamental alternative to privatization: is it non-privatization? What is omitted is that "privatization" is not primarily a political question. Primarily and intrinsically it is an economic question, dealing with ownership, corporate governance and their efficiency. As such, privatization is an open problem that has no pre-conceived answers.

Let us look again at the Czech philosophy of privatization. Generally speaking, Czech privatization was conceived as a reversal of Communist nationalization. There was also a political consensus that only a minor part of the physical assets will be returned to original owners or their heirs. The value of the property privatized was equal to approximately two GDPs. Because the chances to get a share were open to nearly everyone, the agenda of the property return became a dominant economic topic in the Czech society throughout 1991-95. The issue how to become rich by the redistribution of property overshadowed many other economic topics that were crucial for the shaping of events in the long run. It was not considered, for example, that the property was often antiquated, incorrectly allocated, poorly administered and often it was an indispensable sunk capital. Its mere ownership could not guarantee automatically any positive returns. The responsibility for losses should be also a part of privatization deals.

What was even more important for the successful ownership was the **expansion of physical capital by new investments**. As on one hand capital ownership transfers were raised to a symbol of an omnipotent fetish, less attention was given to new investments on the other hand. Thus, as the whole institutional framework was becoming adjusted to facilitate the redistributive requirements, the institutional support to new investments was switched to a periphery. **Human capital** was another factor that remained separated from the issues of privatization. The decision that the development of **education and science** should be postponed and that they (as allegedly factors temporarily irrelevant to the main issues) should bear the costs of transformation, was also unfortunate but logical. It followed from an unduly simplified and politically biased views on privatization.

If the privatization is conceived as a transfer of <u>all</u> production factors from the paternalistic State to the control and decision-making of the non-State (preferably private) bodies, then attention should be devoted not only to the transfers of existing national physical capital to private hands, but also to the creation of savings and their allocation into a stock of new privately-owned capital. The same treatment, as with new capital formation, belongs to the formation of human capital and its allocation for the support of private business ventures. Similarly in the labor market, privatization should be related to the means how workers might establish their own businesses, for example as self-employed entrepreneurs. If privatization is as complex as that, the whole process of

privatization can be left neither to bureaucrats nor it can be limited to mere legal property transfers.

Privatization "from below" can be described as the "wide approach" while privatization "from above" is the "narrow approach". Thus the former contains the latter as a subset and it extends over to the reallocation of other factors than the existing capital. The basic fact, that the reallocation of existing property is not the only issue to be solved by privatization, implies that also the very substance of privatization should be a wider concept than a mere reshuffling of ownership. **It departs from the all-embracing redistributive aims towards the dominance of productive aims**. It is no longer crucial and sufficient that there are new owners of an old physical property but that the national property (production factors), that were formerly under the tutelage of the State, gets under the control of clearly defined owners that can become actors with full-fledged responsibilities in the system of property rights.

At this point our attention can be switched to the generic private sector where the firms are authentically "private", that means they were established as private from the very outset – *de novo* or start-ups. In the narrow sense, such firms could not start-up as merely **privatized** SOEs. In a wider context *de novo* firms could have commenced with a privatized state property but, from the very outset, their owners should be clearly defined and their control over the property as principals should be unchallenged, so that they are able to transform the fundamentals of the firm by restructuring. The restructuring should be deep enough do deal with new investments, labor relocations and absorption of new human capital. What is crucial in that respect are the **intra-firm relationships** dealing with the quality of management and governance (as a function of human capital and institutional arrangements), industrial relationships (as a function of incentives and morals) and the ability to reallocate the cash flows into new investments.

It is evident that the generic private sector in a post-Communist society, where there were hardly any private firms existing during the central planning and with very low accumulated personal savings, had to be very frail at the beginning. There are three main channels for their rise:

- The green-field investments of foreign direct investors.
- The takeovers and acquisitions of foreign direct investors who subject the firms to a deep restructuring.
- The registration of brand-new indigenous firms that were built as "*de novo*" from an own or borrowed capital. Such firms will be generally small or medium sized.

Once the privatization "from below" is orchestrated from the grass roots of the economy and once the aims of privatization are dominated by productive objectives, such an arrangement will dramatically alter the attitudes of the private sector to the institutional build-up and to politics:

- In the first place its actors need effectively functioning markets, especially the capital markets and banks.
- In order to have the position of principals inexorably fixed as undisputed owners of capital assets, residual claimants and actors liable for the strategic decisions, there arises a demand for clearly defined and enforceable property rights guaranteed by

the State. It would induce a pressure for creating a transparent legislation and functioning judiciary.

- The relationship of generic private owners to the State, the government and politics is different from the relationships of redistributionally motivated privatization actors. The former would expect that public institutions should not be so much preoccupied with redistributions and bailouts of failing enterprises but they should devote its powers to an efficient provision of public goods.
- Since the public administration plays a less active role in the privatization from below and the detrimental effects of bureaucracy on firms are asymmetric [20], the stronger position of SMEs and dynamic firms in the environment of privatization from below would press the Government more successfully for lower taxes and lower burden of bureaucracy.

Our conclusions are of crucial importance for economic policy-making. We affirm that **the development of the societies in transition may depend for very long time on the way that privatization was initiated and later conducted.** Privatization in an economy in which the State was an exclusive owner of nearly all productive assets may unleash in people such long-lasting motives and expectations that could divert the behavior of the whole society to aberrant patterns. Let us repeat again the idea of Baumol, 1990, that it depends just on incentives whether economic agents (entrepreneurs) act productively or attempt at realizing redistributive or socially destructive aims. An improperly considered strategic decision at the outset in one single, but paramount agenda such as privatization, can induce spin-offs of unfavorable moves into many other fields. Society may then find itself locked in a series of induced maladjustments. Though society may later find the situation untenable, the enduring hysteresis effect will make the new adjustments difficult.

First, there is a problem of co-ordination while the interests of participating parties are often in conflict. Privatization is not a repeated game and its actors get easily involved in a prisoner's dilemma. Second, the winners from initial rounds of property acquisitions invest (e.g. in cash or in kind) into their ownership. They also adjust the returns to their property to existing economic parameters. Very often these are the legislative loopholes that the system brought with itself. Any attempt to eliminate these loopholes is then opposed by powerful lobbies. At least, such is the observation that we could draw from the Czech history of privatization.

In Table 2 we have tried to make a summery of our findings and trace different potential outcomes arising from alternative approaches to privatization. The typology of "A" and "B" was inspired by the model framework proposed by Winiecki, 2000, and Kornai, 2000. Also Alexeev, 1999, p. 463, contrasts the mass insider privatization with

[20] It was empirically observed in the USA and the EU that bureaucracy hit more harshly the SME sector and dynamic firms (i.e. the smaller firms that were profitable or that were going through restructuring). The burden of bureaucracy is usually represented by a fixed transaction cost that is not proportional to firm size. For example, it was found in Netherlands that the costs of administration of regulated activities in 1993 was 3500 ECU per employee for firms with less than 10 employees, meanwhile the same burden for firms over 100 employees was only 600 ECU per year (Molitor, 1995). The lobby of large firms in streamlining the regulation and in personal networking is stronger for large firms than for small firms (see Stein et al., 1995).

the rise of "genuinely entrepreneurial activities" which originate outside of the privatization arrangements and under a very different motivational context.

Table 2: Different potential outcomes arising from alternative approaches to privatization

No.	**Model "B": Privatization from above**	**Model "A": Privatization from below**
1	Power politics, human engineering	"Organic" development from grass roots
2	Rising role of state and bureaucracy	Rising role of autonomously acting economic agents protected by legal framework
3	Redistribution of existing capital assets	Creation of new capital assets
4	Domination of old firms (SOEs)	Domination of new firms (*de novo*)
5	Communist nomenklatura retaining its economic positions	Emergence of new entrepreneurial and managerial class
6	Acquisition of property on debt	Acquisition of property from own savings
7	State and banks as final creditors	Entrepreneurs as final creditors
8	Debtors dominating creditors	Creditors dominating debtors
9	Easy access to money	Tight access to money
10	Easy fiscal policy	Tight fiscal policy
11	Soft budget constraint	Hard budget constraint
12	Privatization of banks postponed	Privatization of banks at the start
13	Creation of phony capital markets	Creation of efficient capital markets
14	Low supply response as a constraint to growth	Low aggregate demand as a constraint to growth
15	Intransparent myriad of owners and residual claimants	Clearly defined owners
16	Insiders and information asymmetry dominate the creation of rules	Competition and the interests on the demand side dominate the creation of rules
17	Agents dominating principals	Principals dominating agents
18	Adverse selection of owners and managers and their forced criminalization	Fraud and tax evasion is not a rewarding strategy
19	Buildup of the rule of law is postponed	Priority in the buildup of the rule of law
20	Asset stripping as an objective function of entrepreneurship	Efficiency and capital yields as an objective function
21	Profits dependent on relationships to state and bank hierarchies	Profits dependent on competitiveness on contestable markets
22	Failing firms subsidized by successful ones	Profits are retained in firms and reinvested
23	Adverse selection: inefficient firms survive	Selection by contestability: efficient firms survive and unprofitable firms fail
24	Rising role of public budgets and taxation	Taxes can be potentially decreased
25	Low growth or growth easily undermined by macroeconomic demand shocks	Steady growth based on sound supply side
26	Growing gap between firms with FDI and inflexible indigenous firms	Indigenous firms benefit from innovation spillovers, imitation and network linkages
27	Political crises and social apathy	Political consensus and civil society

The theoretical background to our classification of characteristics can be traced to Schumpeter and his description of entrepreneur as the crucial actor of capitalism. Privatization is a policy aiming at promoting both capitalism (i.e. private property) and entrepreneurship. However, privatization alternatives can also lead to alternative ways how this objective is implemented. For example, alternative models of building-up the private ownership lead to alternative institutional, behavioral and organizational outcomes. In model "B" the implementation of privatization policies diverges from Schumpeterian productive processes based on property rights, personalized governance, risk-bearing, competition, allocational adjustments and innovation, as they are assumed in model "A". The Schumpeterian model is also gradual where adjustments to factor and commodity allocations are constantly checked by inexorable impersonalized markets. The tenor of such capitalism is in efficiency and governance. On the other hand, model "B" reflects the exogenous "privatization shock" in which the selection of both the owners and the property are to a large extent random. The objective functions of owners and the market structure borne in such conditions are more akin to Schumpeterian degenerated entrepreneurship where the firms become too large, the principals are dominated by agents and the risk is finally transferred on other parties, such as banks or governments.

The real economy is, of course, more varied in outcomes, as its privatization techniques and government policies are heterogeneous. The Czech economy during 1991-1997 was to a large extent correlated with characteristics of the model "B". The financial crisis of 1997 and the economic crisis of 1998-99 reversed the conditions enlisted in lines 7 through 12 in model "B". Though our aim was to come with generally valid implications, many of the outcomes in Table 2 were inspired by the Czech reality of mass privatization and its effects on the behavioral patterns of its agents. We should keep in mind that the Czech mass privatization (if we set aside the unique German case), aimed to be the fastest and the most intensive among the post-Communist countries. Because of the high speed, the spontaneous "wild privatization" prelude was rather weak until 1994, when the official part of privatization was approaching to its end. At that time Prime Minister Klaus proclaimed the transition finished and declared the Czech economy "a normally functioning market economy". His wishful thinking, confusing nominal privatization with real transformation, was soon to be challenged. The end of 1994 was marked by a rise of the so-called "third wave of privatization". A re-privatization was a natural backlash due to the uncompleted work provided by the privatization commanded "from above". The majority of asset stripping occurred in that period.

Theoretically speaking, the process of finding final owners was expected to happen by nearly everyone. It was justified due to the expected effect of the Coase theorem, as we have discussed it previously. It was assumed that the transient owners would sell their entitlements to those who would feel better prepared for the allocation and usage of assets. It was thought the three stock exchanges would mediate that job. Instead of it, a new belated wave of asset stripping could loom with an unattenuating force. At the same time the Government did not assume any responsibility to supervise or regulate the swollen re-distributional drive and left the process to its "unhampered completion".

In 1997 it was apparent that from approximately 840 former SOEs in the industrial sector that were privatized by mass methods and that remained without a strategic foreign investor, only a handful were viable. The vast majority of large enterprises had problems with losses, debts, efficiency, foreign competition and contracting demand. On the other hand, the SME sector looked less shaken, though still fighting for a space occupied by ailing large firms. Between 1991-98, the share of enterprises with more than 500 employees on the total number of firms with employment over 25 persons shrank from 31% to 16%. The employment in small businesses with up to 25 workers, where over 70% of firms were established as *de novo*, increased from 17% to 38% [21]. The question for our further study is whether this trend can be expected to continue, based on higher viability of new firms over old firms, or whether it was just temporary.

7. The Empirical Evidence about Czech Authentic Private Enterprises

Once we have arrived at a conclusion that the establishment of the authentic (generic) private sector is of a strategic significance, it is our next task to see whether there is in the Czech economy an empirical evidence showing that this sector is more viable than the sector of privatized former state owned enterprises. If the evidence were in conflict with our hypothesis, then would it cast doubts on the validity of statement that the privatization "from below" might be a superior one? Our method of hypothesis testing will be based on a comparison of the performance of SMEs with the remaining firms. As is known since the seminal study of Olson, 1965, the linkages between the government and the industrial sector are subject to information asymmetry and that government policies favor smaller and concentrated pressure groups over extensive ones. As an outcome, we should be prepared for the existence of a bias and adverse selection. The problem could be that the dominance of an inferior privatization may cause the crowding-out of the space for the superior one.

The tendency to treat large indigenous firms differently than SMEs is revealed by the extent of the Czech government support in the forms of explicit subsidies and bailouts. While former SOEs received approximately US$ 14 billion between 1990-99 as support from State funds, the support of the SMEs, whose share on GDP was comparable with the share of former SOEs, was less than US$ 1 billion. The statistically reported profitability of large firms was then overestimated and the viability of those firms was biased.

7.1. Problems with Data

Our original idea was to base our study on industrial statistics collected by the Czech Statistical Office. Each firm over 100 employees must provide a quarterly and an annual report with approximately 25 indicators of production, costs and sales. Firms over 25 employees have to provide annual data and the remaining smaller firms are accessed by random surveys. Unfortunately after we have acquired and pre-processed the raw data for 1994 and 1998

[21] These estimations are based on Monte Carlo simulations with data from 1998 micro census. The source of our data can be found in Jurajda and Terrell, 2001, as will be described later.

(comprising over 12000 enterprises), we have discovered that for many of the small and medium firms there were partially missing statistics. For analyzing the firms with less than 25 employees (representing approximately 15% of industrial output) we ought to reduce the data population to a meaningless sample. Also the firms with 25-100 employees had problems with compatibility of contents with the sector of firms with more than 100 employees, though at a minor scale. If we proceeded with the work on industrial data the results for small and medium-sized firms could have been unbearably biased. So finally we have resigned from relying on this source of data.

We asked then the Ministry of Industry and Trade for providing us their already checked and corrected statistics. Unfortunately there we could work only with data already aggregated into 14 manufacturing industries in NACE classification and the years available were 1995 and 1998. The firms were classified into three groups. Large firms with 500 and more employees, medium firms with 100-499 employees and "small" firms with less than 100 employees, including the self-employed workers. Since we could work only with firms grouped by size (i.e. we were not able to distinguish between new and old firms), we are obliged to interpret our results under the following assumption: small firms were correlated with new firms so highly that we could interpret their characteristics as those of *de novo* firms. Medium-size firms included a large segment of former SOEs, some of more independent plants of which split from the large corporations and got privatized separately. Their results in some industries must be interpreted with a caution.

Another problem is that we were not able to distinguish between indigenous and foreign firms. Unfortunately foreign firms were not distributed in all three size categories in a uniform manner (see Benacek, Zemplinerova, 1997). While the proportion of firms with FDI was similar in the medium and the large enterprise groups, the group with smaller firms received a lesser share. Since foreign firms were more productive and profitable than indigenous firms (in 1995 their productivity of labor was on average higher by 40% in 1995 and by 65% in 1998), some industries with intensive inflows of FDI could show less persuasive performance in the sector of small firms than in the sector of medium and large firms.

In order to assess also the non-industrial sector we also worked with data aggregated for agriculture, industrial sector, construction, trade, catering and hotels, transport and communication, financial sector and other services. There we could work only with three size groups of enterprises: firms with over 249 employees, firms with 1-249 employees and self-employed. Unfortunately here we have lost the groups of firms with 25-99 and 100-249 employees.

7.2. Empirical Evidence about the Size, Structure and Performance of de Novo Firms

Our first step should be to find out how the development of *de novo* firms proceeded since the collapse of Communism in Czechoslovakia. The interest in the development of Czech generic private sector and the SMEs was very marginal until 1998, if taken from the point of view of the central authorities. Their obsession with the mass privatization of SOEs (and later with the resuscitation of these enterprises) overshadowed the interest in the *de novo* sector. This neglect is also reflected by the bias of statistics shying away from data on SMEs, with data on *de novo* firms practically non-existent.

In the Czech statistical records we have found only one microcensus where the businesses (enterprises) were classified into two categories: old and new (*de novo*). The businesses included a large number of small firms which were practically the only *de* *novo* firms under Czech indigenous ownership. The census covered the years 1990-1996. The panel micro-data was based on the working history of 2,284 workers, who worked since 1980s until December 1996. Fortunately, the panel also described the firms where the workers were employed. But unfortunately no later extension of the project was undertaken.

Jurajda and Terrell, 2000, were the first economists to come up with an idea that the census could be used for estimating the structure of firms that were classified into public (such as health service, education and state administration), SOEs, privatized SOEs and *de novo* firms. By using the Monte Carlo method, we can estimate the proportion of employment that belonged to each of these ownership categories. This is most probably the only resource that can address the problem how the new enterprises developed throughout the Czech transition. The estimated results are indicated in Figure 2.

The graph in Figure 2, depicting *de novo* firms, shows that the process of privatization commenced in 1991 with the employment of approximately 8% in the newly founded firms. Their size was very small, practically equal to self-employment. The state sector was clearly dominant, comprising the rest of the economy because privatization still was in the offing. The rise of *de novo* firms during 1991-93 was absolutely staggering. We can raise a hypothesis that the speed and the spontaneity of this growth (at the end of 1993 over 30% of employees were in the newly borne firms) was one of the most valuable capital assets that Czech society had for its quest for prosperity. Though the build-up of new businesses slowed down after 1993, we can presume that in the middle of 1996 the employment in *de novo* firms caught up with the employment in former SOEs (at that time largely privatized by the so-called "mass methods") comprising nearly 40% of the total labor force. Since 1996 the growth of new indigenous businesses stagnated. The initiative, however, was passed to large enterprises established as "green-field ventures" by means of foreign direct investment. Their success was observed first for data for 1994, as was presented by Benacek and Zemplinerova, 1997.

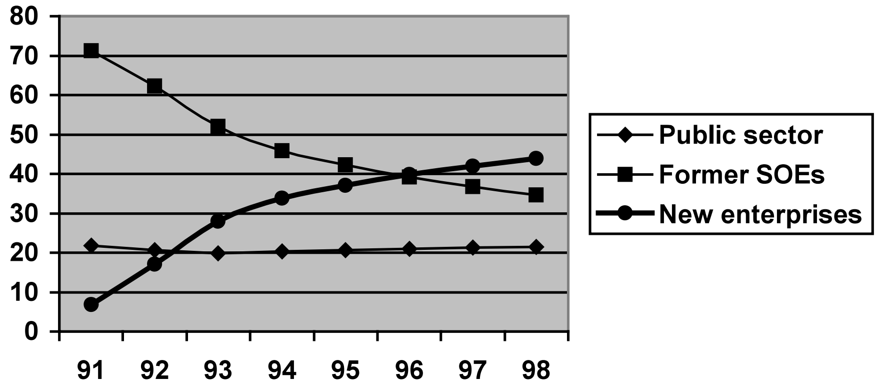

Figure 2: The trade-off of employment between old and new enterprises in 1991-98 (shares are expressed in percentages)

Source: Jurajda and Terrell, 2001

In 2001 there was another survey targeted on SMEs with the number of employees ranging from 10 to 250. There the distinction was made for the *de novo* firms, as different from privatized acquisitions and state-owned firms (see Mejstrik and Zemplinerova, 2001). We can deduce from the sample of 195 enterprises taken from 5 industries that in 2000 approximately 55-70% of all SMEs were established as green-field firms and only approximately 25-40% were acquisitions via privatization or converted old firms. As the Table 3 indicates, there were large differences between industries. Of course, this proportion is valid for firms with less than 250 employees only. It is certain that the extension of the sample on larger firms will decrease the average proportion of new firms on all firms. Would that decrease be as much as by 21 percentage points (i.e. to 47%), only then these figures would be compatible with the estimation by Jurajda and Terrell, 2001. That would also imply that the proportion of new firms on all firms with employment over 250 workers would have to be approximately as little as 25%. That would also point on the rigidity in the sector of large firms.

Table 3: Distribution of New and Old Enterprises in a Recent Survey on SMEs (data for 2000) The number in brackets represents the number of firms responding, the next number is the percentage of the sample in the given industry

Type of firms and industry:	Food	Clothing	Wood	Plastics	Information technologies	**Total**
New firms	(21) 54%	(33) 73%	(16) 67%	(15) 65%	(47) 73%	(**132**) **68%**
Old firms	(16) 41%	(11) 24%	(7) 29%	(7) 30%	(16) 25%	(**57**) **29%**
Total of all firms	**(39) 20%**	**(45) 23%**	**(24) 12%**	**(23) 12%**	**(64) 33%**	**(195) 100%**

Source: Mejstrik and Zemplinerova, 2001

The above estimations and extrapolated data from the previous studies of the author (Benacek, 1995 and 1997c) and findings of Zemplinerova, 2001, concerning productivities can be used for a hypothesis estimating the share of the generic private sector on GDP. Let us point out that we will not estimate so much the share of *de novo* firms alone on GDP but rather the share of firms that reveal characteristics of a stabilized ownership and management aiming at strategic productive development. That means we will include here the *de novo* indigenous private enterprises (e.g. green-field domestic investments), as well as foreign direct acquisitions that brought with themselves new technologies and management, and that successfully restructured the acquired firms. Table 4 contains the conclusions of our estimation.

The problem with the Czech authentic private sector is that a large part of it is concentrated in very small (micro) firms that are very heterogeneous and the statistics about which are scarce. As was observed in the case of Hungary (see Laki, 2001) many of the very small firms are fictitious that either they are not active or they are active in their non-productive orientation. For example, many of these firms were founded for tax evasion or for other speculative purposes. Nevertheless, we have included them among the authentic private firms because they were founded as de novo start-ups. As to the medium-sized sector, we have estimated that more than a third of firms with 10-250 employees cannot qualify as generic private firms because they were just separated and privatized segments of former SOEs. A large part of the successful firms in that medium-sized category are in fact foreign-owned enterprises. The remaining indigenous firms in Table 4 are represented to a large extent by enterprises privatized by managers, investment funds or other insiders. These firms are often heavily indebted and without signs of a successful restructuring. On the other hand, the large firms under foreign ownership, with approximately 30% share on GDP, still did not dominate the Czech economy. Though the estimated 62.6% share of the generic private sector on GDP [22] is relatively high, nearly 37% of GDP still remains stricken by the omen of unsolved property rights, failed restructuring and instability. It is in this quite large "marginal" sector where the firms can survive only subject to low wages and an undervalued exchange rate, that both spill over to the rest of the economy. That prevents the expansion of more successful firms and the growth based on more capital intensive productive techniques [23]. Further progress in the growth rates can thus be achieved if this sector releases its resources that will be used more efficiently in the more successful segments of the economy.

Table 4: Share of the authentic (de novo) private sector in given category of enterprises and on GDP in 2000 – stylized facts

Enterprise category by size	Share of authentic firms on total number of firms in given category	Share of all firms on total output (value added)	Estimated share of authentic firms on total output (value added)
0-9 employees	0.95	0.11	0.105
10-250 employees	0.63	0.34	0.214
over 250 (foreign)	0.90	0.30	0.267
over 250 (indigenous)	0.15	0.25	0.038
All firms	-	1.00	**0.626**

Source: Own simulation of a hypothesis based on estimates from studies by Zemplinerova, 2001, and the data of the author

Though the problems with expansion of the *de novo* firms were visible since the separation of Czechoslovakia in 1993, one cannot deny that the position the SMEs gained in the second half of 90s was not admirable. In many aspects the position of Czech SMEs in 1998 was comparable with that one in developed industrial economies. According to CESTAT statistics (Czech Statistical Office, 2000) the share of registered entrepreneurs by total inhabitants in 1998 was 13,9% in the Czech Republic, while in Poland and Hungary the level was slightly more than a half of that. Even if the Czech

[22] This conclusion is close to the estimation of Selowsky, Mitra et al., 2001, who show in their Figure 3.5 and Table 1 that Czech small enterprises (with 50 employees or less) have a 53% share on total value added in 1998. Though this seems to us a too optimistic figure, the real developments in 2000 in the whole authentic private sector can be compatible with our estimation of a share of 62,6%.

[23] See the comments on Figure 5 in the later text that will explain how the growth can be stimulated by higher wages and by a switchover to more capita- intensive production.

statistics could be methodologically biased, the degree of private initiative in the Czech Republic to take risks and run businesses was generally assessed as the most intensive among these three countries. Similarly Rona-Tas, 2001, has estimated that Czech entrepreneurial activities are among the strongest among the post-Communist countries. In Czechia one individual enterprise is registered per 4,3 economically active persons, while in Hungary it was 5.7 and 8 in Slovakia.

Unfortunately, the comparative advantage of Czechia in this extremely important economic field was not supported by the government. On the contrary, the government policies drove a wedge between the rapidly emerging small and the pampered large businesses.

As was already mentioned, we have found that there was only one statistical microcensus dedicated to *de novo* enterprises. And there has been so far only one published study based on its data: namely the survey by Munich, Svejnar and Terrell, 1999. There the behavior of firms was analyzed with an aim to explain the functioning of the Czech labor market. For example, as the earnings structures in centrally planned economies were very compressed, the question was how the privatization of state owned enterprises (SOEs) and the emergence of *de novo* private firms changed the returns to human capital and how the free wage setting modified the previous wage grid in the public sector vis-à-vis the newly privatized firms.

The transition from the centrally planned to a market system resulted in a major gradual increase in the rates of return to education, with the rates of return reaching West European levels by 1996. This increase is found in all ownership categories of firms. For example, the return from a year of education was 5,6% in the public sector, 6,5% in privatized SOEs and 6,1% in the *de novo* private firms. As to the returns of a year of experience the difference was much more substantial. It was 1,5% in the public sector, 2,2% in privatized SOEs and 3% in the *de novo* firms.

There was another behavioral feature present, where the *de novo* firms differed from the old firms. It was in their relationships to labor experience and its remuneration. The wage policy differences are depicted in Figure 3. Though there was a general trend of increasing the wages until 20 years of working experience (i.e. proportionally to the length of employment), the rise was faster in *de novo* firms. While in the public and the privatized sector the wages did not decrease with age after 20 years of experience, in *de novo* firms there was observed a sharp decrease is wages for workers with more than 30 years of experience. As it seems, the newly established firms remunerated higher the younger experienced workers than the ageing workers. Also they paid to the recent entrants into the labor market higher wages than it was in the privatized or public enterprises. A similar conclusion is derived for Poland (see Winiecki, 2001, chapter 3) and Hungary.

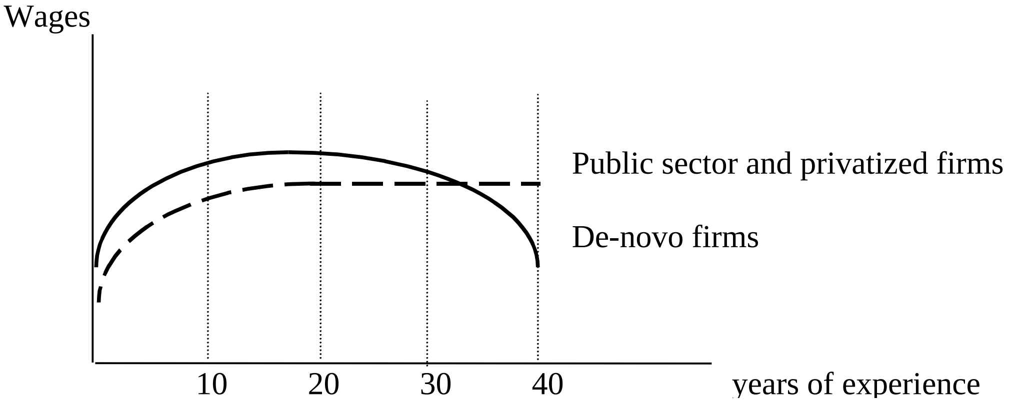

Figure 3: Wage policy in firms with different ownership
Source: according to Munich, Svejnar and Terrell, 1999.

7.3. Comparison of SMEs with Large Enterprises

Unfortunately the statistics of Czech *de novo* firms have been very scarce and we were obliged to take the whole SME sector as a proxy for quantifying their approximate characteristics. Table 5 compares the size of SMEs in the Czech Republic with EU and four other countries. Until 1990, the structure of Czech firms was monopolistic and firms with less than 500 employees were scarce. Taken from historical roots and similarities in factor endowments, the Czech structure of businesses should converge to the Austrian structure. Austria is a country with exceptionally large number of medium-sized firms and with low value added per worker in small firms. In another words, Austrian small businesses (like in the United States) are highly labor-intensive with low requirements of capital. This type of specialization would be advantageous for Czech small firms because they have enormous difficulties with acquiring capital. That is different from the SMEs in Belgium where the small firms are well endowed with capital and their value added per employee is therefore larger than in large firms.

Table 5: The distribution of enterprises by size – comparison of SMEs in Czechia in 1998 with some OECD countries

Country	Number of enterprises			Number of employees			Value added		
	Shares in %								
	1 - 99	100-499	500 +	0 - 99	100-499	500 +	0 - 99	100-499	500 +
USA	98.1	1.6	0.3	38.5	14.6	46.9	14.3	13.6	72.1
Japan	96.0	3.5	0.5	23.7	25.3	51.0	34.8	29.7	35.5
Belgium	98.9	0.9	0.2	45.4	19.5	35.1	54.4	18.6	27.0
Austria	86.1	12.1	1.8	40.6	36.0	23.4	27.4	36.4	36.2
Czechia	**98.1**	**1.5**	**0.4**	**28.0**	**27.8**	**44.2**	**20.9**	**24.3**	**54.8**
Eur. Union	98.9	0.9	0.2	53.3	16.2	30.5	50.0	21.4	28.6

Source: OECD, Meeting of the Industry Committee – Scoreboard of Indicators, Paris, February 1998, p. 81 and the Czech Ministry of Industry, 2000.
Data are for 1992, with the exception of USA (1993) and Czechia (1998).

The tendency of SMEs to a more intensive labor usage was apparent in the Czech Republic from early observations. First, the concentration of SMEs was biased to industries which are labor intensive (clothing, textiles, wood processing, metal working, glass, services). Second, the overall allocation of resources in all industries (i.e. including the capital intensive ones) was biased to labor usage that substituted the expensive new physical capital. There are five explanations of the latter:

a. SMEs have been largely established as *de novo* firms. Thus they could not acquire capital by mere transfers from the SOEs that would be either free or received at a discounted price (e.g. at the book value adjusted to depreciation).

b. The capital stock had to be acquired at free markets where the price of new equipment and buildings was several times more expensive than was the price of similar assets before 1991. It was their book value unadjusted for inflation that was used as a base for the capital depreciation.

c. The bank credits to SMEs was either unavailable or the interest was often higher than was the potential yield of investments.

d. The domestic wages in Euro and unit labor costs relative to main trading partners were exceptionally low.

e. Wages in SMEs were less sticky than in the large firms. The competitiveness in less efficient firms could be increased by lowering wages. It was the price that had to be paid for job security (SMEs often functioned as a refuge from unemployment).

The business structure in EU – outside the German speaking countries - is dominated by small firms. The Czech Republic evidently does not fit in with European patterns because of its over-grown large-sized business sector. It is a paradox that the Czech structure of SMEs shows more similarities with the structure of firms in the US and Japan, which operate on much larger domestic markets. There still remains a gap to be filled by future expansion in either the medium firms (by 30%, to reach the level of Austria) or the small firms (by 90%, to reach the average level of the EU). In either case, the expansion of SMEs must proceed at the expense of the shrinking large business sector. The government industrial policies that after 1998 raised the previous political obsession with large firms to a development fetish, is evidently an impediment against the natural SME expansion.

At the same time the SME sector should be expected to change its structure. Though its share on total Czech employment is not so much different from the advanced countries, there is observed an over-employment in the very small firms. Especially it is the case in the sole proprietorships that work on a part-time basis, often in parallel with the employment at a full-time job. Such firms are not very productive and they may mask the existence of a hidden unemployment. A similar tendency was found in Hungary (Laki, 2001) where tax avoidance was one of the reasons.

Another aspect for uncovering the potential space of expansion of SMEs is in comparing the present situation in the Czech Republic with that of Taiwan. Taiwan is an industrially advanced country with approximately $18,000 per capita, whose development was overwhelmingly associated with SMEs. In 1998 the SME sector [24] employed 78% of the domestic work force. In 1987 it provided 67% of exports. Since that time the share of exports declined to 47% in 1998, which is still significant. The decrease was explained by a switchover of SMEs into the segment of large firms, some of them even becoming international giants (see Cheng, 2000). Also the pressure of rising wages and the shift to capital intensive production decreased the importance of SMEs on total final sales to 31%. Taiwanese SMEs therefore function mainly as flexible providers of intermediate goods and services to large enterprises. The most important lesson from Taiwan is that SMEs are compatible with hi-tech and R&D.

The tendency to crowd-out the Czech corporate sector by the growth in the SME sector was clearly evident throughout 1990-1997, which is confirmed in Tables 6a and 6b. The problems in the period 1997-99 can be also illustrated in Tables 7 and 8. In Czechia in May 1997 there was a financial and political crisis, which was followed by a restrictive package of measures. The recession ended in the middle of 2000. 1998 commenced with a harsh impact of the economic crisis on SMEs. Small firms were hit first. Their recovery in the manufacturing (industrial) sector in 1999 was however very fast, which is confirmed in the first line in Table 7. Unfortunately, in the same year there was a crisis hitting the medium-sized firms (see Table 6a), which somehow aggravated the total recovery [25].

We can see from Table 7 that SMEs in the trade sector were among the most severely afflicted, losing in all indicators: employment, sales and the value added. At the same time construction and transport underwent recession in sales and value added, though they acquired a larger share on employment. Catering had downsized on its labor and increased the sales and value added. Table 8 illustrates that during 1995-98 the industrial sector as a whole was stagnating and the decline of employment in large firms was compensated by the growth in the SMEs. Nevertheless, the progress in the SME sector was slowing down, especially after 1993, churning with impediments coming both from the competition with large enterprises and from the government policies. For example, the slow restructuring in the indigenous corporate sector caused the retention of resources (labor, capital) in inefficient firms that could not be then used in SMEs. On top of it, the survival of large firms was artificially backed by soft fiscal policies, soft bank loans, bailouts and various revitalization schemes.

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[24] In Taiwan the SME sector is defined by employment up to 200 workers in manufacturing and construction, and up to 50 workers in the remaining sectors.
[25] Though we do not have the figures for 2000, the interim monthly reports indicate that the industrial sector was recovering very fast after 1999, with the productivity rise reaching over 12% and SMEs becoming the most successful among the gaining sectors.

Table 6a: Number of active firms in the Czech industrial sector

Year	Number of firms	Structure by the number of employees 0-99	100-249	250-499	0-449	500 +
1993	n.a.	n.a.	1296		n.a.	621
1995	101187	98823	1795		100618	569
1996	111255	108882	1818		110700	555
1997	146902	144407	1414	583	146404	498
1998	129288	126887	1406	536	128829	459
1999 (interim)	151157	**148917**	**1292**	535	150744	413

Source: Industrial statistics of Ministry of Industry and Trade, 1999

Table 6b: Employment structure in industrial sector (number of employees in thousands)

Year	Number of employees	Structure by the number of employees				
		0-99	100-249	250-499	0-449	500 +
1993	n.a.	438	300		n.a.	1044
1995	1641	438	378		816	825
‘95 structure %	100%	**26.7%**	23%		**49.7%**	**50.3%**
1996	1613	473	373		846	767
1997	1659	547	220	200	967	692
1998	1582	529	220	187	936	646
‘98 structure %	100%	**33.4%**	13.9%	11.8%	**59.2%**	**40,8%**
Difference 1998-95	-59	91	29		120	-179
Index 1998/1995	96.4	120.8	107		114.7	78.3

Source: Industrial statistics of Ministry of Industry and Trade, 1999

Table 7: Share of SMEs with employment up to 250 workers in all sectors of the Czech economy, Comparison of 1999 with 1995

	Employment		Sales		Value added	
	1995	1999	1995	1999	1995	1999
Industrial sector	43.1	45.6	33.9	36.6	34.0	37.2
Construction	75.2	76.7	70.3	69.3	74.5	74.1
Trade	85.7	81.9	90.8	87.1	88.5	85.3
Catering	90.8	86.7	85.4	85.8	77.1	80.2
Transport	19.5	22.9	43.7	41.7	29.9	27.3
Other services	82.2	83.8	87.8	88.7	84.2	86.2
TOTAL	**64.4**	**59.1**	**52.9**	**53.5**	**57.4**	**53.0**

Sources: Own estimations for 1995 from industrial database of CSO and estimation of the Ministry of Industry and Trade for 1999

Table 8: Changes in the structure of employment in Czech industrial sector during 1995-98
(The structure was computed as shares on total employment)

NACE category	Changes in the structure of employment; 1998 - 1995			
	Total	according to the size groups by employment		
		small: 0-99	medium:100-499	large: 500 +
All industrial sector	0.0	6.2	3.2	-9.4
including:				
C - Mining and quarrying	-0.9	1.2	0.0	-1.2
Mining of energy-producing materials	-0.9	-0.7	1.5	-0.7
Other mining and quarrying	0.0	13.0	-17.6	4.6
D - Manufacturing industries	1.3	6.5	3.1	-9.6
Food and tobacco	1.0	3.8	-3.7	-0.1
Textile and clothing	-1.1	5.8	1.7	-7.5
Leather and shoes	-0.6	7.8	8.7	-16.5
Wood processing	-0.4	2.0	3.1	-5.1
Paper and printing	0.2	10.6	-2.8	-7.8
Coke and petroleum refining	-0.6	1.4	10.9	-12.3
Chemistry and pharmaceuticals	0.2	3.1	-0.6	-2.5
Rubber and plastics	0.9	7.7	4.6	-12.3
Glass and mineral products	0.4	3.1	0.1	-3.2
Metallurgy and metal products	0.4	9.0	6.1	-15.1
Machinery and equipment	-0.9	8.2	4.5	-12.7
Electrical and optical equipment	1.4	3.7	2.9	-6.6
Cars and transport equipment	0.5	3.4	11.1	-14.5
Other manufacturing	0.0	14.9	-2.7	-12.2
E - Electricity, gas and water	-0.4	0.7	3.5	-4.2

Source: Industrial statistics of Ministry of Industry and Trade, 1999

The above problems are not transparent from the official statistics on the number of firms in the Czech economy, as is shown in Table 9. In difference to Table 6a (where there were reported only the active firms), Table 9 pinpoints the ever-growing number of all firms registered, including those ones that reveal no activity. Such statistics, like in Table 9, must be considered with utmost caution. The rising risk of financial default in enterprises is illustrated by Figure 4 where the number of firms under judicial bankruptcy and liquidation was sharply increasing since 1993. The trend reveals no sign of attenuation. We can derive from the graph that out of 343 thousand firms registered as legal entities only 1% of them is expected to be under bankruptcy procedure in 2001. Approximately as many as that are firms liquidated by courts' decision due to insolvency but without a judicial supervision over the sales of their assets. On top of it there are firms closing down voluntarily. Notwithstanding the problems the Czech authentic private businesses are challenged, the low number of bankruptcies among them is an encouraging perspective.

Table 10 assesses the export and import performance of SMEs, as it was estimated by Zemplinerova, 2000. It is a general trend that due to economies of scale exports per employee increase with the size of the firm. Small firms are also subcontractors for large firms that are intensive exporters. Even though this tendency is also apparent in the Czech export pattern, with their 15% share on all manufacturing exports the small firms up to 50 workers have been successful exporters. Their higher share on imports (26%) is close to their share on total net output. We can see that even small firms are potentially able to participate on the advantages of imports (e.g. the high quality of inputs) and to take share on their externalities.

In Table 11 we compare productivities in SMEs and in large enterprises in 1998. Because of the bias caused by higher capital/labor ratio in SMEs, an approximate estimation of total factor productivity is added in addition to labor productivities. As could be expected, Czech SMEs have productivity advantages in traditional industries like leather, clothing and textiles. Unfortunately, these are declining industries. On the other hand, SME reveal productivity advantages in some very progressive industries, like optical instruments, rubber, plastics, machinery and transport equipment. As to the total factor productivity comparison, SMEs show better performance in 13 out of 23 industries.

Table 9: Number of firms in the Czech economy 1991-99 (in thousands)

INDICATOR:	1991	1993	1996	1998	1999
All registered firms	179	1119	1469	1781	1963
Self-employed	n.a.	n.a.	1104	1328	1426
* Legal entities	54	133	231	297	343
* SOEs	3.5	3.3	1.9	1.3	1.2
* Public enterprises	n.a.	n.a.	16	15	15
* Private firms and corporations	n.a.	n.a.	169	218	260
Firms with limited liability	n.a.	n.a.	131	165	188
Firms with foreign owners	n.a.	n.a.	35	56	82
* Physical entities	n.a.	n.a.	1238	1484	1620
Firms in agriculture	n.a.	n.a.	121	128	130
Firms in manufacturing	n.a.	n.a.	198	235	251
Firms in construction	n.a.	n.a.	158	187	209
Firms in trade	n.a.	n.a.	467	576	627

Source: Statistical Bulletin, Czech Statistical Office, Prague, 2000

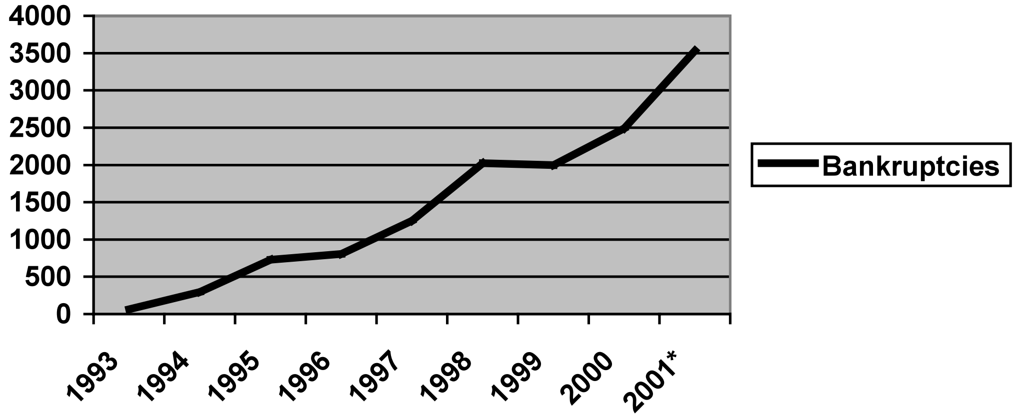

Figure 4: Number of bankruptcies declared by commercial courts

Source: Czech Ministry of Justice, 2001.

Remark: * The figure for 2001 is estimated. It is assumed that only a third of the 10580 existing claims placed by creditors on bankruptcies will be approved by courts. In 1999 nearly 50% of claims were approved for a bankruptcy liquidation. The average duration of a bankruptcy court procedure was 18 months in 2000.

Table 10: Exports and imports in SMEs and in large manufacturing enterprises in 1998

Size of the firm (by number of employees)	Exports	Share on total exports	Imports	Share on total imports
	mil. CZK	%	mil. CZK	%
0 - 49	131 584	15.47	239 242	25.72
50 - 249	176 768	20.78	214 958	23.11
250 and more	539 928	63.48	473 189	50.88
Total	850 529	100.00	930 042	100.00
SMEs 0-249	308 352	36.25	454 200	48.84

Source: Zemplinerova, 2000

Table 11: Comparison of productivities in SMEs and in large enterprises in 1998
(enterprises were classified according to the number of employees)

NACE	Sector	Value added per worker		Total factor productivity *	
		SME 1-249	250 & more	SME 1-249	250 & more
15	Food	314	400	55	62
16	Tobacco	211	2090	40	210
17	Textile	209	214	**44**	39
18	Clothing	175	178	**51**	50
19	**Leather**	**141**	123	**35**	32
20	Wood prod.	227	258	42	44
21	Paper	304	395	**55**	48
22	Printing	389	515	63	82
23	Oil processing	133	1231	-18	109
24	Chemistry	558	577	**75**	67
25	**Rubber, plastics**	**356**	353	**68**	57
26	Minerals processing	388	551	58	67
27	Metals	344	359	**63**	56
28	Metalworking	270	297	58	59
29	**Machines**	**297**	282	**64**	55
30	Computers	101	199	26	45
31	Electric machines	329	352	**78**	65
32	TV, radio	279	357	**82**	70
33	**Optical instrum.**	**287**	250	**62**	50
34	Cars & access.	341	434	53	66
35	**Transport equip**.	**278**	272	**63**	60
36	Furniture	185	254	**53**	50
37	Recycling	**385**	248	32	38

Source: Zemplinerova, 2000

* TFP was derived from a macroeconomic Cobb-Douglas production function estimated as:
value added / (number of employees $^{0.7}$ x book value of the physical capital $^{0.3}$). This is too simplified and the results must be taken for rough orientation only.

8. Institutional Barriers to Expansion of New Businesses

The present author was involved in a series of analyzes of SME performance in Czechia during 1994-96. See Benacek, 1995 and 1997c, and Benacek, Zemplinerova, 1995 and 1996, for results of the study. Let us look now, 4 years after the last research, how the situation has changed in the institutional environment.

In 1995 our list of main barriers to further evolution of small businesses included:

a] ill-performing legal and judiciary systems;

b] problems with the capital acquisition;

c] intransparent and complicated fiscal system;

d] rigidities on the labor market;

e] excessive regulation and bureaucracy infringing with independent decision-making of entrepreneurs.

These problems were generally accepted as socially contrived barriers at the level of both the public discussion and the high politics. Practically all political parties had some reference to the solution of the above problems in their election program. In many aspects there were initiated serious attempts to dismantle the barriers at the level of the government. The most important changes occurred in the first two items.

Ill-performing legal and judiciary systems

At the level of the legal system the convergence of Czech laws to the acquis communautaire of the EU was a straight improvement, even though the present negotiations for the EU accession still claim some large loopholes. Ostentatious fraud and embezzlement of someone else's property became a clearly identifiable crime subject to concrete legal procedures. Therefore the cases of lawlessness and a massive asset stripping were significantly reduced during 1997-2000. The opportunism of moral hazard in running a business under a soft budget constraint has many negative impacts. One of them is the spillover to the public finance in form of bail-outs, subsidies, soft public procurement procedures and general corruption. This is a policy that has run very low legal risks to this moment. As to the enforcement of law, the judicial system did not change so dramatically in its quality. Czech law is based on the principles of "positive law" where the absolute formal wording of the written code rules over the interpretations of the justice issuing from the "natural law". Though the speed of litigation increased (from the average 3 years to 2 years), it was not sufficient enough. It remained overburdened with tens of thousands of unsolved litigations and the attempts to change the system from its core failed. Because of the life tenure ("definitiva" - that the judges received in the meantime) and the lack of judges, the judicial lobby is now difficult to change.

Since the enforcement of contracts at courts is a lump-sum transaction cost invariant to the size of the litigating party, the small businesses are hit much harsher by its ill performance. On the other hand, any improvement in this field would mean a built-in stabilization step for the SMEs. Instead of calling for a discretionary industrial policy actions in support of the SMEs, the main source of improvement should be seen primarily in the global improvements in the functioning of the legislative, judiciary and legal systems.

Capital acquisition

The performance of banks changed most dramatically during 1997-2001. At he beginning of this period the presence of private and especially foreign capital in Czech banking was just symbolic. In July 2001 the last larger bank (Komercni Banka) that remained in domestic hands was acquired by French Société Générale. After that, nearly 100% of the previously so controversial Czech commercial banking sector became controlled by foreign strategic investors. With the inflation rate at 4% in 2001, the interest on loans decreased to mere 7%. After privatization the banks became extremely cautious in their credit policies. As a result, the majority of indigenous firms were cut off the credit lines. Those who were most harshly hit were the large firms without foreign capital. As the competition among banks increased, some banks introduced special schemes for credits to SMEs. We can say that, relatively to the large enterprises, the SMEs have improved in their access to loans.

On the other hand, while the de-novo firms usually performed under well-defined owners and safeguarded their property rights, the mass-privatized large firms have acquired a much larger leeway for acquiring implicit subsidies from the government. The deficit spending of the government of social democrats (in power since 1998) increased to nearly 4% of the GDP. On top of it that very government was very active in selling state banks and the state monopolies to foreign investors, the proceeds from which were used for bailouts of large firms. While the bailouts for 1992-98 were estimated to USD 11 billion, the Government announced plans for spending additional USD 9 billion during 2001-03 in a new re-vitalization scheme for the industrial sector. If such a plan passed through the Parliament it would further strengthen the redistributive drive in the motivation of large firms and hamper the competition between the SMEs and the large firms.

Fiscal Burden

The fiscal system and the taxation became a nightmare for small businesses. The formal requirements are very complicated and subject to incessant amendments. The level of taxation in the Czech Republic is high even by some West European left-wing standards, redistributing in 2001 44% of the GDP. With practically no tax relief for the heavily investing or the newly established SMEs, it is a mighty disincentive to run one's own business. The compulsory 48% social and health insurance levied on the gross payrolls is another serious burden. After the three basic fiscal withdrawals (insurance, income tax and VAT) are applied on the gross wages (i.e. on the labor costs of the employer), the individual's net purchasing power shrinks to 32% in the upper income brackets (i.e. for incomes over approximately $ 3000 per month) or to 38% in the medium income bracket. The remaining 68% (62% respectively) are channeled to the government budget.

However, it is not only the taxes what makes the small-scale business activities difficult. The intransparency and the bureaucracy of the fiscal system are often even more demanding. Since they cannot hire specialists for individual tax agendas, many entrepreneurs in the small businesses spend the majority of their time by studying the tax laws and the endlessly changing regulations, consulting with the tax advisors, revising the tax bills, checking the old accounting records, etc.

Tax evasion is a strong temptation for those small businesses that sell directly to consumers or to foreign firms. The net "profit" can be thus increased approximately 2-3 times and the risk of being prosecuted is low. While the government SME support schemes comprised approximately 30 billion CZK in the last 8 years, the tax evasion presented a relief many-fold higher. Thus the tax evasion in the small businesses in transition became their potentially most important instrument for the capital accumulation. Naturally, not everyone is capable of using this instrument, even though the quest for survival presses many entrepreneurs to use the tax evasion as a last resort for keeping in competition with the less honest competitors. As a result, this unofficial (but tolerated) "scheme" for the promotion of small businesses punishes virtues and rewards vices, becoming one of the least efficient arrangements, which could have been adopted.

Rigidities on the Labor Market

The devastation of the workers' morale is one of the most damaging legacies of the Communist past. The changes in the working discipline have proceeded slowly, especially among older workers in large enterprises and in the government sector. Czech labor is also characteristic for its extremely low mobility. The competition on the labor market is therefore low and the *de novo* firms have a difficult position in acquiring workers even in regions with high unemployment. The introduction of visa on migrant workers from Eastern Europe in 2000 has further decreased the labor availability.

The race on the labor market for acquiring the workers with human capital, as initiated by banks and foreign firms already in 1993, was accepted by the small businesses and their wages in 1996 were by 16% higher than the average. However, after 1996 the drive in SMEs for a staff with higher standards of the human capital has lost on its power and the quest for human capital was won by enterprises owned by the foreign capital. It seems evident that paying lower wages became a strategy for survival adopted by many small firms. Though efficient in a short run, it may become counter-productive as a policy for a long run development. The gap between the firms with FDI and the indigenous firms will further widen if the latter would rely on less paid and less skilled workers. The Czech economy will become a permanent two-speed economy where the fight for the shrinking space for survival at low wages will proceed between the SMEs and the indigenous corporate sector.

Bureaucracy and Regulation

By dealing with bureaucracy we have touched the central point where the Czech ill-conceived institutional set-up spills over into the problems at the grass roots of economy. The rise in the number of officials in the public sector has been unabated since 1989, as is shown in Table 12. Studies dealing with the conditions of entrepreneurship in the Czech Republic point nearly unanimously that the following five barriers can be treated as the most important:

- complicated system of the customs clearance,
- bureaucracy in the regulation of greenfield investments,
- regulation of the product innovation,
- all kinds of property registers (registers of land, real estates, firms, trade certificate, car certificate);
- state health insurance scheme serving as an incentive for high absenteeism and low efficiency.

Table 12: Employment in the Civil Sectors of the Public Administration in Czechia

Sector	1990	1993	1995	1996	1997	1998	1999
Central government [1]	n.a.	8761	8660	9841	10683	N/a	N/a
- 1993 = 100 %	-	100	99	112	122	N/a	N/a
Regional governments [1]	n.a.	25216	31186	30891	31294	N/a	N/a
- 1993 = 100 %	-	100	124	123	124	N/a	N/a
Public adminst. (army+police excl.) [2]	95743	132675	161644	167917	175478	176959	177770
- 1990 = 100 %	100	139	169	175	183	185	186
Education [2]	316807	323893	321601	321839	308612	304097	298272

Sources: [1]data of Czech Statistical Office, special survey of 1998,
[2] Statistical Yearbooks, Labor Statistics, 1997 and 2000 (p. 289)

It can be argued that the mentioned problems are universal to both small and large enterprises. This idea is false. The above problems are usually encountered as fixed transaction costs which are not proportional to the size of the firm (Molitor, 1995). It was estimated in the USA that the cost of the administrative regulation represents 8-9% of the GDP. Stein, Hopkins and Vaubel, 1995, presume that the West European losses due to regulation are higher than in the USA. We can thus assume that the situation in the traditionally bureaucratic Czech Republic must be even less favorable than in the EU and its small firms are challenged with more obstacles than in the majority of developed industrial economies.

The proposed improvement in the public administration can be seen in the abandoning of the extensive prescriptive legislation, targeted at means, and its superseding by the legislation targeted at objectives. Instead of paternalizing of who, what, how, when and where one must (or must not) do, the new liberal regulation commences with the list of objectives and the choice of means is to a large extent left on the incumbent economic agents. Unfortunately the Czech tradition in the public administration has its roots in the authoritative bureaucracies of the Habsburg monarchy, Nazi Germany and Soviet Russia. Though there were many positive changes on the way for dismantling the institutions of central planning, the Czech public administration has "recovered" recently from the shock of "anarchy" of 1989-93 and re-gained some of its former Kafkaesque features, conflicting with the management of a performing market system.

The performance of the government, bureaucracy and the inflated taxation and budget spending will remain the most important burdens to entrepreneurial dynamism in this country. The entry into EU will have a positive effect in this respect because the European Commission is a much less bureaucratic institution if compared with the present Czech state of affairs.

9. Potential Challenges to Generic Private Sector in the Long Run

Figure 5 describes the present and the expected long-term developments in the Czech economy. The graph is based on comparing the costs of production with sales (output). The downward sloping lines represent alternative unit-value isocost functions C:

$K = - (w/r) L + B/r$

for a budget B = 1 mil Korunas where K, L are capital and labor used,

w = wages and r = rental of capital.

Y = convex Cobb-Douglas unit-value isoquants of production (in value added) functions for three types of commodity groups:

a/ capital intensive ("machines"),

b/ rather labor intensive ("textiles"),

c/ non-traded commodities that are highly labor intensive.

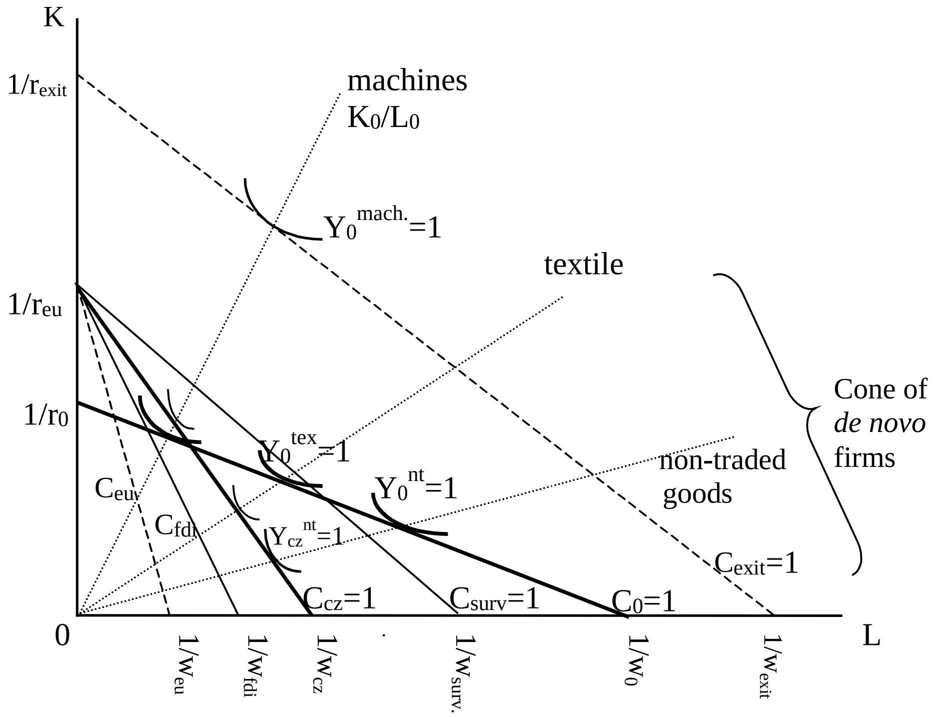

Figure 5: The position of production in SMEs after the tightening of budget constraint if both labor and capital costs converge to factor price levels of the EU due to FDI inflows

The set of rays originating at zero point represent their average capital per labor requirements. Since the majority of Czech generic private firms are concentrated among the labor intensive industries, we show also the "cone of *de novo* firms" that covers non-traded sector and a part of "textiles".

Thick C_0 isocost line represents a cost benchmark as was set by the process of transformation around 1999. The wages were low (1/6 of the average EU wages – see the distance between $1/w_0$ and $1/w_{eu}$) while the cost of capital (r) was approximately by 50% higher than in the EU what is depicted by the distance between points $1/r_0$ and $1/r_{eu}$. The isoquants of restructured indigenous firms should be tangent to the isocost C_0, similarly like Y_0^{nt}. Nevertheless, not all Czech firms were restructured at that time. Some production isoquants were hanging well above C_0, like that of Y_0^{mach}. That firm was wasting its substance, being on a verge of its exit. Its survival is possible only if both its wages and its capital returns are very low, as depicted by isocost C_{exit}. Thus indigenous firms have their isoquants located in the space between C_0 and C_{exit}.

As the transformation draws nearer to its close (for example in 2000-2005), the indigenous firms are challenged by imports from the EU (their isoquants are tangent to C_{eu}) and by technically superior domestic firms with foreign owners (tangent to C_{fdi}). The cost of capital becomes the same as in EU. Foreign and the successfully restructured indigenous firms raise the real wages to $1/w_{cz}$ [26] and the cost benchmark moves to C_{cz}. The indigenous firms that did not restructure in time will be challenged by bankruptcy. The generic private sector will be both relieved and burdened with the new situation. On one hand this sector will adjust most easily in the non-traded industries. With no competition from imports its prices could increase [27] and its isoquant Y_{cz}^{nt} would shift down until it becomes tangent to C_{cz}. This will be the situation in many SMEs in services.

The stabilized enterprises in capital-intensive industries will be significantly relieved, as the isoquant tangent to C_{cz} lies higher than the original one that is tangent to C_0. Indigenous industries in the labor intensive internationally competing industries will be most harshly hit. The labor cost will become too high and a new round of restructuring will be required. As an escape strategy, the labor intensive manufacturing industries could avoid a full adjustment in their wages, becoming a niche for poorly paid workers (e.g. the non-permanent vagrant workers from abroad). Their unit-value isocost line will shift to C_{surv}. It is questionable if such a survival strategy could be viable once Czech foreign policy built barriers to the immigration of cheap labor from Eastern Europe.

The realism of these changes in competitiveness may be signaled by a change in strategies of FDI which became recently more attracted by capital intensive industries and by investments into labor intensive service sector operating in non-traded products (see Benacek and Visek, 2000). In the manufacturing sector the already restructured enterprises active in capital intensive industries will get an additional impetus for growth while the firms active in labor intensive manufacturing industries, i.e. where the *de novo* firms had initially favorable conditions, will be challenged with new hardships as the labor will become too expensive. Thus we cannot expect that the build-up of the *de novo* firms has been recently stabilized in all sectors of the Czech economy.

[26] The wages in terms of Euros will more than double. That can happen either by nominal increases in wage rates (under constant exchange rate) or by mere real appreciation of exchange rate. That also means that the existing differences between nominal GDP per capita (e.g. in Euro) and GDP per capita in purchasing parity will be eliminated. The decrease will be from the existing ERDI factor of 2.4 to unity.

[27] The shift of the isoquant Y_0^{nt} along the K/L ratio from the tangent point on C_0 to the position of Y_{cz}^{nt} tangent with C_{cz} will require approximately a 60% price increase, what is quite realistic in the present situation when the price of Czech services is often a half or one third of the EU prices.

10. Policy implications and conclusions

The main findings in the paper can be summarized up in the following list of conclusions:

- The long-lasting problems of the Czech economy, which became apparent at least since 1996, have their roots in the behavior of a significant part of the domestic enterprise sector.
- These problems were called into being by a very intensive, nevertheless deeply non-standard mass privatization and the negative externalities it had on the behavior of economic agents and institutions throughout the Czech economy.
- The authentic (generic) private sector cannot be based on a command coming from the upper hierarchies of the social organization. It can arise only from gradual acts at the level of economic agents making their decisions autonomously at the grass roots of the economy.
- Soft market environment set by the Czech mass privatization policies was counter-productive for the development of entrepreneurial activities as defined by Schumpeter. It also did not remove the soft budget constraint in a large part of the domestic firms.
- The lobbies of pressure groups, defending the privileges of former socialist corporations, became dominant in shaping Czech politics, fiscal and banking economic policies and the build-up of economic institutions. The authentic private sector that evolved mainly from small and medium-sized enterprises was driven from its start to a position of an outsider.
- Notwithstanding the lack of government support, market imperfections, bureaucracy and failing judiciary, the sector of newly established businesses has shown a high degree of viability and at the end of 90s it became a dominant player on the market side of the Czech economy.
- The future of the Czech economic development cannot be separated from the situation in both the enterprises under foreign ownership and the small and medium-sized firms under indigenous owners. The co-operation between these two healthy segments of the Czech economy the can strengthen if the spillovers from the foreign-owned large firms increase the competitiveness of the indigenous sector.
- In many aspects mass privatization not only fails to improve the performance of the frail emerging markets in transition – it can even break down its evolving institutions.
- Past merits of mass privatization should be subject to a fundamental overhauling on both the academic and the economic policy sides. The quality of privatization matters and the lesson of the "super-fast" Czech privatization points to many dangers which mass privatization techniques can bring into life and entrench them for a long time in the development of institutional frameworks.
- The economic policy-making should be more instrumental in providing more support for the requirements of these two progressive segments of the Czech authentic private sector.

- The main fields for support are expected to be in the less bureaucratic public administration, customs, investment deregulation, investment fiscal relief, support of the information and transport infrastructure and further improvements of the business legislation and property rights enforcement.

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APPENDIX A: **Role of SMEs in Increasing the Contestability and Efficiency of Imperfect Markets**

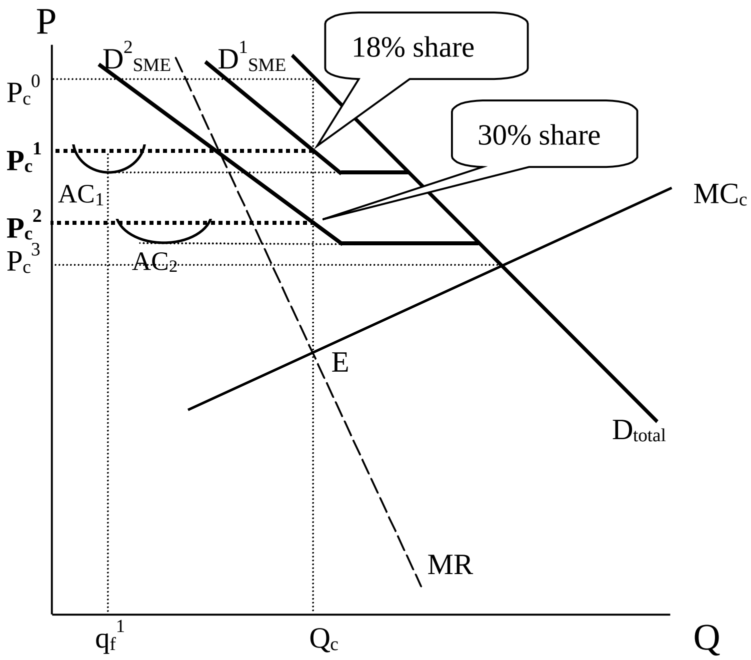


Figure A1: Price and market share competition between a cartelized oligopoly and a SME fringe competitors and the reason for SME industrial policy support

Cartel c acts first as a rent-seeking monopoly charging price P_c^0. With this price given, fringe competitors f (a set of SMEs) can enter the market. First they occupy a niche depicted by average cost curve AC_1 and get a marginal share (18%) of the market by selling at q_f^1. Firms f, operating on a fringe left by the monopoly, always behave like a price taker, adjusting their price to what the cartel charges. That is why we do not follow a Cournot game principle in our analysis [28]. The 18% market share of SMEs means that fringe can “bite-off” 18% of the total demand curve D that first belonged fully to the oligopoly. SMEs, however, cannot sell at price below the minimum of the AC_1 curve, so from all prices lower than that the total demand belongs fully to the cartel. Nevertheless, cartel must adjust the price due to SME competition. Though the price setting remains all the time subject to the point of MR and MC intersection at E, the kink on the total demand, due to the existence of D^1_{SME}, will press the cartel to decrease the price to P_c^1.

[28] Maybe we should reinterpret this model by using Cournot strategies but the SMEs would then become a part of the market power game. That is not very typical for SMEs since there is a problem of their capacity to act in collusion. Their large number and individual smallness offer many reasons for difficult co-ordination and easy deflection.

If the fringe competitors succeed in expanding their production by investment, they could shift their average cost curve to AC_2. The outsiders from SMEs so become serious players on the market by taking 30% of the market share. At that moment another round of price adjustments must be introduced. As the price falls to P_c^2 the cartel will still sell at Q_c but its monopoly power is seriously undermined. However, if the cartel decides to cut the price to P_c^3 or below (what would be a predatory dumping policy) then the fringe competitors would go to bankruptcy. In that case the only way how to uphold the fringe competitors and with them the consumer welfare is either to provide a subsidy to SMEs or to levy a fine to the monopolist for an illicit predatory practice violating the laws of fair market competition. Industrial policy supporting the SMEs can be a very important instrument of market contestability, production efficiency and consumer welfare.

The following conclusions can be derived from our model:

- The position of SMEs is very weak if the domestic industry is dominated by a cartel and the scale economies are important.
- It is very important what is the size of the domestic market. In case of a small country the existence of a monopoly (or cartel) and a low contestability are probable. With it we can expect higher inefficiency and deadweight losses in a small country.
- The enlargement of the market (e.g. by the entry into the EU) will hurt both f and c on domestic market if the contestability would rise and the price would fall bellow P_c^3. However, if the price in EU will be at least at P_c^3, the EU enlargement can be a favorable event for the domestic industry.
- The entry of a small firm into the market is very risky because at the market share of q_f^1 even a small price decrease can endanger its viability.
- The entry of a small firms is more probable if the sunk fixed costs (e.g. the capital expenditure) is not large. That means the SMEs are more probable to exist in labor intensive industries.
- SMEs can be more competitive if they are able to adjust the wages to their standing of competitiveness vis-à-vis the large competitors.
- The expansion of SME is risky if it is subject to capital investment financed by bank credit lines. It would be a moral hazard of the bank to lend to a SME, once the price war (a decline below the minimum of AC) can be envisaged.
- A cautious industrial policy to SMEs can be justified in three ways:

  - in supporting the credits to SMEs (e.g. in mediating the guarantees and subsidies to interest payments),

  - in lowering the transaction costs of SMEs by which the average costs decrease and allow the SMEs to survive downward price fluctuations,

  - in controlling the fair competition on the market.
- The industrial policy supporting SMEs can lead to net social gains since the cost of the intervention is lower than the benefits (in price decreases) that viable SMEs

bring to the society. It will also increase the competition leading to long-term aims at bringing technical efficiency improvements and lowering of prices to customers.

- The moral hazard associated with policy supports of SMEs can also lead to lobbyism and abuses of such policies. The strategic policy is justified only on account of market failures. If they are not evidently present, the Government support of SMEs is a wrong policy.
- The argument in favor of the policy support of SMEs is in fact a variant of the Brander-Spencer model of strategic trade applied on government intervention in cases of export promotion on imperfect markets. See Brander and Spencer, 1985, or Brander, 1986, for more details.

APPENDIX **B**: **Empirical Evidence Provided by the World Bank Study**

(Tables and figures here see Selowsky, Mitra et al., 2001)
<u>Sources:</u> World Bank database on SMEs

AS Figure B1 shows, the leading position of the Czech indigenous entrepreneurship froze to a stagnation after 1995. It was in that year when large mass privatized enterprises entered a stage of the "third wave of privatization" which was characterized by asset stripping and a possibility to exploit numerous other implicit subsidies (unpaid bills, taxes, social and health insurance, privatization installments; soft bank loans, etc), which artificially raised the competitiveness of the large firms. At the same time the employment in the Czech small enterprises retained its slowly rising trend. Thus the development in SMEs after 1995 shows signs of depletion of entrepreneurial vigor, as the barriers to SME development were rising and the large firms were crowding-out the space for SME expansion.

Figure B1: Share of Value Added in Small Enterprises
(Firms with 50 employees or less)

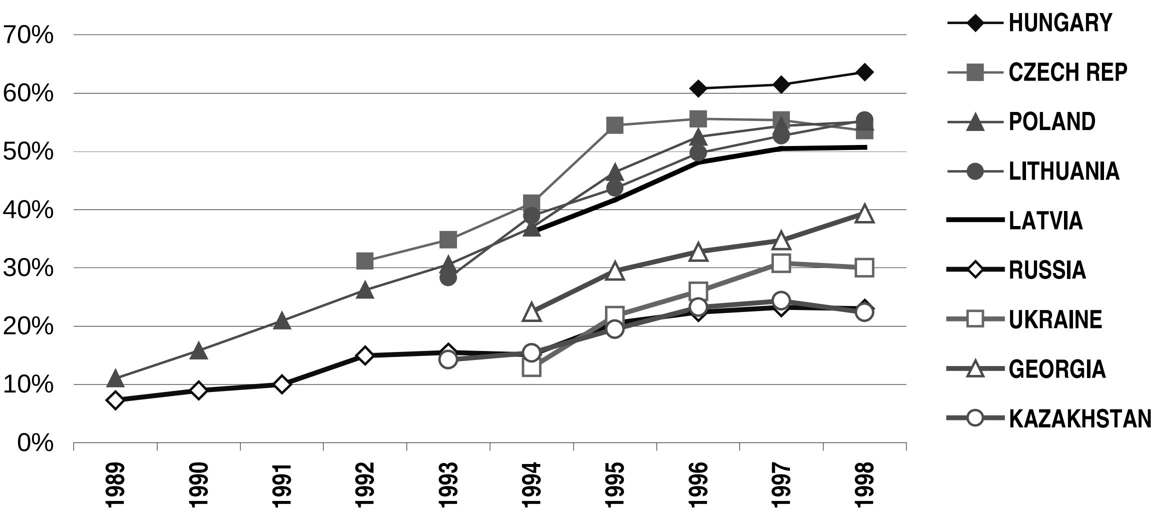


Table B1 points to a fact that labor productivity in small enterprises in nearly all transition countries is larger than in the rest of the economy. In Czechia it was still by 9.9% higher than in enterprises with more than 50 employees, notwithstanding the stagnation in 1996-98. We should also keep in mind that small firms had to compete with a substantial sector of foreign firms where productivity was significantly higher than the average. Small firms are also more labor intensive, as their access to capital was limited. That naturally decreases the productivity of labor at the expense of gains received from the saved physical capital.

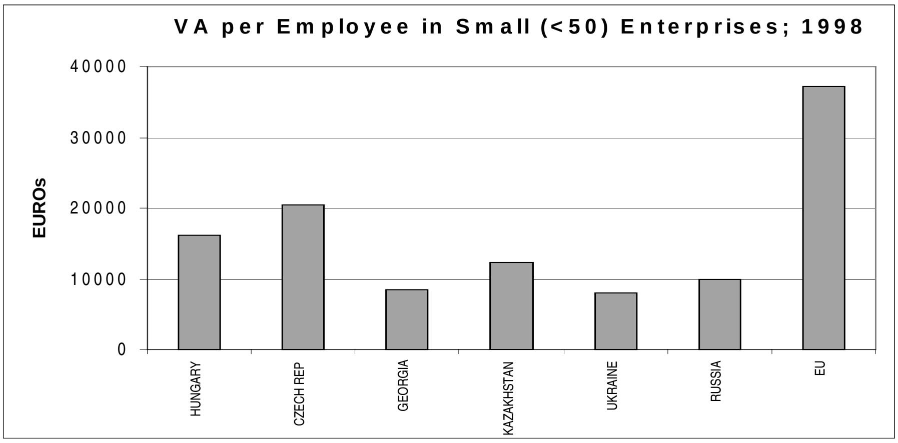
Table B1: **Employment and Valued Added in Small Enterprises, 1998**
(Average for all enterprises = 100%)

	% SMEs	Employment	Value Added	VA per Employee
HUNGARY	96.1%	54.9%	63.6%	115.8%
POLAND	92.1%	45.7%	54.4%	118.9%
CZECH REP.	97.0%	48.7%	53.5%	109.9%
LITHUANIA	97.4%	55.1%	55.3%	100.4%
LATVIA	91.2%	45.5%	50.4%	110.9%
GEORGIA	88.6%	39.6%	39.3%	99.2%
KAZAKHSTAN	88.6%	15.6%	22.4%	143.6%
UKRAINE	69.2%	16.9%	30.0%	177.5%
RUSSIA	56.3%	18.6%	23.0%	123.7%
BELARUS	37.7%	15.9%	n.a.	n.a.

Note: Firms with 50 employees or less. Sources: The World Bank database on SMEs

As Figure B2 points out, the labor productivity of Czech small businesses reaches only 56% of the average level of the EU. That is slightly less than what was the gap between the Czech GDP per capita at purchasing power parity and the EU average (approximately 60%). The lead over the Hungarian productivity by 23% is, nevertheless, a success.

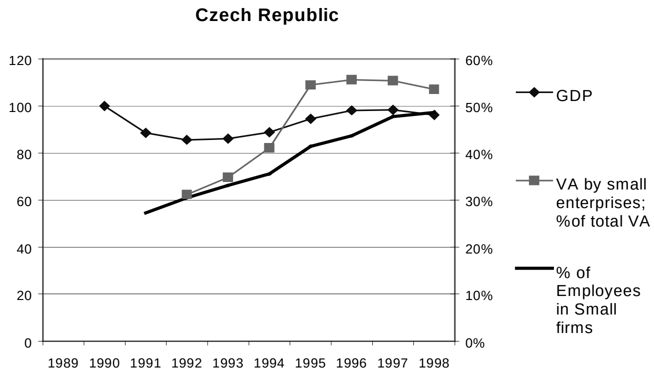
Figure B2: Comparison of productivity in small enterprises with EU



Source: World Bank database on SMEs

While the left-hand scale of Figure B3 depicts the cycle of Czech GDP, the right-hand scale describes the share of value added and employment in small firms on the total statistics. The exponential growth of production is small firms evident since 1992 was sharply constrained at the end of 1995 when the “third way” of privatization started to crowd out the resources for the SME development. Though the employment in small firms continued until 1998, its productivity was declining. The further development of SMEs received serious blows in 1997-99 and its partial recovery happened only in 2000.

Figure B3: GDP, value added and employment in small firms (< 50 employees)



Source: World Bank database on SMEs, 1998