

**SMALL BUSINESSES AND PRIVATE ENTREPRENEURSHIP DURING
TRANSITION.
THE CASE OF THE CZECH REPUBLIC.**

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A B S T R A C T

The impressive and spontaneous build-up of small and medium-sized private businesses in the Czech Republic between 1990-94 coincided with similarly dramatic changes in the "alternative" (shadow) economy. This is the reason why the size of the private sector is significantly statistically underestimated. The origins of the new private entrepreneurs can often be traced to communist times - to the group of nomenklatura and the group of illicit marketeers. The remaining part of society was partially handicapped in its entry into the new capitalist class because of its lower endowments of various kinds of capital. Macro and microeconomic policy was an important factor in promoting, re-directing and checking the productive orientation of emerging businesses. The formation of capital and the institutional conditions influencing both the efficiency of local markets and the behavioural patterns of entrepreneurs, seem to remain the core of problems affecting the development of the whole economy. At the end of this paper, present small businesses environment is discussed and some policy recommendations are raised.

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The most important prerequisite for becoming an entrepreneur is the ownership of capital.

M. Kalecki (1954)

1. The Position and Role of Czech Small Businesses

There are many studies describing the macroeconomic performance of economies in transition from the command to the market system. There are also many analyses estimating the present and the expected financial standing of companies undergoing privatization. Yet surprisingly, there are only sporadic papers describing the environment from which indigenous entrepreneurship is borne, and in which it is supposed to make decisions in order to survive or expand. The newly created small businesses are especially insufficiently covered, many of which have been established as startups on a green field. Their conditions are often very different from those of privatized state companies and corporations. This paper attempts to unveil a part of that environment, as observed from own experience and from communication with various entrepreneurs who have become increasingly visible during the recent few years of Czech transition.

Non-corporate, small and medium sized enterprises (SMEs) play a distinctive and irreplaceable role in any transition to the market economy. On one hand, in the Czech Republic there were, at the beginning of 1993, approximately 1700 industrial enterprises with over 100 employees (see Charap, Zemplerová (1993)) which, in the majority of cases, were toiling through (or even waiting for) the process of privatization or transformation into microeconomic units with market-consistent behaviour. On the other hand, by December 31, 1993, there were registered 1,262,264 licences to run small businesses or to act as entrepreneurial agents (data from the Ministry of Economy, see *Hospodářské noviny*, 16.3.1994, p.13). Many of these businesses were sole proprietorships without any capital involved and run on a part-time basis, but there were also 15,451 private limited liability companies and approximately 5500 joint ventures. According to the same source, at the end of 1993 877,669 business entities (physical or legal persons) were registered for trade activities operating outside of the corporate business. The speed of SMEs development is also a staggering discovery - during 1993 the number increased by nearly 34 %, despite many exits in that period. This figure also implies an amazing real expansion both in output and in employment.

We cannot directly quantify the number of practising entrepreneurs in the country from these figures since some licences could be issued for the same entrepreneur, or some business entity could be represented by more than one entrepreneur. The statistics from the Czech Business Register in January 1993 assessed the total number of registered entrepreneurs at 1,060,222 persons, which would represent 22.5% of the whole labour force of the Czech Republic. If we add to this number their working family members and other employees, we can estimate that approximately a third of the Czech labour force may be fully or partially associated with entrepreneurial activities in the generic private sector with stabilized ownership and performing property rights. These estimates imply that the boom in the SMEs was the most dynamic economic factor behind the stormy changes in the new capitalist developments in Czechoslovakia which were initiated practically from scratch in November 1989. **The crucial aspect of this occurrence is that it evolved spontaneously from the grass roots of society.** Without understanding the background of this fact and its effects on the whole economy, one cannot get to the fundamentals of the Czech economic transformation, its successes and problems.

The following working hypothesis can now be raised: Even though the generic private sector (voucher privatization excluded) officially produced 21.5% of the GDP ² in 1992, its statistically unrecorded activities (including illegal or semi-legal activities) may have substantially compensated for

² *There are many quantifying characteristics and data used throughout this paper. In order to convert the Czech currency (Kč) into US dollars the fixed exchange rate of 28.50 Kč/\$ can be used for 1991-94. The nominal GDP in 1993 was 923 bil. Kč, what makes approximately \$ 3100 per capita. The Czech Republic had 10.4 mil. inhabitants in 1993 and 4.8 mil. persons were officially employed.*

the officially reported fall of 27 % in total production between 1990 - 1993. While on one hand the factual Czech effective domestic production, even with this additional injection included, experienced in 1990-93 several severe structural shocks on the demand side, followed by an intensive reallocative shakeout and falling output in many traditional industries, on the other hand the average household welfare could be still characterized as stagnating or even rising due to improved quality of products, expansion in the service sector, changed structure and the disappearance of shortages and queues.

The Czech household income developed during the first four years of transition subject to the following adverse conditions:

- high uncertainty about its future flow,
- risk of layoffs,
- a sharp rise in the unequal distribution of income,
- stress about the need to acquire new skills,
- increased intensity of effective work (with the exception of some state companies and bureaucracy).

These negative externalities could have caused more dissatisfaction within the households about their "way of living" than the presumed loss in the official real income and the alleged declining standards of consumption. How can the gap between the official figures derived from the "normal economy" and the reality be explained and, if possible, quantitatively assessed? The problem rests in **the size of the second economy**. For better understanding, we shall divide the second economy into "the black" and "the shadow" economies. The former activities are explicitly prosecuted by law, like violent crime, drug dealing, theft, extortion, smuggling and some forms of prostitution. The latter deals with the remaining, seemingly "normal" economic activities which are concealed from official statistical recording. They vary from tax frauds to do-it-yourself engagements.

The size of the Czechoslovak shadow and black economies can be very roughly estimated on the grounds of the following phenomena:

a) In the period of 1990 - 1993 it was recorded at the Czech Statistical Office that 678,000 persons had quit work and, at the same time, there were 205,000 school leavers entering the labour market. Out of the acquittals, 308,000 workers left for retirement and 185,000 registered as unemployed (see Ekonom No. 19, 1994, p. 18). This means that the final assignment of 390,000 persons (i.e. approximately 8% of the total Czech labour force) remains unknown. It is assumed that they, to a large extent, "disappeared" into the black and shadow economies. The OECD estimates that in 1992 350-400 thousand persons of productive age may have been employed in the Czech shadow economy alone (see OECD (1994), p. 15).

b) It is estimated that a large part (30 - 60%) of the registered "unemployed" may in fact work illegally in the private sector, generally as cheap (and insurance and tax free) part-time workers. The number of unfilled vacancies remained large, even though, according to the official statistics, it has been slowly increasing for the whole 1993, but since 1994 it has begun to fall again. For example, in September 1993, 1.8 unemployed people per one vacancy were reported in Bohemia, while in Moravia it was 7.4 unemployed per one vacancy. The adjusted (i.e. slightly lower) real figures may still point to a very relaxed situation in the labour market in the majority of districts throughout 1990-93.

c) A significant number of full-time employees have private "parallel fringes" during their working hours and also second or temporary jobs abound. A large part of these go unrecorded. In 1992 the wages and salaries formed only 49% of all personal income. According to a 1993 microcensus, 29.8% of all household revenues were collected from "other economic activities", i.e. in second jobs, casual contracts and capital gains (Hospodářské noviny, 16.3.94, p. 7). In 1991-93 the official aggregate domestic expenditure (including the rising savings) regularly exceeded the aggregate disposable income by 20-35 bil. Kč.

d) The estimates made at the Ministry of Economy concluded that the receipts from tourism, as recorded in the balances of the Czech National Bank, were not consistent with the micro-census on tourist spending. The gap between them may run up to 51 bil. Kč in favour of unrecorded earnings (see Ekonom No. 19, 1994, p. 22).

e) Many managers of corporations undergoing privatization under the voucher scheme, or managers in restituted firms, have used the environment of weak ownership control to find for themselves

a safe niche allowing them to exercise their own shadow entrepreneurial activities by exploiting the resources and abusing their power over the company which hired them (Prague Post, 23.3.94, p. 5).

f) The output and sales of many private companies is, to some extent, unrecorded and thus underestimated by official statistics, tax evasion being the main motive. The booming years for profit tax evasion were 1991-92, while the introduction of VAT in January 1993 has checked its further growth. On the other hand, the new scheme's two tier system of tax rates (23 and 5 %) offers new opportunities. For example, an 18 % additional profit can be earned if some commodity can be easily declared for the lower 5 % rate, while the sales price includes the 23 % rate. The tax frauds from the retained VAT and excise taxes charged on diesel oil sales (while declaring it as the heating fuel) in 1993 were officially estimated to run up to 5 bil. Kč³.

g) The construction sector, which experienced one of the most dramatic changes during the transition shows many ambiguous features. On one hand, it was the sector with the fastest process of privatization. In 1993 the private construction firms provided 73 % of output. State construction behemoths disintegrated spontaneously into small private working units based on intensive subcontracting. The nature of their business makes the tax and the employment monitoring very difficult. On the other hand, the officially reported output in construction declined more than in other sectors. For example, its share of the Czechoslovak GDP declined from 8.7% in 1989 to 6.6% in 1992, while its share of total employment in the Czech Republic has risen from 8.2% to 9.7%. At the same time, wages in this sector after 1989 steadily grew much faster than average, and its private firms were overloaded with contracts. One possible explanation of this phenomenon would be that the construction sector is systematically underreporting its activities.

h) A similar argument, as related to the construction sector, can be raised with the service sector. With its new booming private ventures and the share of its total employment rising from 42% in 1989 to 49% in 1993, it provides even more potential space for underreporting.

i) With the liberalized foreign trade and with the rise in the number of joint ventures, the occurrence of unreported activities and tax evasion have much wider space for maneuvering. The comparison of the Czech foreign trade statistics by individual countries with the data recorded in the neighbouring countries, points to a systematic underestimation of Czech trade flows. In 1991-92 the Czech figures for exports and imports were by 4-6 % lower.

j) The booming inward processing traffic contracts, used intensively in many Czech labour intensive manufacturing industries, may, due to its forbearing customs regulation, underestimate the real contribution of some industries to GDP.

k) The expansion of the Czechoslovak money supply in 1992 neither decreased the credit crunch (or lowered the interest rates) nor increased the inflation. M2 increased nominally by 27% while the inflation in 1992 was 11.5% and the reported real GDP fell by -7%. The real increase in M1 was also positive (+4.5 %). We can presume that the higher growth in money supply was met by a hidden growth in output of the shadow economy.

l) Preference of work to leisure. According to a January 1994 microcensus (ECOMA), in 1993 32.9% of Czechs did not go on holiday (though they officially took leave) or used only a part of their annual paid leave entitlement. From this, it can be interpreted that the tradeoff between the official offer of leisure and work was biased towards work, and that there were sufficient opportunities to engage in some sort of rewarding work.

m) There were 76,000 people registered for work abroad (e.g. for daily commuting to Germany) at the end of 1992. The real employment of Czech citizens abroad may be significantly above 100,000 jobs, with their relatively lucrative income being predominantly spent at home. The Bavarian Chamber of

³ More speculative estimates inferred from the sudden drop in diesel oil sales after the introduction of VAT and tax frauds from the oil re-export, calculate the potential tax loss at 20 bil. Kč (Telegraf, 28.3.94). The excise tax losses due to tobacco smuggling was officially estimated to be 1-1.5 bil. Kč in 1993. The smuggling of clothing is estimated to cover 30 % of sales, i.e. at least 1.5 bil. Kč (Profit, 21.11.91, p.4). Trafficking in antiques and objects of art abroad is estimated at over 2 bil. Kč per year.

Commerce estimates that Czech daily commuters alone bring from Bavaria at least 300 mil. DM per year (Hospodářské noviny, 22.7.93, p. 6).

n) In June 1993 there was a community of 110,000 registered immigrants in the Czech Republic (coming mainly from Eastern Europe), 61,000 of them registered for long-term stays. They are often engaged in unrecorded temporary jobs and the second economy.

o) Very low share of private entrepreneurs in the aggregate profits in the generic private sector. In 1992 Czech limited liability companies reported 12.5 bil. Kč of profits, while those 670 thousand private entrepreneurs, registered as business entities, declared only 2.6 bil. (i.e. 16 % of the total, see Ekonom, No. 6/1994, p. 27).

p) The stock of inventories decreased in 1992-93 by 73 bil. Kčs (measured in constant prices of 1984, see PlanEcon (1994, p. 16)). A significant part of the sold "useless" inventories were siphoned off by the managers in state enterprises to owners of aligned private firms, with the prices being correlated to the closeness of shared vested interests in these links.

It can be roughly estimated from these facts, by assuming that unreported employment was as productive as in the rest of the economy or by adding the unreported revenue to the official figures, that the actual production must have been significantly higher than the officially reported one. It can also be roughly estimated that at least 18%, but potentially even up to 35%, of the labour force in the Czech Republic may be engaged (as a regular or temporary profession) in the shadow or the black economy. If their income were to be added to the official figures of the GDP, indicating the real fall in output of 27 % in 1990-93, **the alleged dramatic decline in the standard of living over the last 4 years may not be a reality**. Thus the unrecorded activities of the second economy might significantly compensate for the fall in the official figures of the national income.

Apart from the second economy, there is another reason for an incomplete and unreliable statistical recording. The state system of statistics suffered a great deal from the breakdown of the hierarchical structure of central command, the proliferation of new firms and the changes of ownership. Many skilled statisticians moved to better paid jobs in the private sector. Also the whole system of statistical reporting was nearly completely modified. While the errors and omissions in reporting from all economic agents (both small and big) have risen sharply, the capacity to prosecute them decreased. What is of more importance is that this situation has been widely expected, tolerated and thus abused. Combined with the infant tax enforcement institutions, the resultant bias leads to a one-way loss of information and the underestimation of income statistics. The distribution of undetected "errors" has a natural tendency to be biased to the negative tail of the sample, i.e. in favour of the suppliers of information.

All this may explain the following phenomena which are not compatible with dramatic declines in disposable income:

- * No strikes.

- * No visible starvation or extensive pauperization.

- * The belief of the median Czech voter (revealed in many public opinion polls) that layoffs, unemployment and bankruptcies should be expected to rise in the future and that they are a necessary condition for future prosperity.

- * Reversal of emigration. For example, in 1992 only 468 persons emigrated from the Czech Lands to the West, whilst 7332 persons settled permanently in the country (Hospodářské noviny, 21.4.93, p. 1). This development is incompatible with the patterns of 1968-1989 when the average annual Czechoslovak emigration numbered 12,000 persons.

- * Increased propensity of households to save from their income. The behaviour changed dramatically from a steady average of +3.3% during the whole 1980s and a rock bottom -2% in February 1991, to an average of 14% in 1991-92 and to 20.6% for 1993 (Czech National Bank statistics).

- * General satisfaction of the population with the living standards. For example, in March 1993 72 % of the Czech respondents in a public opinion poll declared that their standard of living was either higher (31%) or the same (41%) "as in the past". Similar opinions were reported in January 1994 when dissatisfaction was revealed (in three different and independent surveys) by only 8%, 23% and 36% of

the questioned households.

* High level and steady rise of outgoing foreign travels, especially for summer holidays in Spain, Italy, Croatia and Greece and skiing in the Alps. In 1993 the expenditure on tourism recorded by The Ministry of Industry and Trade increased by 9.5% to \$ 505 mil. (i.e. approximately to a half what is spent on foreign tourism by the average Spaniard).

* Rise in purchases of some high cost durables, e.g. the sales of cars increased from 137,000 in 1987 to 267,000 in 1992, the majority of which were imports from the West. A similar pattern was observed in Poland (see Winiecki (1993)), where the majority of households significantly increased their wealth and the consumption of durables during transition.

* Difficulties of businesses in filling vacancies even in areas where official unemployment figures are high. The unemployed may often ask for wages which are well above the national average.

Of course, we cannot assume that the whole of the shadow and black economies was created just in 1990-93. What matters is the growth of this sector. A significant second economy existed in the Czech Republic prior to 1990. A large part of it (e.g. artisan moonlighting) was transformed into regular small businesses, some activities simply lost their purpose (e.g. hard currency dealing or the standard consumer goods smuggling) and some lost on intensity (e.g. the extensive do-it-yourself business). However, exits from the second economy were more than balanced by even more numerous entries of newcomers. The bulk of the second economy is formed by formally registered entrepreneurs who prefer not to report (and tax) the full extent of their activities. The Czech black and shadow economies of 1993 may thus be much greater than was presumed and may score between the Mediterranean (20-30%) and the Belgian/Swedish (13%) shares on the GDP, rather than approaching the German standard of 9% (The Economist, 14.8.93, p. 25).

If our reasoning is correct, then in 1993 the effective Czech domestic product, income and expenditure for 1993 could have been significantly higher than reported. As a working hypothesis, let us assume intuitively that **the second economy (in its widest definition) might contribute additionally by 18 - 28 % to the officially estimated GDP.** Of course, the main engine of the hidden dynamics is not to be found in the big old corporate sector, where production was recorded quite reliably and where the development of the shadow economy was checked by other institutional barriers. Here we cannot refute the hypothesis of a substantial real downslide in the corporate sector in 1990-93. The explanation thus remains with the effectively privatized businesses which in 1990-93 could be found preponderantly outside the corporate industrial sector - i.e. in the SMEs. In 1994 the share of the SMEs (including the unreported private activities), which represent the core of generic private sector with solved ownership, may thus even comprise 35-40 % of GDP. This is still less than potential 60 %, as is normal in the developed market economies. On the same grounds, the non-state sector (including the firms subject to both voucher privatization schemes) could have contributed by more than the officially estimated 67 % to the effective GDP at the end of 1993.

It is the medium, small and micro businesses and their hidden shadow parts which should be rated as one of the most important determining factors affecting almost immediately the development in an economy undergoing the transformation from a command to a market system. One of many signals supporting this hypothesis is e.g. concealed in the fact that in the Czech Republic there is a high negative correlation between the number of entrepreneurs in a district and the local unemployment rate. The second economy and the SMEs are also closely interlinked in their functioning, which is expressed by their joint unprecedented expansion immediately after the liberalization of markets. They both rely on the strength of private ownership as closely related to the managerial responsibilities and to the direct link between the decision making and the ensuing profit or loss bearing.

The important role of SMEs in the economic development has also been slowly discovered in the West since the oil shocks of the 1970s and the discovery process is still continuing (see Jong-il You (1992)). Other than directly contributing to GDP, small business development has several **positive external effects which can be classified under the provision of public goods** (see also McDermott, Mejstřík (1991)):

- creation of more competitive markets, better information flows and build-up of institutional

environment;

- source of self-sustained economic dynamism, autonomous innovation and counter-cyclical growth;
- creation of new jobs and high productivity standards;
- absorption of layoffs from the ailing state and corporate sectors. (For example, these net reallocations to the private SMEs comprised in the period 1990-93 approximately a quarter of the Czech labour force);
- training ground of self-starting entrepreneurship and management;
- support of the capitalist ethic, e.g. of the belief that one's own work, as opposed to re-distributional bargaining with bureaucracy, is the source of prosperity;
- creation of a politically stable and strong middle class.

If we wanted to contrast these public goods by potential "public bads" of similar standing and with opposite influence, we could speak about the creation of institutions, pressure groups and habits directed to create anarchy and general disobedience to the law. In fact, that is very close to what some people describe as the post-Soviet syndrome. Its correlation with the lack of space for spontaneous large-scale entrepreneurial expansion in these countries may be more than a coincidence.

If we accept the reasoning that the SMEs as public goods provide external social benefits which cannot be commercially rendered by other autonomous business activities and that these benefits are of exceptional importance during the times of transition, then it would be expected that the conditions for the development of the SMEs would become the focus of fundamental interest for the Czech government, other institutions representing the State and their economic policy. As the evidence shows, in many aspects this has been the case neither in the Czech Lands nor in other transient economies. Is the argument about the government failure in transition well founded ?

There are some views in the economic and business literature that the small business revival of 1970s and 1980s does not constitute a new historical break-through. It means that the Schumpeterian concept of the entrepreneurship is once for ever dead. It need not always imply that it is only the corporate sector what matters. Some authors claim (see e.g. Gábor (1994) as the most outspoken case) that the SMEs in Central Europe suffer of over-crowding and over-fragmentation. It is particularly so in the self-employment, allegedly lured into the business by naivety, short-sighted governmental promotion and the lack of employment alternatives. The emerging dualization of the economy can indeed become a social and economic policy problem.

However, we can doubt whether it may become a real barrier of growth - a trap for employment with no way out. What the present Czech experience shows, this sector can hardly assimilate the problems so well known from the agriculture: hidden unemployment, disintegration of large segments of the society, subsidization and rise of inefficiency from the anti-market intervention. The nature of small business activities in emerging market economies is fundamentally different from this pattern. The SMEs are a result of a deliberate and flexible choice. Their activities are not skill downgrading, the capital involved is highly mobile and they do not preclude the buildup of efficiency in the big businesses. In case of ill performance, a SME becomes a burden to its practising protagonists long before it could become a burden to the government. The argument about the negative externalities of the small businesses is thus untenable. As the profitability sinks and as the endless workload becomes unbearable, the owners of the stricken ventures will move elsewhere - to alternative ventures or to the seclusion of 40 hours per week in the big businesses. In cases that the latter are also in recession, one cannot blame the small businesses and use it as a vehicle against their existence. The transition in the Czech Lands has indeed revived the Schumpeterian entrepreneurial creativity. At this stage it is difficult to claim that it is a permanent phenomenon. Nevertheless, it is certain that this spirit helped substantially in making the transition so successful.

2. Origins of the Czechoslovak Entrepreneurship

There are two roots which have moulded the massive rise of the Czech (and Slovak) private economic activities after 1989: the legacy of Czech capitalism and the legacy of Czechoslovak totalitarian socialism.

The roots of Czech capitalism can be traced to the 1780s, when Czech Protestant inclinations began to be tolerated by the Hapsburg rule. The whole 19th century was thus marked by a Czech national revival (vis-a-vis the Austro-German thrust) that aimed more at national economic prosperity than at plain nationalism. The Czech political leaders of that period, such as F. Palacký (1798-1876) or K. Havlíček (1821-1856), were typical liberal intellectuals with cosmopolitan backgrounds relying more on the Czech bourgeois vitality than on local religious, nationalistic or agricultural sentiments. In 1913 the Czech Lands were the most industrially developed part of the Hapsburg Empire, competing technologically and commercially with the most advanced countries in Europe. This trend continued during the period of Czechoslovak independence in 1918-1938.

The following principles ⁴ characterized the Czech society and formed the economic development before 1938 (see also de Ménil, Maurel (1993)):

- Reliance on democracy;
- A combination of market competition with foreign trade controls, cartels and bureaucratic interventions;
- Restrictive monetary policy and convertibility;
- Enforcement of private property rights;
- Liberal attitude towards religion and other nationalities;
- Competition between Czechs and the local German and Jewish minorities;
- Intensive free trading, mainly with its Western and Southern neighbouring countries;
- Division of labour and specialization in labour and human capital intensive industries.

The Nazi occupation of Czechoslovakia in 1939-1945 severely suppressed practically all of the above mentioned factors. The short period of left-wing Czechoslovak capitalism in 1945-48 was marked by extensive nationalization and the confiscation of property, and by the proliferation of theories of central control. However, some features of small-scale entrepreneurship (the ethic of serving the consumer, esteem for the innovator and the hard worker, self-reliance, independence and sole responsibility of the decision maker, etc.) were retained during 1939-48 and survived in a hidden form until the late 1960s, even though by 1964 practically all private property was liquidated. These were the first roots of the present Czechoslovak entrepreneurship, originating in Czech capitalism. Even though the latter socialist developments seem to be more powerful, the long-lasting effects of this legacy must be stressed. It became strikingly apparent in the districts with capitalist entrepreneurial traditions, contrasting with industrial districts developed under socialism but void of this legacy. The Czecho-Slovak divorce can be, to a large extent, explained by social and cultural conflicts emanating from different attitudes to the past and its meaning for the future.

From the middle of the 1960s Czechoslovakia evolved as a country with practically exclusive state ownership, nearly completely controlled by State bureaucracy. For that reason the Czechoslovak industrial production was organized into approximately 400 large-scale monopolies subject to hierarchical organization - a feature with hardly any parallel in the planned socialist commonwealth. None of the major economic reforms (e.g. in 1958, 1963, 1968, 1974 and 1987) changed these systematically evolving characteristics of a totalitarian state (Kysilka (1988)).

The new Brezhnev style of political and economic management of these enterprises was

⁴ *It is interesting to notice how in just 3 years the Czech society returned to these principles, which the external political forces had been trying to suppress systematically for 50 years. The recovery sometimes went straight to shocking details, like increasing the share of exports to Germany from 8.3% in 1989 to 33.3% in 1992 (the turnover with Germany has increased from 6 bil. DM in 1990 to 15 bil. DM in 1993) or bringing the territorial structure of trade to a close similarity with that of 1928.*

introduced in 1970 as an aftermath of the Soviet invasion in 1968. It deepened the formal hierarchical subordination of everyone to central controls, while informally the hierarchical superstructure received the first series of blows. What was innovative and quite substantial was that the managerial bureaucracy received more space for maneuvering in order to fulfil its planned target of production. As an option, there could either be an inward orientation towards innovation and efficiency or an outward orientation towards negotiations with the vertically superior bureaucracies. The former proved to be much more demanding (and thus less often used) than negotiations for a softer plan, higher prices, pollution control exemption, increased quotas of labour, investments, energy and raw material, etc. (see Quandt and Třiska (1991)). With greater possibilities for the official accumulation of wealth, the first socialist millionaires were cropping up during the 1970s. The inequity of income was also slowly increasing, becoming probably higher than in Sweden at that time. When finally the window dressing of the central planning and the hierarchical subordination were completely abolished in 1990, the enterprises and the economy hardly recognized any change. The "shadow management systems" (see Kysilka (1989)) were already in the full control of the economy at that time.

The Brezhnev style of management was in fact a silent revolution introducing into the ranks of bureaucracy a new generation of socialist entrepreneurs. Even though they were definitely not the Marshall-Schumpeter brand of entrepreneurs, they significantly differed from the Stalinist bureaucrats who lacked education, followed dogmatic doctrines of communist orthodoxy, were void of pragmatism and relied on military-type subordination in implementing decisions. If a bureaucrat fulfilled the (slack) plan targets and showed sufficient loyalty to the superiors, they received a free hand to exercise power over resources, staff policy and bonus remuneration in the economic unit belonging to their respective rank in the hierarchy. On the equal horizontal level of bureaucratic subordination the manager had powers to collude with other "partners" in order to form cartels, information asymmetries and political coalitions which liquidated potential competition in the production, distribution or planning processes. In their relation to various superiors (on the level of state planning, district council supervision and party subordination) bureaucrats had a wide range of alternatives for negotiations and vertical collusions in order to strengthen their strategic standing. In fact, the management of the monopolies or their main divisions was in control of both the micro and the macro levels of the economy (see Mlčoch (1991)).

Typically, career building in socialist Czechoslovakia required the selected future elite to complete university, enter the petty functions in the party network, then work in the higher ranks of the administrative bureaucracy and only after reaching maturity, approximately after the age of 50, could the incumbent enter the lucrative and powerful job of a director of some corporation.

These are the second roots of the Czechoslovak private entrepreneurship, which was surprisingly so quickly and so easily introduced within 3 years after 1989. What is absolutely essential to stress is that **these two roots originated from two incompatible and in many aspects antagonistic social groups**. Let us give these two groups a name, for our better orientation, as **"operators" and "nomenklatura"**. The following approximate list of activities can be made in order to distinguish between the two categories:

Group (i) - operators: restaurant and hotel staff, cab (or any automobile) drivers, foreign exchange touts, greengrocers, used car dealers, repair workers, shop managers, shop assistants for personal sales, petrol station operators, stock keepers, popular entertainers; agents selling or buying scarce supplies; administrators of queues, bureaucrats issuing licences, certificates and permits; artisans, tradesmen; ringleaders of organized crime, prostitution, etc.

Group (ii) - nomenklatura: directors of companies, their deputies, heads of divisions or financially independent units, paid party apparatchiks, high-ranking bureaucrats at ministries, district and municipal councils, etc. Please notice that this definition of nomenklatura covers wider groups than the politicians of the Communist Party, army officers and police agents, as is sometimes implied and it does not include the rank-and-file Party members. When speaking about nomenklatura we should distinguish between the ranks (e.g. of those of the Central, County or District Committee subordination levels).

Table 1 gives a review of the most typical characteristics in which these two groups differed. Both of these entrepreneurially oriented groups also shared some similar characteristics and values:
- reliance on their own decision making from a set of alternatives;

- collusion with bureaucratic networks;
- barriers against the entry from the group of outsiders;
- position of a social minority with class distinctions (e.g. in a intuitive estimate the first group may have formed 10-15% of employment, the second group 4-8%);
- wide involvement in money transfers with other economic agents;
- higher income (including unofficial and fringe incomes), e.g. in the late 1980s the income differentials relative to the average could have been (with an intuitive guess) 2-10 times more for operators and 2-5 times more for nomenklatura;
- accumulation of money (cash, bank deposits and convertible currency holdings) or wealth (real estate);
- feeling of being an overworked elite with natural privileges;
- high pragmatism, adaptability and propensity to tolerate or use unethical principles as their means;
- admiration of the Western (mainly lower middle class) life-style;
- persuasion that the state-owned physical and financial capital, administered by them on an employee contract basis, is so much identified with themselves that they can use it as their own property and appropriate a part of the accrued profits or wealth.

Without doubt, even though the vested interests of both macrogroups were of a conflicting nature, the mutual dependence of both groups in their daily working routines on liquid money, bureaucratic networks and shadow markets, the availability of which was not uniformly distributed among them, pressed them to a close collaboration, tolerance and final collusion in running business.

There is still one aspect left which requires comment - the influence of foreign capital and foreign entrepreneurs on the local capitalistic scene. While foreign capital was officially barred from entering the small-scale privatization scheme, and foreign portfolio investments went beyond our definition of small and medium entrepreneurship, there was still a large space remaining. Foreigners could enter the local entrepreneurial class either by using domestic fictitious owners or, in case of Czech emigrants, by accepting Czech citizenship and Czech permanent residence. The high purchasing power of foreign capital became an immediate advantage, hardly matched by local capital. The link between foreign capital and domestic entrepreneurs (real or fictitious) is thus very difficult to uncover, even though it may be quite strong. The evidence that only approximately a quarter of the small scale privatization transactions were leveraged by bank loans, may lead to the assumption that the share of the foreign capital behind it must have been significantly higher than officially recorded.

Let us now concern ourselves with the group of remaining "non-committed" citizens or workers, who fell into neither of the above categories. We shall call them "**outsiders**". The basic question is whether this group was void of entrepreneurial or managerial talent or not. The outsiders form a very heterogenous group whose core consists of people who never aspired to be leaders, innovators or independent workers and who would enter the ranks of entrepreneurs only by mistake. Within the ranks of outsiders there is a large subgroup of professional workers of technical orientation (engineers, computer whizzkids, workers in applied sciences, etc.) whose ambitions to be independent can be strong. Another important subgroup is formed by low-ranking managers (e.g. supervisors, foremen, heads of a small team) whose "higher" position in socialism was generally not associated with privileges (it often implied more work for less pay). The last two subgroups have without doubt serious potential for the recruitment of entrepreneurs. Hence the whole heterogenous group of outsiders, which comprised more than three quarters of the inhabitants, seems to **contain at least as many potential entrepreneurs as in any of the remaining (much less numerous) two groups**. However, now it should be explained why the outsiders still must remain strangers to the fulfilment of that goal.

The mechanism of career building under communism was such that only a fraction of the talent was asked or conceded to enter the ranks of the nomenklatura. The majority, either by being blankly refused or by having ethical/aesthetic inhibitions that kept them from fighting for attention, had to satisfy themselves with staying with the crowd. Entry into the group of operators was also limited in that it required a certain amount of capital and certain skills, which, because of their low educational demands

TABLE 1: Characteristics of two types of entrepreneurship in Czechoslovakia

CHARACTERISTICS	CAPITALIST ROOTS (i)	SOCIALIST ROOTS (ii)
Type of market environment	Perfect competition	Imperfect competition
Attitude to market	Market development	Market suppression
Communist party support	Negative	Positive
Size of activity	Small business	Corporations
Main fields of activity	Small scale services and exchange	Corporate sector, material production, banking
Contacts with state bureaucracy	Occasional (though bribing)	Daily (through subordination)
Original source of power	Bargaining skill	Politics, personal networks
Source of main income	Shadow or illegal	Official remuneration
Fringe benefits	None	Various (housing, car, travels, etc.)
Execution of power	Through skill and cash	Through bureaucracy, remuneration and pull
Social prestige	Low	High
Risk taking	High	Low
Level of education	Low	High

and slicker nature, were intellectually not very appealing. So the entrepreneurially minded members of the subgroup of outsiders could satisfy their natural urge by organizing sports, arts, hobbies, holiday trips, children`s camps, local trade union events, underground political dissent, etc. Their entrepreneurial skills were to a large extent frittered away by being involved in non-business oriented activities, practised nearly exclusively on an amateur, voluntary and un-paid level, without any professional aspirations. Nevertheless, their skills were not completely wasted or forgotten, and their results were often internationally recognized (e.g. in sports or arts). It was these very people who were pressed to take the badly paid low-ranking positions of team heads and assigned some organizational responsibilities.

Even though some segments of the heterogenous group of outsiders are endowed with a high level of human capital (e.g. among the intelligentsia or engineering staff), it was **the social capital (or more specifically the personal network capital)**, as subsets of the human capital, that really mattered (Bourdieu (1986), Sik (1993))⁵. They represent that part of human capital which covers inter-personal links in an exclusive coalition (network of closed informal contacts), built for sharing (insider) information, favours or privileges, having the implicit purpose in economic gains, namely in gains of wealth and power. Unlike physical capital, the use of the social (network) capital is oriented primarily to the task of redistribution of existing opportunities and not to the creation of new values. As a social phenomenon, the network capital is not a complement to perfect market behaviour. In fact it relies

⁵ *The broader concept of capital is based on those stocks of assets which: - take a long time to accumulate; - can be personally appropriated (owned and conserved); - bring certain returns (yields) to their owner, thus reproducing their wealth. What is the essential property of the capital in the case of the economic transformation is its transferability (conversion) to alternative uses, i.e. independence from the technological and institutional setups (Leamer (1993)).*

heavily on the concept of "voice" (see Cyert, March (1972)) in the environment of market imperfections, market failures and bureaucratic decision making.

The speed of capital transferability in an economy under transition seems to be of key importance for the success of becoming an entrepreneur. The money in cash form and the social (network) capital are best suited for this purpose. The nomenklatura and especially the operators were practically the only domestic groups having available liquid financial capital. But, as the total endowments of the asset money in all post-communist countries were by far lagging behind the requirements for starting business transactions, the next capital available for solving that constraint was the social (network) capital. As opposed to the financial capital, the build-up of the social (network) capital was booming during the days of totalitarian socialism, because it was the essence of the local bureaucratic power game, the shadow management systems and the parallel markets.

Because of the highly uneven distribution of the transferable capital of all kinds at the end of 1989, some owners had an advantage in using it in starting their own private businesses. The liquid financial assets were highly concentrated in the hands of operators and nomenklatura, the former being most probably more successful than the latter. Also the ownership of the social (network) capital was unevenly distributed, with the nomenklatura having the lead and the operators following them. The outsiders were trailing last in both cases. Their competitive position in technical or classical education, foreign languages and cultural overview, though helpful in earning them the positions of new managers, administrators or politicians, could not redress them their losses in the ownership of those liquid forms of capital which were the most important assets for acquiring private businesses and for becoming higher ranking entrepreneurs.

3. Macro and Microeconomic Policy Conditions for Emerging Entrepreneurship.

After November 1989 the new Czechoslovak government quite quickly developed a firm macroeconomic strategy for the transition to a market economy. This strategy consisted of:

- * A fiscal policy oriented toward dismantling state paternalism to enterprises by abolishing the plan and its subsidies, introducing a balanced budget and decreasing taxes;
- * A prudential monetary policy checking the danger of inflation;
- * Fixing the massively devalued exchange rate to a role of nominal anchor and liberalizing the trade on current account transactions.

On the microeconomic level the government policy was concentrated nearly exclusively on price liberalization and massive privatization schemes.

It must be stressed that the painstaking concentration of the government and the discipline of execution of the above points was spectacular, and the three years of systematic efforts brought their fruits: at the beginning of 1993 Czechoslovakia at least levelled the lead of Hungary and Poland in the build-up of the small-scale capitalism and in some parameters (e.g. exchange rate and price stability, rate of savings, level of unemployment, number of entrepreneurs and extent of privatization) the results were highly competitive by any standards. (See Table 2 and Bartlett (1993)).

However, the whole process had some snags which became apparent only after deeper scrutiny of the microeconomic developments. First, the government assumed that functioning markets would develop automatically once the macroeconomic conditions were favourable. (For a more extensive discussion of the industrial policy issues see Landesmann (1993) and Aiginger (1993).) Therefore no industrial policy was considered necessary for a long time. Even though the Czech government has never conceded in its rhetoric that it would follow the industrial policy schemes, in reality some general and many discretionary concessions were made. Let us now discuss some of the more visible aspects of the current economic policy of the government and their relationship to the local entrepreneurship.

a) Commodity markets. At the beginning of 1992, after 2 years of sustained pressure, the price market clearing mechanism became operational on both the supply and the demand sides; shortages disappeared. However, many companies in the pre-privatization agony were not able to bring their products to (in some cases even unsaturated) domestic markets. It is a paradox that many cheap products

of domestic origin could not succeed in getting through to the marketing stage and got stuck in unsold stocks. The final demand for cheap local products often either remained unsatisfied or was met by imports of an inferior quality. Significant price controls were retained in the housing sector and the public transport; minor price regulations remained for fuels, energy and some agricultural products.

b) Corporate structure. Evident cases of cartels and market power have been tolerated by the amoebic Ministry for the Economic Competition or even supported by the government. The motive behind this support was to retain the bargaining position against the multinationals, to sustain the inefficient divisions under the umbrella of the more efficient ones, to minimize bankruptcies and unemployment and to retain political stability. 50 bil. Kc of the state bail-out support and practically all the proceeds from privatization (approximately 28 bil. Kcs) were ploughed back to relieve inter-corporate and bank indebtedness and to provide state guarantees of long-term credit to salvage the ailing state corporations. These schemes were not accompanied by complementary schemes supporting SMEs.

Table 2: Selected Official Indicators for the Czech Republic (1989-94)

Indicator	1989	1990	1991	1992	1993	1994
Nominal GDP ^a	524.5	567.3	716.6	803.3	923.1	1037.5
Real GDP ^b % change	4.5	-1.2	-14.2	-6.6	-0.3	+2.6
Real industrial production ^b %		-3.5	-22.3	-10.6	-5.3	+2.3
Productivity of labour %	2.2	-0.3	-9.2	-4.1	-1.2	+5.2
Producer Price annual inflation %	1.2	16.6	54.8	9.9	13.1	5.5
Consumer Price annual inflation %	1.9	10.0	57.9	11.1	20.8	10.0
Real personal income ^b % change	2.2	-0.2	-27.1	5.9	5.6	8.5
Private consumption ^b % change	2.8	2.9	-24.0	15.1	2.9	5.3
Public Consumption ^b % change	+7.6	-0.8	-9.1	-3.1	-0.1	-2.3
Fixed capital invest ^b % change	+3.2	-2.1	-17.7	+6.3	+4.2	+3.4
Change in inventories ^b % n a	3.8	12.1	2.9	-24.3	-24.4	n a
Rate of unemployment %	0.0	0.8	4.1	2.6	3.5	3.2
Inter-enterprise indebtedness ^a	n a	39.3	113.2	94.4	150	132
Exchange Rate (Kč/\$) average	15.1	18.3	29.5	28.3	29.2	28.8
Budget deficit or surplus ^a	-3.5	+4.2	-12.0	-16.7	+1.1	+10.4
Share of OECD in exports %	31.2	42.7	55.2	67.5	69.9	71.2
Exports (visibles) ^c	10942	9203	7985	8842	10163	11730
Imports (visibles) ^c	10720	9562	7145	10273	10772	12581
Current account balance ^c	400	-1105	356	-305	433	298
Balance of payments ^c (surplus=+)	+590	-1102	+898	-80	+3029	+2372
Net foreign investment ^c	171	120	511	947	1540	842
External Debt ^c	7900	8100	9400	9600	9605	11943
M2 ^a % change	4.4	3.7	27.3	25.4	20.5	21.5
M1 ^a % change		-10.0	+26.7	+15.0	+14.6	18.1
Average lending interest rate %	5.0	6.1	15.4	13.8	14.1	13.2
Number of Banks	4	9	28	46	56	59
Loans ^a % change	-2.0	-7.7	+14.5	+13.7	+19.9	+14.3
All Foreign Exchange Reserves ^c	-	1200	3300	3600	6245	8894

Sources: Statistics of SBCS (1990-92), CNB (1993-94), CSO (1993-94), PlanEcon (1994)

Notes: ^a1billion Kč, nominal

^bbillion Kč, 1984 prices

^cmillion U.S. dollars

c) Market efficiency. The experience of all developed market economies shows that it would be a doubtful policy to assume that the best role for the government in creating the competitive markets, ownership structures and entrepreneurship is to abstain completely from any involvement. The initial setup of the post-socialist markets and ownership is confronted with too many non-economic interferences, imperfections, failures and insufficient provisions of the public goods (see Benáček (1993)). The paradox here is that hardly any government and its bureaucracy can be entrusted to be a direct effective provider of market efficiency. However, the responsibilities of the state (regardless of its political leaning) are irreplaceable, and wider than what the already established markets might otherwise require (see Zamagni (1993)). The state as an organizing agent is the body finally responsible for:

- * managing, coordinating, supervising and judging the provision of rules of the market game;
- * providing an efficient monetary framework;
- * guaranteeing provisions for the public and common good (e.g. public information, education, judiciary, security, healthy environment, infrastructure, reliable administration, etc.);
- * enforcing property rights, credibility of contracts, justice and competitiveness;
- * supporting the emergence of frameworks (institutional, social, organizational, normative) for the compensation of market failures and favouring the development of entrepreneurship, innovation and international cooperation.

The mentioned responsibilities remain a sufficient burden to overload any government, not only a frail governmental coalition of a society in transition. Naturally, up until now the Czechoslovak and Czech governments were not able to concentrate systematically on these tasks and relied quite often on incidental solutions, spontaneous activities of enthusiasts and on the ethical instincts of society. However, the enthusiasm and ethical assertiveness had already faded away during 1990-91, as daily experience was showing that the "new freedom" was neither a game with platonic rules, nor one where the gains are equally distributed among all. The bulk of Czech society, being more aware of the contradictions of newly emerging reality, responded with their typical taunting (but still quite disciplined) sarcasm. The wide-spread, seemingly pessimistic expectations, subjecting all positive achievements in the building of the market economy to questioning, is a typical and necessary self-defence for all outsiders. In its criticism it is in fact quite constructive, if the future individual chances are subject to greater openness.

d) Stock market. It took three years and a lot of government support to prepare conditions for a functioning market with commercial paper. Two competing stock exchanges, opened in June 1993, and hundreds of stock brokers, have shown the ability to provide competent services for the local 7 million stockholders. After very shy trading and falling stock prices during the previous three months, the market recovered from a price index of less than 500 points in October 1993 to 1045 in January 1994. The turnover on the Prague Stock Exchange alone in its first year reached 54 bil. Kč., with 1007 different emissions traded. However, the transfers of equity outside the stock exchanges are estimated up to 500 bil. Kč (Hospodářské noviny, 5.5.94). In 1993 the foreign portfolio investment (1060 mil. \$) and the foreign loans to firms (500 mil. \$) became a more important resource of capital than the total of FDIs (550 mil. \$). The majority of stock trading abroad was channelled through the stock market in Vienna. Its turnover of the Czech and Slovak commercial paper in 1993 was approximately three times higher than what was recorded in the Prague Stock Exchange. The catastrophic expectations of some experts that the voucher stockholders would immediately swap their equity for whatever cash it may bear, and thus bring a collapse of the market, were completely flawed.

The excess demand for credit, the lack of competition on the money market and the inability of the banks to distinguish between a promising and a failing investment project call for alternative financial intermediation to the bank credits. E.g. stock issue and equity markets can provide the risk capital inflows to productive borrowers, who the commercial banks so systematically avoid. Repackaging bad loans into securities which can be sold at a premium to the risk-taking investors is another possibility.

e) Money market. In all transient economies banking and financial services remain one of the main bottlenecks of growth (see Phelps et al. (1993)). This paralytic infection is deeply seated in the central institution of capitalism - the flow of money - attacking primarily the capital market. The Czechoslovak government, being always aware of the key role of money in emerging markets, took many measures to avoid risks. However, the tasks seem to be much harder to accomplish than anyone

expected. The country is constantly fighting the global capital shortage, even though not all firms are under a taut capital constraint. The average real interest rates continued to be negative in 1993. (E.g. the real yield on deposits and bonds for July 1992-September 1993 vary between zero and -12%.) The interest tax of 15% on deposit and 25% on commercial paper yields lowers even further the incentives to save. Private business access to bank credits remains extremely difficult, a situation that is often solved by forced inter-firm credits (i.e. by defaults in payments). The credit crunch in the private sector did not subside even after the M1 and M2 supplies significantly increased in real terms in 1992. The situation became even tighter in 1993 when M2 increased by 16.7%, while the CPI increased by 18.2%.

Massive privatization, continuing at least until 1995, will cause a further crowding-out of credits for business transactions if the monetary policy does not expand further. Support of the National Property Fund has not been significant until now, as approximately 80% of its proceeds from privatization were diverted to prop-up the ailing corporate and banking sector in 1993. No change in this policy is planned for 1994. The situation on the loan market in 1992-93 was marked by both a lack of supply of liquidity and failing intermediation facilities. The solution of this problem by the economic policy has become more of a riddle than ever, as the government slowly resigns from its market-oriented cure of the causes, in preference for more bureaucratic control over the effects.

However, there has been one serious scheme undertaken by the government in creating the Guarantee and Development Bank in the central institution of capitalism - the flow of money - attacking primarily the capital market. The Czechoslovak government, being always aware of the key role of money in emerging markets, took many measures to avoid risks. However, the tasks seem to be much harder to accomplish than anyone expected. The country is constantly fighting the global capital shortage, even though not all firms are under a taut capital constraint. The average real interest rates continued to be negative in 1993. (E.g. the real yield on deposits and bonds for July 1992-September 1993 vary between zero and -12%.) The interest tax of 15% on deposit and 25% on commercial paper yields lowers even further the incentives to save. Private business access to bank credits remains extremely difficult, a situation that is often solved by forced inter-firm credits (i.e. by defaults in payments). The credit crunch in the private sector did not subside even after the M1 and M2 supplies significantly increased in real terms in 1992. The situation became even tighter in 1993 when M2 increased by 16.7%, while the CPI increased by 18.2%.

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However, there has been one serious scheme undertaken by the government in creating the Guarantee and Development Bank, which provides guarantees to commercial banks for credits to small firms and subsidies to interest payments for credits in development projects (e.g. in the range of 4-7% of the principal for the each year of repayment). Unfortunately this Bank was still undercapitalized (budget of 1.2 bil. Kc in 1993) for large-scale credit insurance and its thin geographic network precluded more extensive loan intermediation (e.g. relative to the total stock of loans of 606 bil. Kč at the end of 1992). In 1993 more than 500 bank guarantees for the total of 1.9 bil. Kč of credits were taken and the interest subsidies were 1 bil. Kč (25 % were for small firms of up to 10 employees). This Bank's impact on long-term credit provisions (e.g. through development banking) was negligible. See Dědek (1993) for more discussion of these problems, and Zemplinerová (1993) for a review of other industrial policy schemes in the money sector.

To sum up the situation in the Czech money market in 1993, the following problems can be outlined. The supply side was marked by insufficient savings (insufficient relative to the task of transformation) and by the money supply squeeze. The tight monetary policy had to be reinstalled at the beginning of 1993 in order to check both the inflationary pressure of the monetary separation after the

Czecho-Slovak partition and the introduction of the VAT system of indirect taxation. On the demand side, there was an enormously growing demand for transaction money related to property buy-outs, new business revamping schemes and the overheated private sector. With the excess demand for credits in the situation of incomplete information and high risks, the ensuing need for credit rationing became a necessity. That would normally lead to high profit margins to the banks, high average interest and its wide spread around the mean - all of which the government tried to suppress by administrative measures. Thus on the intermediation side the banks' growing risk aversion, combined with oligopolistically contrived scarcities on the rationed credits, led to an even tighter monetary squeeze and corruption. The latter can be explained as a natural rationing device, once there is a gap between the regulated lending interest rate and its higher potential market level.

f) The foreign exchange market was one of the least problematic markets until the introduction of a clearing mechanism for the settlement of bilateral Czech and Slovak payments. These mutual payments currently suffer from administrative difficulties and exchange rate uncertainty. The once flourishing intra-regional trade with Slovakia (reaching the level of nearly 30 % of all Czech foreign trade) is now plummeting due to highly rising transaction costs.

g) Labour market. The 3.5 % average unemployment rate in December 1993, with the average unemployment duration of 4.3 months in 1993, means practically full employment. The extensive employment restructuring was proceeding inconspicuously, yet quite intensively. The frictional and structural unemployment caused by this process was solved locally in the majority of cases. Even in the worst hit regions of Moravia the results are lower than the natural rate of unemployment, which, for the economies in transition, can be estimated to be between 5 and 8 %. This success is mainly due to state corporate debt relief schemes, reluctance of banks to bring their corporate creditors to bankruptcy and efficient employment schemes (e.g. a subsidy of up to 50,000 Kc for companies hiring unemployed persons in certain districts). The private sector was thus able to absorb quite quickly and smoothly the departures and the layoffs from the corporate (mainly manufacturing) sector in 1990-93. With the officially recorded labour mobility over 1.5 million workers only in 1990-92 (see MPSV (1993)) out of the initial full employment of 5.3 million in 1989, the real mobility (including the transfers inside the corporate sector) for 1990-93 could affect over 40 % of the labour force. At least 1.7 mil. jobs were created in the booming SMEs during the first 4 years of transition.

On the other hand the backfire of the labour market on businesses was negative, at least in the corporate sector. In 1993 the wages continued to rise - in manufacturing they increased by 24% and in construction by 29%, while the inflation was 18% and the productivity in real terms (as officially reported) even decreased. Thus the government was forced to introduce a wage regulation scheme for all firms, including small private businesses. The aim is to keep the payroll rises in line with the rise of productivity per worker. A 5% penalty-free cushion was, however, provided. The actual widespread shortage of skilled and reliable employees is also reflected in the loose worker morale.

h) Housing market. The regional mobility of labour remains stalled because of the state housing regulation which keeps the rents at approximately 1/3 of their expected free market level. This results in a shortage of flats and exorbitant prices of houses. On the limited free market, speculative or grey market rents in Prague currently exceed the controlled rents by 5 to 20 times, placing them out of reach for a normal wage earner. The highest shortage is felt on the frail market for office and small business facilities.

As can be seen, the recent Czech economic policy instruments had numerous impacts on the business sector, some of these quite delicately chosen both in time and sequence, some seeming random, and some void of any pre-conceived positive aim. As far as the promotion of entrepreneurship in small businesses is concerned, we can hardly speak about the existence of an extensive systematic policy. Even though it is generally agreed that the government should be involved in such policies, it still remains uncertain if the government has at its disposal reliable and efficient instruments for full-fledged control of this task. It was not long ago that very few economic textbooks were concerned with this question. In the best cases, it was tacitly understood that entry into business and the accumulation of capital required simply time and patience. In the worst cases, it was said that the only ways to get started were by

parsimony, patrimony and matrimony. Without doubt, we cannot expect a miraculous change to enter this scene.

The slow rise of institutional economics during the 1970s and the advancement of the theory of industrial organization turned the attention of economic policy makers to property rights, public goods and market imperfections. The aim of these theories is to find out when the government intervention (e.g. through the industrial policy) can be effective and speed up the otherwise spontaneous process of continuous capitalist development. In the Czech Lands, however, their impact on the policy making was rather marginal.

4. Privatization and Entrepreneurship

The privatization schemes, along with the availability of financial capital, are crucial conditions for the free rise of entrepreneurship. In the first wave of privatization (1992-93) 4,897 business units (firms), valued 539 bil. Kc, were privatized. The total value of assets privatized was 750 bil. Kcs, which compares highly with the total value of assets of 900 bil. Kc in the industrial sector or 1600 bil. Kc in the whole production sector (in 1990 book values). Approximately 1.5 mil employees thus became employed in the Czech private sector. The booming new small businesses offered nearly as much new jobs and competed for employment with the big companies. Practically all massive layoffs from the former big state corporations were absorbed by them. As a consequence, the unemployment rate of 3.5% in April 1994 could remain among the lowest in Europe. The second wave of privatization (1993-94) was in April 1994 at its peak. In its voucher scheme the property valued 155 bil. Kc will be given away to the local citizens. The property which will be privatized by remaining schemes of this wave will add additional 345 bil Kč of assets. It was estimated by the Statistical Office that approximately 67% of production at the beginning of 1994 was produced by the non-state sector.

We can estimate that all official privatization schemes of the Czech government transferred property valued approximately 1200 billion Czech Crowns (in book value of accounting prices) at the end of 1994. The assets which remain to be privatized in 1995-96 are valued at 340 bil. Kc by the National Property Fund. There were only three commercial state firms exempted from the privatization in 1994: Czech Railways, Czech Mail and Consolidation Bank. The non-profit sector (schools, hospitals, cultural establishments, public administration and some public utilities) are also not included in the recent privatization plans.

The Czechoslovak privatization was marked by "class orientation" (in the above sense of stratification of entrepreneurs), as it was divided into so called "small" and "large" privatization schemes. Due to the information asymmetry, higher capacity to retain previous vested interests, higher wealth and better motives to organize into pressure groups, the small privatization (consisting mainly of the auctioning of shops and small businesses) became a prime target for the operator group. On the other hand, the large privatization favoured the nomenklatura on very similar grounds. The non-competitive "direct sales" (e.g. management buyouts) or the "competing projects" (e.g. leveraged buyouts through bank loans) became their most attractive targets. Establishing Investment Privatization Funds (IPFs) was another scheme that enabled the representatives of the old state corporations and high bureaucracy to get hold of the portfolios of companies privatized by vouchers. The nomenklatura also naturally benefited from an exclusive opportunity to spontaneously privatize the assets of state companies which were under pre-privatization agony, while prices were liberalized (i.e. the contracts were not controlled by the authorities).

There were two very important schemes which benefited mainly the group of outsiders: restitutions and the voucher scheme, both due to their random nature. Nevertheless, their potential for offering direct entrepreneurial opportunities to the group of outsiders was insignificant because of the corporate governance problem in the voucher scheme and the extreme randomness of the restitutions. The outsiders' main chance to come closer to entrepreneurial positions remained in wide opportunities to become hired managers (but not owners) or in establishing their sole proprietorships and starting from rock bottom.

As declared by the National Property Fund (NPF), its total proceeds from privatization in 1991-93 were 90 bil. Kč (of which 36 bil. Kč came from the small-scale scheme). Approximately two thirds of all privatized assets were transferred free of charge. According to Mr. T. Ježek (chairman of the NPF), 45 bil. Kč of the revenues were used for the debt relief of the state companies, 10 bil. Kč were transferred to the banks in order to increase their capital endowments and 6 bil. Kč were transferred to the State and Council Budgets. Only 1 bil. Kč was used for financing EGAP - the state export guarantee and insurance company (Hospodářské noviny, 14.10.93, p. 13). Finally, 22 bil. Kč from the small scale privatization scheme were deposited with the banks and their interest, plus some additional funds amounting together 20 bil. Kč, were or will be used for the support of the private health care sector. Except for the last two schemes, the NPF introduced no other general schemes supporting the SMEs. One spontaneously risen relief scheme should be mentioned: in February 1994 the entrepreneurs owed the NPF 6.5 bil. Kč in unpaid balances for 240 privatized enterprises (MF Dnes, 8.3.94, p. 14). The fact that only 5 legal actions (out of 93 cases) were concluded, signals that the unintended credits to the (less disciplined) new private entrepreneurs will become one of the NPF's most important SME incentive schemes.

The extent of the CS privatization opened an enormous space for the rise of entrepreneurship, ownership and management. Some points which deserve to be mentioned are:

- * The privatization opportunities were more favourable to two narrow and privileged groups of the society who evolved from the institutional idiosyncrasies of the communist past;

- * In 1990-93 it still remained significantly easier to accumulate physical capital through redistribution and bargaining with the bureaucracy than through productive entrepreneurial activity;

- * The newly emerging class of capital owners may not be strongly correlated with the entrepreneurial and managerial skills (and vice versa). A long-lasting secondary round of ownership changes should be expected before the process of effective privatization finally calms down;

- * Since the skills for acquiring property through redistribution (privatization) may not always be complemented with the skills for managing its production and because of extensive restitutions, there are developing conditions allowing the rise of the rentier class of owners.

5. Who Are the New Czech "Big" Entrepreneurs ?

According to an extensive sociological survey carried out at the Czech Academy of Sciences (Vítečková (1993)), the structure of Czech private entrepreneurs in December 1992 showed some interesting properties. The study was limited to a widely distributed sample of 1000 businessmen, tradesmen and artisans each of whom had registered as a firm with legal status and hired a staff of employees. It is important to mention that it excluded persons licensed to self-employed proprietorship. While the latter numbered over 1 million licensees in 1992 (out of the full-time Czech employment of 4.8 million), the number of private firms with registered legal status and relevant capital endowment did not exceed 80,000. Thus the number of Czech "big entrepreneurs" with capitalistic businesses of their own, selected from the set of the existing one and a quarter million people with entrepreneurial aspirations, could be estimated to an orientational number of approximately 120,000⁶.

⁶ *Caveat emptor: evidently, this intuitive approach (as do some other estimates in this paragraph) does not represent an unimpeachable scientific method in making generalizations about reality. Unfortunately, the data allowing more objective and verifiable statements have not been made available for this problem. Perhaps we can argue that the intuitive estimates made here about such sensitive matters like ethical classifications, are no more biased than the notoriously subjective personal confessions required in surveys using questionnaires.*

Table 3: Structure of Czech Private Entrepreneurs in 1989 and 1992 (stylized facts)

Rank of management	Estimated No. of workers in 1989 (A)	Shares %	Work position of entrepreneurs of 1992 before 1990 (B)	Shares %	Degree of transition from A to B (B/A)
Top	45,000	0.84%	13,200	11 %	29 %
Middle	161,000	3 %	19,200	16 %	12 %
Low	806,000	15 %	52,800	44 %	7 %
None	4362,000	81 %	34,800	29 %	0.8%
TOTAL	5374,000	100 %	120,000	100 %	2.2 %

Our results characterizing the origin and mobility of the Czech entrepreneurs are summed up in Table 3. Column A shows the estimated breakdown of the total Czech employment in 1989 by managerial ranks (stylized facts intuitive estimate). Column B shows the structure of entrepreneurs (according to the findings of Vítěčková (1993)), who established business firms with legal status **in 1990-92**, classified and ranked according to their highest working assignments achieved anytime during their careers **before 1990**.

If these estimates are correct ⁷ and reflect at least the basic structure of the past management and the present private entrepreneurship, then the following implications can be drawn:

a) There is a very strong link between the incidence of having been a communist bureaucrat in a top or middle managerial position and the membership in an emerging class of private capitalist entrepreneurs. If we keep in mind that the vast majority of communist "executives" survived the shocks of the "Velvet Revolution" (the reshuffling of positions was often a sufficient mimicry) and that in 1992 more than 80 % of the manufacturing output was still produced in the non-private sector, then practically all the departures (forced or voluntary) must have been directed to private businesses. (The politically minded reader is strongly warned that it is **not** the aim of this paper, whatsoever, to make value judgments on the local socio-political scene !)

b) Since practically 100 % of the top and middle ranking managers prior to 1990 were members of the Communist Party (CP), and a high proportion of the low ranking managers also had to be party members, then approximately a half of the Czech emerging capitalist class were people chosen by the CP. However, if we inquired into the transition of real nomenklatura into private businesses and assumed that, except the top communist management, only its middle ranking management was associated with nomenklatura, they may have formed but less than 27 % of the new private entrepreneurs. It is far less than what the majority of public opinion polls claim. Not so much because of its extent, but because of its intensity, the correlation between the nomenklatura and capitalism in the Czech Republic seems to be strong. We should not forget that the nomenklatura had other stakes to win, e.g. in the top management or in the board of directors of the new corporations privatized largely by the voucher scheme (banks, industrial firms) and in the investment funds.

c) None the above statements about the nomenklatura are meant as value judgments. What is of importance are their descriptive implications. The error of many Western observers of transition rests in the tacit assumption that the Eastern totalitarian society was completely void of any entrepreneurship, organizational spirit and rationality. Thus all of these qualities, as erroneously expected, have to be

⁷ Naturally, we cannot take the quantitative estimates in Table 2 strictly at face value. The error term can be relatively large. We can argue about its size and construct alternative estimates. Nevertheless, we should not expect the bias to be so serious, as to reverse the tenor of our conclusions.

imported and introduced from abroad. The philosophy of the early approaches of the West to German unification still has its heirs. The most assertive conclusion of that sort is the absurd recommendation to make the imports of the entrepreneurial know-how exclusively from the more dynamic Far East. On the contrary, it can be found that successful entrepreneurship is often closely linked with domestic management, domestic traditions and domestic resources - a fact that is often disregarded even by the local insiders. Then also the local nomenklatura must have its place in the process.

d) In the better case it should be admitted that in the last 20 years of its rule the CP developed an extremely enlightened and far-sighted personnel policy. (However, very few observers among the dissidents would have come to this surprising conclusion prior to 1990!) In the worst case we can see an updated version of Orwell's "Animal Farm". The true evaluation lies somewhere in between. On one hand, it must be admitted that one of the main reasons for the collapse of communism was that it failed to offer the vast majority of people a free opportunity to fulfil their ambitions and instead nurtured just a narrow, privileged elite organized in the upper levels of the party hierarchy. On the other hand, it required from them some degree of animal spirit and leadership, which have now proved to be viable skills in all circumstances. This would fully fit Baumol's (1990) theory that entrepreneurship and its aim of profit or power is omnipresent in all societies. **The problem is in which alternative economic fields (productive, unproductive or destructive), and under what conditions and incentives, the entrepreneurship is allocated in the given period.**

e) If the Party nomenklatura were subject to a certain degree of efficiency, competition and meritocracy, then they could have had strong motives to take part in the change of the inefficient system of planning, public property, bureaucracy and political paternalism which limited their motives for wealth and power. I.e. the nomenklatura would not mind velvet type revolutions so much. More surprisingly, this statement can also work vice versa. Thus even the new political elite, recruited from the ranks of former dissidents, may have reasons for accepting their former oppressors as business allies.

f) The rate of transition of former low-ranking state managers and supervisors into new private businesses seems to be quite high, forming 44% of the total. (A large part of them may actually come from among the operators and the returned emigrants, as it is now difficult to distinguish.) The former low-ranking managers, lacking the capital and bureaucratic connections, found their most natural destiny in establishing their own small businesses, for which they had the experience and the human capital. It is probably in this subgroup of outsiders, who have not been able to fully exploit their potential until now, that the future hard-working entrepreneurial talent is hidden and from where it may be recruited.

g) The most interesting finding is that only a negligible fraction of people, who were not engaged in the communist past in any formal managerial position, have after 3 years succeeded in entering private entrepreneurship. On top of this, a significant part of this group must have been former operators whose entry into the ranks of entrepreneurs was much easier. Unfortunately the survey does not allow us to separate from the statistical sample of "no managerial rank" those belonging to operators and to outsiders. If it did, then the degree of transition 0.8% for the whole group (see the last column in Table 3) would imply that it was even more difficult for the significantly larger subgroup of outsiders (i.e. for the rank and file wage earners with neither any communist managerial experience nor stakes in illicit marketeering) to enter the emerging capitalist elite of owners and entrepreneurs. Even if we admit that the majority of outsiders was represented by the less ambitious and the less motivated workers, who in all situations can be considered entrepreneurial "dead wood", we still cannot exclude the cases of barriers to outward mobility from its still quite numerous dynamic subgroups. In other words, we cannot deny the existence of cases in which, during the communist days, the only reason behind finding oneself among the non-managerial group of employees was sheer prosecution and political discrimination, or personal resistance to the political power and sticking to ethical principles. **Therefore it would have to be admitted that there must have been other barriers (except managerial incompetence) precluding the outsiders from entrepreneurial entry after 1989: lack of wealth, lack of appropriate access to public property and lack of pull from the bureaucracy or old-boy network** ⁸.

⁸ There have recently been done some other quantitative empirical studies concentrated on the topic of classification, origin and success of the new Czech entrepreneurs. Matěju (1993a) comes to the

The Czech government has opened extremely wide possibilities for the **transfer of property** because more than half of the national physical capital is expected to be privatized between 1991 and 1994. Unfortunately this has not prevented an uneven distribution of opportunities in the majority of schemes which have favoured some privileged social groups, nor has there been a perfect competition for property acquisitions among these privileged groups.

A very similar reasoning applies to the conditions for the **creation of new small businesses**. The only exception was that startups had to acquire their property and physical capital on more competitive markets fetching higher competitive prices. Consequently, their financial funds for required fixed capital investment had to be correspondingly larger. Thus the internal net returns on capital (i.e. the net profits after the deduction of interest and instalments for the credit disbursement) were lower for the green-field investors. There are two groups of new entrepreneurs which should be distinguished: those who have established their ventures under a taut profit constraint, and those who started with a soft profit constraint. The latter acquired their assets at a discount from a non-competitive buyout, allowing them to receive an additional rent to their annual net returns.

Perhaps another classification is of more importance for long-run developments. Some people came into businesses with strong entrepreneurial impulses. In their life-long mission their profit constraints, or the size of the firm they started with, do not matter. Under healthy capitalist conditions they will always be among the winners. On the other hand, there may be people who set up their own businesses just on the grounds that either their possible employers were completely incompetent or they had a unique chance to privatize under advantageous conditions. As their industry recovers they will once more return to being employees. Without a doubt, a substantial part of the Czech entrepreneurs were people from the latter group. This means it should be expected that in some time there will be many exits and bankruptcies in SMEs. If we assume that approximately 20% of the whole labour force can find their employment in the entrepreneurially based working activities (in transition it should be even more), then economic policy must provide conditions for the unhampered entry of newcomers replacing the exiting entrepreneurs. **It can be expected that in the Czech Republic a substantial mobility will continue over the next 5-7 years in the entrepreneurial class, both inside in their hierarchy and in the interchange with the rest of the society.** There are many frustrated outsiders waiting for opportunities and a great deal of them deserve the chance. It is a well known fact that the barriers to entry are rising as the transition is proceeding.

It would be a disturbing finding if, in emerging capitalism, it were as difficult to rise up from the bottom as it was under communism. Maybe the process of rising is now slightly different and requires different techniques; nevertheless, for those without the access to capital it still remains difficult and humiliating.

conclusion that being a member of the nomenklatura results in "far higher chances to enter the group of entrepreneurs" (p. 86), mainly due to the role of various social assets (e.g. the ability to mobilize informal contacts) which had been accumulated in the past career. In another study (Matěju (1993b)), aimed at explaining the level of success of the entrepreneurs (measured e.g. by their 1992 income), a high statistical significance of such exogenous variables as income in 1989, accumulated property before 1990, and importance of the position in the hierarchy of the nomenklatura is discovered. Nevertheless, the study also confirms the significance of such factors as education and professional commitment to the job, both of which testify that the outsiders could have certain positive chances to enter the ranks of entrepreneurs.

6. Present Environment of the Small Businesses in the Czech Republic

Let us now describe the type of environment, procedures and risks which challenged a standard entrant into a small or medium sized Czech business in 1992-93. We may assume that our "standard entrant" commands just the average stock of saved money per capita (40,000 Kč = \$ 1300), average wealth (owns a real estate worth 300,000 Kč = \$ 10,000), has no past career in the group of operators or nomenklatura, has entrepreneurial skills significantly above the average, is able to work 14 hours a day and 7 days a week, and is determined to comply with the tax and other legal regulations. He or she also does not want to run a self-employed, one-person business with no legal status and little capital requirement.

A) Registration and Licensing for Entry.

Formal entitlement to any new business entry starts with registration and licensing for the given type of expected activity. The decision is exclusively in the hands of the district council pertaining to the residence of the applicant. A licence is granted for each required activity from a list of approximately 300 classified entries, so that a standard business has to apply for several of them. The fees are 2000 Kč for each business activity and 1000 Kč for each craft entry. The applicant (not his employees) must show proof of education, professional skill examination and period of practice, to meet the requirements for each given activity. The processing of business applications lasts 1 to 4 months, subject to difficulties of re-negotiation. There is no guarantee that the registration will be successful within this period, even though the candidate has all the required skills. A bribe proportional to the expected producer surplus can significantly shorten both the time and the uncertainty. A similar story can be heard about the problems of registering limited liability companies.

B) Availability of capital

If one was not lucky enough to have restituted the property nationalized after 1948 (the majority of it was nationalized during 1945-47) or recently inherited some property from abroad, you would have to find your own way of financing the new business. The initial capital of \$ 20,000 is supposed to be the minimum required for the majority of ventures - an amount which was impossible to accumulate under legal working arrangements as an "outsider" during the communist days. It was, however, achievable for the nomenklatura and a routine for the black-marketeering operators.

The demise of state control, devaluation, price liberalization and loose enterprise discipline in 1990-92, combined with a rise of private contracting, created lucrative opportunities for the private accumulation of capital. Some opportunities were legal (exports, imports, selling of scarce stocks, speculations), some were not (frauds, theft, insider trading, etc.). Even this additional injection of private capital gains was by far insufficient to bear the transaction costs needed for the establishment of private businesses and privatization on the scale prepared by the government in 1991-1993. Actually, the wild appropriation of property and capital in the Czech business environment was relatively small, if compared with other countries in similar circumstances. The traditional sense for financial discipline, functioning property registration and accounting, obedience of laws and the low degree of organized crime prevented the spontaneous privatization from becoming a dominant way of enrichment.

Thus, in their search for capital, the majority of future Czech entrepreneurs had to rely on the financial market, primarily on the availability of bank credits. This situation is significantly different from that in developed market economies where the retained profits and depreciation provide 55 - 75 % of total investment resources. After 3 years of unparalleled boost, in 1993 the Czech banking sector reached a considerable size, density and scope of activities. Nevertheless, its efficiency was still low and its functioning was subject to market imperfections. The real interest on deposits (the nominal rate was 2-12 %) was generally negative and the nominal interest rate on loans (15-20%) still did not clear the market. The banks, like skilled profit maximizing oligopolists, were limiting the supply of their services by universally refusing to finance the "risky ventures", i.e. those without at least 100% mortgage or other secure collateral available. Hence, as the confidential personal communication widely discloses, the entrepreneurs with highly promising projects but with no property for collateral (e.g. for investing in

inventories or paying for the lease of premises) were regularly refused credit, if a sufficient bribe (2-5% of the loan) was not paid. It has even become a routine to require a 2% bribe for credits hedged by a mortgage - a rather unorthodox interpretation of both the market clearing and the corporate governance in the privatized banks. It is the bribe which blurs the distinction between a loan for a serious investment project and a non-performing loan purposefully acquired for capital stripping and a subsequent suicidal bankruptcy. Even though the latter type of non-performing credits have been on the decrease since 1993 (there were estimates that they formed up to 30 % of loans in 1991-92 and the estimates for 1993 are 10-15 %), their role in spoiling the financial market ethics is substantial.

The rent seeking of the bank agents, behaving like effective owners (without paying taxes and without feeding the appropriated rents back into the banking), is a sign of weak market rules and a failing financial market. It shows all signs of moral hazard and incomplete contracts, with all ensuing devastating externalities present (see Eswaran, Kotwal (1989)). The resulting losses due to inefficient allocation of capital, the insufficient formation of investment in the borrowing private businesses and the sustained concentration of capital in hands of those who were lucky enough to come in the early stages of Czech capitalism, are also creating negative side-effects in the whole society.

C. Acquiring the Working Premises

Once the entrepreneurs succeeded in securing the financial resources, the next stage would be acquiring the working premises, a process also subject to official approval. A lot of problems can be saved, if they received a real estate restitution or if they intended to run the business from their house or flat. Otherwise one must enter the real estates market and lease (very often just for 1 year only) or purchase the property. The private property market became very quickly quite competitive and efficient. The problem is, however, that its prices follow the housing scarcities and the rent in towns can reach \$ 50-700 per square meter per year. The payment must often be disbursed before the premises are approved by the district council.

Acquiring the premises in an auction is a special case, subject to the small privatization scheme. Its prices can be much lower than the competitive prices, especially if the information is incomplete or if the auction is rigged. That means that the success of the future entrepreneur depends on his capacities to comply with the illicit dealings. For example, he is forced to get involved in the "protection" ring and pay for fending off his competitors. But most probably he finds himself on the other side as a target of racketeering and extortion in order to abstain from the auction. Other privatization schemes available are the public tenders (e.g. submitting a "competing project" for privatization) or the bids for a "direct sale" (i.e. an exclusive right to purchase a property for an administratively stipulated price). The decision made by a privatization commission is often subject to most unexpected hazards: luck, bureaucracy, insider trading, corruption, etc.

The green-field capital investments seem to be even more dramatic events. A story of a Czech entrepreneur, who has successfully opened his brand-new glass factory employing 75 workers, was featured in the local press (see Profit No. 36, p. 4, 1993). The number of rubber stamps, permissions and approvals counted over 900. The building and the refurbishing of the factory took 10 months, the preparations and approvals took 26 months. The privatization of an already established and equipped company is a much simpler operation, both in the transaction cost and the capital requirements. However, in the long run it may not represent the most efficient way of market adjustment, restructuring and the use of resources.

D. Getting the Approval for Running the Premises

Approval is granted by the district council pertaining to the location of the premises. The application is placed through the district council pertaining to the living residence of the applicant, and part of the procedure involves getting approval from the Commission for Environment. It is irrelevant that the premises in question are in the applicant's own house, or that the same activity was there, already approved to the previous owner (e.g. who just went bankrupt), or that the business by its very nature cannot be damaging to the environment. The whole process may last 3 to 6 months, with no certainty about the success. This may become critical for those who already had to pay for the premises and who

could run the business immediately.

It is often only a (substantial) bribe or an offer to share the property that can speed up the procedure. The exclusive administrative monopoly of the district council is the main source of their power. The complaints filed over their bureaucracy, intentional procrastination, unfounded objections or professional incompetence seldom get a positive response and applicants generally avoid raising them for fear of the council's retribution. The council can refuse to give approval, or it can later order financial audits, controls of hygiene and simply harass the entrepreneur on endless (often fictitious) charges.

E) Hiring the Working Staff

The travails of entrepreneurs are not over once the business is permitted to be opened. One of the most damaging legacies of the communist past is the devastation of the workers' morale. The continuing very low level of unemployment in the Czech Republic, sustained by the cautious bankruptcy policy of the government and commercial banks (see Hlaváček, Tuma (1993)) and by numerous schemes for resuscitating the indebted corporations, are not pressing for a change in the working discipline. The average unemployment rate of 3.14% in May 1994, for a country in intensive transition, equals practically full employment. A lot can be improved by adopting remuneration incentives. Their impact on performance and discipline crucially depends on the strength of negative alternatives: the unemployment or the transient employment habits should become a deterrent. As the case of Japan (even with unemployment rates below 2%) shows, their transaction cost should be significantly greater than zero also for the employees.

Even though Czech wages are still significantly lagging behind the poorest countries in Western Europe, overall productivity is often proportionally lower. The problem is not so much that the workers expect a soft, regular 8 hour shift and do their shopping or telephoning in the working hours, or that they lack the education or skills. More damaging is the lack of identification with their job. They are not accustomed to cooperate professionally in an informal way and they refuse to take risks, initiative or personal responsibility in their work. This is, however, an essential element of the environment required by the new post-Fordian organization of business (see Piore (1991)). Customer friendly behaviour, immediate response to demand and loyalty to the firm are considered alien and often judged as a "disgusting hypocrisy". The payroll rise by 25-30% above average is not considered by the workers a sufficient incentive for the change of performance. In fact, similar pay rises have been in effect since 1992. Their impact on the economy was felt in inflationary pressures and not in increased productivity. The wage rises by more than 40% (as introduced by some foreign companies and banks) would be prohibitively costly in the vast majority of local firms and would deplete their falling profits even further, especially after the introduction of social security insurance and the wage regulation. Profits in the Czech industry fell by 28% in 1992 (see Benáček, Woergoetter et al. (1994, p. 71)) and the total wage cost rise of 5% was the only cost item which increased in the industrial sector in 1992.

Table 4: The Czech average gross wages per month and per year in 1992 and 1993

C o u n t r y	Private firms	State firms	International firms
1992 Jan-Dec, average monthly	4728 Kčs	4813 Kčs	5653 Kčs
1993 Oct-Dec, average monthly	6595 Kčs	6904 Kčs	8483 Kčs
1992 Jan-Dec, average per year	2025 USD	2062 USD	2423 USD
1993 Oct-Dec, average per year	2748 USD	2878 USD	3535 USD

Source: Statistické přehledy, čSÚ, Prague, no. 3/1993, p. 79 and 6/1994, p. 11

The bilking of the employer and the customers (the latter up to the level of their consumer surplus) is quite frustrating. The firing of an employee and the hiring of a substitute is often a long-lasting and very costly process due to high transaction costs. So the entrepreneur and his family are often the

only people who can bear the weight of the small private businesses. Competition and the vision of future opportunities drive them to 12-18 hours' shifts with no weekends. This is especially typical for those entrepreneurs who formerly did not belong to the privileged classes, who started from scratch and who are trying to earn their own capital for the next real start or to repay a loan.

F) Running the Daily Business Routines

The transition from a sellers' market to a buyers' market, proceeding mainly during September 1990-June 1992 and for which the macroeconomic changes orchestrated by the government were absolutely crucial, was the most significant condition for the quick consolidation of those private activities based on market competition. The nature of these productive entrepreneurial activities became apparently different from becoming rich on grounds of artificially contrived market failures (rent seeking) or bureaucratic redistributive concessions. However, a transition from a sellers' to the buyers' market has not yet been fully completed at the beginning of 1994. Some demanded commodities were still missing from the market (these were often cheap domestic products, some of them piled in the factory inventories) or it took a lot of time to discover who provided them. The price differentials were sometimes irrationally wide, the quality of the same product fluctuated, the quality did not relate to the price, the customers got cheated or rudely treated, etc (see e.g. ECOMA (1993)). On the other hand, some buyers exercised their power over suppliers by requiring a tacit personal commission for a contract or that a payment should be done in cash without any invoice. These behavioural patterns signal that the market prices may not be perfect and that the market clearing may be incomplete.

As the discipline of the suppliers significantly consolidated in 1992, much lower stocks were necessary to secure the regular flow of business. The problem of the credibility of inter-firm payment discipline still remained critical. The processing of a bank transfer can take up to a month, thus some recipient firms cannot honour their other payments because they are often short of liquidity and the banks are reluctant to engage in short-term credit services. There is also a high risk of the customer's long-lasting default in payments because some firms take these as an opportunity to raise their capital. Hence, some firms refuse to accept anything but advance payments in cash, even for large contracts. The inter-firm indebtedness in 1993 was estimated to be around 160 bil. Kč⁹. Legal action against payment defaults is not a credible threat because the whole state judiciary system is in crisis.

The price which Eastern Europe must pay for its capitalist resurrection is an increased intensity of work, a rise in general uncertainty and the proliferation of crime¹⁰. While the first two are natural and revitalizing necessary conditions, the last one is connected with public administration failure. Even though the build-up of modern public administration in the Czech Lands has been proceeding relatively rapidly since 1990, it lagged behind the necessary requirements. Public administration is one of the most expensive institutional social networks, depending on long-time investments into human and physical capital, both of which an economy in transition lacks. Unfortunately, at the same time the demands on the public administration during transition are much higher than in established market economies. The majority of laws must be re-written, the new laws are too complicated to be absorbed into the daily routines, its many loopholes tempt too many to law defaults and the shortage of qualified lawyers,

⁹ See also Charap, Zemplerová (1993), Hlaváček, Tuma (1993) or Hrnčíř (1993) for more detailed analysis of the debt problem.

¹⁰ The total number of investigated crimes in Czechoslovakia has increased from 94,000 in 1989 to 295,000 in 1992 (see *Hospodářské noviny*, 23.6.1993, p.8, quoting statistics of Public Prosecutor). Of this number, crimes against property rights (mainly covering theft) increased from 23,500 in 1989 (30.4% solved) to 327,000 in 1993 (21% solved). However, the number of "other economic crimes" fell from 20,444 in 1989 to 1788 in 1992. These include tax evasion (18 investigated cases in 1991 and only mildly more in 1992), crimes against business competition, fraud, insider trading and corruption. It is not that these types of crime have been falling recently, but simply that they have become less transparent and increasingly difficult to investigate in the new legal environment.

judiciary, police and administrators is often made more severe by contrived scarcities. Naturally, the underground tries to fill the missing links on the "markets" for these services and hence profit from the situation. The majority of entrepreneurs are at loggerheads how to get out of this maze in the rules of the game.

G. Financial Links with the State Bureaucracy

There are two positive idiosyncrasies characteristic of traditional Czech society: to abide by the fiscal obligations and to save. It came as a surprise that the Budget revenues from the ill-prepared new VAT scheme of 1993 surpassed all expectations. This scheme, introducing a 5% tax on food and a 23% tax on the majority of remaining products, became a nightmare for small entrepreneurs. The law was very complicated, amended several times and badly advertised. The help offered to SMEs by the tax exemption option proved later to be a disadvantage, disorganizing the pricing procedures and creating the need to search for a (very scarce) professional accountant even in the smallest businesses.

The level of taxation in the Czech Republic is high even on some West European socialist standards. The sceptics argue by using Murphy's Law that once the taxes are introduced they are never lowered and can become only higher. An income (profit) tax of 45%, with practically no tax relief for the heavily investing or the newly starting businesses, is a heavy disincentive to run one's own business. Many small firms are tempted to manipulate the costs (e.g. on expensive furniture, electronics, cars or travels) in order to reach a "fair" level of taxation (Charap (1993)). Another serious burden is the compulsory 49.5% social and health insurance levied from 1993 on the gross payrolls (of it 36% is paid by the employer). In addition to the 13.5% insurance contribution by the employee, personal income tax must be also paid, so that the individual's net income in its upper brackets is by 47% lower than the labour cost paid to them by the employer. For example, if the average gross wage in the international firms at the end the first half of 1994 was 9000 Kč per month, and if the 36% insurance is added, the resulting labour payment becomes 12240 Kč per month or 5100 USD per year. Definitely it is a lot more than what Table 4 (above) might indicate.

Some entrepreneurs admit that monitoring and adapting the new fiscal system was the most demanding challenge of the whole transition. It sometimes took more time in decision making than all the other remaining problems. On the other hand, some schemes of the industrial policy, which are far less bureaucratic and which support the orientation to investments instead of consumption, were not practically supported. For example, it could be the accelerated depreciation, i.e. the use of an additional portion of gross profits for the partial repayment of the new investment goods during the first year after their purchase. Or there could be considered some other schemes of the tax relief for investment expenditures.

Tax evasion is a strong temptation for those small businesses that sell directly to consumers or foreign firms. The net "profit" can be thus increased approximately 2-3 times and the risk of being prosecuted is negligible. The Ministry of Finance estimated the arrears in tax payments alone to be more than 10 bil. Kč in 1993 (including the corporate sector), while the SME support schemes comprised 16 bil. Kč (the vast majority covered the agriculture). The tax evasion and the tax arrears have thus become some of the most important instruments for the capital accumulation of SMEs during transition. Unfortunately not everyone is able to use this instrument. As a result, this unofficial (but practically tolerated) "scheme", with far-reaching impacts on the developments in small and medium-sized businesses, punishes virtues and rewards vices, becoming one of the least efficient schemes which could have been adopted.

5. Conclusions

The Czech private sector, the small and medium businesses and their entrepreneurship, have expanded with unprecedented speed between 1990-93. Even though the official estimates confirm their booming development, a significant part of the private activities have not been recorded and escaped the statistics. A cautious estimate may be made that the share of the effective private sector (the corporate sector excluded) on the GDP may have already reached approximately 35-40%, far more than the official estimate of 26-30 % for 1993.

Even though a high degree of this success must be attributed to the governmental macroeconomic and privatization policy, the essential element was the spontaneous motivation of the population to use their own capacity and resources in organizing their livelihoods. The legacy of past entrepreneurial animal spirits (both capitalist and socialist) played a key role in the revival of private business. At the beginning, its most important barrier was the lack of individual endowments of physical capital and difficult access to financial capital. Since the emergence of the markets was not subject to industrial policy schemes for the promotion of entrepreneurship, and the capital (i.e. financial, physical, social or network capital) was unequally distributed, some social groups with privileged positions in the socialist economic system had more favourable initial conditions for establishing their own ventures. These groups were identified as the "nomenklatura" and the "operators". The entrepreneurs from the remaining group of "outsiders" are only slowly gaining ground in their plight because of bureaucracy, lack of capital, bank rent-seeking, forced criminalization, overwork and established competitors. It can be expected that in the Czech Republic there will be substantial mobility in the entrepreneurial class over the next 5-7 years, both in the inside hierarchy and in the interchange with the rest of the society. For its natural development this requires conditions friendly to the entrepreneurs' extremely difficult mission and mobility.

A distinction should be made between the government-devised conditions for the redistribution of wealth (i.e. by privatization) and the conditions for the creation of wealth (i.e. running a business). While the former received wide attention, the latter remained to a large extent underdeveloped and neglected, especially in the field of the promotion of new small businesses. We can generalize even further. The Czech economy is split into two sectors according to the criterion of ownership: into the private businesses with stable ownership and the sector wavering in the process of transient and uncertain governance. In 1994 these sectors were approximately of similar size. Their functioning, internal problems and decision making can be so different that each of them may require different economic policy objectives and instruments. For example, the fiscal, monetary, exchange rate and industrial policies aimed at stabilizing the latter sector may impair the development of the former one, and vice versa. Flexible and innovative approaches to economic policy-making should be considered.

The following **policy recommendations**, aiming at the development of the SMEs, can be drawn from the paper:

*1. Because of their wide externalities, small businesses bring more social benefits than their productive contribution to the GDP implies. Their promotion by means of economic and industrial policy instruments should be the government's top priority.

*2. The conclusion of the first wave of Czech privatization in July 1993 and the advanced stage of development of the private entrepreneurship means a watershed in the economic policy making. The macroeconomic instruments and the macroeconomic stabilization aims are quickly losing on their importance and the core of the economic policy is moving to the refurbishing of the whole institutional economic order, the perfection of the markets and the build-up of rules promoting the allocation of entrepreneurs to productive activities and pressing them to abstain from being involved in rent seeking, corruption and crimes.

*3. The policies prevailing in the initial stage of transition should in many aspects be reversed or supplemented with new relevant measures. While the existing policies were oriented predominantly on the transformation of big businesses, the processes of redistribution, the provision of standard marketable goods, the restructuring of the old networks of economic power, the reorganization of the old

bureaucracy and the graceful dismantling of the existing industrial patterns, the new policies should be oriented towards the development of small and medium sized businesses, the creation of new productive units, the provision of public goods and the steady rise of opportunities for the new entrepreneurship, investments and innovations.

*4. The barriers to entry due to high transaction costs and information failures should be significantly reduced, especially on the level of bureaucratic power which has become concentrated in the district councils. A generally tighter discipline should be introduced in the public service, with instant punishment or dismissal for the acceptance of bribes. The remaining much smaller bureaucracy should be offered higher remuneration. The state should help to increase the efficiency of the public information provision in such fields as accountancy, taxation, property market, labour market and legal system. Their structure should be very simple and fully transparent.

*5. The efficiency of the banking sector should be further increased by strengthening the competition at home and from abroad and by improving the rules guarding against its rent-seeking behaviour. The moral hazard of the agents acting both on the supply and demand side of such a key market as the credit market has largely negative externalities over the whole economy; their economic causes should be disclosed and eliminated. The records on the credit history should be centrally registered by individual cases and made available to all banking institutions. Thus all defaults in debt payment could be traced to their origin and the parties associated with wrong decisions identified.

*6. The expansion and the perfection of the legal system should become a top priority, including the privatization of some parts of the judiciary supporting business conflict resolution. E.g. during the transition there have been many standard litigations where the parties would voluntarily agree to accept any qualified court judgement, provided it is made in a short time, irrespective of the legal status (state or private) of the court or the judge. The Chamber of Private Judiciary would be a sufficient body to maintain the social prestige (and thus enforceability) of the judgements concerning standard legal claims.

*7. The sustained expansion of the monetary policy, channelled through the commercial banks and alternative financial intermediaries, should anticipate the natural capacity of the private sector to grow and to innovate. At this stage of Czech economic and institutional development, when the supply is becoming sensitive to the market signals, the previous danger of inflation is subsiding. This policy will thus provide more funds for private sector commercial transactions, which may become restrained by the impact of the increased demand for money as the second wave of large privatization gains momentum.

*8. The policy of bankruptcy containment (or passive non-intervention) should be discontinued and gradually targeted to increasing the competition on the labour market. Its impact, combined with the controlled level of rising unemployment (which need not even be higher than in the majority of countries in Western Europe), will increase the working morale, thus improving the efficiency of labour, and offer new outlets for employment and wage rises.

*9. The industrial policy schemes for the promotion of new and small businesses should be significantly expanded, mainly in the fields of credit availability and promotion of investment. The build-up of nearly completely missing alternative financial facilities, such as venture capital business, development banking, municipal banks, credit unions and non-profit credit cooperatives, should be supported.

*10. The fiscal policy improvements should concentrate on the income tax relief for new small businesses undertaking new investments and on a substantial simplification of the whole tax system, especially the VAT. The services of the fiscal administration (information, advising and the design of the whole system) should be provided with a high professional efficiency.

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